

The International Accounting Standards Board met in London on 19 and 20 March 2003, when it discussed:

- Business combinations (phase II)
- Financial instruments
- First-time adoption of IFRSs
- Insurance contracts
- Measurement objectives

## Business combinations (phase II)

### Full goodwill measurement issues and accounting for business combinations that are not exchanges of equal values

#### *Full goodwill measurement issues*

The Board had previously agreed that the full goodwill method should be used to recognise goodwill in the acquisition of less than a 100 per cent controlling interest in an acquiree. Under the full goodwill method, all of the goodwill of the acquiree, including goodwill attributable to minority interests, is recognised. The Board had also previously agreed that a business combination should be accounted for by measuring whichever side of the transaction provides clearer evidence of the fair value of the net assets acquired—ie by measuring either the consideration paid to obtain the controlling interest (assuming any control premium can be measured reliably) or direct measurement of the fair value of the acquiree.

The Board considered at this meeting certain issues that arise in applying the full goodwill method when the business combination is accounted for by directly measuring the fair value of the acquiree. In particular, the Board considered:

- (a) whether the expected synergies and other benefits from combining the businesses of the acquiree and the acquirer should enter into the measurement of the fair value of the acquiree and therefore the measurement of the full amount of goodwill, and
- (b) if so, how these expected synergies should be measured.

The Board agreed that the fair value of the expected synergies and other benefits should be included in the measurement of the full amount of goodwill. The fair value of those synergies and other benefits should be estimated using assumptions that are not contrary to those that marketplace participants would use.

However, the Board agreed to modify its earlier decision that a business combination should be accounted for either by measuring the consideration paid to obtain the controlling interest or by direct measurement of the fair value of the acquiree. The Board decided that when an acquirer purchases a 100 per cent ownership interest in the acquiree, there should be a rebuttable presumption that the consideration paid by the acquirer is the best evidence of the fair value of the assets acquired and liabilities assumed. Therefore, the consideration paid should be used as the basis for measuring the full amount of goodwill.

When an acquirer purchases less than a 100 per cent ownership interest in the acquiree, the business combination should be accounted for by inferring the fair value of the net assets acquired from the consideration paid, provided any control premium paid by the acquirer is identifiable and measurable with sufficient reliability. If the control premium paid by the acquirer cannot be measured with sufficient reliability, the fair value of the net assets acquired should be measured directly using valuation techniques. In such cases, the objective of the valuation techniques should be to measure the fair value of the consideration that market participants would have paid to purchase a 100 per cent ownership interest in the acquiree.

The Board also considered how goodwill should be attributed to the controlling and minority interests when a business combination is an exchange of equal values. The Board agreed that the goodwill attributable to the controlling interest should be calculated as the difference between the consideration paid for that interest and the controlling

interest's share of the fair value of the identifiable net assets acquired.

The Board also agreed that it should not develop any additional implementation guidance on measuring the fair value of the net assets acquired as part of this project. Any such guidance should be developed as part of a broader consideration of fair value measurement issues.

#### *Accounting for business combinations that are not exchanges of equal values*

The Board considered the application of the working principle to business combinations for which there is evidence to suggest that the transaction is not an exchange of equal values. The Board observed that because a business combination normally is an arm's length transaction in which independent and willing parties exchange equal values, differences between the fair value of an acquirer's interest in the net assets acquired and the consideration paid for that interest are likely to be extremely rare.

However, the Board agreed that when there is a difference between the fair value of the acquirer's interest in the net assets acquired and the consideration paid for that interest, the acquirer should first reassess the fair value measurement of both the net assets acquired and the consideration paid to reaffirm that the business combination is in fact not an exchange of equal values.

*(continued...)*

**Copyright © IASB Update is published immediately after every IASB meeting by the International Accounting Standards Board,  
30 Cannon Street,  
London EC4M 6XH, United Kingdom  
E-mail: [iasb@iasb.org.uk](mailto:iasb@iasb.org.uk)  
Website: [www.iasb.org.uk](http://www.iasb.org.uk)**

**IASB Publications Department,  
30 Cannon Street, London, EC4M 6XH  
United Kingdom  
Tel: +44 (0)20 7332 2730  
Fax: +44 (0)20 7332 2749  
E-mail: [publications@iasb.org.uk](mailto:publications@iasb.org.uk)  
ISSN 1474-2675**

## Business combinations (phase II) (continued)

If, after this reassessment, there is evidence to suggest that the business combination is not an exchange of equal values:

- (a) any excess of the consideration paid over the fair value of the acquirer's interest in the net assets acquired (ie any overpayment) should be recognised in profit or loss at the date of acquisition.
- (b) any excess of the fair value of the acquirer's interest in the net assets acquired over the consideration paid for that interest should be recognised as a reduction in the full amount of goodwill until the goodwill is reduced to zero. Any remaining excess should be recognised in profit or loss at the date of acquisition.

If the fair value of the acquirer's interest in the identifiable net assets acquired exceeds the consideration it paid for that interest, a gain should be recognised in profit or loss only for that excess. No gain attributable to minority interests arises in such a business combination.

### Issues related to minority interests

#### *Potential gaming issues on disposition of a subsidiary*

The Board previously agreed that when control of a subsidiary is lost, amounts recognised directly in equity for the effects of transactions with minority interests in that subsidiary should not be reclassified from equity. At this meeting, the Board considered whether it should modify that decision to address 'gaming' concerns.

The Board concluded that it should not alter its previous decision. However, evidence may exist suggesting that two or more transactions that result in control over the subsidiary being lost are interrelated. In such circumstances, the conceptual principles of substance over form and faithful representation should be applied to ensure that two or more related disposition transactions are viewed in combination.

Given that the IFRIC is developing guidance dealing with linked transactions generally, the Board agreed that it does not need to address this issue directly in its exposure draft arising from phase II of this project. The exposure draft could simply include a cross-reference to the guidance developed by the IFRIC.

#### *Disposal of a Subsidiary*

The Board agreed to reword its previous decision on calculating gains or losses on the disposal of a subsidiary to clarify that the carrying amount of minority interests in the subsidiary is reduced as a result of derecognising the minority interests' share of the carrying amount of the subsidiary's net assets rather than being included in the determination of the parent's profit or loss on disposal.

Specifically the Board agreed to reword its previous decision as follows: (~~amendments, deletions~~):

"If a parent loses control of a subsidiary, whether through a sale of ownership interests or otherwise, any gain or loss should be recognised in profit or loss for the period, and calculated as the difference between:

- (a) the proceeds, if any, from the sale of ownership interests in the subsidiary that resulted in the loss of control, and
- (b) ~~the parent's share of the carrying amount of the subsidiary's net assets in the consolidated financial statements, less the carrying amount of any minority interests in the subsidiary,~~

~~and~~ less the fair value of any investment remaining in the former subsidiary.

The minority interests' share of the carrying amount of the subsidiary's net assets should be derecognised with a corresponding reduction in carrying amount of minority interests."

## Financial instruments

The Board reviewed the main points and issues raised at the roundtable discussions on the proposed amendments to IAS 32 *Financial Instruments: Presentation and Disclosure* and IAS 39 *Financial Instruments: Recognition and Measurement* conducted during the week of 10 March 2003. The Board noted that the roundtables had been very constructive and helpful, and thanked participants for the time and effort they had contributed both to preparing their original comment letters and to participating in the discussions.

The Board's discussion focused on the following main areas:

- Derecognition
- Derivatives and hedge accounting
- Fair value hierarchy
- Fair value option
- Internal contracts
- Liabilities and equity
- Loan impairment
- Macro hedging
- Pass-through arrangements
- Reversals of impairment on available-for-sale financial assets.

The objective of the Board's discussion was to provide direction to the staff in bringing issues to the Board in the coming months in finalising IASs 32 and 39. At the conclusion of its discussion, the Board asked the staff to identify those issues whose resolution might require re-exposure, so that the Board could address them first.

### Derecognition

The Board asked the staff to focus on exploring two approaches: clarifying and removing inconsistencies in the derecognition provisions of the original IAS 39; and amending the continuing involvement approach proposed in the Exposure Draft to take account of the main concerns raised by commentators.

### Derivatives and hedge accounting

The Board asked the staff to explore:

- (a) having only one type of hedge accounting (fair value hedge accounting),
- (b) whether non-derivatives should be permitted to be designated as hedging instruments, and
- (c) ways to simplify, clarify, and permit more flexibility in the Standard (eg explore including the 'short-cut' method).

The Board confirmed that derivatives are assets or liabilities, that fair value is the only relevant measurement attribute for derivatives, and that all ineffectiveness in a hedging relationship should be recognised in profit or loss.

### Fair value hierarchy

The Board asked the staff to focus on the fair value measurement principle, the role of models in estimating fair

value, and when entities may recognise an up-front profit based on a valuation technique.

### **Fair value option**

The Board asked the staff to focus on:

- (a) proceeding with the fair value option as proposed in the Exposure Draft,
- (b) exploring whether additional disclosures should be required when the option is used,
- (c) the issue of changes in own credit risk in the measurement of financial liabilities, and
- (d) first-time application of the option.

### **Internal contracts**

The Board asked the staff to consider how to clarify the provisions in the Standard regarding internal contracts.

### **Liabilities and equity**

The Board asked the staff to explore:

- (a) the extent to which the guidance proposed in the Exposure Draft should be clarified or simplified,
- (b) giving more guidance on possible presentation formats for mutual funds, co-operatives, and similar entities, and
- (c) the need to reinstate the notion of economic compulsion in IAS 32.

### **Loan impairment**

The Board asked the staff to focus on:

- (a) clarifying that the proposed model for recognising loan loss provisions is an incurred loss model (rather than an expected loss model),
- (b) ways to highlight the underlying principle in the Standard (eg by eliminating excessive detail of the methodology used to determine impairment), and
- (c) circumstances under which entities would place individually assessed loans into a portfolio.

### **Macro hedging**

The Board asked the staff to explore whether fair value hedge accounting could be implemented for a macro hedge of interest rate risk without violating the requirement to measure and recognise ineffectiveness.

### **Pass-through arrangements**

The Board asked the staff to focus on:

- (a) clarifying the proposed criteria, and
- (b) clarifying the relationship between SIC-12 *Consolidation-Special Purpose Entities* and the proposed pass-through criteria.

### **Reversals of impairment on available-for-sale financial assets**

The Board asked the staff to consider whether impairment on available-for-sale financial assets can be reversed.

## **First-time adoption of IFRSs**

The Board discussed:

- undue cost or effort
- previously unrecognised intangible assets acquired in a past business combination.

The Board also accepted a staff recommendation that the proposed IFRS should be called *First-Time Adoption of International Financial Reporting Standards* (rather than *First-time Application*).

### **Undue cost or effort**

Under the proposed IFRS, a first-time adopter would comply with the current version of each IFRS, with limited exemptions. ED 1 had proposed that some of the exemptions would be available only if a first-time adopter concluded that compliance with the current version of IFRSs would involve undue cost or effort. The Board agreed at this meeting that none of the exemptions would require a first-time adopter to demonstrate undue cost or effort.

### **Previously unrecognised intangible assets acquired in a past business combination**

ED 1 proposed that, if a first-time adopter did not restate a past business combination to comply with IFRSs, assets and liabilities that were not recognised under its previous basis of accounting (previous GAAP) would have a deemed cost of zero under IFRSs. Hence, if IFRSs require a cost-based measurement for those assets and liabilities, they would not be recognised in the opening IFRS balance sheet. However, the Board agreed in December 2002 that the first-time adopter should recognise those assets and liabilities and measure them on the basis that would be required if the acquiree were a first-time adopter at the same time as the acquirer. To illustrate: if the first-time adopter had not, under its previous GAAP, capitalised finance leases acquired in a business combination, it should capitalise them under IFRSs based on circumstances existing at inception of the lease.

At this meeting, the Board discussed the application of this requirement to intangible assets that were acquired in a business combination before the date of transition to IFRSs but were not recognised under previous GAAP. The Board noted that, in most cases, the intangible assets would not qualify under IAS 38 *Intangible Assets* for recognition in the first-time adopter's opening IFRS balance sheet. The Board agreed that, if they do qualify for recognition, there should be a corresponding adjustment to goodwill, rather than to retained earnings. This is symmetrical with the treatment of those items that are reclassified from intangible assets to goodwill in the opening IFRS balance sheet.

### **Next steps**

If any final issues emerge when Board members complete their review of a draft of the final IFRS, the Board will discuss them in April. The Board expects to publish the IFRS in the second quarter of 2003.

The Board reaffirmed a previous decision that an entity should apply the IFRS if its first IFRS financial statements are for a period beginning on or after 1 January 2004. Earlier application would be encouraged.

## **Insurance contracts (phase I)**

The Board discussed the following aspects of phase I of the project on insurance contracts:

- Cancellation and renewal rights
- Definition of insurance contract
- Discretionary participation features
- Insurance contracts and investment management fees
- Reinsurance.

### **Cancellation and renewal rights**

The Board discussed cancellation and renewal rights in investment contracts issued (ie contracts subject to IAS 39 *Financial Instruments: Recognition and Measurement* because they do not contain sufficient insurance risk to be classified as insurance contracts under the proposed definition). The Board will review the treatment of similar rights within insurance contracts during phase II.

Under IAS 39, an issuer would measure investment contracts at amortised cost. Under the amendments to IAS 39 proposed in the June 2002 Exposure Draft, the issuer could elect to measure them at fair value. The Board agreed to clarify the following when it finalises the amendments to IAS 39:

- (a) the issuer of such contracts should determine amortised cost on the basis of expected (ie probability-weighted) surrender patterns. This is consistent with the treatment of assets subject to prepayment risk under the June 2002 Exposure Draft of amendments to IAS 39.
- (b) the issuer should treat changes in estimated surrender patterns in the same way that a lender treats changes in estimated impairments of loans under paragraphs 111-114 of IAS 39. These paragraphs should be redrafted to focus on the underlying principle, which would apply equally to assets and liabilities.
- (c) if the amortised cost of the liability is less than its surrender value, the issuer should measure the investor's option to surrender at fair value, unless the surrender value is approximately the same as the carrying amount at each date. This complies with paragraph A4(g) of the proposed amendments to IAS 39. However, in February 2003 the Board decided that an insurer need not separate similar options to surrender an insurance contract.
- (d) the fair value of the liability should be based on the expected (ie probability-weighted) surrender patterns and include all associated cash flows, such as deposits, repayments, future front-end fees and surrender charges. However, the guidance should not address the criteria for distinguishing new contracts from continuation of an existing contract, as this is a subject for phase II of the project on insurance contracts.
- (e) if future investment management fees and related costs are in line with market comparables, it is likely, unless there is market evidence to the contrary, that the fair value at inception of the contractual right to those fees equals the origination costs paid.
- (f) if the costs of servicing a financial liability are significant and other market participants would face comparable costs, the issuer would consider them in determining the fair value of that liability.

The Board also:

- (a) agreed that the phase I exposure draft should include an appendix containing the above clarifications of IAS 39. However, commentators would not be invited to comment on these clarifications.
- (b) directed the staff to draft guidance on the treatment of front-end fees for possible inclusion in the appendix to IAS 18 *Revenue*.
- (c) discussed whether there is a need to issue guidance on the treatment of origination costs incurred by the manager of a mutual fund. The Board noted that IAS 38 *Intangible Assets* would apply to intangible assets of the manager.

#### Definition of insurance contract

The proposed definition of an insurance contract requires that the insurer accept significant insurance risk. The Board noted that some participants at the roundtables on IAS 32 and IAS 39 appear to interpret this statement as creating a narrower definition of insurance contract than the Board intends. To clarify the intended emphasis, the Board decided to explain in the guidance on the proposed definition that insurance risk is insignificant if the occurrence of the insured event would require the insurer to make a payment of trivial amount (judged by reference to the contract rather than to an entire book of contracts).

#### Discretionary participation features

The Board reviewed the tentative conclusions it reached in February on investment contracts that contain both a fixed element and a discretionary participation feature. The Board confirmed that the issuer of such a contract:

- (a) may, but need not, report the fixed element separately from the discretionary participation feature.
- (b) should recognise a liability measured at no less than the measurement that IAS 39 would apply to the fixed element. The issuer need not determine the IAS 39 measurement of the fixed element if the total reported liability is clearly higher.

In addition, the Board agreed that the following requirements should apply both to investment contracts that contain such features and insurance contracts that contain such features. The issuer:

- (a) should classify unallocated surplus arising from discretionary participation features as either a liability or equity.
- (b) may split the unallocated surplus into liability and equity components, but should not classify the unallocated surplus as an intermediate category that is neither liability nor equity.
- (c) should, in all respects not described above, continue its existing accounting policies for such contracts, unless it demonstrates that a change in those accounting policies would result in more understandable, relevant, reliable and comparable financial statements.

#### Insurance contracts and investment management fees

The Board agreed that an insurer should not use measurements that implicitly measure contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with market comparables (see above for discussion). However, if an insurer already measures its insurance contracts in its balance sheet on a basis that implicitly measures these rights at more than their fair value, it could continue to do so during phase I.

#### Reinsurance

The Board had agreed in previous meetings that:

- (a) a reinsurance contract is simply an insurance contract issued by one insurer (the **reinsurer**) to indemnify another insurer (the **cedant**) against losses on one or more insurance contracts issued by the cedant.
- (b) offsetting reinsurance assets against the related direct insurance liabilities should be prohibited.
- (c) an insurer should not change the measurement basis for its insurance liabilities when it buys reinsurance. An example of a change in measurement basis is a change from an undiscounted basis to a discounted basis.
- (d) the scope of IAS 36 *Impairment of Assets* does not, and should not, exclude a cedant's rights under a reinsurance contract.

At this meeting, the Board agreed that, in addition:

- (a) a cedant should use the net amounts paid at inception to obtain the reinsurance to measure its rights under the reinsurance contract at that date, so that it does not recognise a gain then.
- (b) if the net amounts paid by the cedant are less than the carrying amount of the related portion of the cedant's liability under the direct insurance contract (for example, because that liability is measured on an undiscounted basis), the cedant should recognise that difference in profit or loss

on a systematic and rational basis over the period of the underlying risk exposure.

- (c) if the net amounts paid by the cedant exceed the carrying amount of the related portion of the cedant's liability under the direct insurance contract, that is evidence that the liability may be understated.

The Board had previously agreed that an insurer should unbundle deposit components from insurance contracts if the cash flows from the insurance component do not affect the cash flows from the deposit component. The Board discussed an example illustrating the application of this proposal to a reinsurance contract, in which a payment by one party leads to automatic future repayments by the other party. The Board confirmed that the deposit components should be unbundled in this example, and directed the staff to include this example in implementation guidance accompanying the exposure draft for phase I.

The Board confirmed in February that the unbundling principle is not intended to capture ordinary life insurance contracts with surrender options. The Board noted at this meeting that the following features distinguish these contracts from the reinsurance example mentioned above:

- (a) the reinsurance contract is a customised contract requiring large payments and receipts. Contracts of this type have sometimes been designed specifically to achieve particular accounting effects, whereas the life insurance contract is likely to be one of many relatively small standardised contracts sold continually.
- (b) without unbundling, the accounting policies used for the reinsurance contract in phase I by the cedant or reinsurer may not lead to the recognition of obligations to repay amounts received, or of rights to recover amounts paid. By contrast, it is likely that an insurer's accounting policies in phase I would lead to the recognition of a life insurer's obligations to pay benefits to policyholders.

### Next steps

The Board reviewed a summary of its decisions for phase I and directed the staff to prepare a pre-ballot draft of an Exposure Draft. The Board plans to discuss two final issues in April:

- (a) treatment of investments held to back insurance liabilities. Participants at the IAS 39 roundtables suggested that there might be anomalies if these investments (particularly interest-bearing investments) are measured at fair value under IAS 39 while insurance liabilities are measured on a different basis in phase I. The Board directed the staff to investigate participants' suggestions for avoiding these anomalies. As suggested by roundtable participants, the staff will also investigate whether an insurer should be permitted:
  - (i) to redesignate some financial assets from one category under IAS 39 to another category if it changes its accounting policies for some or all insurance contracts.
  - (ii) to measure non-financial assets (such as investments in associates or owner-occupied property) at fair value if those assets are held to back insurance liabilities.
- (b) insurance against credit risk and financial guarantees (follow-up of a scope issue discussed in October).

The Board aims to publish an Exposure Draft for phase I around the end of the second quarter of 2003.

## Measurement objectives

In 2002, the Board asked the Canadian Accounting Standards Board (AcSB) to undertake on its behalf a research project on measurement objectives for recognised assets and liabilities. The purpose of the project is to identify, consider, and make recommendations with respect to, issues related to the selection of an appropriate measurement objective or set of objectives. The project is intended to provide the Board with a basis for initiating an active project to amend the IASB *Framework* in respect of measurement.

The AcSB's research project is being conducted in two stages, namely:

- (a) analysing measurement objectives on initial recognition of an asset or liability and on recognition of asset impairments; followed by
- (b) analysing objectives for remeasurement of assets and liabilities (without considering when such remeasurements should occur).

At this meeting, the Board considered a draft discussion paper, *Measurement Objectives*, prepared by the AcSB staff. The purpose of the discussion was to determine whether the Board was satisfied with the direction the AcSB's research project was taking and the plans for carrying it forward. No Board decisions were made about the selection of an appropriate measurement objective.

The Board tentatively agreed that proposed criteria for evaluating alternative measurement objectives in the discussion paper should include:

- (a) the objective of financial statements, including predictive value and feedback value for economic decisions; and
- (b) the qualitative characteristics of relevance, reliability, understandability and comparability.

The Board tentatively agreed that the following issues needed to be addressed:

- (a) market versus entity-specific measurement objectives; and
- (b) entry value versus exit value.

The Board discussed the proposed terminology and definitions of various measurement objectives and attributes, and noted some terms that merited elaboration.

The Board supported the proposed outline of the remaining sections of the discussion paper. It will consider selected issues as the AcSB's work continues. This research project will also be discussed at the Board's meeting with national standard-setters in April.

### Meeting dates: 2003

The IASB will next meet in public session on the following dates. Meetings take place in London, UK, unless otherwise noted.

24 and 25 April; 30 April —2 May<sup>†</sup>

21—23 May

16—20 June<sup>†</sup>, Rome, Italy

23—25 July

17—19 September; 22 and 23 September<sup>†</sup>

22—24 October, Toronto, Canada

17—21 November<sup>†</sup>

17—19 December

<sup>†</sup> Includes a meeting with the Standards Advisory Council

<sup>‡</sup> Includes a meeting with partner national standard-setters