BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASB UPDATE

December 2005

The International Accounting Standards Board met in London on 13 – 16 December, when it discussed:

- Conceptual Framework
- Insurance contracts
- Short-term convergence: income tax
- Fair value measurement
- Puttable instruments at fair value
- Accounting standards for small and medium-sized entities
- Update on IFRIC activities
- Joint ventures
- Technical plan

Conceptual Framework

The Board continued its deliberations on the joint FASB/IASB conceptual framework project. The Board discussed (a) benefits and costs, (b) the definition of an asset, and (c) the reporting entity.

Benefits and costs

The Board discussed benefits and costs as part of Phase A, Objectives and Qualitative Characteristics, and made the following decisions:

- That the benefits of an accounting standard should justify the costs involved is a pervasive constraint, rather than a qualitative characteristic of accounting information.
- The framework should indicate that, although information from preparers, users, and other constituents about their expectations concerning the nature and quantity of benefits, in particular, and costs is likely to be incomplete, in their deliberations standard setters should consider the information they can obtain.
- The framework should describe what is included, and not included, in the benefits and costs to be considered.
- There is no need to modify the cost-benefit constraint for application to smaller entities or any other particular type of entity. However, the results of considering whether benefits justify costs may differ for different types of entities.

Definition of an asset

The Board began its deliberations of Phase B, Elements, Recognition and Measurement Attributes, by discussing the following proposed working definition of an asset:

An asset of an entity is a present right, or other access, to an existing economic resource with the ability to generate economic benefits to the entity.

This proposed working definition was developed by the staff, taking into account existing definitions of an asset in the current frameworks of the IASB and the FASB as well as more recently developed definitions in frameworks of other national accounting standard setters. The proposed definition is intended to make clearer what an asset is in today's environment.

The Board decided that the staff should continue to develop the proposed working definition, refining it to deal with possible ambiguities, for example, what is meant by 'other access'. The Board also noted that the definition of an asset will need to be considered together with recognition criteria to determine what assets are recognised in financial statements.

In early 2006, the staff expect to refine the proposed working definition and to test it by applying it to certain accounting issues that have been difficult to resolve in the past.

Reporting entity

The Board began its deliberations on Phase D, Reporting Entity. It discussed preliminary staff research on the reporting entity concept and reached the following conclusions:

- The reporting entity concept should focus on determining the boundaries of the reporting entity, for both an individual reporting entity and a group reporting entity. This is clear from the objectives of financial statements.
- The identification of reporting entities need not specify that it is limited to those entities that have external users who are unable to demand the information they require and therefore must rely on information provided by the entity.
- The staff should conduct further research into whether a parent-only entity is a reporting entity.
- The staff should investigate whether the boundaries of a group reporting entity should be based on a broader concept of control, for example, a concept that might encompass entities under common control.
- It may be unnecessary to use the term "reporting entity".

The FASB also discussed the same topics and reached similar conclusions.

Insurance contracts

The Board:

- received a briefing on participating insurance contracts from representatives of the International Actuarial Association. No decisions were made.
- discussed how an insurer should account for contractual cash flows that depend on policyholder behaviour.
- discussed possible accounting models for life insurance contracts.

Contractual cash flows that depend on policyholder behaviour

For many insurance contracts, cash flows depend on whether policyholders exercise contractual options. For example, policyholders often have a contractual right to cancel a contract.

In some cases, early cancellation is unfavourable to the insurer. In other cases, early cancellation is beneficial to the insurer. Cancellation may be unfavourable at some stages of the contract and beneficial at other stages.

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If cancellation would be unfavourable to the insurer, the insurer has a contractual stand-ready obligation to pay additional benefits (eg a surrender value) and it will no longer receive previously expected cash inflows (eg future premiums or future fees). Similarly, if continuation would be unfavourable, the insurer has a stand-ready obligation to pay the additional benefits that result from continuation.

How an insurer should account for likely policyholder continuation (if continuation would be beneficial to the insurer) or cancellation (if cancellation would be beneficial) is unclear. The Board held a preliminary discussion of this topic and noted the following:

- A long duration contract containing a policyholder option to cancel may be indistinguishable from a short-term contract with similar economic terms containing a policyholder option to renew. Selecting one of these descriptions should not alter the accounting treatment.
- The definition of an asset refers to the existence of a resource controlled by the entity. Although the insurer does not control the behaviour of policyholders, it does control its contractual rights. In particular, it can exclude other parties from gaining access to the economic benefits that flow from those rights.
- Estimates of policyholder behaviour affect the pricing of a contract, as well as the price negotiated for a business combination or for a portfolio transfer.
- The accounting should not reflect contractual rights that lack commercial substance (ie have no discernible effect on the economics of the contract).
- Some existing accounting models defer costs incurred in originating life insurance contracts (acquisition costs). Some might view such deferrals as a proxy for recognising the insurer's contractual rights. However, the existing description (deferred acquisition costs) and the measurement might not be a faithful representation of those rights.

The Board reached no specific conclusions. A more specific discussion is planned for early 2006.

Life insurance accounting models

In preparation for more detailed discussion in future meetings, the staff gave the Board an overview of four possible generic families of accounting models for life insurance contracts (two cost-based models and two current value models). The Board decided that the discussion at future meetings should focus on the current value models.

Short-term convergence: income tax

The Board considered the following issues that arose from drafting the amendments to IAS 12 and from letters from constituents:

(a) the treatment of assets and liabilities that have a tax base that differs from their initial carrying amount

(b) the recognition of deferred tax assets and liabilities arising on the initial recognition of goodwill

(c) the allocation of tax to components of profit or loss and equity

(d) intragroup transfer of assets.

The Board had previously decided that assets acquired outside a business combination that have a tax base that differs from their acquisition cost should initially be recognised at an amount equal to the fair value that such assets would have if they had a tax base equal to fair value. For those assets, the effect of not having such a tax base is recognised in the deferred tax balance. The Board decided to extend this principle to the initial recognition of all assets and liabilities that have a tax base that differs from their initial carrying amount, including those acquired within a business combination. The Board also decided to extend this principle to all assets and liabilities that are remeasured at fair value. The Board noted that doing this separates tax effects from the asset or liability. The Board noted that it would be helpful to include an example in the proposed amendments to IAS 12 that illustrates how this decision would reflect tax effects unique to an entity and tax effects expected by the market.

The Board decided to require deferred tax liabilities as well as deferred tax assets to be recognised for temporary differences arising on the initial recognition of goodwill. However, the Basis for Conclusions to the proposed amendments should note that this decision is based on the proposals for goodwill set out in the Exposure Draft Amendments to IFRS 3. If the Board decides not to proceed with those proposals it will reconsider this decision. The Board decided not to reconsider its previous decisions on tax allocation and intragroup transfers before issuing the Exposure Draft.

Fair value measurement

The Board began discussing the Fair Value Measurement project, focusing on the questions it had raised during its education session in November. This project will provide guidance on measuring fair value when a standard requires a fair value measurement. The Board's discussion covered the definition of fair value and the existing IFRSs that would be within the scope of its project.

The definition of fair value

The Board discussed differences between the definition of fair value in the FASB's draft standard and the current definition of fair value in IFRSs. The FASB's draft standard defines fair value as "the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market for the asset or liability." The Board noted that, although there are differences between the definitions, the definition in the FASB's draft articulated a measurement objective that was consistent with the measurement objective in the IFRS definition. The Board decided to adopt the FASB's draft definition, subject to gaining a better understanding of the concept of a 'reference market'. The definition of a reference market will be discussed in a future meeting.

Scope of the Fair Value Measurement project

The Board reviewed all IFRSs that currently require fair value measurement to determine whether the fair value measurement objective in each standard is consistent with the definition of fair value in the FASB's draft standard. The Board decided that all IFRSs that require fair value measurement should be within the scope of the project. Although the Board concluded that the fair value measurement objective in each of the standards considered was generally consistent with the definition in the FASB draft standard, it acknowledged that amendments to some IFRSs would likely be necessary.

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Puttable instruments at fair value

The Board continued its discussion of the classification of certain instruments under IAS 32 *Financial Instruments: Presentation*.

The Board confirmed its decision in September 2005 to propose amendments to IAS 32 that would classify financial instruments puttable at fair value as equity if certain conditions are satisfied, including the following:

- the instrument entitles the holder to require the entity to repurchase or redeem the instrument for the fair value of a pro rata share of the net assets of the entity and would, but for this entitlement, have met the definition of an equity instrument;
- the instrument entitles the holder to a pro rata share of the net assets of the entity if the entity liquidates;
- the financial instrument's right to a pro rata share of the net assets of the entity is neither limited nor guaranteed, before or at liquidation;
- the instrument is in the most subordinated class of instruments with a claim to the entity's net assets;
- the instrument was issued at its fair value at the time of issue; and
- all instruments in the most subordinated class are puttable at fair value.

For non-public entities (ie entities with no debt or equity instruments that are publicly traded), the Board decided that it is acceptable for a formula to be used to determine the amount at which the instruments are issued, repurchased or redeemed, provided that the formula is intended to approximate fair value.

The Board also decided that warrants (and other derivatives) to be settled by the issue of financial instruments puttable at fair value should be precluded from equity classification under the proposed amendments; these derivatives would continue to be classified as liabilities.

In addition, the Board decided to propose an amendment to exclude from the definition of a financial liability a contractual obligation that entitles the holder to a pro rata share of the net assets of the entity upon liquidation of the entity. This would result in equity classification of instruments, or components of instruments, that give the holder a pro rata share of the net assets of the entity upon liquidation, including when liquidation is:

(a) certain and outside the control of the entity (affects limited life entities); or

(b) uncertain and liquidation is at the option of the holder (affects partnership interests).

However, for the instruments referred to in (b), the Board decided that equity classification requires all of such instruments to have the right to require liquidation of the entity.

The Board also decided that no amendment is necessary in respect of warrants (and other derivatives) to be settled by an exchange of a fixed amount of cash for a fixed number of financial instruments issued by a limited life entity (or a fixed number of instruments that give the holder the ability to require the entity to liquidate). Hence, such warrants will be equity if the financial instruments to be issued on exercise of the warrants are equity under the proposed amendments. The Board noted that this decision differs from its earlier decision in respect of warrants over financial instruments puttable at fair value, because the circumstances differ. For example, when a warrant over shares in a limited life entity is exercised, the holder receives shares that will remain outstanding until the entity liquidates. This contrasts with warrants over financial instruments puttable at fair value.

The Board also discussed the classification of non-controlling interests under the proposed amendments. Any non controlling interests currently classified as equity in a group's consolidated financial statements would be unaffected by the proposed amendments. The Board discussed non controlling interests that are, at present, classified as financial liabilities in the group's consolidated financial statements, because they are puttable at fair value or represent obligations arising on liquidation of a subsidiary when liquidation is certain or at the option of the minority interest holder. The Board concluded that, in the subsidiary's individual financial statements, these types of non controlling interests might be equity under the proposed amendments, if the relevant conditions were satisfied. However, they would not be equity in the group's consolidated financial statements, because they are not in the most subordinated class of instruments from the perspective of the group. Therefore, these types of non controlling interests would be financial liabilities. The Board decided that this aspect of the proposed amendments should be explained in the application guidance accompanying the proposed amendments.

The Board decided that the staff should proceed with developing an Exposure Draft of the proposed amendments to IAS 32.

Accounting standards for small and medium-sized entities (SMEs)

The Board continued its discussion from the November 2005 meeting of possible modifications for SMEs of recognition and measurement principles in IFRSs. The staff presented recommendations based on:

- recommendations of the IASB's Working Group on SMEs;
- responses to the April 2005 Staff Questionnaire on Possible Recognition and Measurement Modifications for Small and Medium-sized Entities;
- views expressed at the World Standard-Setters meeting hosted by the IASB in September 2005, and
- views expressed by participants in the October 2005 round-table meetings with the Board.

The Board made the following decisions:

Effective interest method under IAS 39 *Financial Instruments: Recognition and Measurement.* Retain the requirement to use the effective interest method. Include one or more examples in the SME standard.

Fair value measurements under IAS 39. The Board asked the staff to develop an approach that involves classifying financial assets into two categories, those for which there is an observable market price and others.

IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* – Revaluation model. The revaluation options for property, plant, and equipment in IAS 16 and for intangible assets in IAS 38 should be options for SMEs via cross-reference to those standards in the SME standard.

IAS 16 – Component depreciation. The SME version of IAS 16 should not refer to component depreciation. However, the guidance in paragraphs 44 through 47 should be included.

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IAS 40 *Investment Property* – Frequency of remeasurement. Include both the cost-depreciation-impairment model and the fair value model in the SME standard. Fair value at the reporting date should be required, but an annual valuation should not be specified.

IAS 40 –Use the IAS 16 revaluation model option? The revaluation model of IAS 16 should not be used by SMEs to account for investment property. SMEs should follow the SME version of IAS 40.

IFRS 1 *First-time Adoption of IFRSs* – Retrospective application. The Board deferred a decision on this issue until the specific SME standards have been decided on.

The Board decided that there is no need for major simplifications to the following:

- Recognition and measurement of provisions and contingent liabilities under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- Capitalisation of development costs incurred after commercial viability has been determined under IAS 38 *Intangible Assets*.
- Measurement of share-based payments under IFRS 2 *Share-based Payment*.
- IFRS 3 *Business Combinations* – Purchase method procedures.
- IAS 16 Residual values and useful lives of property, plant and equipment.
- IAS 7 *Cash Flow Statement*.
- IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*
- Whether a cost model should be an option for SMEs in accounting for biological assets and agricultural produce at point of harvest.

Update on IFRIC activities

The staff reported on the outcome of the IFRIC meeting in December. The IFRIC had decided to publish a Draft Interpretation *Interim Financial Reporting and Impairment of Goodwill and of Investments in Equity Instruments*, subject to Board acceptance of the text. The Board noted that a lack of clear principles in IAS 34 Interim Financial Reporting made it difficult for IFRIC to interpret the Standard.

The IFRIC had completed its review of comments on D16 *Scope of IFRS 2* and requested the Board to approve the Interpretation for issue. The Board discussed the omission from the proposed Interpretation of specific guidance on recognition. The staff explained that the IFRIC had responded to the issue it had been asked to resolve, which was the scope of IFRS 2 *Share-based Payment*. The IFRIC believed that the necessary guidance on recognition of the transactions dealt with within the Interpretation could be found in IFRS 2. The Board approved the Interpretation for issue, subject to editorial amendments.

Joint ventures

The Board discussed addressing the accounting for interests in joint ventures in the context of a short-term convergence project. The Board decided that the existing option of proportionate consolidation in IAS 31 *Interests in Joint Ventures* should be removed.

However, the Board decided that the definition of a joint venture in IAS 31 does not address adequately the difference between a joint venture entity and an undivided interest in the assets and liabilities of a joint arrangement. The Board decided that the scope of the project should be expanded to consider the definition of a joint venture.

Technical plan

The Board made its quarterly review of its Technical Plan. The Technical Plan sets out the expected timetable over the coming 18-24 months for projects on the IASB's active agenda. The Board discussed which topics are precedential to other projects on the agenda. These are nonfinancial liabilities, control, fair value measurement guidance and performance reporting.

The Board expects to publish the IASB project timetable in an expanded format that will provide more information about the Board's long term plans.

Meeting dates: 2006

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

23—27 January

20—24 February

27—31 March

24—28 April (joint with FASB)

22—26 May

19—23 June

17—21 July

18—22 September

16—24 October (joint with FASB), Norwalk, Connecticut, USA

13—17 November

11—15 December

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