BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASB UPDATE

May 2005

The International Accounting Standards Board met in London on 16 – 18 May, when it discussed:

- Fair value option
- Insurance contracts (phase II)
- Measurement
- Accounting Standards for Small and Medium-sized Entities
- Performance reporting
- Conceptual Framework
- ED 7 *Financial Instruments: Disclosures*
- Amendments to IAS 37
- Proposed IFRIC Interpretation – Waste Electrical and Electronic Equipment
- IFRIC D11 *Changes in Contributions to Employee Share Purchase Plans* (ESPP)
- Clarification regarding IAS 12

Fair value option

The Board discussed comments received from several insurers about the comparative financial information an entity may provide when it first applies the amendments to the fair value option in IAS 39 *Financial Instruments: Recognition and Measurement*. The Board reaffirmed its previous decisions in this area. The Board expects to publish the final amendments in mid June 2005.

Insurance contracts (phase II)

The Board discussed various approaches to accounting for non-life insurance contracts. The Board decided to explore two approaches in parallel for the time being, until it determines the basis on which one should be selected. The two approaches:

- are identical in their treatment of the claims liability, in other words, the liability to pay valid claims for insured events that have **already** occurred, including claims incurred but not reported (IBNR).
- differ in their treatment of the stand-ready obligation to pay valid claims for **future** insured events arising under existing contracts, in other words, the obligation relating to the unexpired portion of risk coverage.
- apply existing IFRSs (eg IAS 39) for assets held by insurers.

Under both approaches, non-life insurance claims liabilities would:

- reflect current unbiased estimates of future cash flows. The Board decided that the project should clarify the measurement objective for insurance liabilities and give high level guidance on techniques for estimating the number and amount of claims arising under insurance contracts, but should not give detailed operational guidance.
- reflect the time value of money. In other words, discounting would be required for all non-life claims liabilities. There would be no specific exemption for liabilities that meet particular criteria. Normal materiality criteria would apply.
- include adjustments to reflect risk. Further discussion will be required on methods for determining these adjustments.

The two approaches differ in their treatment of the stand-ready obligation to pay valid claims for future insured events arising under existing contracts:

- Under one approach, that stand-ready obligation would be measured as the unearned portion of the premium, less deferred acquisition costs. The Board has not yet discussed whether the deferred acquisition costs would be presented as an asset or as a deduction from the liability. The unearned premium (with related deferred acquisition costs) would be subject to a liability adequacy test. This test would involve discounting and include adjustments to reflect risk.
- The other approach is similar to an approach the Board has explored in the revenue project: the stand-ready obligation would be measured in the same way as claims liabilities. This approach reflects both 'downside' and 'upside' adjustments, whereas the first approach reflects only 'downside' adjustments.

Next steps

The Insurance Working Group meets next on 26 and 27 July in London. That meeting is likely to concentrate on life insurance accounting topics, but may also include some discussion of non-life topics. In addition, the staff expects that the Board will begin educational sessions on life insurance soon, perhaps at the July meeting.

Measurement

The Board considered a Discussion Paper, *Measurement Bases for Financial Accounting: Measurement on Initial Recognition*, prepared by the staff of the Canadian Accounting Standards Board (AcSB) at the IASB's request. The Board was asked to decide whether:

- the paper identifies and discusses the issues appropriately
- the Invitation to Comment positions the paper appropriately
- the questions in the Invitation to Comment will provide the Board with feedback that will be useful for future standard-setting activities.

The Board decided to support publication of the paper, provided that the Summary/Introduction:

- clarifies that the views in the paper are those of the AcSB staff. Because the Board has not yet deliberated the issues, it has not yet formed a view on them

(…continued)

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Measurement *(...continued)*

- explains the context of the paper relative to the Board's Conceptual Framework project
- notes that the paper's recommendations differ in some respects from the tentative decisions made to date by the FASB in its project on fair value measurements, and describes how the IASB is using the FASB's Exposure Draft *Fair Value Measurements* in its project activities.

Accounting Standards for Small and Medium-sized Entities

Definition of an SME

The Board has previously defined SMEs as entities that (a) do not have public accountability and (b) publish general purpose financial statements for external users. Their definition will provide a frame of reference in which the Board can make decisions in this project.

Public accountability

The Board confirmed its previous decisions that an entity has public accountability if:

- its securities are publicly traded
- it holds assets in a fiduciary capacity (such as a bank)
- it is a public utility, or
- it is economically significant in its home country.

External users

The Board agreed that paragraph 9 of the IASB *Framework* is applicable to defining the external users of SME general purpose financial statements (ie present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public). The Board asked the staff to to make clear that owner-managers, tax authorities, and non-securities government regulators are not included in the Framework definition of external users. In an SME context, external users would normally include owners who are not involved in managing the business, existing and potential creditors (lenders and suppliers), and credit rating agencies.

General purpose financial statements

IAS 1 *Presentation of Financial Statements* defineds these statements: 'General purpose financial statements are those intended to meet the needs of users who are not in a position to demand reports tailored to meet their particular information needs.' The Board agreed that this definition is appropriate in an SME context.

<u>Components of Financial Statements</u>

The Board discussed various issues relating to components of financial statements for SMEs and concluded that the planned staff questionnaire on presentation and disclosure should invite views on the following issues:

- Whether a complete set of financial statements of an SME should include a cash flow statement. If so, whether the direct or indirect method of presenting operating cash flows better meets the needs of users of SME financial statements, and what are the cost-benefit considerations of each format.
- Which format of the statement of changes in equity is most appropriate for SMEs in light of the Board's current project on Performance Reporting. The Board anticipates that an Exposure Draft on the first phase of the Performance Reporting project may be issued at about the same time as an Exposure Draft of SME Standards.
- Whether an SME that is a controlled or jointly controlled entity should be required to be included in combined financial statements with all other entities that are under the common control of the same individual.
- Whether a parent or other entity that jointly controls an SME should be required to present consolidating financial statements that show, in separate columns, financial information for each entity in the combined group, plus a column of eliminating entries (consolidation adjustments) and a consolidated total column.
- Whether an SME that itself has subsidiaries should be required to issue consolidated financial statements.
- Whether the disclosures required by IAS 24 *Related Party Disclosures* should be augmented for SMEs, and whether disclosures about major dependencies (such as dependence on a major customer or vendor) may need to be added for SMEs.

Performance Reporting

The Board decided not to amend IAS 33 *Earnings per Share* in the context of the single statement of earnings and comprehensive income that is being proposed as part of the exposure draft for Segment A of the project. The Board confirmed that:

- entities will be permitted, but not required, to disclose comprehensive income per share in the notes as described in paragraph 73 of IAS 33.
- earnings per share will continue to be presented on the face of the statement of earnings and comprehensive income as required in paragraph 66 of IAS 33.
- entities will disclose the weighted average number of shares used as the denominator in calculating earnings per share in the notes as described in paragraph 70 of IAS 33.

Conceptual Framework

The Board continued its deliberations on its joint IASB/FASB conceptual framework project. The Board discussed issues relating to some of the qualitative characteristics of accounting information. The Board reached the following conclusions:

- *Relevance* is an essential qualitative characteristic. To be relevant, information must be capable of making a difference in the economic decisions of users by helping them evaluate the effect of past and present events on future net cash inflows (predictive value) or confirm or correct previous evaluations (confirmatory value). Also, the information must be available when the users need it (timeliness).
- Accounting information has *predictive value* if users use it, or could use it, to make predictions. It is not intended in itself as a prediction, nor as synonomous with statistical predictability or persistence.
- *Faithful representation* of real-world economic phenomena is an essential qualitative characteristic, which includes capturing the substance of those economic phenomena.

Faithful representation also includes the quality of *completeness*. The common conceptual framework will need to discuss thoroughly what this qualitative characteristic means, and what it does not mean.

- Financial information needs to be *neutral* – free from bias intended to influence a decision or outcome. To that end, the common conceptual framework should no longer include conservatism or prudence among the desirable qualitative characteristics of accounting information. However, the framework should note the continuing need to be careful in the face of uncertainty.
- Financial information needs to be *verifiable* to provide assurance to users that the information faithfully represents what it purports to represent, and that the information is free from material error, complete, and neutral. Descriptions and measures that can be directly verified through consensus among observers are preferable to descriptions or measures that can only be indirectly verified.
- Representations are faithful – there is correspondence or agreement between the accounting measures or descriptions in financial reports and the economic phenomena they purport to represent – when the measures and descriptions are verifiable, and the measuring or describing is done in a neutral manner. Therefore, faithful representation requires completeness, not subordinating substance to form, verifiability and neutrality. Consequently, the common framework should drop the widely misinterpreted term *reliability* from the qualitative characteristics, replacing it with *faithful representation*.
- Although empirical research may provide evidence useful in standard-settingdecisions, for example, in assessing trade-offs between desirable qualities, the conceptual framework project should not seek to develop empirical measures of faithful representation or its component qualities.

The FASB will discuss these issues at its 25 May meeting. The Boards plan to discuss other qualitative characteristics and trade-offs and other interactions between qualitative characteristics at meetings in June and July.

ED 7 *Financial Instruments: Disclosures*

Amendments to IFRS 4 *Insurance contracts*

The Board decided:

- to finalise IFRS 7 in two parts. The main part will be published in July 2005 as planned, and the amendments to IFRS 4's implementation guidance is expected to be published later this year.
- to extend the option in paragraph 45 of ED 7 so that insurers may provide a sensitivity analysis based on a value-based technique (such as embedded value) if the entity's management prepares such a sensitivity analysis and uses it to manage financial risks.
- to require entities to provide sensitivity analyses covering the whole of their business, but to permit them to provide different types of sensitivity analysis for different classes of financial instruments. The Board noted that this decision affects all entities, not just insurers.
- not to explore at this time alternative disclosures about liquidity risk.
- to clarify in the implementation guidance to IFRS 4 that:
  - an entity that measures insurance liabilities using assumptions imposed by a regulator (regardless of whether the related risk variables may vary with market risks) should comply with the requirement to provide a sensitivity analysis by disclosing how a reasonably possible change in the related risk variable would affect profit or loss or equity if such a change were applied to the regulator-set locked-in assumption. The Board also decided to require that if an entity did this, it should also provide a narrative description that explains the limitations of this analysis, including that the regulator may not vary the locked-in assumptions in response to the reasonably possible changes in market conditions.
  - if a reasonably possible change in the risk variable *would not* trigger the liability adequacy test, there may be no effect on profit or loss or equity to disclose in the sensitivity analysis relating to that risk variable.
  - if a reasonably possible change in the risk variable *would* trigger the liability adequacy test, the entity should disclose the effect on profit or loss or equity from the resulting change in the measurement of the liability.
  - the sensitivity analysis permits, but does not require, entities to explain either qualitatively or quantitatively, the potential effect of future management actions that may offset the effect of the disclosed changes in the risk variable under consideration. Entities might provide a qualitative description of actions available to it.

Day 1 profit disclosures

The Board decided to confirm that it would require disclosures about day 1 profits. The Board also decided that it would not formally expose the disclosures for further public comment, but that any comments will be considered by the staff if they are received before 1 June 2005.

Amendments to IAS 37

The Board considered some issues that arose during review of a draft of the exposure draft of proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Terminology

The Board decided to clarify that all non-financial liabilities that are not within the scope of other Standards (for example, IAS 11 *Construction Contracts*, IAS 12 *Income Taxes*, IAS 18 *Revenue* and IAS 39) are within the scope of IAS 37. Accordingly, the Board decided not to use 'provision' as a defined term in IAS 37 and instead use the term 'non-financial liability'. The Board noted that in some jurisdictions, some classes of liabilities are referred to as provisions and entities may continue to use that term in financial statements.

The Board also decided to eliminate the terms 'contingent asset' and 'contingent liability'. The Board had previously decided that assets arise only from non-contingent (or unconditional) rights and liabilities from non-contingent obligations. Therefore, something that is an asset or a liability cannot be described as being contingent. In many cases, items currently described as contingent assets or contingent liabilities satisfy the *Framework* definition of an asset or a liability. This is because the right embodied in the asset or obligation in the liability is unconditional, even if the amount or timing of economic benefits that will flow to or from the entity is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. In the case of liabilities within the scope of IAS 37, the Board had previously decided that uncertainty about the future event is reflected in the measurement of the liability.

As a result of eliminating these terms, the Board decided that the title of the revised Standard should be changed to 'Non-financial Liabilities'.

Disclosure

The Board decided:

- to eliminate the requirement to disclose contingent assets and contingent liabilities. The Board noted that when an entity has a non-financial liability for which the amount required in settlement is contingent upon the occurrence or non-occurrence of a future event, the disclosure required by IAS 37 for the non-financial liability would capture information presently disclosed about the contingent liability. The Board also noted that IAS 1 *Presentation of Financial Statements* requires disclosure of key sources of estimation uncertainty.
- to require an entity to present:
  - (a) for each class of non-financial liability, the carrying amount of the liability at the period end together with a description of the obligation, and
  - (b) for any class of non-financial liability with estimation uncertainty, the other disclosures required by the existing version of IAS 37.
- to eliminate the exemption in the existing version of IAS 37 from presenting comparative information.

Transition

The Board decided that the revised IAS 37 should be applied from the start of the first annual period beginning on or after 1 January 2007. Comparative information would not be restated. The Board decided that this requirement would also apply to first-time adopters of IFRSs.

Illustrative examples

The Board decided to expand the illustrative examples accompanying IAS 37 to provide more measurement guidance, particularly for unconditional obligations (and hence a liability), for which the amount required to settle that obligation is contingent on the occurrence or non-occurrence of one or more uncertain future events.

Proposed IFRIC Interpretation – Waste Electrical and Electronic Equipment

In November 2004, the IFRIC issued a draft Interpretation, D10 *Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment*. At this meeting, the Board received a request from the IFRIC to approve for issue a final Interpretation prepared after a review of the responses to D10.

The IFRIC Consensus remained essentially unchanged from D10. Material had been added to clarify the distinctions between the position at the dates of (i) manufacture or sale, (ii) market participation in the measurement period and (iii) incurrence of waste management expenditures. The Basis for Conclusions included an encouragement to disclose expected future obligations for waste management costs.

The Board concluded that even though the liability addressed in the Concensus is highly specific, there are precedents for issuing guidance in such situations, and approval of the Interpretation should not be withheld for that reason. It also concluded that, ultimately, the Interpretation should be subsumed into the revision of IAS 37 (see earlier article).

The Board asked the IFRIC to relocate the material in the Basis for Conclusions that describes background rather than the rationale for the Consensus to the Interpretation. In particular, statements of what was not covered in the Interpretation needed to be in the main text. It also asked IFRIC to remove the encouragement to disclose future obligations. It is not the Board's policy to include encouragement in its Standards and Interpretations. With these modifications, the Board approved the Interpretation for issue.

D11 – Changes in Contributions to Employee Share Purchase Plans (ESPP)

In December 2004, the IFRIC published a draft Interpretation D11 *Changes in Contributions to Employee Share Purchase Plans*. The IFRIC recently considered the comments received from respondents to D11, but was unable to reach a consensus on the appropriate accounting treatment of a cessation of contributions to an ESPP.

In particular, the IFRIC did not reach a conclusion on whether the event should be:

- accounted for as a cancellation, in which case the entity would recognise immediately the amount that would otherwise be recognised over the remainder of the vesting period (the treatment proposed in D11), or
- disregarded, in which case the entity would continue to recognise the services received from that employee over the remainder of the vesting period.

Therefore, the IFRIC referred the matter to the Board.

The Board concluded that a requirement to pay contributions to an ESPP is not a vesting condition under IFRS 2 *Share-based Payment*. It confirmed its agreement with the IFRIC that a cessation of contributions is a failure to pay the exercise price, rather than a forfeiture.

The Board also confirmed that in developing IFRS 2 it did not intend that the requirements in IFRS 2 relating to cancellations would apply only to cancellations by the entity.

The Board decided that an amendment should be proposed to IFRS 2 under which:

- paragraph 28 of IFRS 2 would be amended as follows: '~~the entity cancels or settles~~ a grant of equity instruments <u>is cancelled or settled</u> during the vesting period…'
- the definition of vesting conditions would be amended, as follows:
  - (a) the first sentence of the definition to read, 'The <u>service or performance</u> conditions must be satisfied for the counterparty to become entitled to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement….'
  - (b) the second sentence of the definition to read, 'Vesting conditions include comprise service conditions, which require the other party to complete a specified period of service, and performance conditions, which require specified performance targets to be met…'

The Board observed that the IFRIC might wish to consider whether the proposed amendment should be supported by additional guidance to ensure its effective application.

Clarification

The April IASB *Update* reported decisions concerning the amendment of IAS 12 to adopt the intraperiod tax allocation requirements of SFAS 109. The amendments include the deletion of paragraph 60 of IAS 12.

Meeting dates: 2005

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

20—24; 27 and 28[†] June

18—22 July

19—23 September

17—21 October (joint with FASB), Norwalk, Connecticut, USA

10 and 11[†]; 14—18 November

12—16 December

[†] Includes a meeting with the Standards Advisory Council

[‡] Includes meetings with partner standard-setters