IASB Update

From the International Accounting Standards Board

June 2010

Welcome to IASB Update

This IASB Update is a staff summary of the tentative decisions reached by the Board at a public meeting. As a project progresses, the Board can, and sometimes does, modify its earlier tentative decisions. Tentative decisions do not change existing requirements until those decisions are incorporated in a new or amended standard.

The International Accounting Standards Board met with the US Financial Accounting Standards Board (FASB) in London on 14 - 17 June 2010. The boards discussed:

- Balance sheet - offsetting
- Insurance contracts
- Leases
- Liabilities.

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Future Board meetings

The IASB meets at least once a month for up to five days.

The next Board meetings in 2010 are:

23 June
19 - 23 July
13 - 17 September
18 - 22 October

To see all Board meetings for 2010, **click here**.

Archive of IASB Update Newsletter

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Podcast summaries

To listen to a short Board meeting audio summary (podcast) or previous Board meetings, **click here**.

Balance sheet - offsetting

At this meeting, the IASB and FASB agreed to work together to achieve greater convergence of the criteria for balance sheet offsetting under IFRS and US GAAP. The boards tentatively decided that the focus of offsetting should be on financial instruments (including other items falling within the scope of the financial instruments standards).

The boards asked the staff to obtain more information on the following:

- The legal enforceability of the offsetting provisions in ISDA and other similar master netting agreements, especially in different jurisdictions.
- The legal enforceability of the right of offset when it is included in a contract other than in a master netting arrangement (for example, a bank's right to offset a deposit payable against a loan receivable with the same customer when the customer is in default of the loan).
- The usefulness of offsetting assets and liabilities in general and in particular the different types of risks (for example, credit risk, liquidity risk, and market risk).
- The operations of central counter parties (CCP), the extent of protection provided by CCPs for transactions that clear through them and the legal basis of their operations.

The boards will continue their discussions on balance sheet offsetting at a future meeting.

Insurance contracts

At this meeting the IASB and FASB discussed:

- draft application guidance on cash flows;

- insurance contracts with cash flows denominated in foreign currency;
- draft application guidance on risk adjustment techniques;
- reinsurance follow-up issues; and
- an overview of the proposed model for insurance contracts, focusing on the main differences between the tentative decisions of the boards.

Draft application guidance on cash flows

The boards discussed draft application guidance on estimating future cash flows. The boards provided some high-level comments and directed the staff to refine the overall principle as well as the section of the guidance related to future events.

Foreign currency cash flows

The boards addressed insurance contracts with cash flows denominated in foreign currency and discussed whether those contracts are monetary items or non-monetary items. The boards tentatively decided that an insurance contract is a monetary item in its entirety.

Draft guidance on risk adjustment techniques

The boards discussed draft guidance on risk adjustment techniques, for inclusion in the approach that uses a risk adjustment plus a residual margin, and tentatively decided:

- that the objective for the risk adjustment should refer to the maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows may exceed those expected.
- to permit the following techniques for determining risk adjustments and no others:
    - confidence interval;
    - conditional tail expectation (CTE); and
    - cost of capital.

Reinsurance

The boards addressed follow-up reinsurance issues arising from the joint meeting on 10 February 2010:

- initial measurement of reinsurance assets; and
- ceding commissions.

The boards tentatively decided that when a cedant measures a reinsurance contract at initial recognition:

- the cedant should remeasure the underlying insurance liability, and apply that measurement in the initial measurement of the reinsurance asset under the building block approach, taking account of the risk of non-performance by the reinsurer.
- If the consideration paid by the cedant to the reinsurer exceeds that measurement under the building block approach, the cedant should treat that excess as the residual margin or composite margin at initial measurement.
- If that measurement under the building block approach exceeds the consideration paid by the cedant to the reinsurer, the cedant shall recognise that difference as a gain in profit or loss at initial recognition of the reinsurance contract.

The boards also discussed ceding commissions paid by a reinsurer to the cedant and:

- the IASB tentatively decided that the cedant should treat them as a reduction in the premium ceded to the reinsurer.
- The FASB tentatively decided that the cedant should recognise them as a gain in profit or loss, to the extent that these ceding commissions relate to the reinsurer's share of the cedant's incremental acquisition costs. The cedant should recognise that gain at the earlier of the day on

which it recognised the reinsurance contract and the day on which it incurred the incremental acquisition costs. The cedant should treat the remainder of the ceding commissions as a reduction in the premium ceded to the reinsurer. The FASB noted that its tentative decision was subject to a review, at a future meeting, of its decision on acquisition costs.

The staff also presented information to clarify two points raised at the joint meeting on 10 February 2010. No decisions were taken on these two issues, which related to:

- impairment testing for reinsurance assets; and
- non-proportional reinsurance contracts.

Main differences in tentative decisions

The boards discussed the main differences between their tentative decisions:

- acquisition costs;
- composite margin or residual margin plus risk adjustment approach;
- interest accretion on residual or composite margins;
- participating contracts;
- notion of insurance risk;
- embedded derivatives;
- derecognition; and
- portfolio transfers.

Acquisition costs

- The boards discussed how to account for the possible recoverability of acquisition costs if an insurance contract lapses. No decisions were reached.
- The boards affirmed their previous tentative decision that an insurer should recognise all acquisition costs as an expense as incurred.
- The IASB also tentatively decided that an insurer should, at inception, recognise as revenue an amount equal to the incremental acquisition costs incurred.
- The FASB indicated that it would reconsider, at a future meeting, whether to maintain its previous decision that an insurer should not recognise any revenue at inception pending a more general future discussion on the nature of the cash flows to be included in the measurement of insurance contracts.

Margins

Regarding the different approaches to margins in the proposed measurement of insurance contracts, the boards affirmed their previous tentative decisions:

- [IASB] to include a residual margin plus a risk adjustment, and to accrete interest on the residual. The staff will investigate whether the interest rate should be a current rate, or the rate determined at inception of the contract.
- [FASB] to include a single composite margin and not to accrete interest on this margin.

Participating contracts

The boards affirmed their tentative decisions on the treatment of participating contracts:

- [IASB] to include participating payments in the same way as any other contractual cash flow.
- [FASB] to include participating payments to the extent that the insurer has an obligation to pay. The FASB noted that this conclusion was provisional, pending a more general future discussion on the nature of the cash flows to be included in the measurement of insurance contracts.

Insurance risk

The boards discussed the notion of insurance risk in the context of the definition of an insurance contract. The FASB affirmed, and the IASB tentatively decided, to add a further condition to the existing criteria in IFRS 4 *Insurance Contracts*: that a contract does not transfer insurance risk if there is no scenario in which the present value of net cash outflows can exceed the present value of premiums.

Embedded derivatives

The boards have tentatively adopted an unbundling principle that requires an insurer to account separately for components of an insurance contract, unless the components are so interdependent that they cannot be measured separately. The boards reconsidered their previous decisions on the interaction of this principle with existing requirements for embedded derivatives and:

- the FASB affirmed that the proposed unbundling principle would apply to embedded derivatives, so that an insurer would separate them from the host insurance contract unless they are so interdependent that they cannot be measured separately from the host contract. This would replace existing requirements to bifurcate some embedded derivatives embedded in insurance contracts.
- The IASB noted that if a derivative embedded in an insurance contract does not qualify for separate accounting under the proposed unbundling principle, existing requirements in IAS 39 *Financial Instruments: Recognition and Measurement* would never require the insurer to account for the derivative separately. Accordingly, the proposed unbundling principle would suffice and it would be unnecessary to apply the criteria in IAS 39 as well.

Derecognition

Regarding the derecognition principle for insurance contracts, the boards tentatively decided that an insurer should derecognise an insurance liability when it is extinguished, ie when the obligation is discharged or cancelled or expires. The supporting guidance should note that when this occurs, the insurer is no longer at risk and is therefore no longer required to transfer any economic resources for the insurance obligation.

Portfolio transfers

Finally, on insurance portfolio transfers, the boards tentatively decided that if the present value of net cash outflows [plus a risk adjustment, in a residual margin approach] exceeds the consideration received, the insurer that assumes the portfolio should recognise that excess as a loss in profit or loss; however, in assessing whether such a loss arose, the insurer should ascertain whether it has recognised all intangible or other assets acquired in the portfolio transfer, and should review its measurement at initial recognition of the portfolio of insurance liabilities.

Next steps

The boards will continue their discussion of this project at an additional joint board meeting on 23 June.

Leases

At this meeting the boards discussed:

- Transition under the partial derecognition approach to lessor accounting
- Lessor accounting models
- Accounting for arrangements with service and lease components
- Accounting for purchase options.

Transition under the partial derecognition approach to lessor accounting

The boards tentatively decided that lessors should recognise and measure all outstanding leases at the date of initial application of the proposed new leases requirements. The recognised lease receivable should be measured at the present value of the remaining lease payments. The recognised residual asset should be measured at fair value.

Lessor accounting models

The boards tentatively decided to use a hybrid lessor accounting model. Under that hybrid model, the lessor would use a performance obligation approach to lessor accounting for leases that expose the lessor to significant risks and benefits associated with the underlying asset. A derecognition approach would be applied to all other leases.

Accounting for arrangements with service and lease components

The boards discussed how lessors should account for lease arrangements that contain both lease components and service components. The boards asked the staff to provide examples of how to apply two different approaches to separating the lease components from the service components of a contract for a lessee and for a lessor under both approaches to lessor accounting. Those examples should include instances when the lease components are distinct from the service components, and when they are not distinct.

Accounting for purchase options

The boards tentatively decided that both lessees and lessors should account for purchase options only when they are exercised.

Liabilities

The staff presented a brief oral report on the responses to the exposure draft *Measurement of Liabilities* in IAS 37. The staff will prepare a detailed written analysis of the responses for discussion at the September Board meeting.

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