IASB Update

From the International Accounting Standards Board

21 - 23 March 2011

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 IASB met in the offices of the US-based FASB, in Norwalk Connecticut, from Monday 21 March to Wednesday 23 March. The meeting was held jointly with the FASB.

The discussions focused on four projects: revenue recognition, leases, insurance contracts and impairment of financial assets.

For revenue recognition, leases and insurance contracts the boards continued to consider in detail the feedback from comment letters and outreach activities on specific aspects of the projects. For the insurance project, the sessions included two presentations by external visitors.

In January the boards had published a supplementary document relating to impairment of financial instruments. Because that document is still open for public comment, the discussions on impairment focused on matters that were outside the scope of that document.

All IASB members were present for the session on Monday 21 March and Tuesday 22 March. Unfortunately, because of illness and other unforeseen circumstances, four Board members were not able to attend the sessions on the afternoon (GMT) of Wednesday 23 March which focused on revenue recognition.

The topics discussed at the joint IASB/FASB board meeting were:

- Disclosure - Cross-cutting issues
- Financial instruments: impairment
- Insurance contracts
- Leases
- Revenue recognition

Contact us

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Tel: +44 (0)20 7246 6410
Fax: +44 (0)20 7246 6411
E-mail: info@ifrs.org
Website: www.ifrs.org

Future Board meetings

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

The next Board meetings in 2011 are:

28-29 March
5-6 April (tentative)
11-15 April

To see all Board meetings for 2011, click here.

Archive of IASB Update Newsletter

Click here for archived copies of past issues of IASB Update on the IASB website.

Podcast summaries

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

Disclosure - cross-cutting issues

The IASB and the FASB discussed cross-cutting issues on the proposed disclosures in the revenue recognition, leases, and insurance contracts due process documents. The discussion focused on several observations and recommendations for the project teams as they finalise their disclosure requirements.

The boards agreed to align the wording of the disclosure objectives of each project.

The boards decided that an entity would be required to present in tabular format any roll forward retained by or added to any of the disclosure requirements of the three projects.

Financial instruments: impairment

The boards discussed methods for estimating expected losses and the impairment accounting for purchased debt instruments.

At a previous meeting, the boards had tentatively decided that an entity should use the best available and supportable information at the date of estimation (historical, current, and forecast) to estimate expected losses. At this meeting, the boards tentatively decided that expected losses should be estimated with the objective of an expected value. They tentatively decided that the final standard will explain that an expected value identifies possible outcomes (or a representative sample of the possible outcomes), makes an estimate of the likelihood of each outcome and calculates a probability-weighted average.

However, the final standard will acknowledge that other appropriate methods could be used as a reasonable way to achieve the objective of an expected value. An example of a suitable method would be a loss rate method and the use of probabilities of default, loss given default and exposure at default data. In performing this calculation, an entity must not ignore observations and possibilities that are known. The boards directed the staff to draft language that will be clear to constituents who are applying this objective.

Regarding purchased debt instruments subject to impairment accounting, the boards discussed interest revenue recognition and impairment accounting. The discussion included making comparisons with the accounting proposed for originated instruments. The boards did not reach a decision on this question and asked the staff to prepare examples for further discussion.

Next steps

The boards will discuss these examples at next week's joint board meeting.

Insurance contracts

The IASB and FASB continued their discussions on insurance contracts by considering the following topics: unbundling, objective of the risk adjustment, discount rate for ultra-long contracts, practical implementation of the risk adjustment and the contract boundary for insurance contracts.

Unbundling

The boards discussed the objectives for separating insurance contracts into non-insurance components and insurance components. This is referred to as 'unbundling'. The boards were not asked to make any decisions about the objectives of unbundling.

The boards confirmed the proposal in the IASB's exposure draft (ED) *Insurance contracts* and the FASB's discussion paper (DP) *Preliminary views on insurance contracts* that an insurer should account separately for embedded derivatives that are contained in a host insurance contract that is not closely related to the embedded derivative.

Thirteen of the fourteen IASB members present supported this decision. One IASB member was not available. The majority of FASB members present supported this decision.

The boards will discuss other aspects of unbundling at future meetings.

Objective of the risk adjustment

The boards tentatively decided:

- to remove references in the objective of the risk adjustment proposed in paragraph 35 of the ED to 'the amount the insurer would rationally pay to be relieved of the risk' and to a 'maximum amount'. As a result, the objective of the risk adjustment would be as follows:
  'The risk adjustment shall be the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected."
- to provide application guidance that this amount would reflect both favourable and unfavourable changes in the amount and timing of fulfilment cash flows.

The staff will consider how to capture in the application guidance the notion that the risk adjustment reflects the point at which the insurer is indifferent between holding the insurance liability and a similar liability that is not subject to uncertainty.

Discount rate for ultra-long duration contracts

The boards discussed the effects of changes in discount rate where the yield curve is extended beyond observable market prices-so-called 'ultra long duration' contracts. The boards indicated that they did not want the staff to develop a separate approach that deals solely with changes in discount rate for this particular type of contract.

Risk adjustment education session

The IASB and FASB invited guest speakers to continue the education session from 15 March 2011 on explicit risk adjustment. The purpose of this education session was to give the boards information on how a risk margin is calculated in practice, by using a probability of sufficiency approach (akin to a confidence interval) for financial reporting in Australia and a cost of capital approach to report under Economic Value Management (EVM).

The external presenters were Tony Coleman from Lonergan, Edwards and Associates, and Mark Swallow and Leopoldo Camara from Swiss Re. Because this was an education session the boards were not asked to make any decisions.

Contract boundary

The boards tentatively decided that:

a. Contract renewals should be treated as a new contract:
    i. when the insurer is no longer required to provide coverage; or
    ii. when the existing contract does not confer any substantive rights on the policyholder.
    All IASB and FASB members supported this decision.
b. A contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.
c. In addition, for contracts for which the pricing of the premiums does not include risks relating to future periods, a contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio.
   All FASB members and 10 IASB members supported decisions (b) and (c). Five IASB members preferred that the assessment should instead take place at an individual policyholder level.
d. All renewal rights should be considered in determining the contract boundary whether arising from a contract, from law or from regulation. All IASB and FASB members supported this decision.

Next steps

The boards will continue their discussion on this project at their joint meeting in the week of 28 March 2011.

Leases

The IASB and the FASB discussed inception versus commencement, discount rate, initial direct costs, separating lease and non-lease components of a contract and sale and leaseback transactions.

Inception versus commencement

The boards discussed the accounting for elements of a lease contract at the date of inception versus the date of commencement from both the lessee's and lessor's perspective.

The boards tentatively decided that the Leases standard would:

a. Require a lessee and a lessor to recognise and initially measure lease assets and lease liabilities (and derecognise any corresponding assets and liabilities) at the date of commencement of the lease. All board members supported this decision.
b. Require a lessee and a lessor to use a discount rate calculated at the date of commencement when initially measuring lease assets and lease liabilities. Four FASB members and 11 IASB members supported this decision (3 FASB members and 4 IASB members voted against).
c. Include application guidance on the accounting for costs incurred by the lessee before the date of commencement of a lease. All board members supported this decision.
d. Include application guidance on the accounting for lease payments made by the lessee before the date of commencement of a lease. All board members supported this decision.
e. Include application guidance on the accounting for incentives provided by the lessor to the lessee. This would clarify that a lessee will deduct all lease incentives from the initial measurement of the right-of-use asset. Six FASB members and 13 IASB members supported this decision (1 FASB member and 2 IASB members voted against).

The boards also discussed the accounting for a lease contract between the date of inception and the date of commencement of a lease when the contract meets the definition of an onerous contract. The IASB affirmed the proposal in the *Leases* exposure draft proposal to exclude lease contracts that meet the definition of an onerous contract from the scope of the Leases standard between the date of inception and the date of commencement. Such leases would be accounted for in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, until the date of commencement. The FASB also indicated support for applying Topic 450 *Contingencies* to those contracts that meet the definition of an onerous contract before the date of commencement, but noted that this issue would be reviewed when the boards consider impairment at a future meeting.

Initial direct costs

The boards discussed the definition of *initial direct costs* and the accounting by lessees and lessors for initial direct costs.

The boards tentatively defined *initial direct costs* as follows:

> Costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made.
>
> All board members supported this decision for lessees. Seven FASB members and 9 IASB members supported this decision for lessors (6 IASB members voted against).

The boards affirmed the decision in the *Leases* exposure draft that lessees and lessors should capitalise initial direct costs by adding them to the carrying amount of the right-of-use asset and the right to receive lease payments, respectively. Six FASB members and 14 IASB members supported this decision (1 FASB member and 1 IASB member voted against).

Discount rate

The boards discussed how lessees and lessors would determine the discount rate to use to initially measure lease payments at present value.

The boards tentatively reaffirmed the proposals in the *Leases* exposure draft, but clarified the following (all board members supported this decision):

a. The lessee would use the rate the lessor charges the lessee when that rate is available; otherwise the lessee would use its incremental borrowing rate.
b. The lessor would use the rate the lessor charges the lessee.
c. The rate the lessor charges the lessee could be the lessee's incremental borrowing rate, the rate implicit in the lease, or, for property leases, the yield on the property. When more than one indicator of the rate that the lessor charges the lessee is available, the rate implicit in the lease should be used.

The boards also tentatively decided to provide application guidance for the determination of the discount rate when considering the use of a group discount rate and determining the yield on property. All board members supported this decision.

Separating lease and non-lease components of a contract

The boards tentatively decided that an entity should be required to identify and separately account for the lease and the non-lease components of a contract. Four FASB members and 13 IASB members supported this decision (3 FASB members and 2 IASB members voted against).

The boards tentatively decided that in allocating payments in a contract between the lease and non-lease components of the contract:

1. The lessor should allocate payments in accordance with the guidance on revenue recognition. All board members supported this decision.
2. The lessee should allocate payments as follows:
   a. If the purchase price of each component is observable, the lessee would allocate the payments on the basis of the relative purchase prices of individual components. Six FASB members and 14 IASB members supported this decision (1 FASB member and 1 IASB member voted against);
   b. If the purchase price of one or more, but not all, of the components is observable, the lessee would allocate the payments on the basis of a residual method. Six FASB members and all IASB members supported this decision (1 FASB member voted against) ; or
   c. If there are no observable purchase prices, the lessee would account for all the payments required by the contract as a lease. All FASB members and 13 IASB members supported this decision (2 IASB members voted against).

The boards directed the staff to include application guidance on how a lessee should determine what would be an observable price, taking into consideration the relevance of guidance in other projects such as revenue recognition.

Sale and leaseback transactions

The boards affirmed the decision in the *Leases* exposure draft that when a sale has occurred, the transaction will be accounted for as a sale and then a leaseback. If a sale has not occurred, the entire transaction will be accounted for as a financing. All board members supported this decision.

The boards tentatively decided that an entity should apply the control criteria described in the revenue recognition project to determine whether a sale has occurred. Six FASB members and 12 IASB members supported this decision (1 FASB member and 3 IASB members voted against).

The boards affirmed the decision in the Leases exposure draft (all board members supported this decision) that in a transaction accounted for as a sale and leaseback:

1. When the consideration is at fair value, the gains and losses arising from the transaction should be recognised when the sale occurs.
2. When the consideration is not established at fair value, the assets, liabilities, gains and losses recognised should be adjusted to reflect current market rentals.

The boards affirmed the decision in the *Leases* exposure draft that the seller/lessee would adopt the 'whole asset' approach in a sale and leaseback transaction. The 'whole asset' approach deems that in a sale and leaseback transaction, the seller/lessee sells the entire underlying asset and leases back a right-of-use asset relating to part of the underlying asset. All FASB members and 11 IASB members supported this decision (4 IASB members voted against).

The boards tentatively decided that the leases guidance would not prescribe a particular type of lessee accounting model for entities that are accounting for the leaseback part of a sale and leaseback transaction. All board members supported this decision.

Next steps

The boards will continue their redeliberations of the *Leases* exposure draft in April 2011.

Revenue recognition

The boards discussed when and how an entity should adjust the promised amount of consideration in a contract to reflect the effects of the time value of money, collectability and uncertain consideration.

Promised amount of consideration

The boards tentatively decided that an entity should adjust the promised amount of consideration to reflect the time value of money if the contract includes a financing component that is significant to that contract. In assessing whether a contract has a significant financing component, an entity should consider various factors including:

- whether the amount of customer consideration would be substantially different if the customer paid in cash at the time of transfer of the goods or service;
- whether there is a significant timing difference between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and
- whether the interest rate that is explicit or implicit within the contract is significant.

The decision was supported by all members of both boards.

The boards also tentatively decided that, as a practical expedient, an entity should not be required to assess whether a contract has a significant financing component if the period between payment by the customer and the transfer of the promised goods or services to the customer is one year or less.

That decision was supported by 11 members of the IASB and 4 members of the FASB.

Collectibility

The boards discussed how an entity should account for the effects of a customer's credit risk, and changes in that risk, in a contract with a customer.

The boards tentatively decided that:

1. An entity should not reflect the effects of a customer's credit risk in the measurement of the transaction price and, hence, revenue upon transfer of a good or service to the customer. Consequently, an entity would recognise revenue at the promised amount of consideration (ie at the stated contract price). That decision is a change from the boards' proposals in the exposure draft, *Revenue from Contracts with Customers*.
2. The final revenue standard should not include a revenue recognition criterion that requires an assessment of the customer's ability to pay the promised amount of consideration.
3. An entity should recognise an allowance for any expected impairment loss from contracts with customers. The corresponding amounts in profit or loss should be presented as a separate line item adjacent to the revenue line item (as contra revenue).

The first two decisions were supported unanimously by the members of both boards. Nine members of the IASB and six members of the FASB supported the third decision (with two members of the IASB and one member of the FASB voting against it).

The boards will discuss the interaction between the revenue model and the impairment model at a future meeting.

Uncertain consideration

The boards discussed how an entity would determine the transaction price and recognise revenue when the promised amount of consideration is uncertain. No decisions were reached.

Next steps

In April, the boards will discuss the following topics:

1. Uncertain consideration
2. Allocation of the transaction price
3. Costs
4. Licences and rights to use
5. Disclosures
6. Scope

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