IASB Update

From the International Accounting Standards Board

June 2011

Welcome to IASB Update

The IASB held public sessions on Monday 13 June to Wednesday 15 June. Members of the FASB participated in the meeting in London, with some FASB staff participating by video from Norwalk.

The meeting focused on revenue recognition, including considering whether the proposals should be re-exposed, leases, insurance contracts and financial instruments—impairment and off-setting.

This was the last public meeting for Sir David Tweedie, Tatsumi Yamada and Warren McGregor who complete their terms with the Board at the end of June. All three have been Board members since the IASB was formed in2001. IASB staff paid tribute to the retiring Board members and to Michael Butcher, the Editorial Director of the IFRS Foundation who has been responsible for editing all IFRSs since 2001 and who also retires on 30 June.

The next public sessions will be held in London from Wednesday 20 July to Friday 22 July. The FASB will be participating in several of those sessions. The public sessions are scheduled to start early on the morning of 20 July and finish in mid-afternoon on 22 July.

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

- Asset and liability offsetting
- IFRS 9: Financial instruments: classification and measurement: Education session on FASB model
- Impairment
- Insurance contracts
- Investment property: Education session on FASB project
- Leases
- Revenue recognition

The topics discussed at the IASB meeting were:

- Agenda consultation: proposed timetable
- Annual improvements: comment period
- Investment entities: sweep issues

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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 2011 are:

18-22 July
27 and 28 July
19-23 September
19-21 October (Norwalk, US)

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) of previous Board meetings, click here.

IASB/FASB sessions

Asset and liability offsetting

The IASB and the FASB discussed alternative approaches for requiring offsetting financial assets and financial liabilities on the face of the balance sheet. The staff offered the following alternatives:

1. Alternative 1-This approach requires a right of set-off that is exercisable both in the normal course of business and in bankruptcy, insolvency, or default and intention to settle a financial asset and financial liability net or simultaneously.
2. Alternative 2-This approach requires a right of set-off that is legally enforceable in the normal course of business and intention to settle a financial asset and financial liability net or simultaneously.
3. Alternative 3-For derivative instruments, this approach provides an exception to the general offsetting criteria, which would allow offsetting of fair value amounts recognised for derivatives and fair value amounts recognised for the right to reclaim cash collateral or the obligation to return cash collateral, arising from derivative instrument(s) recognised at fair value with the same counterparty under a master netting agreement. This approach requires a right of set-off that is only enforceable in bankruptcy, insolvency, or default of one of the counterparties. The boards also considered a variation of this approach which would limit the exception for offsetting derivative instruments to only collateralised derivatives with daily variation margin postings.

All IASB members supported Alternative 1. Four members of the FASB supported Alternative 3, and three supported Alterative 1.

The boards noted that users consistently asked that information be provided to help reconcile any differences in the offsetting requirements for IFRSs and US GAAP. The boards agreed to work on converging disclosure requirements to assist users in comparing financial statements prepared in accordance with IFRSs and US GAAP.

IFRS 9: Financial instruments: classification and measurement: Education session on FASB model

FASB staff presented to the boards a summary of tentative decisions reached by the FASB on classification and measurement of financial instruments. The meeting was for information only; no decisions were reached.

Impairment

The boards discussed a 'three-bucket' expected loss approach for the impairment of financial assets.

The guiding principle of the 'three-bucket' approach is to reflect the general pattern of deterioration of credit quality of loans. Allowance balances would be established for all financial assets subject to impairment accounting. The different phases of the deterioration in credit quality are captured through the 'three-buckets' that determine the allowance balance. Generally, the 'three-bucket' approach would encompass the following:

- Bucket 1: in the context of portfolios, assets evaluated collectively for impairment that do not meet the criteria of Buckets 2 or 3 (this would include loans that have suffered changes in credit loss expectations as a result of macroeconomic events that are not particular to either a group of loans or specific loan).

- Bucket 2: Assets affected by the occurrence of events that indicate a direct relationship to possible future defaults, although the specific assets in danger of default have not yet been identified.
- Bucket 3: Assets for which information is available that specifically identifies that credit losses are expected to, or have, occurred on individual assets.

The boards decided to continue to develop the 'three-bucket' approach. In addition, the boards agreed with the broad approach to distinguish between the buckets on the basis of credit risk deterioration. The boards decided that the allowance balance of Buckets 2 and 3 should be the remaining lifetime expected loss estimate.

The boards provided the following direction to the staff for future deliberations:

- Pursue an approach for Bucket 1 with an overall objective of recognising an impairment allowance equal to losses expected to occur in the next twelve months based on initial expectations plus the full amount of any changes in expected credit losses. However, the boards also noted the operational complexities of such a model, and directed the staff to consider how to operationalise the approach.
- The boards noted the importance of having clear and well-defined indicators and guidance related to when to transfer assets between Buckets 1, 2, and 3. Consequently, they instructed the staff to further develop criteria to determine to which of the three buckets the financial assets should be attributed.

Insurance contracts

The IASB and FASB continued their discussion of insurance contracts. They considered the following topics: whether and how to unlock the residual margin, allocation methods for the residual margin, the accounting for acquisition costs and presentation.

Whether to unlock the residual margin

The IASB tentatively decided that the residual margin should not be locked in at inception. Eight IASB members supported and Seven members opposed this decision.

The FASB has already tentatively decided to propose a single-margin approach. However, the FASB also indicated that if it were to adopt an approach that includes both a risk adjustment and a residual margin, they would not favour unlocking a residual margin.

How to unlock the residual margin

The IASB tentatively decided that an insurer should:

a. adjust the residual margin for favourable and unfavourable changes in the estimates of future cash flows used to measure the insurance liability. Experience adjustments would be recognised in profit or loss. Eleven IASB members supported this decision and four opposed it.
b. not limit increases in the residual margin. Twelve IASB members supported and three opposed this decision.
c. recognise changes in the risk adjustment in profit or loss in the period of the change. Nine IASB members supported and six opposed this decision.
d. make any adjustments to the residual margin prospectively. Ten IASB members supported

and five members opposed this decision.

The IASB discussed whether changes in discount rate should be recognised as an adjustment to the residual margin or in profit or loss in the period of the change to the extent that these changes create an accounting mismatch. No decision was made.

The FASB did not vote on how to unlock the residual margin.

Allocation methods for residual margin

The IASB tentatively decided that:

a. the residual margin should not be negative. All IASB members supported this decision.
b. insurers should allocate the residual margin over the coverage period on a systematic basis that is consistent with the pattern of transfer of services provided under the contract. Nine IASB members supported and six opposed this decision.

Acquisition costs

The boards tentatively decided that the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all the direct costs that the insurer will incur in acquiring the contracts in the portfolio, and should exclude indirect costs such as:

- software dedicated to contract acquisition
- equipment maintenance and depreciation
- agent and sales staff recruiting and training
- administration
- rent and occupancy
- utilities
- other general overhead
- advertising.

Forteen IASB members supported and one opposed this decision. All FASB members supported this decision.

In addition:

a. the IASB tentatively decided that no distinction should be made between successful acquisition efforts and unsuccessful efforts. 9 IASB members supported and 6 opposed this decision.
b. the FASB tentatively decided that the acquisition costs included in the cash flows of insurance contracts will be limited to those costs related to successful acquisition efforts. All FASB members supported this decision.

Presentation of the statement of comprehensive income

The boards indicated a preference for the presentation model outlined in Example 2 in Appendix A of Agenda Paper 3A /FASB Memo No. 70A. The example presents the underwriting results of contracts measured under the building-block approach separately from contracts measured using the modified approach and includes volume information as follows:

a. line items for the underwriting margin of insurance contracts that present the following amounts for the reporting period:
    i. building block approach underwriting margin reflecting:

            i. Change in/release of:
                1. Risk adjustment (IASB)
                2. Residual margin (IASB)
                3. Composite margin (FASB)
            ii. experience adjustment related to the current period disaggregated as:
                1. premium due
                2. claims incurred
                3. expenses incurred
                4. expected net changes in the liability for the period
            iii. changes in assumptions
            iv. gains and losses at initial recognition
        ii. modified approach underwriting margin reflecting:
            i. change in/release of
                1. risk adjustment (IASB)
                2. composite margin (FASB – if applicable)
        iii. premium revenue (based on the release of the preclaims obligation grossed up for amortisation of acquisition costs)
        iv. claims incurred
        v. expenses incurred
        vi. amortisation of acquisition costs included in the preclaims obligation
        vii. experience adjustments related to the current period
        viii. changes in assumptions
        ix. changes in additional liabilities for onerous contracts
    b. Investment performance:
        i. Investment income
        ii. Interest accreted on the expected net cash flows
    c. Changes in discount rate

Five FASB members supported and two opposed this direction. Seven IASB members supported and Seven opposed this direction. One IASB member was absent. The IASB then indicated that it would not oppose proceeding on this basis. Three IASB members objected to this approach.

The boards discussed whether they would require all insurers to present each of the above line items in all cases on the statement of comprehensive income, rather than in the notes. No decision was made.

Next steps

The boards will continue their discussion of insurance contracts in their July meeting.

Investment property: Education session on FASB project

FASB staff presented the IASB with an overview of decisions made in the FASB's investment properties project. The session was only for educational purposes, and the boards were not asked to reach any decisions.

Leases

The IASB and the FASB discussed Shariah-compliant lease contracts, lessor accounting, subleases and short-term leases.

Shariah-compliant lease contracts

The boards discussed the accounting implications of applying a right-of-use lease model to Shariah-compliant lease contracts. The discussion was educational in nature and no decisions were made.

Lessor accounting

The boards continued discussing the accounting by lessors under a right-of-use model.

The boards discussed a single approach to lessor accounting whereby the lessor would recognise a lease receivable and a residual asset at lease commencement. The boards will consider at a future meeting whether, and if so when, under such an approach, it is appropriate for a lessor to recognise profit at lease commencement. The boards will also consider at a future meeting whether there should be different lessor models for (a) a lease of a portion of an asset and (b) a lease of an entire asset.

The boards did not make any decisions about lessor accounting at this meeting.

Subleases

The boards discussed the accounting for subleases under the proposed leases requirements for lessees and lessors and tentatively decided the following:

1. A head lease and a sublease should be accounted for as separate transactions.
2. An intermediate lessor, as a lessee in a head lease arrangement, should account for its assets and liabilities arising from the head lease in accordance with the decisions to date for all lessees.
3. An intermediate lessor, as a lessor in a sublease arrangement, should account for its assets and liabilities arising from the sublease in accordance with the decisions to date for all lessors.
4. If the Boards decide that there should be more than one approach to lessor accounting, an intermediate lessor, as a lessor in a sublease, should evaluate its right-of-use asset, not the underlying asset, to determine the appropriate lessor accounting approach to apply to the sublease.

All board members present agreed.

Short-term leases

The boards discussed the accounting for short-term leases by lessees. A short-term lease is defined as follows: a lease that, at the date of commencement of the lease, has a maximum possible term, including any options to renew, of 12 months or less.

The boards tentatively decided that, for short-term leases, a lessee need not recognise lease assets or lease liabilities. For those leases, the lessee should recognise lease payments in profit or loss on a straight-line basis over the lease term, unless another systematic and rational basis is more representative of the time pattern in which use is derived from the underlying asset. Nine IASB members and six FASB members agreed.

The boards also tentatively decided that a lessee may elect to apply the recognition and measurement requirements in the leases guidance to short-term leases. Twelve IASB members and five FASB members agreed.

The boards expressed support for requiring disclosure of the rental expense recognised in the current period and a statement about the extent to which that expense is expected to be representative of rental expense in future periods. The boards will continue to discuss disclosures for short-term leases, as well as lessor accounting for short-term leases, at a future meeting.

The IASB and the FASB continued their discussions on insurance contracts by discussing the presentation of the statement of comprehensive income.

Revenue recognition

The IASB and the FASB completed their planned redeliberations of the exposure draft *Revenue from Contracts with Customers* by discussing the following topics:

1. The effect of the proposed standard on telecommunications (and other) companies
2. The transition requirements for the proposed standard
3. Whether it is necessary to re-expose the proposed standard.

Effect of the proposed standard on telecommunications (and other) companies

The boards discussed concerns raised by constituents in the telecommunications industry about the effect of the boards' proposed standard. The boards tentatively decided to not revise the requirements of the proposed standard. This decision was supported by ten members of the IASB and five members of the FASB.

Transition requirements

The boards tentatively affirmed their decision in the exposure draft that an entity should apply the proposed standard on a retrospective basis. However, to ease the burden of applying the proposed standard in the first year of application, the boards tentatively decided that:

1. An entity should not be required to restate contracts that begin and end within the same reporting period.
2. An entity should be permitted to use hindsight in estimating variable consideration in the comparative reporting periods.
3. An entity should be required to perform the onerous test only at the effective date unless an onerous contract liability was recognised previously in a comparative period.
4. An entity should not be required to disclose the maturity analyses of remaining performance for prior periods.

An entity should apply any relief employed consistently to all transactions throughout the comparative periods.

The decision to propose retrospective application was supported by all members of the IASB and the FASB. The decision to provide entities with the transitional reliefs outlined above was supported by twelve members of the IASB and four members of the FASB.

The boards also tentatively decided that if an entity employs any of the available reliefs above, the entity should disclose the following information:

1. The reliefs that have been employed by the entity
2. To the extent possible, a qualitative assessment of the likely effect of applying those reliefs.

Those disclosures were supported by eight members of the IASB and five members of the FASB.

Re-exposure of the proposed standard

The boards agreed to re-expose their revised proposals for a common revenue recognition standard. Re-exposing the revised proposals will provide interested parties with an opportunity to comment on revisions that the boards have undertaken since the publication of an exposure draft on revenue recognition in June 2010. Specifically, the boards plan to invite feedback on:

1. the extent to which the revised requirements are understandable and whether the drafting of the requirements has not created unintended consequences for specific contracts or industries; and
2. a few specific aspects of the revised requirements.

It was the unanimous view of the boards that while there was no formal due process requirement to re-expose the proposals it was appropriate to go beyond established due process given the importance of the revenue number to all companies and the need to take all possible steps to avoid unintended consequences. The boards intend to re-expose their work in the third quarter of 2011 for a comment period of 120 days.

Next steps

The boards directed the staff to draft an exposure draft for vote by written ballot. No board members indicated that they intend to dissent to the publication of the exposure draft.

IASB sessions

Agenda consultation: proposed timetable

The Board considered the proposed timing of the forthcoming agenda consultation. The Board tentatively agreed with the proposals, which anticipate launch of the consultation in July after discussion of the consultation plans with the IFRS Advisory Council and the IFRS Foundation Trustees. The Board tentatively agreed to a deadline of 30 November 2011 for comments on the agenda consultation.

Annual improvements: comment period

The comment period for the forthcoming *Improvements to IFRSs* exposure draft was discussed at the Board meeting in May 2011 at which the Board agreed to a 90-day comment period. The Board reviewed that decision and decided that the comment period for this particular ED should be lengthened to 120 days.

Investment entities: sweep issues

The Board discussed two sweep issues with respect to publishing the exposure draft *Investment Entities*. The Board unanimously agreed that the exposure draft should have a comment period of not less than 120 days.

Go to the top of this page

ISSN 1474-2675