IASB Update

From the International Accounting Standards Board

December 2011

Welcome to IASB Update

The IASB met on 13 to 16 December 2011 in a public meeting. Some sessions were held jointly with the FASB Board members.

This was the last public meeting for 2011. A significant portion of the meeting focused on the impairment model for financial instruments, with the boards reaching tentative conclusions on measuring the allowances in the category into which financials assets are recognised initially. The boards also reached conclusions on how to assess when financial assets should be transferred out of this initial category and lifetime expected losses recognised.

The boards also discussed insurance contracts (focusing on participating contracts, discounting of the liability for claims incurred, unit of account and onerous contracts) and leases (focusing on cancellable leases and revenue recognition and disclosure requirements for lessors with leases of investment property not within the scope of the receivable and residual approach).

The January meeting was originally scheduled to last for two days, but it has now been extended to three days and begins on Wednesday 25 January.

The full list of topics for discussion at the joint IASB/FASB meeting was:

- Financial instruments: Impairment
- Insurance contracts
- Leases

The topics discussed at the IASB meeting were:

- Comment period for the exposure draft *Transition Guidance* (Proposed Amendments to IFRS 10)
- IFRS Interpretations Committee: update from last meeting
- Limited modifications to IFRS 9
- Macro hedge accounting
- Work plan

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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 2012 are:

25-27 January
23 February
27-29 February

To see all Board meetings for 2012, **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

Financial instruments: Impairment

The boards discussed the three-category (or 'bucket') impairment model being developed, most notably the measurement of the allowance balance in the first bucket, the transfer principle out of that bucket (ie when a financial asset would qualify for recognition of lifetime expected losses), a few pervasive issues, and the application of the model to loans and publicly traded debt instruments (for example, debt securities).

Initial recognition—the first bucket

The boards previously decided that all financial assets would be classified into the first bucket when first recognised. At this meeting, the boards decided that the objective and measurement in Bucket 1 would be to capture the losses on financial assets expected in the next twelve months. The losses being measured are not just the cash shortfalls over the next twelve months, but also the lifetime expected losses on the portion of financial assets on which a loss event is expected over the next twelve months. The losses expected to occur in the next 12 months will be determined using all reasonable and supporting information, including forward-looking data, which will reflect updated estimates as expectations change.

Fifteen IASB members and six FASB members agreed.

Recognition of lifetime losses

The boards had previously decided that financial assets would move out of Bucket 1 if their credit quality deteriorated, and that lifetime expected losses would be recognised for financial assets in Buckets 2 and 3. At this meeting, the boards decided that recognition of lifetime losses would be appropriate (ie financial assets would move out of Bucket 1) when there is a more than insignificant deterioration in credit quality since initial recognition and the likelihood of default is such that it is at least reasonably possible that the contractual cash flows may not be recoverable. The boards asked the staff to develop examples to illustrate that the 'reasonably possible' criterion differs from how it may currently be interpreted in GAAP (particularly in the US), and primarily refers to when the likelihood of cash shortfalls begins to increase at an accelerated rate as an asset deteriorates. Fifteen IASB members and six FASB members agreed.

Regarding the recognition of lifetime expected losses, the boards also decided that the assessment of whether recognition of lifetime expected credit losses is required reflects the likelihood of not collecting all the cash flows, as opposed to incorporating the 'loss given default' in the assessment. Fourteen IASB members and seven FASB members agreed.

In addition, the boards decided to include within the model indicators (including those presented at the meeting) of when the recognition of lifetime expected losses may be appropriate. Fifteen IASB members and seven FASB members were in favour of the decision.

Pervasive issues—Grouping of assets

The boards decided that the following principles should be used for aggregating financial assets into groups for the purposes of evaluating whether transferring out of Bucket 1 is appropriate:

- Assets are to be grouped on the basis of 'shared risk characteristics'.
- An entity may not group financial assets at a more aggregated level if there are shared risk characteristics for a sub-group that would indicate that recognition of lifetime losses is appropriate.
- If a financial asset cannot be included in a group because the entity does not have a group of similar assets, or if a financial asset is individually significant, an entity is required to evaluate that asset individually.
- If a financial asset shares risk characteristics with other assets held by an entity, the entity is permitted to evaluate those assets individually or within a group of financial assets with shared risk characteristics.

Fifteen IASB members and seven FASB members agreed.

Pervasive Issues—Bucket 2 and Bucket 3

The boards discussed the difference between Buckets 2 and 3. The boards decided that the difference between the two buckets would be on the basis of the unit of evaluation. Bucket 2 will contain financial assets evaluated on a group basis while Bucket 3 will contain financial assets evaluated on an individual basis.

Nine IASB members and seven FASB members agreed.

Application of the credit deterioration model to publicly traded debt instruments (for example, debt securities) and loans

In applying the credit deterioration model to debt securities, the boards decided against a bright-line presumption that would result in recognition of lifetime expected losses (for example, when the fair value of a security is less than a specified percentage of the amortised cost basis for some specified time period). In applying the credit deterioration model to commercial and consumer loans, the boards decided against a presumption resulting in recognition of lifetime expected losses on the basis of an explicit bright line (for example, reaching a particular delinquency status).

Fifteen IASB members and five FASB members were in favour of the decision (two FASB members were absent from this portion of the meeting).

Next steps

The boards directed the staff to consider whether application of the principle for recognition of lifetime expected losses, and the indicators, could be applied to financial assets that may improve in credit quality such that a move from Bucket 2 to Bucket 1 would be appropriate (that is, whether the model would be symmetrical). The boards also directed the staff to further analyse the practical application of the expected value objective.

Insurance contracts

The IASB and FASB continued their discussions on the following topics relating to insurance contracts: participating contracts, discounting of the liability for claims incurred, unit of account and onerous contracts.

Participating contracts

The FASB reported to the IASB their 30 November discussions regarding the measurement of the obligation from any non-discretionary performance-linked participating features that both (a) contractually depend wholly or partly on the performance of other assets or liabilities of the insurer, or the performance of the insurer itself, and (b) are a component of an insurance contract's obligations. For those contracts, some or all of the cash flows to policyholders depend on cash flows generated by the underlying item. An underlying item is defined as the asset or liability (or group of assets or liabilities) on which the cash flows resulting from the participation feature depend.

Both the IASB and the FASB noted that their previous tentative decision meant they would measure the obligation for the performance-linked participation feature in a way that reflects how those underlying items are measured in the US GAAP/IFRS financial statements. That could be achieved by two methods, which both lead to the same measurement:

a. eliminating from the building block approach changes in value not reflected in the measurement of the underlying items; or
b. adjusting the insurer's current liability (that is, the contractual obligation incurred to date) to eliminate accounting mismatches that reflect timing differences (between the current liability and the measurement of the underlying items in the US GAAP/IFRS statement of financial position) that are

expected to reverse within the boundary of the insurance contract.

The boards tentatively:

a. confirmed that options and guarantees embedded in insurance contracts that are not separately accounted for as derivatives when applying the financial instrument requirements should be measured within the overall insurance contract obligation, using a current, market-consistent, expected value approach.
   All IASB and FASB members present agreed with this decision. Two FASB members and one IASB member were not present.
b. agreed that, when an insurer measures an obligation, which was created by an insurance contract liability, that requires payment depending wholly or partly on the performance of specified assets and liabilities of the insurer, that measurement should include all such payments that result from that contract, whether paid to current or future policyholders.
   Thirteen IASB and five FASB members agreed with this decision. One IASB member disagreed. Two FASB members and one IASB member were not present.

Discounting of the liability for claims incurred

The boards tentatively confirmed their earlier decision to require insurers to discount the liability for incurred claims (for contracts accounted for using the premium allocation approach) when the effects of discounting would be material. All IASB and FASB members present agreed with this decision. One IASB member and one FASB member were not present. In addition, for contracts accounted for using the premium allocation approach, the boards tentatively decided not to provide additional guidance on determining when the effect of discounting the liability for incurred claims would be material. However, the boards tentatively decided to provide a practical expedient that would permit insurers not to discount portfolios where the incurred claims are expected to be paid within 12 months of the insured event, unless facts and circumstances indicate that payments will no longer occur within 12 months.

All IASB and FASB members present agreed with this decision. One FASB member was not present.

Unit of account

The IASB noted that the objective of the risk adjustment is to reflect the compensation that the insurer requires for bearing the uncertainty inherent in the cash flows of a portfolio that arise as the insurer fulfils the contract. The IASB tentatively decided that it would not specify further guidance on the unit of account for the risk adjustment. Nine IASB members supported and six IASB members opposed this proposal.

The IASB and FASB also discussed the definition of a portfolio and the unit of account that should be used to determine and allocate the residual/single margin. No decision was made.

Onerous contracts

The boards tentatively decided that:

a. An insurance contract is onerous if the expected present value of the future cash outflows from that contract [plus, for the IASB, the risk adjustment] exceeds:
   i. the expected present value of the future cash inflows from that contract (for the pre-coverage period).
   ii. the carrying amount of the liability for the remaining coverage (for the premium allocation approach).

   All IASB and all FASB members present agreed with this decision. One FASB member was not present.

b. Insurers should perform an onerous contract test when facts and circumstances indicate that the contract might be onerous. The boards also tentatively decided that they would provide application

guidance about the facts and circumstances that could indicate that a contract is onerous.
All IASB and all FASB members present agreed with this decision. One FASB member was not present.

c. Onerous contracts identified in the pre-coverage period should be measured on a basis that is consistent with the measurement of the liability recognised at the start of the coverage period. Similarly, onerous contracts identified under the premium allocation approach should be measured on a basis that is consistent with the measurement of the liability for claims incurred. The boards noted that these decisions require further consideration in view of the boards' tentative decision to introduce a practical expedient that would permit insurers not to discount claims incurred that are expected to be paid within 12 months of the insured event.
All IASB and all FASB members present agreed with those decisions. One FASB member was not present.

Next steps
Both boards will continue their discussion on insurance contracts in January 2012.

Leases

The IASB and FASB discussed cancellable leases and revenue recognition and disclosure requirements for lessors with leases of investment property not within the scope of the receivable and residual approach.

Cancellable leases

The boards discussed the accounting treatment for leases that (a) are cancellable by both the lessee and lessor with minimal termination payments, or (b) include renewal options that must be agreed to by both the lessee and lessor. The boards tentatively decided that the lease proposals should be applied only to periods for which enforceable rights and obligations arise. Consequently, such cancellable leases would meet the definition of short-term leases if the initial non-cancellable period, together with any notice period, is less than one year. (Twelve IASB members and six FASB members agreed.) In reaching that decision, the boards also tentatively decided not to change their previous decisions regarding the definitions of short-term leases and of the lease term. (Ten IASB members and all FASB members agreed.)

Revenue recognition for lessors with leases of investment property

The IASB tentatively decided that, for leases of investment property, a lessor should recognise rental income on a straight-line basis or on another systematic basis, if that basis is more representative of the pattern in which rentals are earned from the investment property. (Fourteen IASB members agreed.)

The FASB tentatively decided that, for leases of investment property, a lessor that is not an investment property entity or an investment company should recognise rental income on a straight-line basis or on another systematic basis, if that basis is more representative of the pattern in which rentals are earned from the investment property. (All FASB members agreed.)

The boards also tentatively decided that a lessor with leases of investment property that are not within the scope of the receivable and residual approach should recognise only the underlying investment property on its statement of financial position (as well as any accrued or prepaid rental income). (Fourteen IASB and all FASB members agreed.)

Disclosure requirements for lessors with leases of investment property

The boards discussed the disclosure requirements for lessors with leases of investment property that are not within the scope of the receivable and residual approach. The boards tentatively decided to require disclosure of the following:

1. A maturity analysis of the undiscounted future non-cancellable lease payments. The maturity analysis

should show, at a minimum, the undiscounted cash flows to be received in each of the first five years after the reporting date and a total of the amounts in the years thereafter. That maturity analysis would be separate from the maturity analysis of the payments related to the right to receive lease payments under the receivable and residual approach.
2. Both minimum contractual lease income and variable lease payment income within the table of lease income.
3. The cost and carrying amount of property on lease or held for leasing by major classes of property according to nature or function, and the amount of accumulated depreciation in total.
4. Information about leases that are not within the scope of the receivable and residual approach, consistent with paragraph 73 of the 2010 exposure draft (which has been updated with decisions that the boards have reached to date). That information would include:
   a. a general description of those lease arrangements;
   b. information about the basis and terms on which variable lease payments are determined;
   c. information about the existence and terms of options, including for renewal and termination;
   d. a qualitative description of purchase options, including information about the percentage of assets subject to such agreements; and
   e. any restrictions imposed by lease arrangements.

(Fourteen IASB members and all FASB members agreed.)

IASB sessions

Comment period for the exposure draft *Transition Guidance* (Proposed Amendments to IFRS 10)

The IASB discussed a shortened comment period for the exposure draft *Transition Guidance (Proposed Amendments to IFRS 10)*. A shorter comment period would still be in compliance with the *Due Process Handbook for the IASB*, because the exposure draft is short, the matter is urgent and there is likely to be broad consensus on the topic. The amendments to the guidance are essentially clarifications of the Board's intentions when IFRS 10 was issued and they should allay concerns that some have that the transitional requirements are more burdensome than had been intended. The shortened comment period will allow for the amendments' effective date to be aligned with that of IFRS 10. It will also allow the amendments to be provided as early as possible, in order to benefit preparers as they plan for making the transition to IFRS 10. The Board decided to set a comment period of 90 days.

All IASB members voted in favour of this decision.

IFRS Interpretations Committee: update from last meeting

The IASB received an update from the November 2011 meeting of the IFRS Interpretations Committee. Details of the meeting were published in IFRIC *Update*, which is available by **clicking here**.

Limited modifications to IFRS 9

In the November 2011 meeting, the IASB tentatively decided to consider making limited modifications to IFRS 9 *Financial Instruments*. At this meeting the Board discussed the scope of this project.

It was confirmed that the basis for reconsidering items was for three reasons: to address specific application issues in IFRS 9, the interaction of these items with the insurance project and the FASB's classification and measurement model.

At this meeting, the Board tentatively decided to consider the following topics within the scope of this project:

- an instrument characteristics test to decide whether additional application guidance should be provided to clarify how the principle was intended to be applied;
- bifurcation of financial assets, after considering any additional guidance provided for the instrument characteristics test; and
- expanded use of OCI or a third business model for some debt instruments.

In addition, the Board tentatively decided to consider the inclusion in the educational materials being prepared for IFRS 13 *Fair Value Measurement* of specific guidance on how to determine the fair value of an unquoted equity instrument.

Eight board members agreed with the tentative decision.

Macro hedge accounting

As part of its deliberations on macro hedge accounting, the IASB discussed the first three steps for the valuation of the risk position as introduced as part of the 11-step overview at the November meeting. Full fair value measurement (step 1) was discussed by comparison with limiting the valuation to fair value changes attributable to the hedged risk (step 2). In addition, the implications of a risk management focus on a net interest margin (step 3) were discussed.

The Board will continue its discussion at future meetings.

No decisions were made.

Work plan

A revised version of the work plan was placed on the IASB website on 20 December. The work plan has been updated to reflect recently issued amendments and exposure drafts, and the closing of comment periods. Because the Board has still to consider some important aspects of the leases project, the projected publication date for the revised exposure draft has been moved from Q1 to Q2 2012. The work plan also identifies when the Board expects to hold public round-table meetings to discuss the three-yearly agenda consultation and the investment entities project.

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