IASB Update

From the International Accounting Standards Board

October 2011

Welcome to IASB Update

The IASB held public meetings in Norwalk, USA, over two days, on Wednesday 19 and Thursday 20 October 2011.

The main focus of the Board meeting was the IASB-FASB MoU projects. Those discussions were held jointly with the FASB. The IASB also discussed Annual Improvements in an IASB-only session.

The boards made good progress on the development of an impairment model for financial assets carried at amortised cost, with the boards agreeing to pursue a model in which the overall objective is to reflect the deterioration in the credit quality of financial assets.

The discussions on insurance contracts focused on determining what type of fixed fee service contracts should be accounted for using the general revenue recognition requirements rather than as insurance contracts. The boards also discussed presentation requirements for insurance contracts.

A significant portion of the meeting was dedicated to the Leases project, covering lessor accounting, the subsequent measurement of a lessor's residual asset when the lease contract includes variable lease payments that are not recognised as a part of the lease receivable at lease commencement, transfers of lease receivables, presentation requirements for lessors in the statement of comprehensive income, and transition. The boards did not have the opportunity to discuss three of the papers dealing with disclosure and some additional transition matters. Those papers will be discussed in the IASB's public meeting on 1 November.

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

- IFRS 9: Financial instruments: Amortised cost and impairment of financial assets
- Fair value measurement
- Insurance contracts
- Leases
- Revenue recognition
- Education session: Accounting for financial instruments: disclosures
- Work plan

The topic discussed at the IASB meeting was:

- Annual improvements

IASB/FASB sessions

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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:

31 October and 1 November
7 November
12-16 December

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**.

IFRS 9: Financial instruments: Amortised cost and impairment of financial assets

The IASB and the FASB continued to discuss a 'three-category' expected loss approach to the impairment of financial assets.

The boards decided to pursue a model in which the overall objective is to reflect the deterioration in the credit quality of financial assets. Under this approach, impairment losses would initially be on the basis of the objective for the first category (or bucket), being the category into which loans are placed on origination. The boards asked the staff to develop a principle that would underpin the measurement attribute of the credit allowance for financial assets in that category. In addition, the boards asked the staff to develop a principle and indicators for when recognition of lifetime expected losses becomes appropriate. The boards emphasised that robust disclosures will be critical to support the principle-based impairment model and to ensure comparability between entities. Furthermore, the boards emphasised that the staff should consider the application of the model for various types of financial assets, notably debt securities, and various types of entities, notably non-financial institutions.

Fair value measurement

The IASB and FASB discussed the staff's plan for developing educational material relating to fair value measurement. This educational material will describe at a high level the thought process that one might go through to meet the objective of a fair value measurement.

Because the fair value measurement project was a joint project, the educational material will be consistent with both IFRS 13 *Fair Value Measurement* and Topic 820 *Fair Value Measurement* in the *FASB Accounting Standards Codification*®. The IASB and FASB staff will work together in its development.

The staff will form an advisory group to help with developing examples that are relevant for understanding the processes involved when applying the fair value measurement principles in IFRS 13 and Topic 820.

Insurance contracts

The IASB and FASB continued their discussions on insurance contracts, considering: fixed fee service contracts, eligibility criteria for premium allocation approach and presentation in the statement of financial position and comprehensive income. The staff also provided an oral report on recent investor outreach activities.

Fixed fee service contracts

The boards tentatively decided to exclude from the scope of the insurance contracts standard fixed-fee service contracts that provide service as their primary purpose and that meet all the following criteria:

a. The contracts are not priced on the basis of an assessment of the risk associated with an individual customer,
b. the contracts compensate customers by providing a service, rather than cash payment; and
c. the type of risk transferred by the contracts are primarily related to the use (or frequency) of services relative to the overall risk transferred.

All IASB and FASB members agreed with this decision.

Eligibility criteria for the premium allocation approach

The boards discussed when insurers should apply the premium allocation approach. No decisions were made.

Presentation of the statement of financial position

The boards tentatively decided that:

a. An insurer should disaggregate the following components, either in the statement of financial position (balance sheet) or in the notes, in a way that reconciles to the amounts included in the statement of financial position:
    - expected future cash flows;
    - risk adjustment (for the IASB);
    - residual margin (for the IASB);
    - the single margin, where relevant (for the FASB); and
    - the effect of discounting.

    Nine IASB and six FASB members agreed with this decision, subject to future consideration of whether the cash flows relating to the recovery of acquisition costs should be separately disaggregated.

b. For those contracts measured using the premium allocation approach, the liability for remaining coverage should be presented separately from the liability for incurred claims in the statement of financial position.
    All IASB and FASB members agreed with this decision.
c. For contracts measured using the building block approach, any unconditional right to any premiums or other consideration should be presented in the statement of financial position as a receivable separately from the insurance contract asset or liability and should be accounted for in accordance with existing guidance for receivables. The remaining insurance contracts rights and obligations should be presented on a net basis in the statement of financial position.
    All IASB and FASB members agreed with these decisions.
d. For contracts measured using the premium allocation approach, all insurance contract rights and obligations should be presented on a gross basis in the statement of financial position.
    All IASB and FASB members agreed with this decision.
e. Liabilities (or assets) for insurance contracts should be presented separately for contracts measured using the building block approach and those measured using the premium allocation approach.
    Ten IASB and six FASB members agreed with this decision.
f. Portfolios that are in an asset position should not be aggregated with portfolios that are in a liability position in the statement of financial position.
    Thirteen IASB and all FASB members agreed with this decision.

Presentation of the statement of comprehensive income

The boards tentatively decided that an insurer should present premiums, claims, benefits, and the gross underwriting margin in the statement of comprehensive income. The boards will consider at a future meeting whether these items should be presented in the statement of comprehensive income separately for contracts measured using the building block approach and the premium allocation approach.

All IASB and FASB members agreed with this decision.

Next steps

Both boards will continue their discussions on insurance contracts in November 2011.

Leases

The IASB and FASB discussed lessor accounting, the subsequent measurement of a lessor's residual asset when the lease contract includes variable lease payments that are not recognised as a part of the lease receivable at lease commencement, transfers of lease receivables, presentation requirements for lessors in the statement of comprehensive income, and transition.

Lessor accounting

The IASB and the FASB tentatively decided that a lessor's lease of investment property would not be within the scope of the receivable and residual approach. Instead, for such leases, the lessor should continue to recognise the underlying asset and recognise lease income over the lease term.

The boards discussed the receivable and residual approach and tentatively decided that for all lease contracts within the scope of that approach, a lessor should:

1. Initially measure the right to receive lease payments at the present value of the lease payments, discounted using the rate that the lessor charges the lessee, and subsequently measure it at amortised cost applying an effective interest method.
2. Initially measure the residual asset as an allocation of the carrying amount of the underlying asset. The initial measurement of the residual asset comprises two amounts: (a) the gross residual asset, measured at the present value of the estimated residual value at the end of the lease term, discounted using the rate that the lessor charges the lessee and (b) the deferred profit, measured as the difference between the gross residual asset and the allocation of the carrying amount of the underlying asset.
3. Subsequently measure the gross residual asset by accreting to the estimated residual value at the end of the lease term using the rate that the lessor charges the lessee. The lessor would not recognise any of the deferred profit in profit or loss until the residual asset is sold or re-leased.
4. Present the gross residual asset and the deferred profit together as a net residual asset.

The boards also tentatively decided that there should be no distinction between when profit is or is not reasonably assured.

Variable lease payments

The IASB and the FASB discussed the subsequent measurement of a lessor's residual asset when the lease contract includes variable lease payments that are not recognised as a part of the lease receivable at lease commencement.

The boards tentatively decided that:

1. if the rate that the lessor charges the lessee does not reflect an expectation of variable lease payments, the lessor would not make any adjustments to the residual asset with respect to variable lease payments.
2. if the rate that the lessor charges the lessee reflects an expectation of variable lease payments, the lessor would adjust the residual asset by recognising a portion of the residual as an expense when the variable lease payments are recognised in profit or loss. The adjustment is made on the basis of the expected variable payments. No adjustment is made to the residual asset for any difference between actual and expected variable lease payments.

Eleven IASB and all FASB members agreed.

Transfer/securitisation of lease receivables

The boards discussed the measurement of lease receivables held for the purpose of sale and the derecognition guidance to be applied when lease receivables are transferred or sold.

The boards tentatively decided that a lessor:

1. should not measure a lease receivable at fair value, even if part or all of that receivable is held for the purpose of sale. Fourteen IASB and five FASB members agreed.
2. should apply existing derecognition requirements (in IFRS 9 *Financial Instruments*, or Topic 860 *Transfers and Servicing* in the *FASB Accounting Standards Codification®*) to lease receivables, but should instead allocate the carrying amount of a lease receivable on the basis of its fair value, excluding any option elements and variable lease payments that are not transferred. All IASB and FASB members agreed.
3. should apply the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*, and Topic 860 for transferred lease receivables. All IASB and FASB members agreed.

Lessor presentation

The boards discussed presentation requirements for lessors in the statement of comprehensive income. The boards tentatively decided that a lessor should present:

1. the accretion of the residual asset as interest income. All IASB and FASB members agreed.
2. the amortisation of initial direct costs as an offset to interest income. All IASB and FASB members agreed.
3. lease income and lease expense (for example, revenue and cost of sales) in the statement of comprehensive income either in separate line items (gross) or in a single line item (net), depending on which presentation best reflects the lessor's business model. Thirteen IASB and all FASB members agreed.

The boards also tentatively decided that a lessor should separately identify income and expenses arising from leases either by separate presentation in the statement of comprehensive income or by disclosure in the notes to the financial statements. If disclosed, the notes should reference the line item in which the income is presented. All IASB and FASB members agreed.

Transition

The boards discussed transition requirements and transition disclosures for lessees and lessors.

Lessees

The boards tentatively decided that for capital or finance leases existing at the beginning of the earliest comparative period presented, a lessee would not be required to make any adjustments to the carrying amount of the lease assets and lease liabilities. However, the entity would reclassify the lease assets and lease liabilities as right-of-use assets and liabilities to make lease payments.

The boards tentatively decided that for each operating leases at the beginning of the earliest comparative period presented, a lessee should:

1. Recognise liabilities to make lease payments at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate as of the effective date for each portfolio of leases with reasonably similar characteristics. The incremental borrowing rate for each portfolio of leases should take into consideration the lessee's total leverage, including leases in other portfolios.
2. Recognise right-of-use assets on the basis of proportion of the liability to make lease payments at lease commencement, relative to the remaining lease payments.
3. Record to retained earnings any difference between the liabilities to make lease payments and the right-of-use assets at transition.

The boards also tentatively decided that when lease payments are uneven over the lease term, a lessee should adjust the right-of-use asset recognised at the beginning of the earliest comparative period presented by the amount of any recognised prepaid or accrued lease payments.

Lessors

The boards tentatively decided that for finance- or sales-type leases and direct finance leases existing at the beginning of the earliest comparative period presented, a lessor would not be required to make adjustments to the carrying amount of the assets associated with those leases.

For operating leases existing at the beginning of the earliest comparative period presented, the boards tentatively decided that a lessor should:

1. Recognise a right to receive lease payments, measured at the present value of the remaining lease payments, discounted using the rate charged in the lease that was determined at the date of commencement of the lease, subject to any adjustments that are required to reflect impairment.
2. Recognise a residual asset that is consistent with the initial measurement of the residual asset under the receivable and residual approach, using information available at the beginning of the earliest comparative period presented.
3. Derecognise the underlying asset. The boards also tentatively decided that when lease payments are uneven over the lease term, a lessor should adjust the cost basis in the underlying asset that is derecognised at the date of the earliest comparative period presented by the amount of any recognised prepaid or accrued lease payments.

Lessees and lessors

To ease the potential burden of applying the final standard in the first year of application, the boards tentatively decided that lessees and lessors may elect the following reliefs:

1. An entity is not required to evaluate initial direct costs for contracts that began before the effective date.
2. An entity may use hindsight in comparative reporting periods including the determination of whether or not a contract is a lease, or contains a lease.

The boards also tentatively decided that lessees and lessors should provide transition disclosures that are consistent with Topic 250 *Accounting Changes and Error Corrections* in the *FASB Accounting Standards Codification*® and IAS 8 *Accounting Policies, Changes in Estimates and Errors*, but that they would not need to disclose the effect of the change on income from continuing operations, net income, any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods adjusted retrospectively. In addition, if an entity elects any of the available reliefs, the entity should disclose which reliefs it elected. Notwithstanding all of the above tentative decisions on transition, the boards tentatively decided that a lessee or lessor could choose to apply the requirements in the new leases standard retrospectively in accordance with Topic 250 or IAS 8.

Revenue recognition

The IASB and FASB discussed whether an entity should apply the proposed disclosure requirements in the forthcoming revised exposure draft, *Revenue from Contracts with Customers* to interim financial statements. The boards tentatively decided to amend IAS 34 *Interim Financial Reporting* and Topic 270 *Interim Reporting* in the *FASB Accounting Standards Codification*® to specify that an entity that prepares interim financial statements should disclose in its interim financial statements the following information (if material):

1. a disaggregation of revenue;
2. a tabular reconciliation of the movements in the aggregate balance of contract assets and contract liabilities for the current reporting period;
3. a maturity analysis of remaining performance obligations;
4. information on onerous performance obligations and a tabular reconciliation of the movements in the

corresponding onerous liability for the current reporting period; and
5. a tabular reconciliation of the movements of the assets recognised from the costs to obtain or fulfil a contract with a customer.

This decision was supported by 11 IASB members and 5 FASB members.

Education session: Accounting for financial instruments: disclosures

The FASB provided the IASB with an overview of their proposed disclosure requirements for financial instruments. No decisions were sought or made.

IASB sessions

Annual improvements

IFRS 13 *Fair Value Measurement*—Short-term receivables and payables

The IASB discussed an amendment to be included in the annual improvements exposure draft (ED), which is due to be published in December 2011. The amendment aims to clarify an amendment to IFRS 9 *Financial Instruments* (issued October 2010) that resulted from IFRS 13 *Fair Value Measurement*. IFRS 9 was amended by deleting paragraph B5.4.12, which allowed an entity to measure short-term receivables and payables with no stated interest rate at invoice amounts if the effect of discounting is immaterial. At the time, the Board did not intend to change practice, believing that the other references to materiality covered this matter. However, the Board was informed that some users of IFRS think that the deletion means the requirements have changed.

To address this issue, the Board tentatively agreed to add a paragraph in the Basis for Conclusions of IFRS 13 that would provide the rationale to support the deletion of that paragraph in IFRS 9. This amendment will be exposed within the 2010-2012 annual improvements cycle.

Twelve members agreed with that decision.

IFRS 3 *Business Combinations*—consistency of contingent consideration guidance

The IASB discussed a proposed amendment to remove perceived inconsistencies related to the guidance in IFRS 3 for contingent consideration in a business combination. Currently IFRS 3 makes reference to multiple IFRSs for determining the classification, subsequent measurement and disclosure of contingent consideration. Specifically the concerns relate to:

a. which IFRS is applicable for the classification of the contingent consideration as debt or equity (IFRS 3 paragraph 40);
b. which IFRS is applicable for the measurement of subsequent changes in the fair value of contingent consideration (IFRS 3 paragraph 58); and
c. whether the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures* apply in addition to the requirements of IFRS 3 paragraph B64.

The proposed changes would delete references to guidance in other IFRSs. In addition, the scope of IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* would be amended to ensure that any contingent consideration within the scope of those standards would not qualify for amortised cost measurement.

The Board tentatively decided to include the proposed amendment within the next *Improvements to IFRSs* exposure draft. All Board members voted in favour of this proposal.

Work plan

Since the work plan was last updated on 30 September the IASB has published an exposure draft proposing to amend IFRS 1 *First Time Adoption of International Financial Reporting Standards* to provide some relief to first-time adopters in relation to government loans that they hold on which the interest is below market rates. The IASB also issued IFRIC Interpretation 20 *Stripping Costs in the Production Phase of a Surface Mine*.

An updated work plan as at 31 October 2011 will be posted on the IASB website in the first week of November.

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