March 2011 IASB meetings

Highlights

- Constituents broadly support hedge accounting proposals
- Expected losses to be estimated with objective of an expected value; method not specified
- Impairment accounting and interest income recognition for originated and 'good' purchased financial assets aligned
- Another busy month for the leases project
- Boards deliver key tentative decisions on the insurance contracts project
- Promised amount of consideration for revenue recognition – time value of money in; credit risk out

The March meetings of the IASB[1] took place on 1 – 2, 14 – 18, 21 – 23 and 29 March 2011. The summary below combines the outcomes of the individual sessions from the March meetings. In a number of sessions the IASB held joint discussions with the FASB[2]. The following projects were discussed:

- financial instruments: hedge accounting
- financial instruments: impairment
- leases
- insurance contracts
- revenue recognition.

The IASB and the FASB (the Boards) also discussed effective dates and transition methods for key projects, and cross-cutting issues from the proposed disclosures in the revenue recognition, leases and insurance contracts due process documents. The IASB separately discussed the forthcoming standards on disclosure of interests in other entities and fair value measurement, proposed changes to discontinued operations standard and the outcome of the outreach activities in respect of the financial statement presentation project.

Financial instruments project: hedge accounting

The IASB discussed summaries of the outreach activities undertaken and the 233 comment letters on the exposure draft on hedge accounting. The comment letters broadly supported the approach of addressing hedge accounting comprehensively and agreed with the principles-based approach proposed in the exposure draft. A number of respondents commented that the proposal would resolve many of the current problems that have resulted from applying IAS 39 *Financial Instruments: Recognition and Measurement* in practice.

Financial instruments project: impairment

Estimating expected losses

The Boards discussed methods for estimating expected losses and the impairment accounting for purchased debt instruments. The Boards decided tentatively that expected losses would be estimated with the objective of an expected value, which 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, other appropriate methods could be used as a reasonable way to achieve the objective of expected value. A suitable method would be, for example, a loss rate method and the use of probabilities of default, loss given default and exposure at default data.

Impairment accounting for purchased financial assets

The Boards discussed impairment accounting for purchased financial assets, including whether an impairment allowance should be established upon acquisition and the subsequent interest income recognition for purchased financial assets.

The Boards discussed whether originated instruments and purchased instruments subject to impairment accounting should have consistent accounting models for interest income recognition and impairment.

The Boards decided tentatively that for purchased financial assets that do not have an explicit expectation of losses, i.e. loans recognised in the *good book* upon acquisition, an entity should account for impairment in the same way as for originated loans when analysed at the individual asset level (even when acquired as part of a portfolio). Interest income for these assets would be recognised on the basis of contractual cash flows. The Boards' tentative decision would align impairment accounting and interest income recognition for originated loans and 'good' purchased financial assets. The Boards will determine the appropriate impairment accounting model for these loans when they redeliberate the Supplementary Document, which is currently open for comment.

The Boards also discussed impairment accounting, including interest income recognition, for financial assets purchased when an explicit expectation of loss exists at the individual financial asset level, i.e. the loan is allocated to the *bad book* on acquisition.

The Boards decided tentatively that the recognition of interest income should be based on expected collectible cash flows estimated at the date of acquisition in order to accrete purchase price to expected cash flows. By limiting the recognition of interest income for these credit-deteriorated assets, a separate impairment expense would not be recognised at the date of acquisition.

The Boards noted that their decisions at this meeting were subject to future discussions on pending issues, including:

- determining how to differentiate purchased portfolios of financial assets into good books and bad books and what the underlying accounting should be; and
- whether 'non-accrual' guidance is necessary, and, if so, then how to apply it.

Leases project

The Boards discussed key issues common to lessee and lessor accounting. The more significant tentative decisions made by the Boards in their joint March meetings included the following.

- The Boards confirmed that there will be an exemption for short-term leases. Further, the Boards aligned the exemption for lessees and lessors such that neither will recognise assets and liabilities for short-term leases.
- The Boards confirmed that arrangements that do not contain a lease, e.g. an in-substance purchase and sale, should be accounted for in accordance with other applicable standards, for example IAS 16 *Property, Plant and Equipment*.
- In a number of areas the Boards agreed to increase consistency between the forthcoming leases and revenue standards.
- The Boards confirmed that the definition of initial direct costs, other than deleting the reference to *recoverable,* is to remain consistent with the exposure draft. Furthermore, the Boards confirmed that lessees and lessors would be required to capitalise indirect costs.
- In a notable departure from the exposure draft, the Boards agreed that a purchase option should be included in lease accounting if there is a significant economic incentive to purchase the asset.

Refer *IFRS – Leases Newsletter Issue 4* for more details.

Insurance contracts project

The Boards deliberated on the following topics:

- discount rate
- discount rate for participating contracts
- recognition
- definition of an insurance contract
- objective of the risk adjustment
- embedded derivatives
- discount rate for ultra-long contracts
- contract boundaries
- unlocking the residual or composite margin
- acquisition costs.

The Boards decided tentatively that:

- there be no practical expedient for the discount rate;

- to the extent cash flows from participating insurance contracts reflect performance of specific assets, the discount rate for those cash flows should reflect that dependency;
- the recognition of an insurance contract should be at the date coverage begins unless management becomes aware of onerous contracts in the pre-coverage period;
- the definition of an insurance contract should be retained;
- acquisition costs should be determined at the portfolio level;
- the existing separation requirements in IFRS 4 *Insurance Contracts*, IAS 39 and US GAAP for derivatives embedded in insurance contracts should be retained; and
- the revisions to the risk adjustment objective should include the concept of 'compensation'.

Refer *IFRS – Insurance Newsletter Issues 13 and 14* for more details.

Revenue recognition project

Onerous contracts

The Boards decided tentatively that all contracts, including 'loss-leader' contracts should be subject to an 'onerous contract' test.

The Boards affirmed tentatively the proposal in the exposure draft that the costs to be included in the onerous contract test and in measuring an onerous liability would be the costs that relate directly to satisfying the remaining performance obligations. The Boards observed that when an entity is committed to cancelling a contract and has the contractual right to do so, the costs would reflect the amount that the entity would have to pay to cancel the contracts, including any penalties. The Boards also observed that cancelling the contract may give rise to other obligations that would be accounted for in accordance with the relevant standards.

Promised amount of consideration

The Boards discussed how and when 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. No decision was reached in respect of uncertain consideration.

Time value of money

The Boards decided tentatively that the promised amount of consideration should be adjusted to reflect the time value of money if the contract includes a financing component that is significant to that contract. Factors to consider in making the determination include:

- whether the amount of customer consideration would be substantially different if a cash payment was made at the time of transfer of the goods or services;
- whether there is a significant timing difference between when the promised goods or services are transferred to the customer and when payment is made; and
- whether the interest rate that is explicit or implicit within the contract is significant.

The Boards also decided tentatively that an entity does not need to determine whether a contract has a significant financing component if the period between payment and the transfer of the promised goods or services is one year or less.

Collectability

The Boards discussed how to account for the effects of a customer's credit risk, and changes in that risk, in a contract with a customer.

The Boards decided tentatively that:

- a customer's credit risk should not be reflected in the measurement of the transaction price and revenue upon transfer of a good or service to the customer. Accordingly, an entity would recognise revenue at the promised amount of consideration, i.e. the stated contract price; this is a change from the proposal in the exposure draft;
- the final standard should not include a revenue recognition criterion requiring an assessment of the customer's ability to pay the promised amount of consideration; and
- 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.

The Boards plan to discuss the interaction between the revenue model and the impairment model at a future meeting.

Other projects or issues discussed

- **Effective dates and transition methods.** The Boards decided tentatively to determine the effective dates and transition methods for their projects on fair value measurements and financial instruments with characteristics of equity on a standard-by-standard basis when each of those projects comes to a conclusion. The IASB decided tentatively that it would determine effective dates and transition methods for its financial instruments project as each project phase is completed. The Boards indicated that they would determine the effective dates for their joint projects on leases, revenue recognition and insurance contracts by taking into account the significance of the accounting changes required and the methods of transition. In doing so, they will provide adequate time for stakeholders to apply the new requirements.
- **Disclosures: cross-cutting issues.** The Boards discussed cross-cutting issues from the proposed disclosures in the revenue recognition, leases and insurance contracts due process documents and agreed tentatively to align the wording of the disclosure objectives of each project.

- **Forthcoming standard on disclosure of interests in other entities.** The IASB agreed tentatively that the final standard will clarify that an entity should provide information about its exposure to risk from involvement that it had with unconsolidated structured entities in previous periods, e.g. sponsoring the structured entity, even if the entity no longer has any contractual involvement with the structured entity at the end of the reporting period.
- **Forthcoming standard on fair value measurement.** The IASB decided tentatively that the effective date of the final standard should be 1 January 2013 and that early application should be permitted. The IASB plans to issue the final standard on fair value measurement in April 2011.
- **Financial statement presentation project.** The Boards discussed the results and findings of the outreach activities related to the staff draft issued in July 2010, including the feedback received through several joint outreach meetings conducted by EFRAG[3] and national standard setters. The Boards noted that many parties thought that developing a conceptual basis for other comprehensive income should be addressed sooner rather than later. No decisions were made.
- **Discontinued operations.** The IASB decided tentatively that the proposed changes to discontinued operations do not meet the criteria for inclusion in the annual improvements process. The IASB decided tentatively that it would not publish an exposure draft to amend IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* before the third quarter of 2011.

Abbreviations

1 IASB: International Accounting Standards Board

2 FASB: US Financial Accounting Standards Board

3 EFRAG: European Financial Reporting Advisory Group

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