IFRS news

Common impairment model for financial assets

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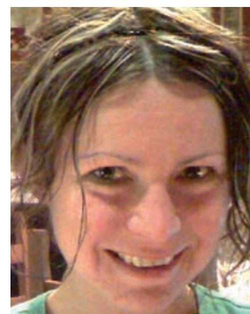
John Althoff



Yulia Feygina

The IASB and FASB have issued a 'supplementary document' to the their original proposals on impairment of financial assets. John Althoff and Yulia Feygina from PwC's Accounting Consulting Services Central Team look at the implications.

This document, 'Financial instruments: Impairment', proposes a common approach to the timing of recognition of expected credit losses on financial assets managed in an open portfolio. The proposals reflect the feedback received on the boards' original impairment models; it will help the boards in developing a common approach to credit loss recognition.

Common proposal

The supplement proposes a dual impairment model driven off the credit characteristics of the financial assets. This is consistent with how banks manage credit risk and is often referred to as a 'good book' and 'bad book' approach.

Financial assets in the 'good book'

Impairment will be recognised on a portfolio basis over the life of the book such that the allowance account is the higher of:

- the time-proportionate expected credit losses; and
- the credit losses expected to occur within the foreseeable future (but not less than 12 months).

The supplement does not describe how to measure expected credit losses. However, it illustrates how to use expected loss estimates and the weighted average age and life of a portfolio to calculate the time-proportionate expected credit losses.

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Financial assets in the 'bad book'

The boards have concluded it is not appropriate to recognise impairment losses over time on a 'bad book'. Instead, the entire amount of the lifetime-expected credit losses will be recognised immediately.

Whether or not it is appropriate to recognise expected credit losses over time depends on the degree of uncertainty about the collectability of a financial asset. When collectability becomes so uncertain that the entity's credit risk management objective changes from receiving regular payments to recovery, it is no longer appropriate to recognise impairment losses over time, and the financial asset should be transferred into a 'bad book'.

Financial assets therefore move between the 'good book' and the 'bad book' according to the entity's internal risk management policies.

Alternative approaches

The common proposal is the result of the joint IASB and FASB discussions on an impairment model for credit losses that addresses the primary objectives of the individual boards. However, some members of the IASB and FASB prefer the models that they were developing separately. The supplement therefore also seeks comments on the respective IASB and FASB approaches, in addition to the common proposal.

Under the IASB alternative approach in the supplement, an entity recognises the time-proportionate lifetime-expected credit losses on a 'good book' with no 'floor', and the full amount of lifetime-expected losses on a 'bad book'. This reflects the IASB view that expected credit losses are priced into the margin earned on financial assets.

Under the FASB alternative approach, an entity immediately recognises all credit losses expected to occur in the foreseeable future, with no minimum period specified. There is also no split between 'good book' and 'bad book'. This reflects the FASB objective of ensuring a sufficient impairment allowance at any point in time.

Scope

The scope of the proposals is limited to open portfolios – that is, portfolios that contain financial assets with similar credit characteristics irrespective of the time of their origination. The boards invite comments as to whether the proposed approach is suitable for closed portfolios, individual instruments and any other types of instrument.

For the IASB, the proposals exclude from the scope short-term trade receivables, pending redeliberations of the revenue exposure draft.

The boards are not re-exposing other aspects of the impairment model, such as measurement of credit losses or interest revenue recognition. They will continue re-deliberating these issues based on the feedback received from their original exposure drafts while the supplement is open for comment.

IASB-only appendix

The supplement contains an IASB-only appendix, which seeks input on:

- presentation and disclosure proposals driven off the common approach;
- 'decoupling' of the effective interest rate and recognition of expected credit losses; and
- application of the common proposal to loan commitments and financial guarantees.

Am I affected?

The common proposal will mainly affect financial institutions that manage their financial assets on an open-portfolio basis.

If the proposals are extended to other types of portfolio and financial assets, they may affect any entity that holds financial assets measured at amortised cost under IFRS 9, or those not measured at fair value through net income under the FASB tentative classification and measurement model.

What do I need to do?

The comment deadline is 1 April 2011. The IASB expects to finalise the impairment requirements by June 2011. It has not yet decided when the proposals will be mandatory. The FASB expects a final update on the credit impairment model to be issued in 2011.

Management should assess the impact of the proposals and consider commenting on the supplement to ensure their views are considered.

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Cannon Street Press

FASB may change course on financial asset proposals

The FASB is continuing its work on the joint project with the IASB on financial instrument accounting. It seems to be moving away from the proposals in its May 2010 document 'Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities', which considered fair value accounting for financial assets.

In its redeliberations it has made significant, tentative decisions for financial assets, which would include the introduction of an amortised cost category, resulting in three categories overall:

- Fair value with changes in fair value recognised in other comprehensive income;
- Fair value with changes in fair value recognised in net income; and
- Amortised cost.

Its latest decisions are intended to address the many concerns expressed in comment letters received in response to the May 2010 proposal. The FASB decisions could be viewed as a step closer to the IASB's approach, but they are not fully convergent at this stage. The FASB and IASB plan to meet once their respective models have been more fully developed in order to consider how any remaining differences can be reconciled.

IASB and FASB address single largest balance sheet difference

The IASB and FASB have issued proposals that would eliminate the single largest balance sheet difference between the two accounting frameworks today.

The ability to 'net' or offset certain financial assets and liabilities can create trillion dollar differences between the balance sheet of a financial institution reporting under IFRS and one reporting under US GAAP.

These proposals would result in little change for entities reporting under IFRS but a big change for US GAAP preparers, particularly financial institutions.

Key provisions

The proposals require an entity to offset a recognised financial asset and financial liability only if it has an unconditional right of set-off and intends either to settle the asset and liability on a net basis or to realise the asset and settle the liability simultaneously.

An unconditional right of set-off is a right that exists in the normal course of business and is enforceable in all circumstances.

Master netting agreements where the legal right of offset is only enforceable on the occurrence of some future event, such as default of the counterparty, would not meet the offsetting requirements.

Disclosures

The proposals will expand disclosure requirements under IFRS and US GAAP. The disclosures focus on quantitative information about rights of set-off, including conditional rights of set-off, and related collateral arrangements.

Transition and effective date

The boards propose that the requirements should be applied retrospectively. The ED does not propose an effective date, as these are being addressed in a separate discussion paper. However, we expect the final standard to have an effective date of no earlier than 1 January 2013.

Am I affected?

The comment letter period ends on 28 April 2011; a final standard is expected mid-2011. Management should consider commenting on the exposure draft to ensure their views on the proposals are considered.

'Revenue' – the responses are now in

Andrea Allocco

The comment period for the exposure draft, 'Revenue from contracts with customers', ended in October 2010. Andrea Allocco in PwC's Accounting Consulting Services Central Team looks at the key themes emerging from the responses received by the IASB and FASB.

The IASB and FASB (the boards) got a record-breaking number of comment letters in response to the exposure draft, 'Revenue from contracts with customers' (over 980). The proposed standard could significantly change the way revenue is recognised in many industries; the focus would change from completion of an 'earnings process' and industry-specific guidance to a single, contract-based model that reflects changes in contract assets and liabilities.

The boards hope to issue the final standard in June 2011 – more on this below.

The majority view

One would expected 980 comment letters to present a diversity of views, and this was certainly the case. But responses did show a number of common themes. Many of these highlight the delicate balance required between preserving a single, principles-based model and providing adequate guidance to ensure consistent application.

Common themes	Summary of observations
Separating a contract. The boards proposed a two-tier approach. The contract is first segmented for goods or services that are independently priced, and then evaluated for separate 'performance obligations' that provide a 'distinct' good or service.	Respondents consistently suggested that the first step in the guidance is not required as long as the principle for identifying performance obligations is clarified. Many objected to the subjectivity in the proposed concept of 'distinct' performance obligations and expressed specific concerns over the use of 'distinct' profit margin as an indicator.
Recognition. Revenue would be recognised when control of a good or service transfers (when a performance obligation is satisfied).	Most respondents agreed with the principle but requested additional clarification for assessing when control transfers continuously, especially in service contracts.
Measurement. The revenue-recognised price should include the probability-weighted estimate of any variable consideration and should reflect the time value of money if material.	Most respondents argued that a probability-weighted approach is not always practical or appropriate and proposed that a 'best estimate' model be permitted. Respondents agreed with the principle of time value of money but suggested that the application challenges outweigh the benefits unless there is a clear financing component.
Warranties. The boards proposed two types: a latent defect warranty, which may indicate that the sale has not occurred; and a warranty for post-sale defects, which is a separate performance obligation for which revenue is allocated.	Respondents generally disagreed with the proposal because it is difficult to distinguish between the different types of warranties. Some also suggested that the current warranty models should be retained, as they are understood in practice and reflect the substance of warranty obligations.
Onerous contract provisions. The ED requires a provision for each 'performance obligation' in which the present value of the probability-weighted direct costs exceeds the allocated transaction price.	Respondents thought that a contract-level assessment may be more appropriate. Some also thought that onerous provision accounting would be better addressed in the relevant liability or contingency standards.
Respondents also commented on several other matters, including the accounting for credit risk, the extent of disclosures and the impact of retrospective application.	

Industry perspectives

The ED attracted comment from a number of industries. Some key concerns are highlighted below.

- *Engineering and construction.* Most entities do not believe that the proposed model improves existing accounting. The responses focused on retaining percentage-of-completion accounting and the importance of achieving comparability within industries rather than across industries.
- *Retail and consumer.* Most entities opposed classifying payments to customers as an expense, as they are not for the services that are distinct from the related product sale. An example of this would be slotting fees paid by suppliers to retailers for advantageous product placement. Franchisors have a specific concern that they might recognise royalty revenue before the sale by the franchisee.
- *Licensing.* A number of industries shared concerns over the licensing proposals, including entertainment and media, technology, telecommunications and pharmaceuticals. Most entities disagreed with the focus on exclusivity, which generally results in the recognition of exclusive licence revenue over the licence term. Some respondents also suggested further consideration of the similarities between licences of intangible assets and leases of tangible assets.
- *Contingent arrangements.* The telecommunications and pharmaceutical industries also expressed concerns with recognising revenue that is contingent upon a future event and the consequential earnings volatility specifically for royalty arrangements. Some respondents suggested that an option to limit the revenue recognised to the non-contingent portion should be retained.

The next steps

The boards have begun redeliberation with the two fundamental issues raised by the comment letter process: separating a contract and performance obligations, and determining when control over goods or services is transferred. The preliminary discussions focused on the development of separate recognition criteria for goods and services, establishment of a less complex approach to segregating contracts and the concept of 'distinct' goods and services.

The timetable could be affected by the extent of redeliberations required to address respondents' concerns; the interaction of the exposure draft with the leasing project; and the request for views on effective dates and transition methods of other new standards expected in 2011.

The final standard is likely to have an effective date of no earlier than 2014; we expect the proposals in the exposure draft to change before implementation. However, management should begin to consider the impact of the proposals on existing contracts with customers and broader implications on processes and controls.

For more information on the comment letter responses, see PwC's 'Practical guide – Revenue from contracts with customers'.

'Leases' – what constituents are saying

Marian Lovelace

The IASB and FASB have received over 770 comment letters in response to the proposed leasing standard (a record beaten only by the responses to the revenue ED – see p4). These, combined with the consultation they have undertaken, including a number of roundtable discussions, have given the boards some food for thought. Director in PwC's Accounting Consulting Services in the UK Marian Lovelace looks at some of the themes.

January's public roundtable discussions on the leasing project provided an early indication that the boards are willing to address some of the issues raised by constituents; however, these discussions were only education sessions, and no formal decisions have been made yet. There were several themes in the comment letters and roundtable discussions, even across industries. There was broad support for the need for the project in general, especially as

it aims to bring all leases onto lessees' balance sheets; however, most respondents expressed concerns about many aspects of the proposals. They are encouraging the boards to take the time necessary to produce a standard that is both high quality and operational.

The boards have outlined five key areas where redeliberation is necessary, namely:

- definition of a lease (distinguishing a lease from a service);
- lessor accounting;
- lease term;
- contingent payments; and
- profit and loss recognition patterns.

Decisions made during the re-deliberation of these key areas could significantly change the direction of the project. The boards are still targeting to issue the final standard in the second quarter of 2011, so there is a substantial work left to do.

The table below summarises the key comment letter themes by topic.

For more information on the comment letters responses, see PwC's 'Practical guide – Leasing proposals: the results are in'.

Major area	Summary of comments
Definition of a lease	There was a high level of concern raised about whether an arrangement contains a lease, both in relation to the current accounting model and the proposed model. Some respondents indicated that many transactions legally identified as a lease may not be a lease for accounting purposes under the proposed definition. Others have indicated that certain other contracts, although called something else, may be fundamentally a lease, such as some power purchase contracts. Still others have raised significant concerns that there may be many more multiple-element contracts than originally expected that contain an 'embedded lease', which would substantially increase the complexity of applying the proposed standard.
Lessee accounting	Many respondents supported the right-of-use model for lessees, at least with respect to the balance sheet implications for simple leases. However, many disagreed with the measurement provisions for more complex leases. In addition, many expressed concern about the 'deemed financing' premise and resulting accelerated expense recognition pattern.
Lessor accounting	Views on lessor accounting are more diverse. The ED proposes a 'hybrid' model, under which certain leases are accounted for under a performance obligation approach, while others are required to use a derecognition approach. Many believe that the proposed hybrid model for lessor accounting has not yet been demonstrated to be a significant enough improvement from the current model to warrant a change. Some believe that a hybrid model is necessary to deal with different business models (for example, financing versus contracts to use). Others believe a hybrid model is not consistent with concepts in the revenue recognition exposure draft and that only a derecognition approach is appropriate.
Extension options	Almost all respondents disagreed with the definition of lease term as the longest possible term 'more likely than not' to occur. They believe this may result in recognition of amounts for extension periods that do not meet the definition of a liability. They also believe this approach would be highly subjective in application, could result in significant volatility and could be subject to manipulation in practice. While most respondents believe that some extension options should be included, there were differing views regarding the threshold at which respondents believe they should be recognised.
Contingent payments	The ED proposes that contingent payments to be included in the amounts recorded using a 'probability-weighted' approach. Most respondents were critical of a probability-weighted approach and believe a 'best estimate' approach is more appropriate. Some respondents also believe that certain types of contingencies (usage, performance and index-based) should be treated differently, although there were differing views as to which types should be included and why.
Profit and loss recognition pattern	The ED includes an inherent financing element in the right-of-use model. This model results in a recognition pattern for the lessee that changes the expense recognition pattern of operating leases from rental expense to a combination of amortisation and interest expense. It will also typically result in the acceleration of expenses compared to today's operating lease accounting and the timing of cash payments. Many respondents questioned the usefulness of this information.

Reassessment	The ED provides for reassessment of significant assumptions if facts and circumstances indicate there would be a significant change in the amounts from a previous reporting period. Many respondents raised concerns about the operationality and cost/benefit of this approach. Some respondents indicated that an annual reassessment may be appropriate; others suggested a 'trigger-based' reassessment.
Transition	The ED provides for a 'simplified retrospective' approach and does not allow for early adoption. Many respondents supported this approach for cost/benefit reasons, but others observed that it creates an artificial and non-recurring expense pattern. Many respondents also asked for more guidance on transition issues in general (for example, use of hindsight) and for specific issues (for example, sale leasebacks and build-to-suit leases).
Disclosure	Most respondents supported the overall disclosure objectives but believe that preparers should be allowed to exercise judgement in determining the volume of disclosures and financial statement presentation.

Transition issues from around the world – Korea

Kyungho Lee

This is the second article in the series about issues affecting countries that are moving to IFRS. This month, ACS partner Kyungho Lee in Korea looks at the scope of the consolidation requirements, the measurement of post-employment benefits and classification of financial liabilities and equity instruments.

Consolidation scope

The first step in the transition to IFRS is defining a 'reporting group'. A reporting group includes a parent and all subsidiaries that the parent controls. Control is defined in IAS 27, 'Consolidated and separate financial statements', and is not subject to local regulations. The definition of what is and is not a group entity will change the whole picture of the IFRS financial statements.

The scope of subsidiaries under Korean GAAP has been regulated by local law. For example, when an entity

Local background

- Korea announced in 2007 that IFRS adoption would be mandatory for all Korean-listed companies from 2011, implemented in a 'big bang' approach. The aim is for Korean listed companies to have wider access to global capital markets.
- They were also permitted to voluntarily adopt IFRS from 2009; global companies such as Samsung Electronics and LG Electronics early adopted IFRS in 2010.
- Korean accounting standards have been issued based on IFRS in an effort to improve the transparency of local accounting standards.
- The translated version of IFRS is termed 'IFRS as adopted by Korea (K-IFRS)'. It follows the framework set up locally. However, K-IFRS is a word-for-word translation of IFRSs issued by the IASB. Additional disclosure requirements are included in K-IFRS but only in a handful of circumstances.
- Separate accounting standards have been issued for non-listed companies. These are a simplified version of current Korean GAAP and reduced in volume to minimise the burden of transition for those companies. However, non-listed companies can also voluntarily adopt K-IFRS in full.

owns over 50% of the shares of another entity, or owns over 30% of the shares and is the number one shareholder, the entity is deemed to control that entity. However, the entity is not a subsidiary and is not consolidated if the total assets of entity are less than KRW 10 billion (a 'small-sized company'). This is considered to be one of the major differences between Korean GAAP and IFRS. Many Korean companies are facing consolidation judgements on transition. Some examples are outlined below.

Does control reside with the major shareholder if it holds more than 30% but less than 50% interest?

There is a potential complication about to be added to the debate on de facto control decisions. The IASB is expected to issue a new standard, 'Consolidated financial statements', in March 2011. More guidance on de facto control will be included in this standard and the impact on the current discussions is unclear until the new standard is available.

If the new standard is not available for adoption until after 2011 and results in changes in consolidation scope, it would cause significant distress among Korean companies adopting IFRS in 2011. This will be one of the most controversial issues when the new standard comes out.

Consolidation of small-sized sub-sidiaries

The local regulation exempting consolidation of small-sized entities will no longer be effective on transition to IFRS. All entities will therefore have to be consolidated by their controlling investor regardless of size.

Measurement of post-employment benefits

Adopting IFRS is not just a change in accounting standards. It involves a transformation in companies' operations, and a wide range of areas need to be considered. One of the most significant issues in Korea relating to this change of framework is pension accounting.

Corporate pension schemes were only recently introduced in Korea. Basic compensation schemes for completion of service by employees has been 'severance payment', in which a lump-sum amount is paid based on the length of service and average salary in last three months. Under Korean GAAP, the company's liability for severance payment was measured at the liquidation value; the full amount to be paid by the company to all employees for severance payment was recognised at the reporting date.

The actuarial technique for estimating the amount of benefit is a daunting issue – not only for preparers but also for auditors. There has been no practice of involving third-party actuaries or valuation specialists to measure a company's liability to employees. Management has had to set up a whole new process and internal controls to cope with the new requirements. Additional audit procedures should also be performed to verify the competence and objectiveness of third-party actuaries or pension fund providers, and to review the plan valuation and disclosure items provided by them.

In tandem with the fair valuation of financial instruments and other non-current assets, the requirement for actuarial valuation is changing the way Korean companies manage financial reporting as we move toward IFRS.

Classification of financial liabilities and equity instruments

Under Korean GAAP, equity and derivatives to be settled in the issuer's own equity instruments have been classified as equity regardless of their substance, based on the terms and conditions. All preference shares and derivatives that oblige the company to deliver cash to another entity and that cannot meet the 'fixed for fixed' requirement under IFRS are classified as equity.

Many companies in Korea have issued redeemable preference shares, which are redeemable at the holder's option. These companies are required to recognise more liabilities and less equity on transition to IFRS. The reclassification from equity to liability will increase the debt-equity ratio.

In Korea, conversion rights in convertible preference shares often contain terms that violate the 'fixed for fixed' requirements, typically through adjustments to the conversion ratios based on pricing of future share issuances. Where debt and equity reclassification includes derivatives, the knock-on effect on the issuers is more pervasive. Since derivative liabilities are required to be measured at fair value at every reporting date, issuers often rely on third-party valuation specialists to provide the fair values. Application of such new valuation strategies will require the implementation of more control processes and result in the increased cost of financial reporting. In addition, continuous remeasurement increases volatility in profit and loss and key financial ratios.

Last word

As the deadline for IFRS adoption gets closer, we are working with companies to iron out some of these complexities and towards a smooth transition.

For further help on IFRS technical issues contact:

Business Combinations and Adoption of IFRS
mary.dolson@uk.pwc.com: Tel: + 44 (0)20 7804 2930
caroline.woodward@uk.pwc.com: Tel: +44 (0)20 7804 7392

Financial Instruments and Financial Services
john.althoff@uk.pwc.com: Tel: + 44 (0)20 7213 1175
jessica.taurae@uk.pwc.com: Tel: + 44 (0)20 7212 5700
elizabeth.m.lynn@uk.pwc.com: Tel: + 44 (0)20 7804 0306

Liabilities, Revenue Recognition and Other Areas
tony.m.debell@uk.pwc.com: Tel: +44 (0)20 7213 5336
mark.lohmann@uk.pwc.com: Tel: +44 (0)20 7212 4482

IFRS news editor
joanna.c.malvern@uk.pwc.com: Tel: +44 (0)20 7804 9377

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