

IFRS news

Emerging issues and practical guidance*

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IASB and FASB propose significant changes to lease accounting

The IASB and FASB have proposed a new approach to lease accounting that would significantly change the way entities account for leases. Their exposure drafts, both entitled 'Leases', will result in a converged standard that aims to address the weaknesses of existing standards. The key objective is to ensure assets and liabilities arising from lease contracts are recognised in the balance sheet. Marian Lovelace of PwC's Accounting Consulting Services in the UK looks at the key implications.

Key provisions – lessee accounting

The proposed model will eliminate off-balance sheet accounting for leases. All assets currently leased under operating leases will be brought onto the balance sheet, removing the distinction between finance and operating leases. The new asset represents the right to use the leased item for the lease term. The liability represents the obligation to pay rentals. These will be recognised and carried at amortised cost, based on the present value of payments to be made over the term of the lease. The lease term will include optional renewal periods that are 'more likely than not' to be exercised. Lease payments used to measure the initial value of the asset and liability will include 'contingent' amounts, such as rents based on a percentage of a retailer's sales or rent increases linked to variables such as the Consumer Price Index (CPI). The proposed model will require lease renewal and contingent rents to be continually reassessed, and the related estimates to be trued up as facts and circumstances change.

Income statement 'geography' and timing of recognition will change. Straight-line rent expense will be replaced by depreciation, which will be recognised on a basis similar to similar owned assets, and interest expense, which will be recognised on an effective interest basis.

Key provisions – lessor accounting

The boards were unable to agree upon a single lessor accounting model and decided that concerns about the application of each of the two approaches in certain fact patterns could only be addressed through a dual model.

- Where the lessor retains exposure to significant risks or benefits associated with the leased asset either during the term of the contract or subsequent to the term of the contract, the 'performance obligation' approach would be followed. The lessor

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recognises the underlying asset and a lease receivable, representing the right to receive rental payments from the lessee, with a corresponding performance obligation, representing the obligation to permit the lessee to use the leased asset.

- For all other leases, the ‘derecognition approach’ would be followed. The lessor recognises a receivable, representing the right to receive rental payments from the lessee, and records revenue. In addition, a portion of the carrying value of the leased asset is viewed as having transferred to the lessee and is derecognised and recorded as cost of sales.

Similar to lessee accounting, lessors under either approach would also need to estimate the lease term and contingent payments and true-up these estimates as facts and circumstances change.

Disclosures

The proposed model will require more extensive disclosures than are currently required under IFRS and US GAAP. The disclosures focus on qualitative and quantitative information, and on the significant judgements and assumptions made in measuring and recognising lease assets and obligations.

Transition

Pre-existing leases are not expected to be grandfathered. The boards are proposing the new leasing approach to be applied by lessees and lessors by recognising assets and liabilities for all outstanding leases at the date of the earliest period presented using a simplified retrospective approach.

The exposure draft does not propose an effective date. We anticipate the final standard to have an effective date no earlier than 2012.

Am I affected?

The change will have a pervasive impact for IFRS and US GAAP preparers, as almost all companies enter into lease arrangements. Some entities will be affected more than others, depending on the number and type of leases in existence at the transition date.

The proposal applies to all entities, but certain types of leases are excluded from its scope. The boards propose that the scope of the leasing standard exclude leases of intangible assets. The boards also propose to exclude from the scope:

- Leases to explore for or use natural resources (such as minerals, oil, and natural gas);
- Leases of biological assets; and
- Leases of investment property measured at fair value.

What do I need to do?

The comment letter period ends on 15 December 2010; a final standard is expected mid-2011. Given the potential impact of the proposed changes on accounting and operations, management should begin to assess the implications of the proposal on their existing contracts and current business practices. Management should also consider commenting on the exposure draft to ensure their views on the proposed changes are considered.



IASB proposes to fundamentally change accounting for insurance contracts

The IASB has issued an exposure draft (ED) of a comprehensive standard that will fundamentally change the accounting by insurers and other entities that issue contracts with insurance risk. Elizabeth Lynn of the Global Accounting Consulting Services central team looks at the proposals.

What is the issue?

The proposals are the output of the IASB and FASB's joint efforts to develop a single converged insurance standard. The FASB plans to issue a discussion paper that will incorporate the IASB's proposals. The proposed standard would replace IFRS 4, which currently permits a variety of practices in accounting for insurance contracts.

Scope of the proposals

The proposed standard would apply to all entities that issue contracts that contain insurance risk. The ED retains the IFRS 4

definition of an insurance contract as “a contract under which one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder”. This broad definition could result in contracts issued by non-insurers being subject to the standard, such as certain financial guarantee contracts and loans with waivers upon death of the borrower. However, unlike IFRS 4, fixed-fee service contracts where the level of service depends on an uncertain future event (such as maintenance contracts where specified equipment is repaired after a malfunction) will not be within the scope of the proposed standard. The standard does not address the accounting by policyholders (other than reinsurance) entering into insurance contracts.

Insurance contracts often contain other elements such as financial or service components. These are required to be unbundled and accounted for separately if they are not closely related to the insurance coverage. In particular, embedded derivatives will be separated in accordance with IAS 39 and certain account balances (that is, deposit or savings components within insurance contracts) will be required to be unbundled.

Measurement model

The proposals require all insurance contracts to use a current measurement model of the present value of expected cash flows to fulfil the obligation, where estimates are re-measured at each reporting period. Except for certain short duration contracts, this measurement model is based on the building blocks of discounted probability-weighted cash flows, a risk adjustment and a residual margin to eliminate any initial profit.

The cash flows are explicit, unbiased, probability-weighted cash flows that the insurer expects to incur in fulfilling the contract, including expected premiums, policyholder benefits, expenses and participating dividends. Unlike the previous discussion paper proposal, the cash flows are measured from the issuer's perspective (rather than a market participant) although any market variables must be consistent with observable market prices. Acquisition costs that are incremental to a contract (such as commissions) will be included in these net cash flows rather than deferred as an explicit asset, but all other acquisition costs will be expensed when incurred.

The estimated cash flows are discounted at risk free interest rates adjusted for differences between the liquidity characteristic of the insurance contracts and the corresponding risk-free instruments. The discount rates will not be based on the assets backing the insurance contracts, unless those asset returns affect cash flows to the policyholders.

The measurement model includes an explicit risk adjustment for the effects of uncertainty about the timing and amount of future cash flows. This adjustment is the maximum amount the issuer would pay to be relieved of the risk that the ultimate cash flows exceed those expected. The inclusion of an explicit risk adjustment has been one of the most controversial issues in the boards' discussions. The ED limits the permitted techniques to calculate this adjustment.

The residual margin eliminates any initial gain on the contract. It is not subsequently re-measured but is released in a systematic way over the coverage period. Any initial loss on a contract is recognised immediately in profit or loss.

As a result of the debates around the risk adjustment, the ED outlines an alternative measurement model favoured by the FASB, that also eliminates any initial profit but has a single composite margin, rather than recognising an explicit risk adjustment and a residual margin.

The proposals require that short-duration contracts of approximately 12 months or less that do not contain any embedded derivatives or options are initially measured as premiums less any incremental acquisition costs. This preclaim liability is reduced in a systematic way over the coverage period, with any claims that occur being measured using the building-block approach described above.

At each balance sheet date, the discounted estimated future cash flows and risk adjustment are updated based on current estimates. Any changes (both positive and negative) in either financial variables (such as the discount rate) or other estimates (such as expenses, claims experience, lapses and the risk adjustment) are recognised immediately in profit or loss.

Income statement presentation

The income statement will be driven by the measurement model. Issuers will not recognise premiums as revenue (except where the short-duration simplified approach is used) but will separately show an underwriting margin (comprising changes in the risk adjustment and residual margin) and changes in estimates and experience variances. Supplemental disclosures would provide premium and claim information.

Transition arrangements

The ED includes transition provisions that require insurance contracts in force at the transition date to be measured at the present value of the expected cash flows and risk adjustment as described above without any residual margin. Any deferred acquisition costs will need to be written off. The only profit that will be recognised in future profit or loss for contracts in existence at transition will come from the release of the risk margin, experience variances and any subsequent changes in estimates. This will be a significant change for most life insurers.

Am I affected?

The proposals will affect all entities that issue contracts that meet the definition of insurance contracts, including financial guarantee contracts. The proposals are likely to result in increased volatility in the income statement and significant changes in the presentation of the income statement. The proposals will create additional demands on data and modelling systems. The extent of these demands will vary from territory to territory, depending on current accounting and regulatory reporting requirements

What do I need to do?

Given the profound impact of the proposed changes, management should begin to assess the implications of the new model on their existing contracts and current business practices. Management should also consider commenting on the ED to ensure their views on the significant changes are considered. The comment letter period ends on 30 November 2010 and a final standard is currently expected in mid-2011.

Cannon Street Press

Proposed amendment to remove fixed dates for first-time adopters

What is the issue?

The proposed amendment to IFRS 1 will eliminate references to fixed dates for one exception and one exemption in the standard, both dealing with financial assets and liabilities. The first change will require first-time adopters to apply the derecognition requirements of IFRS prospectively from the date of transition rather than from 1 January 2004. A first-time adopter can apply the IFRS derecognition requirements from an earlier date if it has the necessary information and that information was collected at the time of the relevant transactions.

The second amendment relates to financial assets or liabilities at fair value on initial recognition where the fair value is established through valuation techniques in the absence of an active market. The proposal is that the guidance in IAS 39 para 76 and IAS 39 para 76A can be applied prospectively from the date of transition to IFRS rather than from 25 October 2002 or 1 January 2004. This means that a first-time adopter does not need to reconstruct fair value for financial assets and liabilities for periods prior to the date of transition.

Am I affected?

Entities adopting IFRS that had derecognised financial assets or liabilities prior to the date of transition to IFRS will need to apply the derecognition guidance from the date of transition, as it is a mandatory exception. The second change will only be relevant for entities that elect to use the exemption for fair value established by valuation techniques. The effective date for the proposed amendment is uncertain but it is expected to be available for early adoption if the amendment goes forward so that it is available for entities adopting in 2011.

What do I need to do?

The IASB is requesting comments on the proposed amendment by 27 October 2010. Management should consider commenting on the proposed amendment. If you have questions on the application of the proposed amendment or require further information, speak to your regular PwC contact.

Draft interpretation on 'Stripping costs in the production phase of a surface mine'

What is the issue?

The IFRIC has published today a Draft Interpretation (DI) on stripping costs that may have significant day one impacts for IFRS mining companies. The interpretation sets out guidance on the accounting for waste removal (stripping) costs in the production phase of a mine. The challenge in accounting for stripping costs in the production phase is identifying and allocating the benefits and the costs of stripping activity across different reporting periods. There is some diversity in practice as there is no specific guidance under IFRS. Some entities expense stripping costs as a cost of production and some entities capitalise some or all stripping costs on different calculation bases (for example, life-of-mine ratio).

The proposals will require the costs associated stripping activity that creates improved access to the ore body as part of a stripping campaign to be capitalised as an addition to or enhancement of an existing asset. Routine stripping costs that are not part of a stripping campaign are accounted for as a production cost in accordance with IAS 2.

The transition provisions of the DI may have significant impacts when adopted; they will apply to all stripping campaigns in progress and require existing stripping cost balances to be reclassified and associated with specific ore quantities. Balances that cannot be associated with specific ore bodies will be written off to profit and loss on adoption.

The DI applies only to stripping costs that are incurred in surface mining activity during the production phase of the mine.

Am I affected?

All surface mining companies applying IFRS would be affected by the DI. Early application of the DI would be permitted. The DI is proposed to apply to all ongoing stripping campaigns as of the effective date. Any existing stripping cost asset balances at the date of transition should be reclassified as a component of the mine asset to which the stripping activity related and then depreciated/amortised over the related specific ore quantity. A component that cannot be associated with specific identifiable ore, and any stripping cost liability balances, should be written off to profit or loss at the beginning of the earliest period presented. This could have a significant impact on results in the initial year of adoption.

Entities would also have to assess whether processes exist to implement the 'specific association' approach in the DI.

What do I need to do?

The IFRIC is requesting comments on the DI by 30 November 2010. Management should consider commenting on the proposals. Existing IFRS preparers may be most interested in the proposed transition provisions in the interpretation. If you have any questions about the issues in this interpretation, please contact your PwC engagement partner.

Trustees seek views on criteria for annual improvements process

The IFRS Foundation has proposed enhancements to the criteria for the IASB's 'annual improvements' process (the process that provides a mechanism for non-urgent but necessary amendments to IFRSs to be issued in one package). The proposals recommend enhancing the criteria for determining whether a matter relating to the clarification or correction of IFRSs should be addressed using the annual improvements process.

The IFRS Foundation invites responses on whether the

proposed criteria provide a sufficient and appropriate basis for assessing whether matters relating to the clarification or correction of IFRSs should be addressed using the annual improvements process.

The consultation document *The annual improvements process: Proposals to amend the Due Process Handbook for the IASB* is open for comment until 30 November 2010 and can be accessed via the 'Comment on a Proposal' section of www.ifrs.org.

IFRS Foundation creates an IFRS for 'SME implementation group'

The IFRS Foundation, which is responsible for the adoption of IFRSs and the oversight of the IASB, has created an IFRS for 'SME implementation group'.

The mission of this group is to support the international adoption of the IFRS for SMEs and to monitor its

implementation. The group has two main responsibilities:

- to develop non-mandatory guidance for implementing the IFRS for SMEs in the form of questions and answers that will be made publicly available on a timely basis; and
- to make recommendations to the IASB if and when needed regarding amendments to the IFRS for SMEs.

For further help on IFRS technical issues contact:

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