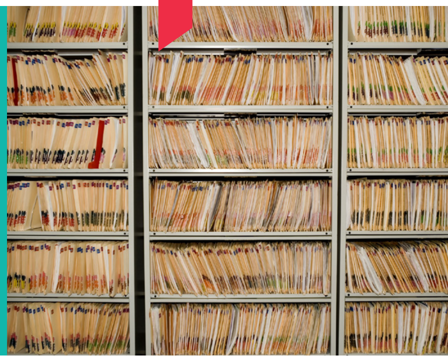
31 DECEMBER 2013 –
UPDATE ON KEY IASB PROJECTS
INTERNATIONAL FINANCIAL REPORTING BULLETIN 2013/32



Background

The International Accounting Standards Board (IASB) is currently working on a number of major projects that are at various stages of completion. A number of these are likely to impact most entities to varying degrees.

There is no requirement for entities to make disclosures regarding outstanding IASB projects in their 31 December 2013 financial statements. However, because of the potential effect of the new standards that will ultimately be issued, it is advisable to keep a watching brief on the status of those projects and key (tentative) decisions that have been taken by the IASB.

This IFRB sets out a summary of the most significant current IASB projects. These are:

1. Revenue from Contracts with Customers
2. Leases
3. Classification and Measurement: Limited Amendments to IFRS 9
4. Financial instruments: Expected credit losses (IFRS 9)
5. Insurance Contracts

STATUS
IASB projects

EFFECTIVE DATE
To be confirmed

ACCOUNTING IMPACT
Likely to be significant for all entities.

Summary

1. Revenue from Contracts with Customers

In November 2011 the IASB reissued their proposals for revenue recognition in ED/2011/6 *Revenue from Contracts with Customers*. The basic five step process has been retained as follows:

STEP ONE	STEP TWO	STEP THREE	STEP FOUR	STEP FIVE
Identify the contract	Identify separate performance obligations	Determine transaction price	Allocate transaction price to performance obligations	Recognise revenue when each performance obligation is satisfied

In doing so, the Board is proposing to amend the original proposals contained in the earlier ED/2010/6 as follows:

Step one: Identify the contract

The concept of 'price independence' has been eliminated to reduce the number of contracts being combined and the proposals to segment contracts have been removed because this will be dealt with through identifying separate performance obligations.

Step two: Identify separate performance obligations

When identifying separate performance obligations, the criteria for assessing whether a good or service is distinct have been simplified so that entities only need to consider whether they would sell the good or service separately, rather than having to consider whether other entities would sell the good or service separately. In addition, a good or service will not necessarily be 'distinct' merely because it has a distinct profit margin as this criterion has been removed.

The new proposals should reduce the number of performance obligations identified for construction contracts (as compared to the original proposals) because they specify that a bundle of highly interrelated goods or services should be accounted for as a single performance obligation.

Step three: Determine transaction price

(i) Variable consideration

Where the amount of consideration is variable, entities may use the most likely amount or the expected value amount (i.e. probability-weighted amount). The original proposals only permitted the use of the probability-weighted measurement techniques.

Since the release of the ED the board has discussed in several meetings the constraint on recognising variable consideration. From discussions at these meetings the board has tentatively decided that the objective of the variable revenue constraint is to include an estimate of variable consideration in the transaction price subject to a high recognition hurdle (i.e. that it is highly probable that a significant revenue reversal will not subsequently occur).

(ii) Treatment of warranties

Warranties will only be accounted for as separate performance obligations (and hence deferred revenue) if the customer could purchase the warranty separately from the entity, or if the warranty provides a service in addition to the assurance that the company's past performance was as specified in the contract (e.g. warranty could not be purchased separately but covers for future claims, rather than for past performance).

(iii) Accounting for the time-value-of-money

The time value of money would be included in determining the transaction price if:

– The contract includes a financing component that is significant to the contract, or

– At contract inception, the period between transfer of goods or services and payment is expected to be greater than one year.

(iv) Customer credit risk

Allowances for each customer's credit risk would not be included when determining the transaction price. Rather, impairment losses will be measured in accordance with the IFRS 9 *Financial Instruments* and presented as a separate line adjacent to the revenue line.

Since the release of the ED the board has discussed in several meetings the presentation of initial and subsequent impairment losses on customer receivable balances. From discussions at these meetings the board has tentatively decided that impairment losses on customer receivable balances should be presented as an expense, rather than in a line adjacent to revenue.

Step four: Allocate transaction price to performance obligations

Recognising losses on onerous contracts will continue to apply at the level of each performance obligation but, for contracts where performance obligations are satisfied over time, losses will only need to be recognised on onerous contracts where performance obligations are expected to be satisfied over a period of greater than one year. This may alleviate the problem of having to recognise losses on components of a contract designed as 'loss leaders' where the overall contract is expected to be profitable.

Step five: Recognise revenue when each performance obligation is satisfied

Further guidance is to be provided for circumstances in which the customer obtains control of goods or services when transfer occurs over a period of time, and 'risks and rewards' has been added as an indicator of when control of a good or service is transferred.

Next steps

The IASB is expected to issue a final revenue standard in the first quarter of 2014. Items that are likely to change from those within the ED include:

- Providing additional clarification to help identify separate performance obligations, i.e. when they are distinct
- Clarifying that the objective of the constraint on the cumulative amount of revenue recognised is for the entity to recognise revenue at an amount that should not be subject to significant reversals. The confidence level would need to be relatively high for an entity to recognise revenue for variable consideration (i.e. that it is highly probable that a significant revenue reversal will not subsequently occur)
- Licences of intellectual property where the customer promises to pay an additional amount of consideration (e.g. sales-based royalty) will follow the general principles for constraint of revenue
- Recognising losses on onerous contracts at the contract level instead of the performance obligation level as originally proposed in the ED
- Clarifying that entities would not need to adjust for the time value of money on advance payments when the transfer of goods or services is at discretion of the customer, e.g. a prepaid phone card
- Simplifying the requirements for recognising revenue over time as the criteria in the ED are unclear and complex
- Including additional guidance in determining the transaction price (step 3) in relation to distinguishing customer credit risk that should be accounted for as a price discount or an impairment loss
- Providing additional guidance when the contract does not meet step 1
- Presentation of customer credit risk either in line item adjacent to revenue or as an impairment expense within profit or loss (as noted above, at their recent board meetings the board has tentatively decided impairment losses on customer receivable balances should be presented as an expense, rather than in a line adjacent to revenue.

2. Leases

In May 2013, the IASB issued revised exposure draft ED/2013/6 which contained the revised proposals for leases accounting that would result in the recognition of lease assets and liabilities arising under lease contracts on an entity's balance sheet.

The IASB has made significant changes to the proposals set out in its previous ED/2010/9, with a key change being that ED/2013/6 proposes two types of lease model for lessees and lessors, depending on the proportion of economic benefits consumed during the lease, and the type of the underlying asset.

'A dual lease' model

The two types of leases are:

- **Type A** leases – the lessee consumes some of the economic benefit of the asset – usually equipment and vehicle leases
- **Type B** leases – the lessee consumes an insignificant part of the total economic life of the underlying asset – usually property leases.

If the underlying asset is not property, a lease is classified as Type A, unless:

- The lease term is for an insignificant part of the total economic life of the underlying asset, or
- The present value of the lease payments is insignificant relative to the fair value of the underlying asset at the commencement date.

If the underlying asset is property, a lease is classified as Type B lease unless:

- The lease term is for the major part of the remaining economic life of the underlying asset, or
- The present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

The ED provides no specific guidance as to what is meant by 'insignificant', 'major part' and 'substantially all'.

Example Type A lease – Equipment lease classification

(Example 12 of the Illustrative Examples of the 2013 ED)

Facts are as follows:

- Two-year lease of an item of equipment
- Total economic life of 12 years
- Lease payments are CU9,000 per year
- Present value of lease payments is CU16,700 calculated using the rate the lessor charges the lessee
- Fair value of the equipment at the commencement date is CU60,000.

The lessee determines that the lease is a Type A lease because:

- Underlying asset is not property
- Lease term is for more than an insignificant part of the total economic life of the equipment (i.e. 2/12 years is considered more than insignificant in this example)
- Present value of the lease payments is more than insignificant relative to the fair value of the equipment at the commencement date (i.e. CU9,000/CU16,700).

Example Type B lease – Commercial property lease classification

(Example 13 of the Illustrative Examples of the 2013 ED)

The following facts are relevant:

- 15-year lease of an office building
- Remaining economic life of 40 years at the commencement date
- Lease payments are CU30,000 per year
- Present value of lease payments is CU300,000, calculated using the lessee's incremental borrowing rate (i.e. the rate the lessor charges the lessee is not readily determinable to the lessee)
- Fair value of the property at the commencement date is CU400,000.

The lessee determines that the lease is a Type B lease because:

- Underlying asset is property
- Lease term is not for the major part of the remaining economic life of the property (i.e. 15/40)
- Present value of the lease payments does not account for substantially all of the fair value of the property (i.e. CU300,000/CU400,000).

Lessee Accounting

For both Type A and Type B leases, the 2013 ED proposes that the lessee will recognise in its balance sheet a:

- Right-of-use asset
- Lease liability.

The lease liability is equal to the present value of the lease payments discounted using the rate the lessor charges the lessee (or if unknown, the lessee's incremental borrowing rate.

The right-of-use asset in a Type A lease is amortised on a straight-line basis (unless another systematic basis is more representative).

The amortisation expense for a right-of-use asset in a Type B lease is calculated as the difference between:

- The periodic lease cost
- The periodic unwinding of the discount on the lease liability.

Essentially, the amortisation charge is the balancing figure that ensures that the overall charge to profit or loss is consistent each period.

The effect of the proposed requirement would be such that for:

- Type A leases: the amortisation charge would result in a front-end loaded interest expense and a straight line or similar amortisation expense in profit or loss
- Type B leases: the amortisation charge would result in one combined expense in profit or loss, being the interest cost and the 'balancing number' for amortisation as described above.

Lessor accounting

For Type A leases, the lessor derecognises the full value of the underlying asset but also records a residual asset which is the right to the underlying asset that the lessor retains (this represents the portion of the asset's life that will remain at the end of the lease term when it is returned to the lessor). Interest is also unwound on this residual asset as income so that its value increases over time.

For Type B leases, the proposed accounting is asymmetrical between lessees and lessors, specifically:

- The lessor continues to recognise the underlying asset whereas the lessee would also recognise the right-of-use asset
- Lessors do not recognise a lease receivable whereas the lessee would recognise a lease liability
- Income is recognised on a straight line basis or a more representative basis by lessors whereas lessees must recognise a straight-line cost.

Short-term leases

For short term leases, which are leases which have a maximum possible term, including any options to extend, of twelve months or less, the 2013 ED proposes an accounting policy choice to either:

- Apply the accounting policies described above for Type A and Type B leases, or
- Recognise lease payments in profit or loss (on a straight line basis for lessees and a straight line or more representative basis for lessors).

Summary

These proposals are likely to impact most entities that are engaged in lease contracts as either a lessee or lessor, other than those entities with very short-term rental agreements (less than 12 months including the effect of any extension options, regardless of how likely it is that those options will be exercised).

If finalised, the proposals in the 2013 ED will result in changes to the timing of amounts recognised and presented in the balance sheets and income statements of both lessees and lessors. These may have effects on bank covenants, employee remuneration arrangements linked to reported results (including share-based payments), and on key metrics that they report to the markets and other users of their financial statements.

Next steps

The comment period for the ED closed on 13 September 2013.

For more information please refer to the BDO *Need to Know* publication, *Leases – The 2013 Exposure Draft*, available for download from the following link:

http://www.bdointernational.com/Services/Audit/IFRS/Need%20to%20Know/Documents/Need%20to%20Know%20-%20Leases-The%202013%20Exposure%20Draft%20%28print%29.pdf

3. Classification and Measurement: Limited Amendments to IFRS 9

In November 2012, the IASB issued exposure draft ED/2012/4 which proposes to change certain aspects of IFRS 9 *Financial Instruments* relating to accounting for financial assets.

The ED proposes to:

- Include additional application guidance to clarify the 'contractual cash flow characteristics test'(one of the two required tests in order to classify and account for financial assets after initial recognition at amortised cost)
- Introduce a new category for certain debt instruments held by the entity, that would result in:
  - The instruments being carried at fair value in the balance sheet
  - Any subsequent changes in fair value being recognised in other comprehensive income
  - Interest income being recognised at the effective interest rate in profit or loss
  - Impairment being recognised in profit or loss on an amortised cost basis.

  This new measurement category would apply to debt instruments where the entity is holding the debt instrument to both collect the contractual cash flows, and to sell the financial assets (i.e. where the entity has a dual business objective for that debt instrument).

Under the current version of IFRS 9, debt instruments are either carried at:

- Amortised cost (if the business objective is to hold to collect the cash flows and meets the 'contractual cash flow characteristics test'), or
- Fair value through profit or loss (if business objective is held to sell).

The proposals within the ED were in response to requests for additional application guidance, as well as requests for the IASB:

- to consider how IFRS 9 will interact with the insurance project
- to align the requirements of IFRS 9 more closely with those expected from the US Financial Accounting Standards Board (FASB).

Next steps

The IASB is currently redeliberating the proposals based on the comments received, and is discussing them with the FASB. The changes are expected to be finalised in the first half of 2014.

For more information please refer to the BDO *Need to Know* publication, *Classification and Measurement: Limited amendments to IFRS 9*, available for download from the below link:

http://www.bdointernational.com/Services/Audit/IFRS/Need%20to%20Know/Documents/Need%20to%20Know%20%20-%20Classification%20and%20Measurement%20%28IFRS%209%29.pdf

4. Classification and Measurement: Limited Amendments to IFRS 9

In March 2013, the IASB issued exposure draft ED/2013/3 *Financial Instruments: Expected Credit Losses* that proposes to replace the current incurred loss model (where impairment is only recognised when a certain loss event has occurred) with a forward looking expected loss model. The proposed general model would require an entity to assess impairment in three distinct stages:

- *Stage 1*: Recognise the next 12-months expected credit losses on financial assets
- *Stage 2*: Recognise lifetime expected credit losses if there has been a significant credit deterioration
- *Stage 3*: Recognise lifetime expected credit losses and recognise interest revenue on the net carrying amount (gross amount less the provision amount) if the incurred loss triggers in IAS 39 *Financial Instruments: Recognition and Measurement* have been met.

Next steps

Comments in relation to the ED closed on 5 July 2013.

The IASB is currently redeliberating comments received from the ED and is expecting to issue a final standard in the first half of 2014.

For more information please refer to the BDO *Need to Know* publication, *Financial Instruments: Expected Credit Losses (Exposure Draft)*, available for download from the below link:

http://www.bdointernational.com/Services/Audit/IFRS/Need%20to%20Know/Documents/BDO%20Need%20to%20Know%20-%20FI%20Expected%20Credit%20Losses%20ED%20%28print%29.pdf

Stage	1	2	3
Recognition of impairment	12-month expected credit loss	Lifetime expected credit loss	
Recognition of interest	Effective interest on the gross amount		Effective interest on the net (carrying) amount

Financial assets that have low credit risk (e.g. at investment grade – AAA to BBB) would only be required to recognise the next 12-months of expected credit losses.

The next 12 months of expected credit losses does not mean only those losses that are expected to occur within 12 months. Instead, they are losses that are expected to arise from a loss event that takes place within the next 12 months. This would capture losses where there a loss event is expected 11 months after the reporting date, with an associated loss occurring 18 months after the reporting date.

The model proposes that when payments are 30 days or more past due there is a (rebuttable) presumption that a significant deterioration in credit risk has occurred, at which point lifetime expected credit losses would need to be recognised.

In terms of short term trade receivables, the ED proposals that a simplified approach would apply, where an entity would only recognise lifetime expected losses. Other long term trade receivables and lease receivables would have the option to apply either the simplified approach, or the general approach proposed by the ED.

As a practical expedient, the ED would allow entities to calculate the expected credit losses on trade receivables using a provision matrix, where trade receivables are grouped based on different customer bases and different historical loss patterns (e.g. geographical region, product type, customer rating, collateral or trade credit insurance, or type of customer).

Under the simplified model, entities could adjust the historical provision rates (which are an average of historical outcomes) on their trade receivables to reflect relevant information about current conditions compiled with reasonable and supportable forecasts.

5. Insurance Contracts

In June 2013 the IASB published revised exposure draft ED/2013/7 *Insurance contracts* replacing the original exposure draft ED/2010/8 that was released in July 2010.

Like the previous ED, the revised ED proposes that an entity should measure insurance contracts using a current value approach and covers all types of insurance contracts issued by all entities (not only insurers).

Under the proposals an insurance contract, other than a short-duration contract, would be measured on the basis of the obligations and rights under the contract using the following 'building blocks':

- A current estimate of the future cash flows
- A discount rate that adjusts those cash flows for the time value of money
- An explicit risk adjustment, and
- A residual margin.

For short-duration insurance contracts, a modified version of the comprehensive measurement approach would involve an entity applying:

- A premium deferral model for pre-claims liabilities ('stand ready' obligations to meet valid claims for insured events that have not yet occurred), and
- The 'building block' approach for claims liabilities (obligations to meet valid claims for insured events that have occurred).

The key changes from the original ED are:

- The insurance liability would include a contractual service margin (i.e. expected profit on the contract) that is 'unlocked' i.e. you would adjust the margin for changes in assumptions relating to future coverage and services
- Insurance contracts for which cash flows are contractually linked to, and vary directly with an underlying item, would use the carrying amount of the underlying item to account for such cash flows
- Gross presentation of insurance contract revenue and claims/ expenses incurred (the original ED proposed a net margin presentation format in the statement of comprehensive income)
- Interest expense recognised based on amortised cost, and all other current value changes recognised in other comprehensive income
- Full retrospective approach to transition if practicable and with a modified retrospective approach otherwise.

Next steps

Comments in relation to the revised ED closed on 25 October 2013.

The IASB is planning to discuss comments received during the fourth quarter of 2013. No date has yet been set for a final standard.

For more information please refer to the BDO *IFR Bulletin* publication, *2013/19 Insurance Contracts*, available for download from the below link:

http://www.bdointernational.com/Services/Audit/IFRS/IFR-Bulletins-2011/IFRB%202013/IFRB-2013-19.pdf

www.bdointernational.com

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