

IFRS news

Emerging issues and practical guidance*

Issue 74 – May 2009



Board accelerates timetable for IAS 39 replacement

The IASB has accelerated its comprehensive project on the replacement of IAS 39 and expects to publish proposals within the next six months. This is in response to the call from the G20 “to take action by the end of 2009 to reduce the complexity of accounting standards for financial instruments”. Jessica Taurae considers what key issues need to be resolved in revising IAS 39 on this expedited basis.

The IASB and FASB reaffirmed their commitment at their meeting in March to a joint approach to the financial crisis and to the goal of seeking convergence between IFRS and US GAAP. The newly formed IASC Foundation Monitoring Board and the Trustees have stated their support for the IASB’s prioritisation of the project to produce a new financial instruments standard rather than making further amendments to existing requirements. The new standard will replace IAS 39 on an accelerated basis with a comprehensive standard that will address key issues arising from the financial crisis. The IASB plans to publish proposals within six months (see timetable below).

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Timetable	
April-June	<ul style="list-style-type: none">• Development of measurement methods, including consideration of the expected loss methodology, impairment, and effective interest rate for a cost based method
May-June	<ul style="list-style-type: none">• Development of categorisation approach• Development of presentation requirements
July	<ul style="list-style-type: none">• Decision regarding measurement methods and impairment for cost-based method• Decision regarding categorisation approach
August	<ul style="list-style-type: none">• Decision regarding initial measurement• Decision regarding fair value option and reclassification• Development of other aspects, including scope, derivatives and embedded derivatives, disclosures, transition and effective date
September-October	<ul style="list-style-type: none">• Development of application guidance• Finalisation of proposals for public comment• Consideration of the implications of the conclusions for other aspects of IAS 39, including hedge accounting

Tentative decisions so far

A number of key issues need to be resolved before an exposure draft can be issued, although the IASB has already made some tentative decisions:

- The project's primary objective is to provide information that improves 'decision usefulness'; the secondary objective is to reduce complexity.
- It will focus on classification and measurement of financial instruments, including impairment if necessary.
- The question of whether to require fair value through profit or loss for all financial instruments has been taken off the agenda. After listening to comments from previous consultations, the Boards accept that a full fair value model would not simplify accounting at a time when determining fair value has become so much more challenging.
- There will therefore be two measurement categories: one fair value through profit or loss and a second measurement basis – see below.

Second measurement basis

The Boards are considering two other measurement methods. The first is amortised cost, which is currently widely used for loans and receivables and many liabilities, and is generally well understood. This seems to be the preferred approach of many IASB board members.

The alternative method is a current value measurement method. This involves a discounted cash flow model that reflects current economic conditions but not such factors as liquidity risk and market imperfections. Investors may consider this model more 'decision useful', as it reflects current inputs in the measurement process. This seems to be the preferred approach of many FASB board members.

Impairment

An impairment model will need to be determined if amortised cost is chosen as the second measurement model. The Boards favour one model for impairment of all financial instruments. Possible models under consideration are the incurred loss model in current IAS 39, an expected loss model or fair value.

- **The incurred loss model** does not seem to be the preferred model; there are concerns that it overstates revenue prior to a loss event and that the timing of loss recognition is too late.
- **The expected loss model** received the most attention at the IASB meeting in April. Interest revenue is recognised on a basis that factors in expected credit losses from day one but does not give rise to a credit loss recognised in profit or loss on initial recognition of the financial asset.
- **The fair value model** might require accounting at fair value through profit or loss once there is a decline in fair value below amortised cost; or once there is evidence of impairment based on a notion of a credit loss, an impairment

loss should be recognised as the difference between carrying value and fair value; or if there is a decline in fair value below cost and management cannot assert its intent and ability to hold until recovery, an impairment should be recognised.

- **Other: dynamic or 'through the cycle' provisioning** has been raised. Some Board members see these as regulatory rather than accounting provisions and would not include them in financial reporting.

Classification

Once the Boards decide on the two measurement models, they will need to determine how to classify financial instruments into each category. They are considering a number of approaches, including classification based on the contractual nature of the instrument; classification based on the business purpose for which the instrument is held; classification as FVTPL for all instruments that are quoted in an active market; or a combination of the above. The IASB has been focusing on considering the contractual nature of the instrument. If it has highly variable cash flows (for example, derivatives and equities), the instrument should be classified at FVTPL. For those with non-highly variable cash flows, the IASB would overlay a business approach such that if management had the intention to trade the instrument, it should also be measured at FVTPL.

Other matters to be considered

- Is there any ability to move instruments between categories after initial recognition?
- Depending on how classification is determined, should there be a fair value option?
- If liabilities are measured at FVTPL, what to do about changes in fair value due to own credit?
- What should the measurement basis be on initial recognition?
- How should financial instruments be presented?
- What should be in the scope of the ED (for example, own use contracts, loan commitments, financial guarantees)?
- How does hedge accounting need to be amended?
- What should be done about embedded derivatives?
- What disclosures need to be made?
- What should the effective date be, and how should entities be required to transition to the new standard?

It is not surprising that the IASB staff has indicated that they will schedule additional meetings in August, as well as in between the usual monthly meetings (for example, the IASB discussed the current value measurement model on 5 May). The IASB will also reach out to other interested parties, including Basel Committee on Banking Supervision, securities regulators, the Financial Crisis Advisory Group, the Standards Advisory Council and the IASB's Financial Instruments Working Group.

The next six months will be the extremely challenging for the Boards as they try to reach decisions on these issues. Rely on *IFRS news* to keep you updated.

FASB and IASB act on fair value measurement

Jessica Taurae looks at actions taken by the FASB and IASB to address political concerns over fair value measurement in the economic crisis.

The IASB and FASB have issued discussion documents in the last few weeks that respond to politicians' concerns over fair value measurement.

Pressure from the US Congress resulted in the FASB publishing staff position papers (FSPs) on fair value and impairment of debt securities. The IASB then initiated a shortened 30-day consultation process on the FSPs, given the urgency of the issues and the desire of many constituents for consistency on matters relating to the financial crisis.

New FASB requirements

Estimating fair value after a decrease in market activity

FSP 157-4 clarifies the factors that should be considered in estimating fair value when there has been a significant decrease in market activity. The guidance does not change the objective of fair value: to determine the price that would be received to sell an asset or transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants under market conditions at the measurement date.

Other-than-temporary impairments of debt securities

FSP 115-2 establishes a new method of recognising and reporting other-than-temporary impairments of debt securities. Impairment is now considered to be other than temporary if an entity:

- intends to sell the security;
- is more likely than not to be required to sell the security before recovering its cost; or
- does not expect to recover the security's entire amortised cost basis (even if the entity does not intend to sell) – that is, a 'credit loss'.

This credit loss is based on the present value of cash flows expected to be collected from the debt security. If a credit loss exists but an entity does not intend to sell the impaired debt security and is more likely than not to be required to sell before recovery, the impairment is other than temporary. It should therefore be separated into:

- the estimated amount relating to the credit loss, and
- all other changes in fair value.

Only the estimated credit loss amount is recognised in profit or loss; the remaining change in fair value is recognised in 'other comprehensive income'. This approach more closely aligns the impairment models for debt securities and loans by reflecting only credit losses as impairment in profit and loss.

IASB proposals

The IASB has considered more than 70 responses received to its 'Request for Views' consultation on the FSPs, as well as comments from the Financial Crisis Advisory Group, Standards Advisory Council and other interested parties. The Board's conclusions are set out below.

Fair value measurement

The IASB agreed with respondents that the FASB guidance on fair value measurement was broadly consistent with existing guidance on IFRSs contained in the IASB's Expert Advisory Panel (EAP) report. The two documents have different emphases (the FSP focuses on indicators of inactive markets; the EAP requires management to consider all available information and to apply judgement) and a few subtle differences (for example, on transactions that are not orderly). However, this was not expected to result in differences in practice. Guidance from the FSP and the EAP will be included in the exposure draft on fair value measurement that the IASB is expecting to publish in May.

Impairment of debt securities

There are a number of significant differences between IFRS and US GAAP on impairment. The IASB will consider the accounting for all aspects of impairment of financial assets in the context of their broader project on financial instruments, rather than making limited short-term amendments at this time to 'level the playing field'. The IASB is working with the FASB on this comprehensive project; both Boards plan to issue an exposure draft within the next six months.

These decisions are consistent with the recommendations and timetable set out by the G20 in April for standard-setters "to take action by the end of 2009 to reduce the complexity of accounting standards for financial instruments" and to "improve accounting standards for provisioning and valuation uncertainty".

Timeline of FASB and IASB actions

12 March	17 March	19 March	1 April	2 April	9 April	20 April	22 April
FASB chairman Bob Herz meets with US Congress	FASB publishes proposed FSPs	IASB publishes 'Request for Views' on FSPs	Comments due on FASB FSPs	FASB discusses comments and agrees to finalise FSPs	Final FSPs published	Comments due on IASB 'Request for Views'	IASB decides not make any quick amendments as a result of FSPs



Beginners' guide: consolidation

What is on and, more importantly, off balance sheet has received a lot of attention during the credit crunch. Michael Stewart and Yulia Feygina, of PwC's Global Accounting Consulting Services' Central team look at how consolidation decisions are made.



Consolidation is the reporting in one set of financial statements the assets and liabilities of all the entities that the reporting entity controls. Consolidated financial statements are presented as if all of these controlled entities ('the group') are a single reporting entity. Why is this important? Analysts and other users want information that is useful in predicting an entity's future cash flows, and in particular, a good picture of the entity's obligations.

Future cash inflows arise from the reporting entity's ability to use economic resources (assets) to its advantage. Future cash outflows reflect its need to use cash to meet obligations (pay liabilities). Management should therefore consolidate the appropriate assets and liabilities to give a balanced view of the group. Consolidating more assets than the reporting entity has the ability to control, or excluding liabilities that the reporting entity is required to pay, would present a misleading picture. Users of the financial statements might draw the wrong conclusions about the group's likely future cash flows. Investors' views of a reporting entity's future cash flows have a direct impact on the entity's share price. Unexpected changes in the market's views of those cash flows will cause the share price to change and may lead to a loss of confidence in the reporting entity's management and its prospects for the future.

Accounting standards (IAS 27, 'Consolidated and separate financial statements', and SIC 12, 'Consolidation – special purpose entities') require consolidation of all entities controlled by the reporting entity. Control is defined as the power to govern financial and operating policies of the subject entity so as to obtain benefits from its activities.

Most consolidation decision are straightforward. Control is deemed to exist when a reporting entity, directly or indirectly, owns more than 50% of the subject entity's voting shares. This is because holding a majority of voting rights normally ensures sufficient representation on the subject entity's Board of Directors, or equivalent governing body, to convey the power to govern that entity's activities. Consolidation analysis seldom has to go further than this. A large multinational group might have hundreds or even thousands of wholly owned subsidiaries that are legal entities, and the consolidation decision may be very simple for all of them.

Ownership of a majority equity interest, however, is not always representative of the ability to govern a subject entity. Key operating and financial decisions may require more votes than a simple majority, or Board representation may not be

proportionate to the equity interest held. A closer analysis of the governance of the subject entity may be needed. This requires a thorough understanding of what key decisions need to be taken in the normal course of business, how these decisions are made and the extent of the reporting entity's involvement in making these decisions. It is the power to unilaterally govern the subject entity that drives a conclusion whether the reporting entity controls.

Complications may arise, however, when the subject entity is a special purpose entity (SPE). An SPE is an entity established to accomplish a narrow, well-defined objective – for example, to effect a lease or a securitisation transaction.

A cautionary tale – Enron

Blue-chip company Enron¹ was ranked seventh on the Fortune 500 list. It had a stock market capitalisation in excess of \$80 billion in early 2001. The company grew rapidly by making significant investments, financed largely by debt. These investments and the related debt were often held in unconsolidated special purpose entities (SPEs²). These had been created to preserve Enron's credit rating by keeping debt off its consolidated balance sheet. A good credit rating will result in lower borrowing costs and more availability of credit. Enron provided credit enhancements to the SPEs. These credit enhancements typically required Enron to top up collateral with cash if Enron's share price fell below a specified level or if Enron's credit rating was downgraded below investment grade.

These credit enhancement obligations made Enron vulnerable to a drop in its share price or a downgrade in its credit rating, as they would trigger an obligation to pay cash. The cash top-up obligations related to the credit enhancements were triggered when declining energy prices in 2001 adversely affected Enron's operating results. Its share price fell sharply within a short period of time. Enron had to scramble to find cash to satisfy the collateral demands. Investors and counterparties lost confidence

in Enron, which had an adverse effect on the company's ability to raise cash precisely when its need for cash became acute. Enron filed for bankruptcy on 2 December 2001. Its collapse has had profound implications for the accounting profession worldwide and remains one of the largest business failures in history.

It is impossible to judge the extent of the role played by off balance sheet liabilities in Enron's demise. However, market sentiment was badly affected by the liabilities, which seemed suddenly to appear from thin air.

¹ Enron was a US-listed corporation reporting under US GAAP, not IFRS. However, the concerns over the consolidation or non-consolidation of special purpose entities equally apply under IFRS as under US GAAP.

² Also referred to as special investment vehicles, structured investment vehicles (SIVs) and special purpose vehicles (SPVs).

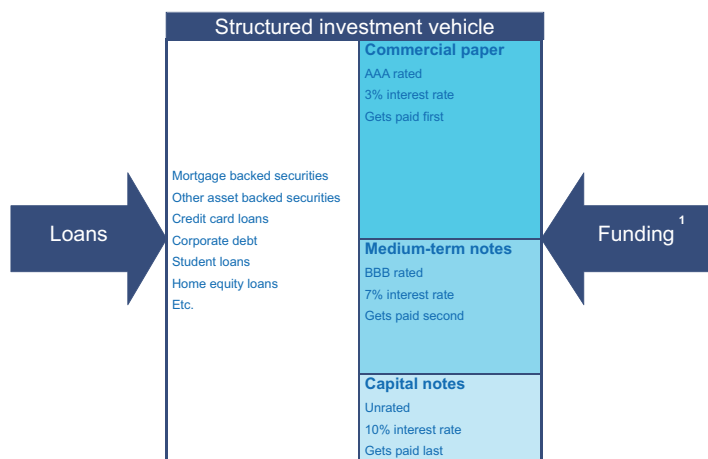
SPE. It is the substance of the relationship with an SPE that drives the consolidation decision.

Assessing control over an SPE needs to be updated. Changes in the reporting entity's involvement with the SPE, in the SPE's governing rules, in its capital structure or in contractual arrangements may indicate that the substance of the relationship has changed and thus change the consolidation decision.

Credit crunch

Banks establish structured investment vehicles (SIVs) in the normal course of business. An SIV is a type of SPE established to invest in diversified portfolios of interest-earning assets, usually asset-backed securities (mortgages, for example) and other debt instruments. SIVs are typically funded through the issue of commercial paper, medium-term notes or other senior debt (collectively referred to as 'senior debt'), as well as via subordinated notes (commonly referred to as 'capital notes'). This level of subordination determines the order in which investors receive cash flows from the SIV.

See the typical SIV funding structure below.



¹ Using three classes of funding enables the SIV to raise finance at a better weighted average interest rate

The bank typically provides only limited liquidity support to the senior debt investors through liquidity facilities. It would not have consolidated the SIV. Liquidity in SIVs is primarily managed by refinancing debt at maturity or, if that is not possible, by selling assets to provide protection to senior debt holders.

This worked well until mid-August 2007, when markets started experiencing severe liquidity disruptions, driven by valuation concerns over securities linked to US sub-prime mortgage loans. This resulted in funding difficulties for many SIVs. It soon became clear that the liquidity constraints were not temporary. Some sponsoring banks provided additional funding to the SIVs and sometimes initiated restructuring of the affected entities. This allowed third-party investors to exchange their capital notes in the existing structures for notes issued by the restructured SIVs, with liquidity provided by the bank. The support provided by the banks indicated that the substance of their relationship with the SIVs changed such that the banks were required to consolidate the SIVs from that point onwards.

Consolidation helps provide information about the assets that a reporting entity has access to and the obligations it must pay. This allows a user of the financial statements to consider the implications for the reporting entity's future cash flows. What happens when the current involvement of the reporting entity, and hence its risk exposure, of a reporting entity is limited so that consolidation is not required? A change occurs in the degree of involvement between the reporting entity and the SPE. Suddenly, the reporting entity has potentially undetermined additional exposures. This became an acute concern as the credit crisis unfolded and SPEs' sponsoring banks stepped in, in some circumstances, to provide liquidity to support the vehicles they had created.

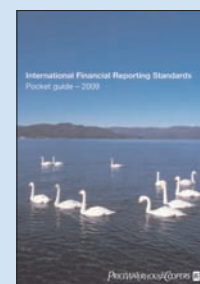
Concerns were expressed about consolidation decisions, particularly for SPEs, and about the perceived inadequate disclosures for non-consolidated SPEs. The Financial Stability Forum called on the IASB to accelerate work on a new consolidation standard. ED 10, 'Consolidated financial statements', was published in December 2008. The exposure draft retains the principle of control and the prime driver of consolidation decisions but will incorporate additional guidance for more challenging decisions. The exposure draft also proposes additional qualitative and quantitative disclosures of the entity's involvement with unconsolidated SPEs. It is expected to be issued as an IFRS in December 2009 and become mandatory in 2010. Entities should start thinking about the SPEs they are involved with and their related exposures now. Many observers felt that ED 10 will not bring fundamental change in consolidation decisions, but the final standard will need careful analysis.

IFRS pocket guide updated for 2009

PwC's *IFRS pocket guide – 2009* is a quick-reference guide that provides definitions of terms and recognition and measurement requirements of IFRSs issued up to April 2009. Its high-level coverage is intended for a variety of audiences, including finance directors,

financial controllers and other members of the finance team, as well as broader management, actuaries, lawyers, merchant bankers and analysts.

Visit www.pwc.com/ifrs to order a copy.





Memoires of a founding IASB member

Mary Barth has been a member of the IASB since its inception in 2001. Her term ends next month. She talks to *IFRS news* about the highs and lows.

What were your main areas of focus during your time at the Board?

I joined the Board right back when it first started in 2001. Since then I've worked on a variety of technical projects, like all members. I also became the unofficial editor of some of the Board's texts and was consulted on editorial detail. My background in academia I guess gave me the reputation for caring about this sort of thing.

Board members also act as 'Board advisers' as a resource for the staff. The staff can call on us to work through issues. For example, I consulted on the conceptual framework, revenue recognition, IAS 37 and fair value measurement, among other areas. Again, because I'm an academic, I often found myself involved in projects that were more about conceptual thinking. That suited me just fine; that's the way I think about things.

But I have a number of other roles outside the Board, which were pretty complementary to my role as board member – the various roles are somewhat inseparable. I engaged the accounting academics by doing presentations on research, kept them up to date on developments, helped them figure out how to do research that would help the Board, and advised on how to teach IFRS.

None of these roles is a part-time job – it's more like having several full-time jobs. But there's a nice synergy, which makes it workable.

What changes have you seen in standard-setting during this time?

We have matured as an organisation and figured out how to operate, although there's still more to learn. It has been fun to watch. At the start, few countries and companies were using our standards, and then Europe came on board and others started to follow. We didn't expect this would happen. We all had a vision, which is why we wanted to be part of it and put our energies into it, but I don't think any of us would have predicted we'd get to where we are today. We never thought the US would even consider adopting IFRS. We dreamed that within, say, 10 years of the Board's inception, the SEC would have removed reconciliation requirement; and when it happened [last year], it was a big milestone. But this potential for the US to adopt IFRS has come as quite a surprise.

It is great what has happened. I don't attribute it to the IASB's success – we can't force anyone to adopt IFRS – but it has happened on our watch, we helped facilitate it. From that point of view, it's great because we believe in what we're doing: making financial reporting better around the world. Having said that, being in the limelight is also being in the firing line!

In terms of the way the process has evolved in these eight years, we have become more efficient and effective – the introduction of the board adviser concept mentioned above is one example of how we have improved.

What should the Board's priorities be?

I believe our main priority – to work to improve the standards – is right. But as for which projects are priorities, the Memorandum of Understanding is important because it helps us to improve the standards, which in turn promotes convergence and gets us closer to our ultimate vision that we all use the same standards. The US is the last major capital market that hasn't adopted IFRS (besides Japan, which also is planning to adopt IFRS soon), so we hope the MoU will help promote convergence.

How is the US convergence project going?

Fine! The MoU targets and timeframe are pretty aggressive, and the FASB is helping us meet those targets. That is within our control. However, the SEC decision to adopt IFRS is not within our control; we can only do our best to write high-quality standards and move things along. I'm an eternal optimist and a globalist, and I don't think the US has any choice but to mandate IFRS – it's a question of 'when' not 'if'.

There is no reason to have different standards around the world. The rest of world has worked this out. When we started, people saw US GAAP as the international standards by default. But as more territories took on IFRS, this changed. I believe there may be more entities as a percentage of market capitalisation using IFRS than US GAAP. This is powerful.

Who will take over from Sir David Tweedie?

I wish I knew! He has two more years left as chairman. But the qualities needed are more than technical accounting. The chairman needs to be able to manage an organisation and the whims of the various constituents and politicians. It takes a

diplomat, someone who is even-handed and has a thick skin. You have to know how to take the criticism but also when to defend your position.

Will the absence of women change the dynamic of the board?

It is hard to tell. The new board members have not been announced yet, and I'm hopeful there won't be an absence of women. It's important to have women on board because female accountants (and all women) need role models and to see other women in these positions.

What will be the best memory you take away with you from your time at the Board?

One event in particular that I will never forget is when the SEC decided to remove the reconciliation requirement. We stopped the board meeting that was going on at the time and put the video screen up. We all watched the live webcast of the SEC meeting, and everyone was stunned. We had been working towards it so for long, and yet when it happened, we couldn't believe it. It was a shared moment where we saw the tangible evidence of progress being made.

Being on the Board has been an unbelievable experience. On a professional level, it has been very interesting, challenging, thoroughly enjoyable. But mostly I have enjoyed the people I have interacted with. The Board is made up of very special individuals, and we spend a lot of time together. And beyond that are our constituents around the world. Continuing in academia fortunately means I will see some of these people again.

What are your plans for the future?

I will now focus on being of professor of accounting at Stanford. I will not disappear from the standard-setting scene. I want to continue to support the Board and its mission. I'll be talking at the IASCF conferences and about teaching and research. I won't miss the air travel though!

What one piece of advice would you give to a new board member?

That the number-one job of the Board is to improve the standards. Any new member needs to focus on that, on getting the principles right, and should try not to get frustrated or distracted by the slings and arrows from outside. It takes time and energy to deal with these onslaughts, but you have to keep your eye on the ball and have the courage of your convictions. Remember, it's not personal. Find it interesting and don't panic.

Professor Mary Barth

- **January 2001–June 2009:** part-time IASB member.
- **1995 to date:** Joan E Horngren Professor of Accounting and Senior Associate Dean for Academic Affairs at the Stanford University Graduate School of Business. Research focuses on financial accounting and reporting issues, particularly those relating to global capital markets and of interest to accounting standard-setters.
- **1995 to date:** member of the editorial boards of several other academic journals in Australia, China, New Zealand, the UK and the US.
- **1999-2001:** member of the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants.
- **1998-2001:** member of Financial Instruments Task Force of the FASB.
- **1996-2001:** associate editor of *The Accounting Review*.
- **1996-2000:** member of the Financial Accounting Standards Advisory Council of the FASB.
- **1992-2000:** chair of several AAA committees.
- **1995-1997:** vice-president of the American Accounting Association.
- **1989-1995:** associate professor at Harvard Business School.
- **1974-1985:** Arthur Andersen & Co. Last position held: audit partner.

Professor Barth is also a Certified Public Accountant and holds an AB from Cornell University, an MBA from Boston University, a PhD from Stanford University, and an honorary doctorate, DSc(HC), from Lancaster University.

PricewaterhouseCoopers updates online IFRS training

P2P IFRS – from principle to practice, PwC's comprehensive electronic learning tool, has been updated to reflect the standards issued up to April 2009. P2P IFRS helps improve technical understanding of IFRS through 20 hours of learning, in 40 modules.

Its highly interactive design enables executives, reporting teams and accounting professionals to explore at the touch of a button the key aspects of the standards in a business context. To find out more, visit www.pwc.com/ifrs.



Cannon Street Press

Board amends 12 standards

The 2009 Annual Improvements have been published by the IASB in April.

There are three amendments to IAS 39 out of five considered by the Board. The other two were postponed, as the Board will

reconsider these as part of the new financial instruments standard. The amendments are effective for annual periods beginning on or after 1 January 2010. Early adoption is permitted. They are subject to EU endorsement.

2009 annual improvements		
Standard	Subject of amendment	Effective for annual periods beginning
IFRS 2, 'Share-based payment'	Clarifies that IFRS 3 does not apply to business combinations under common control or the contribution of a business on formation of a joint venture.	1 July 2009
IFRS 5, 'Non-current assets held for sale and discontinued operations'	Clarifies the disclosures required for non-current assets or disposal groups class as held for sale or discontinued operations	1 January 2010
IFRS 8, 'Operating segments'	Clarifies that disclosure of segment assets is only required if such amounts are regularly provided to chief operating decision-maker.	1 January 2010
IAS 1, 'Presentation of financial statements'	Clarifies that the ability of the holder of convertible debt to force conversion does not automatically make convertible debt current.	1 January 2010
IAS 7, 'Statement of cash flows'	Only expenditure that results in a recognised asset can be classified as investing activities in the statement of cash flows.	1 January 2010
IAS 17, 'Leases'	A lease that includes both land and buildings can be separated into two elements and each classified as appropriate.	1 January 2010
IAS 18, 'Revenue'	Additional guidance on whether an entity is acting as principal or agent,	None – amendment to non-mandatory guidance
IAS 36, 'Impairment of assets'	Clarifies that goodwill must be tested at the operating segment level before aggregation.	1 January 2010
IAS 38, 'Intangible assets'	Now includes specific references to the more commonly used methods of valuing intangible assets: market comparisons, discounted cash flow (including the relief from royalty method) and the replacement cost approach.	1 July 2009
IAS 39, 'Financial instruments: Recognition and measurement'	Three separate changes: scope exemption for BC contracts was narrowed; the effective portion of gains and losses on cash flow hedging instrument should be recycled to profit or loss when the expected forecasted cash flows affect the income statement; an embedded pre-payment option in a host debt instrument should not be separately recognised as an embedded derivative where repayment penalties are designed to reimburse a lender for lost interest over the remaining term of the host contract.	1 January 2010
IFRIC 9, 'Reassessment of embedded derivatives'	Clarifies that IFRIC 9 does not apply to business combinations, common control transactions or formation of joint ventures.	1 July 2009
IFRIC 16, 'Hedges of a net investment in a foreign operation'	Eliminates restrictions on what entity can hold the hedging instruments.	1 July 2009



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Emerging issues and practical guidance*

Supplement – May 2009

The future of lease accounting

This supplement follows on from the article in last month's *IFRS news* on the lease accounting discussion paper. Marian Lovelace looks in more detail at the proposals announced in March and their implications for businesses.

The basic lease accounting model under IFRS has not changed since the adoption of IAS 17, 'Leases', in 1982. It has been the subject of significant criticism from some quarters for almost as long.

Concerns regarding the off-balance-sheet nature of operating leases, the different treatment of similar transactions and the 'all or nothing' approach to lease accounting led many to criticise the model. This culminated in the 1999/2000 G4+1 white paper, 'Leases: implementation of a new approach'. It proposed a 'property right' perspective, where all leases are recognised on balance sheet, not just finance leases.

A joint FASB/IASB project to address lease accounting was added to the Boards' agendas in 2006. It built on the work contained in the G4+1 report and resulted in the discussion paper, 'Leases: preliminary views', issued in March 2009.

Scope

The DP focuses on lease arrangements within the scope of IAS 17 and FAS 13, 'Accounting for leases'. This includes arrangements that are leases in form but are acquisitions of the leased assets in substance.

IAS 17 applies to arrangements that convey the right to use an asset. FAS 13 applies to arrangements that convey the right to use property, plant and equipment. The scope of IAS 17 is broader than that of FAS 13, because it includes leases of some intangible assets. Property that meets the definition of investment property is within the scope of IAS 40 rather than IAS 17. Under US GAAP, SFAS 13 applies to all leases of investment property. The differences in scope between IAS 17 and FAS 13 are expected to be reconciled before the Boards release a final standard.

The DP also incorporates leases contained within other arrangements (for example, service or supply contracts), as determined by IFRIC 4, 'Determining whether an arrangement contains a lease', and EITF 01-8, 'Determining whether an arrangement contains a lease'. Under the proposal, the leases embedded in these arrangements would be recorded on the lessee's balance sheet at an amount that contemplates expected contingent rentals as well as non-contingent rent payments. Determining the 'rents' in these arrangements can be difficult, as it entails allocating consideration between the service or supply portion and the embedded lease.

At a glance

The proposals:

- Eliminate operating lease accounting.
- Result in all leases, including those in effect when the new standard is issued, giving rise to assets and liabilities for the lessee, similar to capital leases today.
- Require lessees to reassess the lease term, contingent rentals, residual value guarantees and the corresponding lease obligation at each reporting date.
- Are expected to have the greatest impact on lessees of significant amounts of 'big-ticket' items, such as real estate, aircraft and ships. However, they would affect virtually every company, including those that lease cars, computer equipment, copiers, office furniture and telecommunications equipment.

A final standard is expected in 2011. Companies should understand the potential impact now, given the long-term nature of some leases.

PwC insight

The embedded leases within these arrangements are usually accounted for as operating leases under current guidance because the rents to be paid are contingent. Many entities have not previously had to determine the portion of the total contract consideration to allocate to 'minimum lease payments'.

The DP is silent on whether to exclude short-term leases and leases of non-core assets from the scope of the new standard. Board members commented during discussions that many short-term leases and leases of non-core assets may give rise to material assets and liabilities and, therefore, may fail to meet the needs of users.

PwC insight

IAS 17 and FAS 13 include scope exclusions. For example, leases to explore for or use natural resources are excluded from the scope of both standards. The Boards will decide whether to incorporate existing scope exemptions into the new standard before publishing an exposure draft.

The proposed lease standard will apply only to material items. However, the DP does not address high-volume, 'low-value' leases. For example, the lease of one computer may not be material, but the lease of 10,000 computers may be material in the aggregate.

Right-of-use approach

The right-of-use approach that the DP takes requires the lessee to recognise an asset for its right to use the leased item for the lease term (the right-of-use asset) and a corresponding liability for its obligation to pay rentals. This approach applies the same accounting to all lease contracts, so lessees would account for all leases in a manner similar to that used for capital leases today. The current operating lease classification would be eliminated.

The Boards believe the right-of-use approach for lessee accounting is the most consistent with the Conceptual Framework and increases the transparency of lease accounting. Leases are commonly viewed as a form of financing; the obligations recognised on the balance sheet under the right-of-use approach would be consistent with how businesses reflect other financing arrangements.

PwC insight

The proposed model may result in changes in the way companies write leases in the future and may change 'lease versus buy' decisions. The long-term nature of many leases and the Boards' desire for comparability mean that it is unlikely that existing leases will be 'grandfathered'.

Management should consider the implications of these potential changes when long-term leases and contracts are negotiated, even if these arrangements are executed prior to the effective date of the new standard.

Initial measurement

The DP proposes that lessees initially measure the right to use the asset at cost. 'Cost' is defined as the present value of the lease payments discounted using the lessee's incremental borrowing rate. The Boards consider the incremental borrowing rate the simplest approach, as measuring the asset and liability at fair value, or using other rates, can be more difficult for the lessee.

Lease term

Optional periods under existing standards are considered part of the lease term if the lessee concludes at lease inception that it is 'reasonably certain' (IAS 17) or 'reasonably assured' (FAS 13) that the lessee will exercise the right to renew the lease for the optional periods. The DP proposes a 'most likely lease term' approach.

PwC insight

This change may lengthen the accounting lease term beyond that determined under existing standards, as options to renew or extend the term would not have to meet the 'reasonably assured' or 'reasonably certain' threshold currently required before they can be included.

The proposal provides guidance on factors to consider when determining the lease term, such as all contractual and non-contractual financial factors and non-financial business factors. The lessee's intentions and past practice would not be considered in determining the lease term.

Purchase options

Purchase options give the lessee the right to purchase the leased item on or after a specified date. The DP proposes the accounting for purchase options to be similar to the accounting for options to extend a lease. In particular:

- Purchase options are not recognised as separate assets.
- The lessee considers all contractual and non-contractual financial factors, as well as non-financial business factors, when deciding the most likely outcome.
- The obligation to pay rentals includes the exercise price of the option if the most likely outcome is that the option to purchase is exercised.

Contingent rentals

Current practice generally recognises contingent rentals as expenses in the period incurred. The DP proposes a model to reflect the obligation to pay contingent rentals in the initial measurement of the obligation.

PwC insight

The DP proposes that the asset and liability recognised should reflect contingent rental payments. However, some Board members believe the recognition of contingent rent should depend on the nature of the contingency. That is, if the nature of the contingency is dependent on an index, the contingency should be reflected in the asset and liability recognised. If the nature of the contingency is dependent on usage or performance (for example, sales volume), the obligation should exclude the contingent element.

Residual value guarantees

The maximum amount payable under a residual value guarantee is included in the minimum lease payments for purposes of determining the lease classification under existing guidance. A payment under a residual value guarantee is not accrued before payment becomes probable for an operating lease.

The DP proposes that the lessee's obligation to pay rentals should include payments to be made under a residual value guarantee; the Boards tentatively decided that the measurement of residual value guarantees should be consistent with the decisions made on contingent rentals.

Subsequent measurement

The Boards agreed on an amortised cost-based approach to determining the subsequent measurement of the right-of-use asset and of the obligation to pay rentals; they believe it will be the simplest method for preparers to apply.

Changes in estimates and remeasurements

The Boards considered how to deal with subsequent changes in (1) the lease term, including changes in the likelihood of the exercise of a purchase option, and (2) the estimated payments to be made for contingent rentals and residual value guarantees. The DP proposes that lessees would be required to reassess these estimates each reporting period, including consideration of new facts or circumstances, and reflect those changes in the measurement of the lease obligation.

PwC insight

The proposal to reassess these estimates at each reporting date requires significant incremental effort compared to the current model.

The DP proposes a 'catch-up' approach to reflecting changes in estimates in the lessee's obligation to pay rentals. The carrying amount of the obligation is adjusted to the present value of the revised estimated cash flows, consistent with the conclusions of the Boards on measurement of certain other financial liabilities.

The following table summarises the different IASB and FASB views set forth in the DP for changes in certain estimates after lease inception.

Change in estimate	IASB view	FASB view
Lease term (options to extend and purchase options)	Update the obligation using the catch-up approach, with a corresponding adjustment made to the right-of-use asset	
Cash flows (contingent rentals and residual value guarantees)	Update the obligation using the catch-up approach, with a corresponding adjustment made to the right-of-use asset	Update the obligation using the catch-up approach, with the adjustment taken to earnings
Discount rate	Remeasure the obligation using a discount rate equal to the current incremental borrowing rate (perhaps only if there is a change in the estimated cash flows)	Always use the original incremental borrowing rate as the discount rate

Presentation

The right-of-use asset should be presented in the statement of financial position on the basis of the nature of the leased item, but should be presented separately from owned assets. The Boards differ in their views about the presentation of the obligation to pay rentals. The FASB suggests that the liability be presented separately from other financial liabilities; the IASB does not agree.

The presentation of the right-of-use asset within the statement of financial position would most likely drive the related income statement presentation. The reduction to the carrying value of a right-of-use asset presented in property, plant and equipment would be presented as depreciation in the income statement. The reduction related to an intangible asset would be presented as amortisation expense.

The DP discusses possible approaches but does not provide a preliminary view on other income statement and cash flow presentation matters.

PwC insight

The right-of-use model would significantly change financial statement presentation and impact financial metrics, including many metrics used in debt covenants and compensation arrangements. For example, compared to a lease classified as an operating lease under current accounting:

- Balance sheets will include both the right-of-use asset and the lease obligation.
- The expense recognition pattern will change. Expense will be higher than straight-line expense during the early part of the lease term and lower during the latter part of the lease term. The asset will typically be amortised using the straight-line method, but the obligation will be accounted for using an effective yield model. As with any amortising loan, the interest expense will be higher during the early part of the lease term.
- EBITDA is likely to increase, as rent expense will be replaced with interest and amortisation expense, which are below-the-line charges.

Other lessee issues

The Boards have not yet discussed a number of issues in sufficient detail to form a preliminary view. The following are not addressed in the DP:

- Timing of initial recognition.
- Sale and leaseback transactions.
- Treatment of initial direct costs.
- Leases that include service arrangements.
- Disclosure.

PwC insight

The Boards have not yet reached preliminary views on these issues, but respondents may wish to comment on them in their response letters. For example, the Boards are considering treating all sale-and-leaseback transactions as either financings, sales or a hybrid of the financing and sales approach. This would have a significant impact on entities that utilise sale-and-leaseback transactions as a means of off-balance-sheet financing, or frequently enter into such transactions. The DP does not touch on all lessee accounting issues. Among those not mentioned are (1) accounting for lease incentives, (2) accounting for lease modifications, and (3) accounting for acquisitions of leased property during the lease term at an amount not contemplated in the recognised obligation.

Lessor accounting

The Boards have tentatively decided to defer consideration of lessor accounting for the purposes of this DP. Among the reasons given by the Boards for doing so are (1) lessor accounting issues are being addressed in numerous ongoing IASB/FASB projects, such as de-recognition and revenue recognition, and (2) consideration of lessor accounting at the same time as lessee accounting would delay the release of a new standard for lessees, which affects a larger population.

The DP does include a high-level overview of potential lessor considerations without expressing any preliminary views on lessor accounting. However, it describes two methods in which a right-of-use approach could be applied to lessors:

- The lessor would be considered to have transferred all or a portion of the leased item for the right to receive payments over the lease term. The lessor retains the right to the leased asset at the end of the lease term. The lessor derecognises the leased item in its balance sheet and recognises a receivable and a residual value asset.
- The leased item continues to be treated as an economic resource of the lessor. The lessor grants the lessee the right to use its economic resource. The asset remains in the lessor's statement of financial position. The lessor also recognises a lease receivable and corresponding performance obligation.

The DP also considers three ways of addressing subleases:

- Provide additional guidance on how to apply the existing lessor accounting standards to subleases.
- Exclude the head lease from the scope of the new standard.
- Develop a lessor right-of-use model for subleases only.

Timing

Comments are due on the 29 questions in the DP by 17 July 2009. The Boards expect to release an exposure draft in 2010 and a final standard in 2011.

PwC insight

Companies should consider the implications of the DP on their businesses and consider submitting a response letter because of the significant and pervasive nature of the changes proposed.

