

Accounting Alert

Staying on top of developments



In this issue:

- Major overhaul proposed for ...
 - ... lease accounting
 - ... revenue recognition
 - ... insurance contracts
- Possible relief for entities affected by the Budget 2010 removal of tax depreciation on buildings
- Other topics of interest

This Accounting Alert provides you with information about a number of recent developments in financial reporting, including exposure drafts issued by the IASB and FRSB. We note that the IASB is forging ahead with its significant reform of several standards, with exposure drafts issued over the last month in relation to three of its key projects – leases, revenue and insurance. These exposure drafts involve new ways of thinking about the accounting for these items and may result in significant changes in the financial reporting by many entities. We urge you to work through the implications that these exposure drafts may have on your entity and consider whether you want to submit on the proposals. Entities will also need to consider the potential impacts on structuring of contracts, performance metrics used, debt covenants, accounting policies and changes to systems.

We will continue to keep you apprised of developments as they occur, so watch this space...

Major overhaul proposed for lease accounting

The International Accounting Standards Board's (IASB) long anticipated exposure draft on lease accounting signifies a major change in accounting for lease commitments. The most discussed proposal is the requirement for lessees to book assets and liabilities for leases formally classified as operating leases, with off-balance sheet treatment no longer permitted. The asset booked would represent the lessee's right to use the leased asset for the lease term, with a liability recorded to make lease payments.

With the top 200 companies in New Zealand¹ disclosing off balance sheet lease commitments totalling more than \$10 billion in their most recently published financial statements (where publicly available), this represents a significant change for many entities.

Lessees

Lessees will record a right-to-use asset at the present value of lease payments plus initial direct costs, with a corresponding liability to make lease payments using the lessee's incremental borrowing rate as the discount rate (or if readily determined, the rate the lessor charges the lessee). In determining the present value of lease payments, entities will need to do a probability-weighted average of the cash flows for the possible outcomes including an estimate for contingent rentals, residual value guarantees and expected payments to the lessor under term option penalties. Purchase options are not included.

The right-to-use asset will be amortised over the lease term. In determining the lease term, a lessee "*estimates the probability of occurrence for each possible lease term, taking into account the effect of any options to extend or terminate the lease*". This requires determining the "*longest possible lease term that is more likely than not*" as demonstrated in the following example:

¹The top 200 companies (by revenue) as identified by the Deloitte/Management survey, reported in the December 2009 Management magazine.

Example: Lease term

An entity has a lease with a non-cancellable 8 year term, an option to renew for 4 years at the end of that period, and a subsequent option to renew for a further 4 years at the end of year 12. The entity determines the probability for each term as follows:

8 year term	35%
12 year term	40%
16 year term	25%

The longest possible lease term that is more likely than not is 12 years as there is a 65% probability that the term will be 12 years or more but only a 25% chance that the term will be 16 years.

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As a result of the new approach there will also be an impact on profit or loss as entities will be required to record an interest expense as the liability unwinds, and amortisation of the right-of-use asset. In addition a lessee may also need to record:

- revaluation gains and losses as required by IAS 38: *Intangible Assets* when a right-of-use asset is revalued,
- any changes in the liability to make lease payments resulting from reassessment of the expected amount of contingent rentals or expected payments under term option penalties and residual value guarantees, and
- any impairment losses on a right-of-use asset.

The timing of the impact on profit or loss will likely differ from the current straight line recognition of an operating lease expense due to the interest unwind on the liability on an effective interest basis.

Lessors

Lessors will also be affected by the ED with a hybrid model proposed:

- A derecognition approach is applied where a lease does not expose the lessor to the significant risks and benefits associated with the underlying asset during the expected term of the current lease contract or subsequent to that term, by having the expectation or ability to generate significant returns by leasing that asset multiple times subsequent to the current contract, or by selling the underlying asset.
- A performance obligation approach is used for leases that expose the lessor to significant risks and benefits associated with the underlying asset.

The standard includes further guidance to assist in making this distinction such as assessing the significance of contingent rentals, availability of options to extend or terminate the lease, the existence of non-distinct services, the length of the lease term and the residual value risk.

	Derecognition approach	Performance obligation approach
Recognition	<p>The lessor:</p> <ul style="list-style-type: none"> recognises a right to receive lease payments, derecognises the portion of the carrying amount of the asset that represents the lessee's right to use the underlying asset during the lease term, and reclassifies the remaining asset portion as a residual asset representing the rights retained. 	<p>The lessor recognises:</p> <ul style="list-style-type: none"> its right to receive rental payments as an asset, and its obligation to make the leased asset available to the lessee as a liability. <p>The underlying leased asset is not derecognised.</p>
Initial measurement	<p>Lease receivable – present value of expected lease payments discounted using the rate implicit in the lease and initial direct costs incurred.</p> <p>The residual asset is an allocation of the previous carrying amount of the underlying asset.</p>	<p>Initial measurement of the lease receivable and the performance obligation would be at the present value of the lease payments discounted using the interest rate implicit in the lease and any initial direct costs incurred.</p>
Subsequent measurement	<p>Asset – amortised cost using the effective interest method.</p> <p>Residual asset – is not remeasured or adjusted apart from impairment.</p>	<p>Asset - amortised cost using the effective interest method.</p> <p>Performance obligation – amortised in a systematic manner based on the pattern of use of the underlying asset by the lessee.</p>
Subsequent changes in the expected lease term	<p>Reassessment of the expected lease term is treated as a new event – the lessor would need to derecognise or reinstate a portion of its residual asset.</p>	<p>Adjusts the asset and liability to reflect the change in the right to receive lease payments arising from changes to the lease term.</p>
Subsequent changes in contingent rental arrangements, residual guarantees and term option penalties	<p>Recognised in profit or loss.</p>	<p>Adjustment to the original transaction price and allocated to the receivable and performance obligations. When allocated to a satisfied performance obligation, the change is recognised in revenue. If the performance obligation is not yet satisfied, its carrying amount is adjusted.</p>
Purchase options	<p>Accounted for only when exercised.</p>	<p>Accounted for only when exercised.</p>
Impairment	<p>Apply IAS 39 at each reporting date to determine if the right to receive lease payments is impaired – impairment loss recognised in profit or loss.</p> <p>Apply IAS 36 to the residual asset.</p>	<p>Apply IAS 39 at each reporting date to determine if the right to receive lease payments is impaired – impairment loss recognised in profit or loss.</p>
Impact on profit or loss	<p>The following items will affect profit or loss:</p> <ul style="list-style-type: none"> lease income representing the present value of the lease payments and lease expense representing the cost of the portion of the underlying asset that is derecognised at the date of commencement of the lease. This may be presented gross or net depending on the entity's business model, interest income on the right to receive lease payments, lease income and lease expense for any reassessment of the lease term, any changes in the right to receive lease payments resulting from reassessment of contingent rentals and expected payments under term option penalties and residual value guarantees, and any impairment losses on the right to receive lease payments or the residual asset. 	<p>The following items will affect profit or loss:</p> <ul style="list-style-type: none"> interest income on the right to receive lease payments, lease income as the lease liability is satisfied, any changes in the lease liability resulting from reassessment of contingent rentals and expected payments under term option penalties and residual value guarantees, and any impairment losses on the right to receive lease payments.

Again, the timing of the impact on profit or loss will likely differ from the current straight line recognition of operating lease revenue.

Other matters

There are simplified requirements where leases are for twelve months or less.

In addition to the change in methodology for accounting for leases, entities should note that:

- Robust accounting policies may need to be developed by lessees and lessors due to the extent of judgement that may be involved in determining the lease term and the amount of contingent rentals at lease inception.
- System modifications and enhancements may be necessary to track individual leases and to perform the calculations necessary to determine the lease term and contingent rentals (also allowing for subsequent reassessment).
- The new leasing model may affect existing debt covenants requiring early discussion with the bank to ensure that breaches do not occur.
- Performance metrics may need to be modified and analysts educated on the effect of the new leasing standard.
- The terms of new and existing lease contracts may need to be modified. The proposed transition requirements would not grandfather existing leases.

Comments are due to the Financial Reporting Standards Board (FRSB) by 1 December 2010 and to the IASB by 15 December 2010.

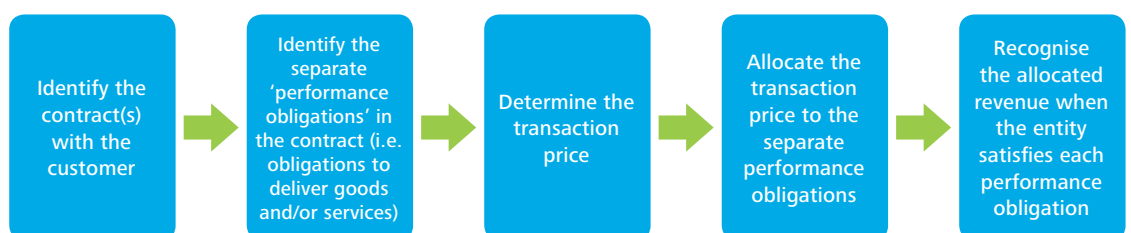
Further information can be found in Deloitte Global newsletter [IFRS in Focus: IASB issues exposure draft on lease accounting](#).

The [Exposure Draft](#) and [Basis for Conclusions](#) are available on the NZICA website.

Major overhaul proposed for revenue recognition

The IASB recently published Exposure Draft ED/2010/6: *Revenue from Contracts with Customers*. Similar to the existing revenue standard, the core principle requires an entity to recognise revenue when goods and/or services are transferred to the customer. However, entities should not assume that their current revenue recognition policy will be consistent with the proposed model due to differences in how the principle is applied.

In order to apply the proposed model, based on a contract with a customer, an entity would work through the following steps:



The ED outlines the requirements for each step, and includes over 30 illustrative examples to demonstrate how the principles are to be applied.

Some of the key areas of difference include the following:

- Under the ED, revenue relating to a performance obligation is only recognised once the customer controls the goods or service. Therefore, some entities applying a percentage of completion model may be required to recognise revenue at the later point of delivery to the customer. This may be the case where the customer does not obtain legal title or physical possession of any work in progress.
- Entities that provide warranties with goods sold will need to defer revenue for the warranty obligation instead of recognising revenue when the goods are sold with a corresponding warranty provision.
- Under current standards, a customer's credit risk affects whether revenue is recognised with revenue deferred when there are significant uncertainties over whether a customer will pay. The proposals would instead factor this into the calculation of revenue expected to be received, resulting in earlier recognition of revenue than under current standards – and at a different amount.
- As the current standard does not include guidance on how to unbundle multiple element contracts, some entities may find that components currently unbundled are not distinct goods and services as determined by the ED. This may affect the timing of revenue recognition.
- The ED proposes allocating revenue between performance obligations based on relative stand-alone selling prices. Where an entity has multiple performance obligations within a contract that are satisfied at different times, this may result in a different profile of revenue recognition. The allocation methodology may also lead to the recognition of an onerous performance obligation (effectively a “day 1 loss”) where “loss-leading” products are bundled with highly profitable products.
- Where intellectual property is licensed on an exclusive basis for less than its economic life revenue recognition may be required over the term of the licence rather than at inception.

Further information can be found in the following Deloitte newsletters, both available on www.iasplus.com:

- [IFRS in Focus: IASB issues revenue recognition exposure draft](#)
- [Accounting in the Telecommunications industry: A new view of revenue emerges](#)

Comments are due to the FRSB by 8 October 2010 and to the IASB by 22 October 2010.

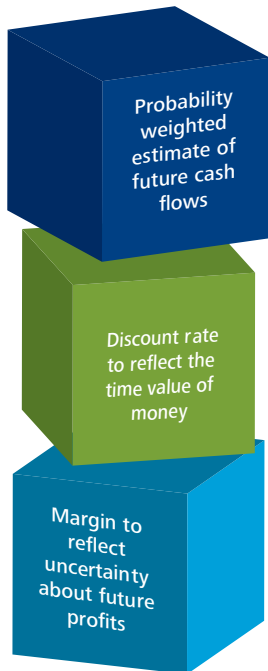
The [Exposure Draft](#) and [Basis for Conclusions](#) are available on the NZICA website.

Major overhaul proposed for insurance contracts

The IASB and US standard setter, the Financial Accounting Standards Board (FASB) have been collaborating on a comprehensive project on accounting for insurance contracts. This work has led to the IASB's release of ED/2010/8: *Insurance Contracts*. When finalised, the new standard will replace the current New Zealand and Australian standards on insurance for both life and general insurers and line up accounting practice for insurers around the world. Many of the key concepts will be familiar to New Zealand and Australian insurers.

Measurement

The ED requires insurance liabilities to be measured using a ‘building blocks’ accounting model based on a discounted probability-weighted estimate of future cash flows. The combination of rights and obligations arising from an insurance contract would be measured to portray the current entity-specific assessment of the future cash flows necessary to achieve the fulfilment of the contract and is therefore a current fulfilment value model rather than the market-based measure which was proposed in the IASB's earlier 2007 discussion paper. The building blocks include:



- the unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the contract,
- the effect of time value of money, and
- a margin separated into
 - a risk adjustment that measures that effects of uncertainty about the amount and timing of future cash flows, and
 - an amount that eliminates any accounting gain at inception of the contract which is subsequently released over the coverage period (the residual margin).

Any losses arising at inception would be immediately recognised in profit or loss and the contract is presented on a net basis (rather than a separate asset and liability component).

The exposure draft notes there are two approaches the Boards are considering in relation to the margin:

- a separate risk adjustment and residual margin as noted above and included in the ED (approach preferred by the IASB), or
- a single composite margin approach (preferred by the FASB).

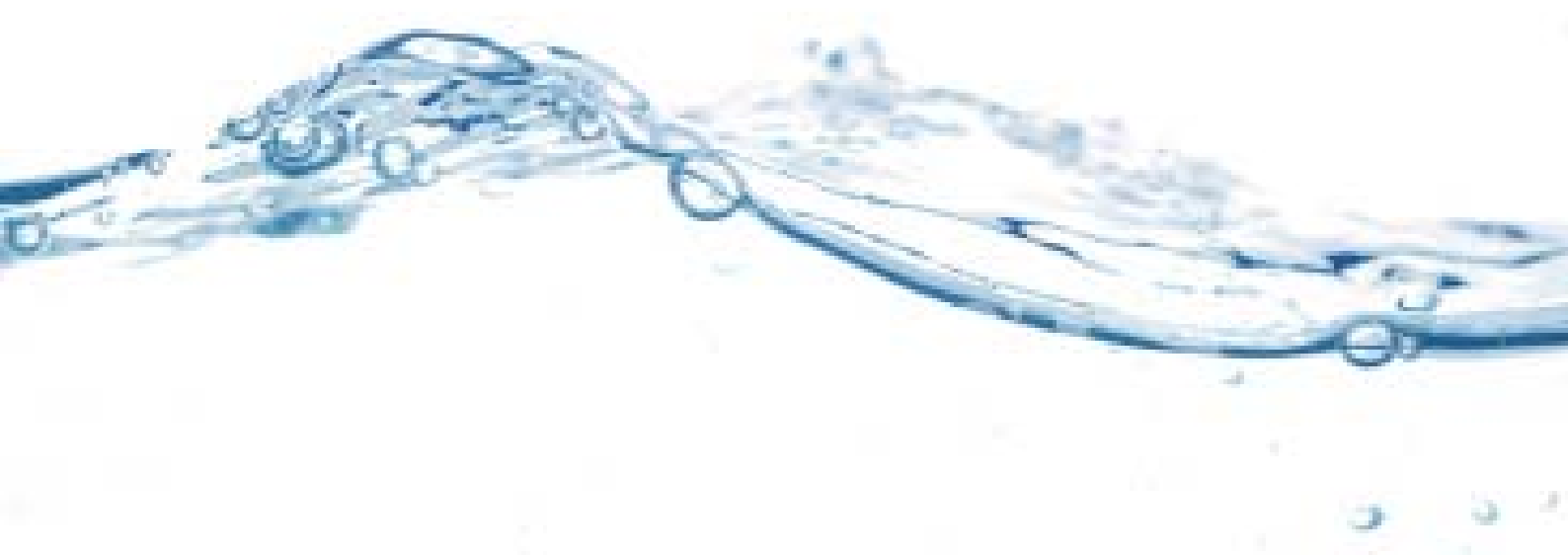
Accounting for the uncertainty inherent in the cash flows has been a contentious issue between the two boards and the two approaches may have a differing impact on the recognition of insurance profits. In the first approach, an explicit risk margin is added to the best estimate calculation of cash flows under the insurance contract. This adjustment measures explicitly at each reporting date the effects of uncertainty about the timing and amount of future cash flows and may change over time. The second approach defers the profit calculated under the contract at inception and then recognises it on a systematic basis over the life of the contract. With this method profit recognition is independent of whether the future cash flows are more or less uncertain than last year.

A modified version of the model is proposed to apply to most short duration insurance contracts. During the coverage period, the insurer would measure the contract using an allocation of the premium received. For insured events that have already occurred, the insurer would use the building block approach to measure claims liabilities.

The proposals in the ED would also apply to reinsurance contracts.

Acquisition costs

The cash flows would include the incremental acquisition costs, determined at the contract level, of selling, underwriting and initiating an insurance contract, but only for those contracts actually issued. All other acquisition costs (including non incremental acquisition costs) would be expensed as incurred.



Presentation and disclosure

All income and expense arising from insurance contracts will be recognised in the profit or loss. The proposed presentation aims to assist users of an insurer's financial statements understand important performance factors by highlighting:

- the underwriting margin (i.e. changes in the risk adjustment and release of the residual margin),
- experience adjustments (i.e. differences between actual cash flows and previous estimates) and changes in estimates (i.e. changes in current estimates of cash flows and discount rates), and
- interest on insurance contract liabilities (presented or disclosed in a way that highlights its relationship with the investment return on assets backing those liabilities).

Premiums would be treated as deposit receipts. Claims expenses, claims handling expenses, incremental acquisition costs and other expenses included in the measurement of the insurance contract would be treated in the same way as repayments of deposits.

Comments are due to the FRSB by 26 October 2010 and to the IASB by 30 November 2010.

Further information can be found in the following Deloitte newsletters:

- **IFRS in Focus: Insurance Contracts**
- **Insurance Accounting Newsletter: The start of a new accounting era.**

The **Exposure Draft** is available on the NZICA website.

Possible relief for entities affected by the Budget 2010 removal of tax depreciation on buildings

Our **special tax and accounting alert** issued in June 2010 outlined the impact on deferred tax from the 2010 Budget's removal of tax depreciation on buildings, with several entities subsequently reporting significant increases in their deferred tax liabilities.

The IASB has discussed a possible exception to the income taxes standard which may provide relief for some affected entities with an exposure draft titled *Deferred Taxes: Recovery of Underlying Assets* expected to be released in early September with a 60-day comment period.

The IASB has tentatively decided to introduce an exception to the measurement principle in paragraph 52 of IAS 12: *Income Taxes* which currently requires an entity to measure deferred tax assets and liabilities using the tax rate and tax base consistent with the expected manner of recovery or settlement (i.e. sale or use). The IASB meeting minutes from the August meeting note that the IASB tentatively decided that the exception would:

- a. apply when the expected manner of recovery of certain underlying assets is difficult and subjective to determine,
- b. apply when deferred tax assets or deferred tax liabilities arise from:
 - i. investment property that is measured at fair value in accordance with IAS 40: *Investment Property*, and
 - ii. property, plant and equipment or intangible assets that are measured using the revaluation model in IAS 16: *Property, Plant and Equipment* or IAS 38: *Intangible Assets*,
- c. be applied equally to both deferred tax assets and deferred tax liabilities,

- d. measure deferred taxes based on the tax consequences following the rebuttable presumption of recovery of the carrying amount of the underlying asset entirely by sale, and
- e. be required, rather than permitted, to be applied, unless an entity consumes the asset's economic benefits throughout its economic life.

The IASB also noted it will propose the withdrawal of SIC Interpretation 21: *Income Taxes - Recovery of Revalued Non-Depreciable Assets*.

The **IASB Update** for the August meeting is available on the IASB's website: www.ifrs.org.

Other topics of interest

Proposals to Harmonise Australian and New Zealand equivalents of International Financial Reporting Standards

The FRSB has issued ED 121: *Proposals to Harmonise Australian and New Zealand Standards in Relation to Entities Applying IFRSs as Adopted in Australia and New Zealand*. The ED proposes to eliminate many of the differences between the Australian and New Zealand versions of IFRS for for-profit entities. For example, the ED proposes to:

- remove the requirement to disclose donations made,
- reinstate the option to use either the direct or indirect method to present the Statement of Cash Flows,
- remove the requirement to disclose the reasons for presentation of receipts and payments as a net cash flow,
- remove the requirement to use an independent valuer where items are valued at fair value under NZ IAS 16: *Property, Plant and Equipment* or NZ IAS 40: *Investment Property*,
- remove the New Zealand specific disclosure requirements where the equity method of accounting is used (such as the amount of goodwill included in the equity accounted figure), and
- reinstate the cost option for accounting for investment property. It should be noted that this change would only have limited application to entities with existing investment property as the requirements of NZ IAS 8: *Accounting Policies, Changes in Accounting Estimates and Errors* still apply which only allow changes in accounting policies in limited circumstances. Entities that do not have existing investment property will be able to apply a cost model.

The FRSB has also issued ED 122: *Proposed Separate Disclosure Standards* (ED 122) which complements the proposals in ED 121. To make it easier to identify the New Zealand specific disclosures required by for-profit entities in adopting NZ IFRS, these have been relocated to one place.

Comments are due to the FRSB by 8 October 2010.

ED 121 and **ED 122** are available on the NZICA website.

Dealing with multiple assumptions in measurement uncertainty disclosures of fair value measurements

The IASB has issued ED/2010/7 *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements* which proposes that an entity should take into account the effect of correlation between observable inputs when estimating the effect on a fair value measure if there is a reasonably possible change in more than one input. This applies to financial instruments as well as other assets held at fair value, such as investment property.

The comment deadline to the FRSB closed on 13 August 2010, but comments can still be made to the IASB until 7 September 2010.

The **Exposure Draft** is available on the NZICA website.

Securities Commission – Review of Corporate Governance Disclosures by Selected Issuers

The Securities Commission has issued a report on the results of its review of corporate governance disclosures by a sample of issuers with balance dates from 30 June 2008 to 30 June 2009. The Commission reviewed the annual reports and website disclosures of 68 issuers against the Commission's nine principles for corporate governance.

The Commission noted that while some areas of disclosure provided relevant information, there are a number of areas where improvement can be made by issuers. These include:

- how directors observe and foster high ethical standards,
- how remuneration incentives align with the issuer's objectives and risk management policies,
- how risk management policies are applied to material risks faced,
- how the board builds constructive relationships with shareholders that encourage them to engage with the entity, and
- who the board considers its key stakeholders are and how it respects their interests.

The **Review of Corporate Governance Disclosures by Selected Issuers** is available on the Securities Commission's website at www.seccom.govt.nz.

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