September 2010 – Quarterly edition

iGAAP Newsletter
Beyond the standards

Published for our clients and staff in the UK

Contents

Upfront

As mentioned in our last quarterly newsletter, the International Accounting Standards Board (IASB) and their US counterparts the Financial Accounting Standards Board (FASB) have modified their strategy for the convergence of IFRSs and US GAAP. As part of this, three joint projects were identified as critical to the process and given priority.

Two of these projects have since borne fruit in the form of exposure drafts (EDs) in areas which are significant to the majority of companies – leasing and revenue from customers. As a result of the significance of these proposals and the number of companies likely to be impacted, this quarter's newsletter includes a topic of focus on each ED.

The third project identified as key, the replacement for IAS 39 on financial instruments, is ongoing with an ED on hedge accounting currently scheduled for publication by the end of 2010. Any significant output from this project will be covered in our next newsletter.

Our interviewee this quarter, Ian Mackintosh, is a member of the IFRS Advisory Council – a body with which the IASB consults regularly on matters including its technical agenda and project priorities. In his role as chairman of the Accounting Standards Board (ASB), Ian is also central to the current debate over the future of corporate reporting in the UK.

Deloitte LLP
September 2010

Topic of focus: Revenue from contracts with customers

Deloitte in the UK has issued an iGAAP Alert which covers this topic (including some issues not addressed in detail by this article) and is available at www.deloitte.co.uk/auditpublications.

Generating revenue from customers could be seen as the primary purpose of a commercial enterprise, and the top line revenue figure for the year is often the most widely reported and scrutinised item in an entity's financial statements.

Given this level of significance, it is perhaps surprising how little detailed guidance is included in IFRSs on the recognition and measurement of revenue. IAS *18 Revenue*, which was issued in 1993 and has been the subject of only minor amendments in the following 17 years, makes only brief reference to some important issues (for example sales made with a right of return attached or the possibility of identifying separate components within a single contract) and says little about the presentation of revenue in the financial statements.

In addition, this is an area where the approaches of IFRSs and US GAAP (which has very detailed guidance on a number of issues, often tailored to specific industries) are diverged.

In response to this, development of a comprehensive standard on revenue was identified as a key plank of the FASB (the U.S. Financial Accounting Standards Board) and the IASB's efforts to converge the two reporting frameworks and to improve both. This project is now a step further to nearing completion with the recent publication of a joint exposure draft ED 2010/6 *Revenue from Contracts with Customers.*

This article aims to summarise the scope and key principles of the exposure draft (ED) and to highlight a few of the proposals which could have a significant impact in practice.

Scope

The ED is intended to cover all contracts with customers other than those covered by the standards on leasing, insurance contracts, financial instruments and non-monetary exchanges between entities in the same line of business (for example, exchanges of oil to fulfil demand in a specific location). Thus, a final standard based on the ED would replace not only IAS 18, but also:

- IAS 11 *Construction Contracts;*
- IFRIC 13 *Customer Loyalty Programmes;*
- IFRIC 15 *Agreements for the Construction of Real Estate;*
- IFRIC 18 *Transfers of Assets from Customers; and*
- SIC 31 *Revenue – Barter Transactions involving Advertising Services.*

The control principle

Under current IFRSs, revenue is recognised based on a performance of obligations principle (whether that obligation is to deliver goods or to provide services). The ED proposes to replace this with a principle of recognising revenue when the customer obtains control of the goods or services.

> Control is defined as:
>
> *"An entity's ability to direct the use of, and receive the benefit from, a good or service."*

The ED identifies a number of potential indicators of control (unconditional obligation to pay for the asset or service in question, legal title, physical possession and customer-specific design or function) but stresses that an overall assessment must be made – no one indicator takes precedence over the others.

This principle may lead to significant changes, particularly for companies which currently deem contracts for construction of an asset (perhaps a property or a piece of software) to be either construction contracts or contracts for the provision of services and hence recognise revenue on a percentage completion basis. If, under the proposed model, it is deemed that the customer does not have control of the asset until it is completed and delivered, then no revenue will be recognised until that point.

It seems likely that this is an area where in practice entities might have difficulty in applying the guidance. The concept of control in the context of revenue is a new one which may not be intuitive to grasp. It might be expected that commentators will ask for additional clarification on the indicators of control.

Areas of detailed guidance

As well as changing the overall model for recognition of revenue, the ED includes proposals for detailed requirements in a number of areas, including:

- Identification of separate performance obligations within a single contract;
- Onerous performance obligations;
- Contract modifications;
- Sales with a right of return;
- Warranties; and
- Credit risk.

Identification of separate performance obligations within a single contract

IAS 18 alludes to the possibility of splitting a single contract into its component parts (often referred to as 'unbundling'), but has little in the way of guidance on how to apply this concept in practice.

> The ED focuses on the principle of a 'performance obligation', defined as:
>
> *"An enforceable promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to the customer."*

Where a single contract includes more than one performance obligation (for example, delivery of an asset followed by ongoing maintenance of that asset), the ED proposes separate accounting for each obligation if, and only, if they are 'distinct'.

The ED defines a good or service, or a bundle of goods and services, as 'distinct' if either:

- the entity, or another entity, sells an identical or similar good or service separately; or
- the entity could sell the good or service separately because the good or service has a distinct function (i.e. could be used on its own or with other goods or service available separately and has a profit margin subject to distinct risks and identifiable separately from the other elements of the contract).

Once 'distinct' performance obligations are identified, the total contract value is then allocated to each obligation in proportion to the 'stand-alone' selling price of each good or service (i.e. the price at which the good or service would be sold separately).

This additional guidance provides a more comprehensive basis for making judgements on unbundling multi-element contracts. However, once separate performance obligations have been identified allocation of revenue is required to be on the relative fair value of each good or service (leaving no scope for determining the allocation on another basis, for example, using a method that might be viewed as more closely reflecting the entity's business model).

Onerous performance obligations

The concept of providing for losses on onerous contracts is a familiar one, particularly for entities applying contract accounting under IAS 11, but such provisions are generally recognised only in respect of contracts which are in totality loss-making. The ED makes clear that this consideration should be at the individual performance obligation, not the overall contract, level.

If this onerous performance obligation is in the nature of a 'loss leader' it may be that these requirements would result in recognition of a loss at the inception of a contract which overall is expected to be highly profitable.

Contract modifications

The pricing of a long term contract (for example, a service contract covering a number of years) may often be renegotiated. The treatment of such a renegotiation under the ED's proposals would depend on whether the prices of the modified and the existing contract are deemed to be 'interdependent' and the ED includes indicators of interdependent pricing.

In addition, the application guidance to the ED includes an example of a contract modification which draws a distinction between repricing to current value (deemed not to be interdependent) and to a different value (deemed to be interdependent with the original contract).

Where the prices are deemed to be interdependent, the modified contract is treated as a continuation of the existing contract, with the cumulative effect recognised at the point of modification. Where the prices are not deemed to be interdependent, the modified contract is treated as a new contract.

The effect of this distinction is illustrated in the example below.

Example

An entity enters into a 10 year service contract with a customer at a fixed rate of £100,000 per year. At the start of the sixth year, the price is renegotiated to £60,000 per year.

Year	Cash received £'000	Revenue (pricing deemed interdependent) £'000	Revenue (pricing deemed not interdependent) £'000
1-5	500	5*100 = 500	5*100 = 500
6	60	(20)	60
7-10	240	4*80 = 320	4*60 = 240

Thus, the judgement on whether the two prices are interdependent, which may be a fine one, can have a significant effect on the recognition of revenue (particularly in the period of a modification).

Sales with a right of return

Where sales are made with a right of return, under the ED's proposals an estimate must be made at the point of sale (based on a probability-weighted average) of the value of refunds to be made – whether they be in the form of cash or replacement products. This value is then recognised not as revenue, but as a refund liability. If a reliable estimate cannot be made, then all of the consideration received is recognised as a liability, with no revenue recognised at all.

As always, the probability-weighted average approach could be deemed to be flawed as it may not result in a value which is any of the possible outcomes. This may not be significant for a retailer with many rights of return outstanding at any given time, but for a company with a small number of large customers it may result in recognition of a refund liability which will inevitably be remeasured in the future.

Warranties

Under current IFRSs, warranties are generally accounted for by recognising a provision for the expected cost of repairing or replacing the product. The proposals would significantly change this. For warranties to cover faults arising after the transfer of the product is delivered the warranty will be identified as a separate performance obligation. The portion of revenue allocated to this performance obligation will be recognised on an appropriate basis over the warranty period.

Credit risk

The approach to credit risk of the counterparty is also proposed to give rise to a change from current practice. While there is currently no specific guidance on credit risk many entities will recognise revenue as the total amount receivable and reflect 'bad debt' as an expense when it is incurred. It is proposed that in future the credit risk be incorporated into the measurement of revenue, based on expected default. Only the difference between the expected and actual default would be reflected as an expense or income (not as an adjustment to revenue).

Disclosure

IAS 18 has only two paragraphs covering disclosures. In contrast, the disclosure requirements proposed by the ED run to five pages – with an additional two pages of clarifying guidance. Meeting some of these requirements may be challenging from a data collection point of view, as they include items that may not currently be tracked for either financial or management accounting purposes. In particular, reconciliations are required of the opening and closing balances of:

- Contract assets (a single item encompassing items currently thought of as, for example, trade receivables, accrued income and amounts recoverable on contracts);

- Contract liabilities (currently thought of as deferred income and amounts due to customers for contract work); and

- Onerous performance obligations (which, as noted above, may occur more frequently under the proposals of the ED).

In addition, extensive disclosures of the judgements that affect the recognition and measurement of revenue (for example, the methods, inputs and assumptions used to measure obligations for returns and to determine the stand-alone selling prices of individual elements of a contract).

The next steps

Comments are invited on the ED by 22 October 2010 and following consideration of comments received the IASB intends to issue a final standard by mid-2011. The effective date of the standard is yet to be determined, but the ED proposes full retrospective application (i.e. with no transitional relief for contracts entered into before the effective date).

The proposals in the ED may result in significant changes to how entities account for revenue transactions and they depend on a number of unfamiliar concepts and definitions. Companies may, therefore, wish to begin their consideration of the proposals at an early stage.

A coffee with … Ian Mackintosh

Ian Mackintosh is the Chair of the UK Accounting Standards Board (ASB). Originally from New Zealand, Ian has spent much of his career in Australia, first with Coopers & Lybrand and later as a consultant in his own practice. In November 2000, he was appointed Chief Accountant of the Australian Securities and Investment Commission and following that was Manager, Financial Management, South Asia at the World Bank.

Ian has played an active role in standard-setting since 1983. He was a member, and later Deputy Chairman, of the Australian Accounting Standards Board, as well as chairing its Urgent Issues Group. Ian is also a member of the International Accounting Standards Board's Standards Advisory Council and chair of the National Standard Setters Group of standard setters from around the world.

Assuming the UK moves to an accounting framework based on IFRSs, what will be the ASB's future role?
The ASB has a few major roles. One major role which will continue is that of influencing the IASB in its deliberations. That involves drawing together our constituents in trying to get a consensus – which of course we don't always achieve – and communicating with the IASB in many ways including written responses.

The ASB performs that role by itself and also internationally within the National Standard Setters Group, which is a much larger group of standard setters from all over the world. This is one of many channels into the IASB and it is very important for the ASB to continue to be engaged with that process.

Secondly, in setting UK GAAP onto an international framework the ASB won't wash its hands of the process or absolve itself of responsibility for keeping a watch on that framework. Depending on what happens to the SME standard in the future the ASB will, I think, be regularly reviewing the situation. I'm sure its constituents will be coming through with suggestions for change which it has to consider, and keep an open mind and a watching brief on UK GAAP and be prepared to deal with any problems that arise.

The third role is, I think, very important and that's being involved with research. Again it does that in a number of ways: through EFRAG (*the European Financial Reporting Advisory Group*), through the National Standard Setters Group and by itself. It's a very important role for national standard setters in general because the IASB, particularly at the moment, doesn't really have much time to sit back and do the longer term research and it'll become more and more dependent on national standard setters. It is already asking national standard setters to start undertaking research.

The ASB has been working with EFRAG on various areas of research, including pensions. Are some of the other national standard setters going to become more involved in that kind of activity?
It's interesting to watch the development. The French national standard setter for instance has just reconstituted itself with a big focus on research, including additional resources in that area. Again through EFRAG they're looking at share-based payments at the moment.

The Japanese have built up a large and a very good staff and are working very hard on a number of areas, particularly given the prospect of them adopting IFRSs in the near future. The Canadians have always done a lot of research and continue to do so, as do the Australians and the New Zealanders so it's all around the world now. If the US adopts IFRSs, then I think FASB will also become quite a large research base.

As IFRSs are adopted in more countries across the world, do you think we will see changing influences on the IASB and what it is doing?
We're seeing that already. I've been chairing the National Standard Setters Group for six years and the change in that time has been quite extraordinary. We're definitely seeing the Asians becoming much more vocal and much more involved than they ever have been before and we are now seeing Brazil, for instance, coming on board to adopt IFRSs and they are getting very involved in the debates. We had 25 countries at the last meeting of the National Standard Setters Group and there really was a very balanced debate. The debate used to be a bit isolated amongst a few countries, now it's a very balanced, broad-based debate.

South Korea is another country that's really got good resources for research and I think this change in balance will influence the IASB going forward.

Do you think this will change the agenda, with different issues being raised?
Already there are some different issues. The Canadians are considering a lot of issues at the moment particularly on mining and rate-regulated industries.

The other one that's coming up is agriculture, and the issue of bearer based assets – like rubber trees in Malaysia. That's actually a very good example of where the new countries moving to IFRSs are raising topics that a lot of the old countries who are already on IFRS wouldn't have raised. It reflects the industries and issues that are quite important for those countries and so they can't be ignored.

On the IASB's current agenda, do you think it will meet its deadline for completing the revenue and leasing projects?
It depends on the responses received, it's really as simple as that. I think it is working really hard, particularly on those topics. I don't think it can do much more at the moment to try and succeed but whether it do or not depends on the responses.

Revenue recognition is a big question in the US, but a very hard issue to resolve and on leasing there is going to be a lot of push-back by people in the industry.

I think one of the dangers with leasing is that most people can agree there is a problem to be fixed. I just hope we don't get lost in the detail and lose sight of the big advantage.

I think an important one for the Board to get through by next year is financial instruments and the question there is whether it will be a converged standard by the time it goes out. FASB seem to be approaching that topic a little differently from the IASB. We're all awaiting the responses to FASB on its exposure draft, which I understand are coming in at the rate of 50 a day, and what it does with those responses.

Do you think the exposure draft on the future of UK GAAP will get 50 responses a day?
I hope not! I hope we'll get a lot but not that many and I hope we get responses from a wide variety of constituents. Users, preparers, auditors. A good spread is what we would really like.

During the six month consultation period we will be going out to encourage various groups to respond. Whether they agree with us or not, we will need to hear from them.

For you, what are the most rewarding and the most challenging aspects of being a standard setter?
The most rewarding is getting the standards out and getting good financial reporting as a result. I think despite all the complaints a lot has been done to get good financial reporting. Most of it has been done at the international level in the last few years but I've been involved in standard setting since 1983 and obviously a lot of things have changed and improved over that period.

Most challenging is getting a consensus on what you are doing. In responses there is often a negativity, people are often anxious to find anything that's wrong rather than sitting back with the big picture and thinking "is this moving the whole thing forward?"

You will always get disagreements and that is very challenging, but there is no easy answer to that. You've to keep talking and working with people.

One thing that has become obvious since the IASB has been in existence is that it's much harder to set a standard internationally than it is nationally. The divergence of cultures and backgrounds means that almost always somebody doesn't like what's being done and you have to make a judgement call in the end to decide which way to go forward – knowing that somebody will disagree with it.

Are you surprised there hasn't been more movement towards the IFRS for SMEs in the rest of Europe?
I think it's history and culture. If you take the French for instance, they've had the Napoleonic code for a long, long time and it would be a huge step for them to move to something else. They have gauged the mood so far in their country and they're sticking with what they've got; happy for listed groups to use IFRSs and for everybody else to do something else.

In Germany, I think there are slightly different reasons, again bound up in the fact that their standards are part of the law and also the tax situation. But there are quite a few other European countries that are starting to move towards IFRSs, particularly Scandinavian countries and some others as well. A lot of countries will wait until others have tried the IFRS for SMEs and see how it goes. But in the UK we've been fiddling with this for so long; the time has come for a decision.

Do you have any views on public sector accounting and whether that might be something that comes onto the IASB's agenda in the future?

The work being done by IPSASB (*the International Public Sector Accounting Standards Board*) is very good and very relevant. These days, we are looking at the credit ratings of governments and all the things that the financial crisis has bought about. I think you need a sovereign balance sheet which includes all the assets and all the liabilities of the government and the UK is moving towards that. There is a lot of work to be done and it's quite important that public sector and private sector accounting don't diverge too much. There are differences, legitimate differences, but not many and it's important for things that are the same to be treated the same between the two sectors.

On the question of the IASB's agenda: when I was chairman of what was then the public sector committee in 2000 or 2001, I was already talking to David Tweedie about that. The response, which is not unreasonable, has always been that the IASB has enough on its plate with the private sector and any move to address also the public sector would take a lot of time and a lot of thinking. Eventually, though, I would see it at least coming under one roof if not under one Board.

On a different topic, you've spent some time in both England and Australia during your career. Who will you be supporting in the Ashes?

Australia! Since I've been in England, Australia has lost both Ashes series in the UK so I've had a really bad time of it. But I did go to see one of the tests in Australia last time when they won 5-0.

Thank you for your time and is there anything you'd like to add?

Just to say that London is a great place to work and it's still a very great financial centre and I think the UK should be doing whatever it can to make sure that continues, because it's something the world shouldn't lose and something the UK shouldn't waste.

The good, the bad and the ugly	
The IASB's project to replace IAS 39	I think it's good.
The expansion of FASB from five to seven board members	My personal view always was that five was too few, so I see it as a positive thing.
British food	Well, I first came here in 1973 and it wasn't very good. But now I think there's international standard food available, if you can afford it.

Topic of focus: Leasing

The idea of distinguishing between operating and finance leases on the basis of whether the risks and rewards of the asset lie with the lessee or with the lessor has been with us in the UK as far back as 1984, when SSAP 21 *Accounting for leases and hire purchase contracts* was issued. However, this approach is not without its problems as depending on this distinction (which may in some cases require a finely balanced judgement) the accounting for lease contracts diverges completely (either by the lessee recognising the leased asset and a financing liability to pay for it, or by recognising only the periodic leasing cost and effectively holding the liability for future rental payments 'off balance sheet'). This is often particularly problematic in the case of leases of land and buildings, potentially requiring the lease of the building and of the land to be accounted for quite differently even though there is only one contract in place.

The FASB (the U.S. Financial Accounting Standards Board) and the IASB have now proposed the elimination of this distinction in their joint exposure draft ED 2010/9 *Leases*.

Deloitte in the UK has issued an iGAAP Alert which covers this topic (including some issues and examples not addressed in detail by this article) and is available at www.deloitte.co.uk/auditpublications.

Lessee accounting

At the commencement of a lease contract, the exposure draft (ED) proposes that a lessee should recognise two items:

- a lease liability (measured at the present value of the lease payments); and
- a right-of-use asset (measured at the amount of the lease liability plus any initial direct costs incurred by the lessee).

The present value of the lease payments is determined using the rate the lessor charges the lessee or, if this is not readily determinable, the lessee's incremental borrowing rate

Subsequently, the right-of-use-asset is amortised and an interest expense recognised in respect of the lease liability.

An example of the treatment of a simple lease contract is shown below.

Example

On 1 January 201X, an entity leases a truck for three years, for fixed rentals of £10,000 per year (payable in arrears), incurring initial direct costs of £1,000 in negotiating the lease.

The entity's incremental borrowing rate is 10% per annum.

Under the ED's proposals, the entity would record the following entries in the first year of the lease:

Dr/(Cr)	Right-of-use asset £'000	Lease liability £'000	Income statement £'000	Cash £'000
1 January 201X	25.9	(24.9)		(1.0)
Amortisation of right-of-use asset	(8.6)		8.6	
Interest expense		(2.5)	2.5	
31 December 201X		10.0		(10.0)
	17.3	(17.4)	11.1	(11.0)
Similar entries would be recorded in the remaining two years of the lease.				

Of course many leases have more complicated features than those included in the example above. The ED's proposals in respect of some of these are summarised below.

Contingent rentals and residual value guarantees	Extension and early termination options	Purchase options
An estimate of contingent rentals (based on forward rates or prevailing rates) and residual value guarantees payable to the lessor are included in the measurement of the lease liability using a probability weighted average method. Any future changes in those estimates are recognised in profit or loss (where they relate to the current or prior period) or as an adjustment to the right-of-use asset (where they relate to future periods).	The lease term is defined as 'the longest possible term that is more likely than not to occur' and is determined by estimating the probability of exercise of any extension and early termination options in the contract (as well as any other relevant legal or business factors). Any future changes in this estimate are reflected by an adjustment to the lease liability and right-of-use asset.	Leases including a 'bargain purchase option' (i.e. one expected to be significantly lower than the fair value of the asset at the date the option becomes exercisable such that it is reasonably certain that the option will be exercised) are outside the scope of the ED and would be expected to be accounted for as a purchase of the asset on deferred terms. Other purchase options are not accounted for until exercised.

Another issue that is raised by the proposal to abandon operating lease accounting and to account for all leases in the financial statements of lessees as an asset and associated liability is what to do with very short leases. There were calls earlier in the leasing project to scope such leases out entirely on cost-benefit grounds. The ED does not propose such a scope out but does include the option for lessees (available on a lease by lease basis) to measure the lease liability and right-of-use asset on an undiscounted basis (such that the lease payments equal the amortisation charge on the asset) for those leases with a maximum possible lease term (including any extension or renewal option) of not more than 12 months.

Presentation

The ED also includes quite detailed requirements on the presentation of the various components of lease accounting.

Item	Proposed presentation
Right-of-use asset	Within property, plant and equipment or investment property as appropriate, but separate from owned assets
Lease liability	Separate from other financial liabilities
Amortisation of right-of-use asset and interest expense on lease liability	Separate from other amortisation and interest expense (either on the face of the income statement or in the notes)
Cash payments	Within financing activities in the cash flow statement, separate from other financing cash flows

These presentational requirements would make the effect of leasing on the financial statements quite visible, which may be helpful in identifying their effect in, for example, setting or measuring loan covenants.

It is also worth noting that inclusion of all lease payments in financing cash flows may increase net operating cash flows, particularly for entities with a high level of contracts currently accounted for as operating leases.

Lessor accounting

In contrast to lessee accounting, the ED proposes to retain a differential approach to lessor accounting, with two potential models depending on the extent to which significant risks and rewards associated with the underlying asset are retained. The two approaches are summarised below.

	Performance Obligation Approach	Derecognition Approach
Applied when	Exposure to significant risks or benefits of the underlying asset retained	No exposure to significant risks or benefits of the underlying asset retained
Recognised in balance sheet at commencement of lease	Right to receive lease payments (present value of lease payments plus initial direct costs incurred by the lessor) An equal and opposite performance liability	Right to receive lease payments (present value of lease payments plus initial direct costs incurred by the lessor) Residual asset for portion not transferred
Subsequent measurement of items recognised in balance sheet at commencement	Right to receive lease income at amortised cost less any impairment Performance liability amortised based on use of the asset by the lessee or, if not available, straight line basis Right to receive lease income and performance liability remeasured on reassessment of contingent rentals, lease term etc.	Right to receive lease income at amortised cost less any impairment Right to receive lease income remeasured on reassessment of lease term, contingent rentals and residual value guarantees
Treatment of underlying asset	Retain at previous carrying value and depreciate as normal	Residual asset retained based on proportion of fair value of rights to the asset retained compared to rights transferred to the lessee. The rest of the asset derecognised Residual asset only remeasured due to reassessment of the lease term or impairment
Recognised in profit or loss	Interest income on right to receive lease income and any impairment Lease income as lease liability satisfied Changes due to reassessment of lease liability to the extent that the liability has been satisfied Depreciation of underlying asset	Lease income on initial recognition of right to receive lease income Lease expense on derecognition of underlying asset Interest income and any impairment on right to receive lease income Lease income or expense on remeasurement or impairment of right to receive lease payments and residual asset

As can be seen above, the mechanics of the proposed treatment of leases in the financial statement of the lessor are rather more complicated than in the financial statement of the lessee and may require more analysis of present and expected fair values (for example, in measuring the residual asset under the derecognition approach).

For leases which at commencement have a maximum possible term of 12 months or less, lessors may on a lease-by-lease basis choose not to recognise any lease asset or liability, but instead to recognise lease income in profit or loss over the lease term.

Presentation

Again, the presentation of items in the financial statements differs depending on which approach is taken to accounting for a lease.

In the balance sheet:

- under the performance obligation approach, the underlying asset, right to receive lease payments and lease liabilities are presented together as a net lease asset or liability; whereas

- under the derecognition approach, the right to receive lease payments and residual assets are recognised separately within financial assets and property, plant and equipment respectively.

In the income statement:

- under the performance obligation approach, interest income, lease income and depreciation expense are presented separately; whereas

- under the derecognition approach, interest income is presented separately from lease income and lease expense (which are presented net if the lessor's business model is to use leases for the purposes of providing finance and gross if the model is to use leases as an alternative to sales of assets).

Under either approach, cash receipts from lessees are classified as operating cash flows.

Taxation

HMRC are currently considering whether and what changes will be necessary to the tax rules on leased assets. If steps are taken to enable the current rules to continue to apply to leased assets there will be increased divergence between the accounting treatment and the treatment for tax, leading to a likely increase in deferred tax balances relating to these assets and liabilities.

Disclosure

Given the number of inputs and the potential judgements involved in applying either lessee or lessor accounting, it is perhaps unsurprising that the ED proposes quite extensive disclosure requirements. These include:

- a description of the entity's lease arrangements (including information on contingent rentals, renewal and termination options, purchase options and residual value guarantees);

- information on which options were included in the measurement of the right-of-use asset and which were not;

- restrictions imposed by lease arrangements (for example, relating to dividends, additional debt or further leasing);

- amounts recognised in respect of short-term leases accounted for on an undiscounted basis;

- for lessees, a reconciliation of opening and closing balances of right-of-use assets and lease liabilities, disaggregated by class of underlying asset;

- for lessors, a reconciliation of opening and closing balances of rights to receive lease payments, lease liabilities and residual assets; and

- for lessors, information on why the use of the performance obligation or derecognition approach was deemed appropriate.

The full impact

It is clear that the implementation of such a fundamental change in the accounting for leases will require significant effort and that the on-going application of the requirements is likely to require more effort that previously was the case for leases. Significant system changes may be required to allow for the determination and tracking of the lease term and contingent rental assumptions. The assessment of whether there is a service element to the arrangements will be more important since the service element will be accounted for separately.

The proposals will change the shape of the balance sheet and the income statement. This may impact key performance metrics and consideration needs to be given to all the potential consequences of that.

The next steps

Comments are invited on the ED by 15 December 2010 and following consideration of comments received the IASB intends to issue a final standard by mid-2011. The effective date of the standard is yet to be determined. The ED proposes retrospective application for all lease contracts outstanding at the date of transition, but with some simplifications to the measurement requirements for leases entered into before the date of transition.

The UK Accounting Standards Board (ASB) and Finance and Leasing Association (FLA) are jointly hosting a public meeting to discuss the ED on 5 November 2010, which will include a presentation on the proposals by members of the IASB. Interested parties can register to attend via ASB's website www.frc.org.uk/asb.

Activities of the IASB

The following amendments can be downloaded from the IASB's website at www.iasb.org

Deloitte (Global) has issued an IFRS in Focus Newsletter covering this topic in more detail, which is available at http://www.iasplus.com/iasplus/1008leases.pdf and Deloitte in the UK has issued an iGAAP Alert which is available at www.deloitte.co.uk/auditpublications

Deloitte (Global) has issued an IFRS in Focus Newsletter covering this topic in more detail, which is available at http://www.iasplus.com/iasplus/1008insurance.pdf

IASB and FASB publish proposals on the financial reporting of leases

The IASB and the US Financial Accounting Standards Board (FASB) have published for public comment an exposure draft (ED) proposing significant changes to the financial reporting of lease contracts.

The proposals would dispense with the current distinction between operating and finance leases for lessees, replacing this with a 'right-of-use' approach. Among other changes, this approach would result in the liability for payments arising under the lease contract and the right to use the underlying asset being included in the lessee's statement of financial position.

The ED includes two accounting models for lessors. A lessor which retains exposure to significant risks or benefits associated with the underlying asset would apply the performance obligation approach (recording a receivable for the expected lease payments and a corresponding performance obligation liability), a lessor which does not would apply the derecognition approach (derecognising a portion of the asset and recording a receivable for the expected lease payments and a residual asset representing the right to the underlying asset at the end of the lease term).

Comments on the ED are requested by 15 December 2010.

IASB issues exposure draft on insurance contracts

The IASB has published for public comment an exposure draft (ED) of a proposed IFRS for insurance contracts. The ED proposes a single IFRS that all insurers, in all jurisdictions, could apply to all contract types on a consistent basis. The proposed IFRS would apply to writers of both insurance and reinsurance contracts and would include the following key terms:

Scope and recognition	Measurement	Disclosure
The proposed IFRS would apply to all insurance contracts as defined. An insurance contract would be recognised at the earlier of: • the insurer being on risk to provide coverage to the policyholder for insured events; and • the signing of the insurance contract.	Measurement of the insurance contract is based on a 'building block approach' that portrays a current assessment of the contract, using the following: • an unbiased, probability-weighted average (expected value) of future cash flows expected to arise as the insurer fulfils the contract; • the effect of time value of money; and • a margin.	With respect to disclosure, the ED proposes that entities should disclose qualitative and quantitative information about: • the amounts, recognised in its financial statements, arising from insurance contracts; and • the nature and extent of risks arising from insurance contracts.
An insurer would derecognise an insurance liability when it is extinguished.	The building blocks would be used to measure the combination of rights and obligations arising from an insurance contract rather than to measure the rights separately from the obligations. The combination of rights and obligations would be presented on a net basis.	

Comments on the ED are requested by 30 November 2010.

IASB issues limited-scope exposure draft on fair value measurement

The IASB has issued an exposure draft (ED) *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements* proposing relatively minor amendments to the proposals in its May 2009 ED on fair value measurement. The May 2009 ED proposed a three-level fair value hierarchy that categorises observable and non-observable market data used as inputs for fair value measurements in a manner consistent with the disclosure requirements of IFRS 7 *Financial Instruments: Disclosure*. Under that hierarchy, Level 3 inputs are 'unobservable inputs' used for the fair value measurement of assets or liabilities for which market data are not available.

The May 2009 ED proposed disclosures including a 'measurement uncertainty analysis' (sometimes called a 'sensitivity analysis') of fair value measurements categorised within Level 3 of the fair value hierarchy. The new ED proposes enhancement of these disclosures by reflecting the interdependencies between unobservable inputs used to measure fair value in Level 3.

Comments on the ED are invited by 7 September 2010.

Deloitte (Global) has issued an IFRS in Focus Newsletter covering this topic in more detail, which is available at http://www.iasplus.com/iasplus/1007fvm.pdf

IASB proposes to amend accounting for deferred tax

The IASB has published an exposure draft (ED) *Deferred Tax: Recovery of Underlying Assets.* The ED proposes an amendment to one aspect of IAS 12 *Income Taxes*. Under IAS 12, the measurement of deferred tax liabilities and deferred tax assets depends on whether an entity expects to recover an asset by using or by selling the asset. In some cases, this distinction is difficult and subjective to determine. To provide a practical approach in such cases, the proposed amendment would introduce a rebuttable presumption that an asset is recovered entirely through sale unless the entity has clear evidence that recovery will occur in another manner. The presumption would apply when investment properties, property, plant and equipment or intangible assets are measured at fair value under IAS 40 or the revaluation model under IAS 16 or IAS 38.

Comments on the ED are requested by 9 November 2010.

Deloitte (Global) has issued an IFRS in Focus Newsletter covering this topic in more detail, which is available at http://www.iasplus.com/iasplus/1010eddeferredtax.pdf

IASB proposes amendments to IFRS 1 on removal of fixed dates for first time adopters

The IASB has published for public comment proposed amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards*. The proposal would amend IFRS 1 by replacing references to a fixed transition date of '1 January 2004' with 'the date of transition to IFRSs'. As a result, entities adopting IFRSs for the first time would not have to restate derecognition transactions that occurred before the date of transition to IFRSs. In addition, first-time adopters would also not have to recalculate 'day 1' differences on initial recognition of financial instruments, where the transaction occurred before the date of transition to IFRSs.

Comments on the proposed amendments are requested by 27 October 2010.

Deloitte (Global) has issued an IFRS in Focus Newsletter covering this topic in more detail, which is available at http://www.iasplus.com/iasplus/1009amendifrs1.pdf

IASB proposes severe hyperinflation amendment to IFRS 1

The IASB has published for public comment an exposure draft *Severe Hyperinflation*, proposing amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards.*

The amendment proposes guidance on how an entity should resume presenting financial statements in accordance with IFRSs after a period when the entity was unable to comply with IFRSs because its functional currency was subject to severe hyperinflation. According to the proposed amendment an entity that has been subject to severe hyperinflation would be allowed to measure assets and liabilities at fair value and use that fair value as the deemed cost of those assets and liabilities in the opening IFRS balance sheet.

Comments on the exposure draft are requested by 30 November 2010.

IASB and FASB complete first stage of conceptual framework

The International IASB) and FASB have announced the completion of the first phase of their joint project to develop an improved conceptual framework for IFRSs and US GAAP.

Work on the framework project is being carried out in stages. As each chapter is finalised, the relevant paragraphs in the Framework for the Preparation and Presentation of Financial Statements that was published in 1989 will be replaced.

Chapter 1 *The objective of financial reporting* and Chapter 3 *Qualitative characteristics of useful financial information* have been published.

Deloitte (Global) has issued an IFRS in Focus Newsletter covering this topic in more detail, which is available at http://www.iasplus.com/iasplus/1009strippingcosts.pdf

IFRS Interpretations Committee publishes proposed guidance on surface mining

The IFRS Interpretations Committee has published for public comment proposed guidance on the accounting for stripping costs in the production phase of a surface mine.

The IFRS Interpretations Committee has reached the conclusion that costs associated with a 'stripping campaign' should be accounted for as an additional component of an existing asset, and that this component should be amortised over the expected useful life of the reserves that become directly accessible as a result of the stripping campaign (using the units of production method unless another method is more appropriate).

Comments on the proposed guidance are requested by 30 November 2010.

UK GAAP Round Up

UITF issues Abstract 47 on extinguishment of financial liabilities with equity instruments

The Urgent Issues Task Force (UITF) has issued Abstract 47 dealing with the treatment of extinguishment of a liability fully or partly by issuing equity instruments to the creditor.

The key features of UITF 47 are:

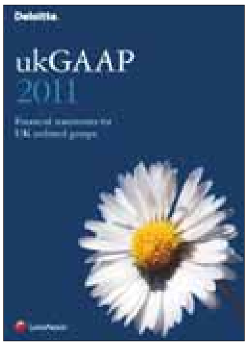
- If a debtor issues equity instruments to a creditor to extinguish all or part of a financial liability, those equity instruments are 'consideration paid' in accordance with FRS 26.41. Accordingly, the debtor should derecognise the financial liability fully or partly.

- The debtor should measure the equity instruments issued to the creditor at fair value, unless fair value is not reliably determinable, in which case the equity instruments issued are measured at the fair value of the liability extinguished.

- The debtor recognises in profit or loss the difference between the carrying amount of the financial liability (or part) extinguished and the measurement of the equity instruments issued.

UITF 47 mirrors the requirements of IFRIC 19, issued in December 2009 as an interpretation of the requirements of IAS 39 *Financial Instruments: Recognition and Measurement,* and is effective for periods beginning on or after 1 July 2010 for those entities within the scope of or who apply FRS 26 (IAS 39) *Financial Instruments: Recognition and Measurement*.

Publications



ukGAAP 2011 – Financial statements for UK unlisted groups

ukGAAP 2011 – Financial statements for UK unlisted groups provides model financial statements for companies following UK GAAP, covering all relevant provisions of the Companies Act 2006 as well as pronouncements of the Accounting Standards Board (ASB). The 2011 edition provides updated material on:

- finalised guidance, issued by the Financial Reporting Council for directors of UK companies, on going concern and liquidity risk;
- Auditing Practices Board guidance regarding the form of the audit report and the directors' responsibilities statement; and
- Additional disclosure requirements arising from amendments to FRS 29 *Financial Instruments: Disclosures.*

ukGAAP 2011 – Financial statements for UK unlisted groups may be ordered from LexisNexis at: www.lexisnexis.co.uk/deloitte.

IFRS issued but not yet effective or endorsed by the EU

Title	Subject	Mandatory for accounting periods beginning on or after	Endorsed* or when endorsement expected (EFRAG 1 July 2010)
IAS/IFRS standards			
IAS 24 (revised November 2009)	Related Party Disclosures	1 January 2011	19 July 2010
IFRS 9 (November 2009)	Financial Instruments: Classification and Measurement	1 January 2013	To be confirmed
Improvements to IFRSs (May 2010)	Improvements to IFRSs 2010	1 July 2010 or 1 January 2011 (varies by standard)	Q4 2010
Interpretations			
IFRIC 19	Extinguishing Financial Liabilities with Equity Instruments	1 July 2010	23 July 2010
Amendment to IFRIC 14	Prepayments of a Minimum Funding Requirement	1 January 2011	19 July 2010

* The critical date when considering endorsement is the date of approval of the financial statements

ASB and IASB timetables

ASB Current Projects

The Future of UK GAAP	• The ASB issued on 11 August 2009 a consultation paper 'Policy Proposal: the future of UK GAAP', which sets out its proposals for the future reporting requirements for UK and Irish entities. • The Board's proposals envisage a differential reporting regime based on public accountability, with publicly accountable entities applying IFRS as adopted by the EU, small entities continuing to apply the FRSSE and all other entities applying the IFRS for SMEs. • In July 2010, the ASB issued a request for responses to gather views on the direction of travel of UK GAAP and on the possible costs and benefits involved in implementation of the proposed changes. This request also included proposals to allow subsidiaries to apply the same recognition and measurement regime (either IFRS as adopted by the EU or IFRS for SMEs) as used in the consolidated financial statements but with reduced disclosure requirements. The period for responding closed in August 2010. • An exposure draft outlining the Board's recommendations is expected by the end of 2010.
Convergence	• The ASB and the UITF continually consider what consequential amendments will be needed to UK GAAP once the IASB and IFRIC finalise standards, amendments and interpretations. • UITF 47 (IFRIC 19) on extinguishment of financial liabilities with equity instruments issued July 2010

IASB Project Timeline – Active Projects

Annual Improvements to IFRSs – 2009-2011	• Final IFRS issued May 2010. • Further ED expected second half of 2010. • Further Final IFRS expected first half of 2011.
Common Control Transactions	• Added to agenda December 2007. • Timing not yet determined.
Conceptual Framework Eight phases in all	• ED on objectives and qualitative characteristics was issued in May 2008. Final chapter issued September 2010. • ED on reporting entity was issued in March 2010, final chapter expected second half of 2010. • DP on measurement expected second half of 2010 or first half of 2011. • Timing not yet determined on elements and recognition.
Consolidation, including SPEs*	• ED issued in December 2008. • Round tables held in June 2009. • Final IFRS replacing IAS 27 expected second half of 2010. • ED on proposed changes for investment companies expected second half of 2010, Final IFRS expected first half of 2011.
Derecognition*	• ED issued March 2009. • Round tables held June 2009. • Final IFRS on disclosure requirements for derecognitions expected second half of 2010. • Comprehensive standard on derecognition to be considered at a future date.
Discontinued operations amendment	• ED issued September 2008. • Further ED expected first half of 2011 and Final IFRS second half of 2011.
Earnings per share amendment	• Exposure draft issued August 2008. • Further discussion expected second half of 2010.
Emissions Trading Schemes	• ED expected second half of 2011.

Fair Value Measurement Guidance	• ED issued May 2009. • ED on measurement uncertainty analysis disclosures issued June 2010. • Final IFRS expected first half of 2011.
Financial Instruments with the Characteristics of Equity*	• DP issued February 2008. • ED expected first half of 2011 and Final IFRS second half of 2011.
Financial Instruments (replacement of existing standards) *	• Classification and measurement of financial assets, Final IFRS issued November 2009. • Classification and measurement of financial liabilities ED issued May 2010, Final IFRS expected first half of 2011. • Impairment ED issued November 2009, Hedging ED expected second half of 2010, Final IFRSs expected first half of 2011. • ED on asset and liability offsetting expected second half of 2010, Final IFRS expected first half of 2011.
Financial Statement Presentation* Phase B: Statement of information in the financial statements	• DP issued October 2008. • ED on presentation of items of other comprehensive income issued May 2010, Final IFRS expected second half of 2010. • ED on replacement of IAS 1 and IAS 7 expected first half of 2011, Final IFRS second half of 2011.
Income Taxes – limited scope project	• ED on recovery of underlying assets issued September 2010. • Final IFRS expected first half of 2011.
Insurance Contracts – Phase II	• ED issued July 2010. • Final IFRS expected first half of 2011.
Joint Arrangements	• ED issued September 2007. • Final IFRS expected second half of 2010.
Leases*	• ED issued August 2010. • Final IFRS expected first half of 2011.
Liabilities (IAS 37 amendments)	• ED issued June 2005 and certain elements re-exposed in January 2010. • Further ED expected 2011.
Management Commentary	• Output will be best practice guidance, not an IFRS. • ED issued June 2009. • Final guidance expected second half of 2010.
Post-employment Benefits (including Pensions)*	• DP issued March 2008. • ED on defined benefit plans issued April 2010. Final IFRS expected first half of 2011. • Final IFRS on termination benefits expected second half of 2010.
Rate-regulated Activities	• ED published July 2009. • Further public consultation expected.
Revenue Recognition*	• DP issued December 2008. • ED issued June 2010, to be followed by round tables second half of 2010. • Final IFRS expected first half of 2011.

*IASB projects with milestones agreed in the February 2006 IASB-FASB Memorandum of Understanding on convergence – download the MoU at www.iasplus.com/pressrel/0602roadmapmou.pdf

This timetable is derived from the IASB's published timetable supplemented by decisions and comments made at recent meetings of the Board. You will find details on each project, including decision summaries from each Board meeting, at www.iasplus.com/agenda/agenda.htm

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