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Setting the standard

A spotlight on the FASB's and IASB's projects

March 29, 2012

What's inside

What you need to know about the FASB's and IASB's standard setting activities

Welcome to the latest edition of *Setting the standard*, our publication designed to keep you informed about the standard setting activities of the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB).

What's on the menu this quarter in standard setting?

Probably no surprise here. The priority joint projects remain the primary focus, with the boards continuing their redeliberations on financial instruments and leases, and performing extensive outreach on the latest revenue proposal. Insurance is also occupying a healthy portion of the boards' time. Interested in the feedback on the trio of proposals for consolidation, investment companies, and investment property entities? Well, there's something for everyone. Read on for a preview.

This quarter, the buzz is on the leases project. The issue "de jour"? Whether lessees can recognize expense on a straight-line basis. This may sound familiar, as the boards debated—but then dropped–the topic last year. Constituents urged them to reconsider and, as a result, the boards are evaluating a couple of options. However, they appear to be favoring different approaches. So, the staff is seeking constituents' views through outreach, likely setting the project back a few more months.

Momentum continues, though, on other projects. In a positive development, the boards are making efforts to align their views on classification and measurement of financial instruments and moving forward together on financial asset impairment. On revenue recognition, a second round of comment letters as well as targeted outreach is giving the boards more food for thought for upcoming redeliberations.

What's the best approach for private company standard setting?

The letters have been counted. The Financial Accounting Foundation (FAF) received over 7,300 of them—albeit mostly form letters—in response to its recent proposal to establish a "Private Company Standards Improvement Council" (the Council).[1] The Council would work with the FASB to develop a set of criteria to determine when exceptions or modifications to U.S. GAAP are warranted for private company standards. Similar to the process followed by the Emerging Issues Task Force, any changes proposed would be subject to FASB ratification.

Opponents of the proposal commented that a separate board is necessary to address private company issues. Supporters of the FAF's proposal, however, believe having a separate board could cause greater diversity in financial reporting and fail to address complexity and cost concerns shared by both private and public companies. Stay tuned for a final plan from the FAF, expected this spring. In the meantime, the FASB remains focused on private company issues as it develops a decision-making framework for private companies. It also recently announced a new project to define "nonpublic" entities.

New releases

Since we last reported to you, the FASB released its standard on balance sheet offsetting disclosures.[2] It also deferred the requirement to present components of reclassifications of other comprehensive income on the face of the income statement. You can find additional information in Dataline 2012-01, Pr*esentation of comprehensive income – Applying the FASB's final standard on presenting comprehensive income after deferral of the reclassifications requirement*.

[1] Refer to In brief 2011-41, Fin*ancial Accounting Foundation lays out its plan to improve standard setting for private companies*.
[2] Refer to In brief 2011-53, *FASB issues final standard on balance sheet offsetting disclosures.*

Status of projects

Below is the FASB's currently scheduled project timetable. Key differences from the IASB's timetable are specified.

<table>
<tr><th>Joint projects:</th><th>Q1 2012</th><th>Q2 2012</th><th>H2 2012</th><th>Thereafter</th></tr>
<tr><td>FI: classification and measurement</td><td colspan="2">R (1)</td><td>ED</td><td></td></tr>
<tr><td>FI: impairment</td><td colspan="2">R</td><td>ED</td><td></td></tr>
<tr><td>FI: hedge accounting</td><td colspan="4">R (1)</td></tr>
<tr><td>FI: disclosures</td><td>D</td><td>ED</td><td></td><td></td></tr>
<tr><td>Revenue recognition</td><td>C</td><td colspan="2">R</td><td></td></tr>
<tr><td>Leases</td><td colspan="2">R</td><td>ED</td><td></td></tr>
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<tr><td>Consolidation</td><td>C (3)</td><td>R</td><td>F</td><td></td></tr>
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<tr><td>Lower priority projects</td><td colspan="4">(4)</td></tr>
<tr><td>FASB-only projects:</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Investment property entities</td><td>C</td><td></td><td></td><td></td></tr>
<tr><td>Indefinite-lived intangible assets</td><td>ED</td><td>C</td><td></td><td></td></tr>
<tr><td>Liquidation basis of accounting</td><td>D (5)</td><td>ED</td><td></td><td></td></tr>
<tr><td>Nonpublic entity fair value disclosures</td><td>D (6)</td><td>ED</td><td></td><td></td></tr>
</table>

Legend:

D = Deliberations
C = Comment period ends
ED = Exposure draft expected
F = Final standard issued/expected
R = Redeliberations

(1) Represents FASB's timing for completion. The FASB's timing for hedge accounting remains to be determined. Although the IASB had finalized its classification and measurement standard in October 2010, it is reconsidering certain aspects as it evaluates limited improvements. The IASB's general hedge accounting standard is scheduled for issuance in the second half of 2012.

(2) The FASB intends to issue an exposure draft during the second half of 2012. The IASB is considering re-exposure.

(3) FASB timeline. The IASB issued its consolidation standard in May 2011.

(4) Lower priority projects include: Financial statement presentation (including discontinued operations), financial instruments with characteristics of equity, emissions trading schemes, and loss contingencies. Action is not expected by the boards in the near term, although loss contingency disclosures remain a focus area of the Securities and Exchange Commission.

If and when the boards re-engage on these projects, we will provide updates. Until then, should you wish to refresh on the status of these projects, refer to the October 2010 and December 2010 editions of *Setting the standard*. Additional information on loss contingencies can also be found in the June 2011 and September 2011 editions.

(5) Represents the FASB's *Disclosures about Risks and Uncertainties and the Liquidation Basis of Accounting* project, which is now focused only on the liquidation basis of accounting.

(6) The FASB has a project to evaluate whether nonpublic entities can be exempt from certain fair value disclosure requirements.

Financial instruments

What's new?

Progress! The boards are working *jointly* on classification and measurement. We'll see how it goes, but clearly it's a step in the right direction. Of course, impairment also remains a priority as the boards continue to work on their latest model. And, a disclosure package is expected to be released soon by the FASB for comment. Nothing much to report on hedge accounting, though, which continues to wait on the sidelines.

Classification and measurement—finding the right balance

So what's the headline news here? The FASB and IASB recently agreed to jointly debate changes to their respective approaches on the classification and measurement of financial instruments. The FASB was in the midst of its redeliberations when the IASB agreed in late 2011 to revisit its previously finalized standard. Although the IASB's reasoning was to address developments on the insurance contracts project and implementation questions about its standard, it also acknowledged the opportunity for convergence.

Prospects have improved for convergence on financial instruments as the boards work together on classification and measurement.

The boards' approach to financial instruments' classification and measurement focuses on two criteria: (1) the individual instrument's characteristics and (2) the entity's business model for those instruments. However, to date these two criteria have been defined differently by the two boards. The FASB recently decided to adopt the IASB's instrument characteristics approach. For a financial asset to qualify for measurement at other than fair value through net income (for example, amortized cost), the contractual cash flows of the asset must represent "solely payments of principal and interest." The IASB also decided it will make clarifications to its application guidance.

Next up will be the business model criterion. The big question: will the IASB add a third category, for debt investments measured at fair value through other comprehensive income? Currently only the FASB has included this category in its model.

Also coming up are discussions on financial liabilities and whether hybrid financial assets need to be bifurcated. The FASB's latest model applies the instrument characteristics test to financial liabilities, whereas the IASB had retained its existing approach. So, the two models currently may yield different results for financial liabilities. In addition, the boards have yet to align on hybrid contracts. The FASB has retained the requirement to bifurcate hybrid financial assets, unlike the IASB, who eliminated that requirement in its final guidance.

Impairment—getting closer to a new converged approach

After months of deliberations, the boards have made progress on the impairment of financial assets. The proposed approach—also known as the "three bucket" approach—is intended to recognize impairment in a way that reflects the general pattern of deterioration in the credit quality of financial assets. At a high level, here's how the model works:

- In general, financial assets would start out with reserves equal to 12 months of expected losses. These financial assets would be categorized in "bucket one."
- Reserves would generally increase to reflect expected losses over the life of those assets if: (1) the credit quality deteriorates after origination or purchase and (2) there is an expectation that substantially all of the contractual cash flows will not be recovered. Financial assets with reserves determined at a portfolio level would

be categorized in “bucket two” and those for which reserves are determined at the individual instrument level would be categorized in “bucket three.”

If credit subsequently improves (based on expectations over the lifetime of the financial assets), reserves can be adjusted to again equal 12 months of expected losses (that is, the financial assets could move back to “bucket one”). This would be a significant change from current guidance. The boards have also developed a variation of the model that would apply to financial assets that are already credit-impaired at the time of purchase. In those cases, the reserve will reflect the expected amount of lifetime losses from the time of purchase.

Discussions to date have focused on loans and trade receivables with some preliminary considerations for debt securities. For trade receivables, the boards are exploring whether new guidance is needed. For those with a significant financing element, the loan model would be followed. It’s less clear, though, which model should be used for trade receivables that do not have a significant financing element—much more common for corporate entities. For these trade receivables, the boards are considering whether reserves should be recorded using an incurred loss model (similar to existing guidance) or whether an expected loss model is more appropriate.

Beyond the high level principle for impairment, the devil will be in the details. The boards also need to develop indicators for movement between categories, as well as other aspects of the model over the coming months.

For more information:

See a summary of key board decisions in the Appendix to this publication.

- In brief 2012-03, *FASB and IASB discuss the potential for a more converged financial instrument accounting approach*
- In brief 2011-52, *Let’s try again–the impairment model for financial assets refined*
- Dataline 2011-26, *Financial instruments—An update on the FASB’s financial instruments project redeliberations as of June 30, 2011*
- Dataline 2011-06, *Accounting for hedging activities—A comparison of the FASB’s and IASB’s proposed models*

Risk disclosures—a separate phase on a faster track

The FASB has carved out its planned improvements to interest rate and liquidity risk disclosures for financial instruments from the rest of the project. Why? Users are asking for more immediate improvements in this area. The disclosures will include both quantitative and qualitative information about financial assets. The focus is on providing insight into what types of liquidity and/or interest rate risks entities have and how they manage those risks. However, different disclosure requirements will apply depending on the type of entity. Liquidity risk disclosures will be required by all companies while interest rate risk disclosures will only apply to financial institutions. You can find details of the types of disclosures that will be proposed in the Appendix to this publication.

What’s next?

The IASB plans to issue an exposure draft on its targeted amendments to its classification and measurement standard in the second half of 2012. The FASB has yet to make a formal decision about re-exposure, but it is likely that constituents will have an opportunity to formally weigh in. A joint exposure draft on impairment is also expected in the second half of 2012.

The FASB does not plan to begin redeliberations on hedge accounting until the joint discussions on classification and measurement are complete. And, while the IASB had planned to issue a staff draft of its general hedge accounting standard in early 2012, that timing has now been postponed to second quarter 2012 as it also focuses on the other two pieces of the financial instruments project.

Revenue recognition

What's new?

The comment letter period for the November 2011 exposure draft closed this month. To date, about 300 letters have been submitted and more are likely to trickle in. Respondents largely continue to support a single revenue model with a caveat: the standard must be adaptable across industries and faithful to transaction economics.

A second helping of comments brings new and old ideas

Comment letters were submitted from a diverse base of constituents—no surprise given the new standard will replace most existing revenue guidance, including industry-specific guidance. While many comments are industry-focused, a number of common themes are emerging. Transition and disclosures continue to be hot buttons for both preparers and users, with the two groups generally holding opposing views on the topics. Additional common areas of concern include: (1) variable consideration; (2) time value of money; (3) transfer of control; and (4) onerous performance obligations. We discuss general themes on each of these below.

Transition—should the retrospective approach be mandated or optional?

Preparers generally disagree with mandating the restatement of prior periods; users, on the other hand, favor retrospective application.

The proposed guidance requires retrospective application to all periods, with certain relief accommodations. While preparers understand that consistency is ideal for financial statement users, most believe the costs of retrospective application may outweigh the benefits. Accordingly, most preparers would prefer to see retrospective application as an option rather than a mandate. They have also suggested prospective application, supplemented with adequate transition disclosure, as an alternative. Users, however, continue to push the boards to mandate retrospective application arguing that revenue trend information is critical for their analyses.

Disclosures—users like them, preparers concerned about overload

Compared to current guidance, the proposal significantly increases the level of revenue-related disclosures, with most required for both interim and annual periods. Examples include individual rollforwards of contract assets and contract liabilities, onerous obligations, and costs to obtain or fulfill a contract, as well as a future revenue "maturity" analysis. Financial statement users broadly support the proposed disclosures and believe they are a significant improvement over today's requirements.

Preparers, however, generally cite significant cost-benefit concerns and fear the volume of information could obscure important information in the financial statements. Most preparers believe the disclosures should be streamlined, particularly the rollforwards, interim disclosures, and forward-looking information. Many have also suggested the boards address disclosures more holistically through a broader framework that is principles-based.

General agreement for a constraint on revenue recognition

Respondents generally support the constraint on recognition of revenue until amounts are "reasonably assured." However, many believe the guidance for sales-based fees from licenses of intellectual property is inconsistent with the overall model. Under the proposed model, license consideration that becomes payable after a customer's subsequent sale of a good or service is not deemed "reasonably assured" until the future sale occurs. Many have recommended this specific guidance either be removed or made applicable to all types of sales-based fees.

Time value of money—cost-benefit concerns raised

The proposal requires time value of money be included in the transaction price when significant and if the timing between performance and payment exceeds a period greater than one year. In general, respondents believe the requirements will create undue complexity that outweighs the benefits. In addition, concerns have been raised that applying time value of money only to revenue, without considering costs, could yield uneconomic results.

Transfer of control—some open questions

Under the proposed model, revenue would be recognized as control passes to the customer for goods and licenses, subject to the reasonably assured constraint. Respondents are generally satisfied with this guidance. However, there are questions regarding how to determine when control transfers in certain license arrangements (for example, licenses to distribute entertainment intellectual property over certain digital distribution platforms).

For services, recognition would occur as the obligation is satisfied, if certain criteria are met. While the boards are receiving positive feedback for incorporating more guidance for services, many would like additional clarification in this area. For example, it's not always clear whether a service is performed at a point in time or over time, which could yield different revenue recognition patterns (and could affect the applicability of the onerous test).

Onerous performance obligations—concerns persist

The requirement to evaluate and potentially record an onerous liability applies to those performance obligations satisfied over a period of time longer than one year. What do constituents think here? In general, cost-benefit concerns are prevalent.

Many also believe that uneconomic consequences may arise including: (1) the potential for losses to be recorded at the performance obligation level even when the overall contract is profitable and (2) the ability to only consider revenue from a specific customer contract despite the existence of other related revenue streams (such as those that will be received from other parties as a result of the transaction). For these reasons, respondents suggest the onerous guidance either be removed entirely or revised to be applied at the contract level or higher.

What's next?

The boards are beginning to review the comment letters and are holding several public roundtable events in April and early May 2012. Did you miss out on the comment letter deadline? You may still have time. The boards plan to consider comments received through the roundtable dates. A final standard is still targeted for the second half of 2012, but could slip to early 2013 given the breadth of feedback to consider.

For more information:

See a summary of key board decisions in the Appendix to this publication.

- Dataline 2011-35, (revised January 3, 2012), *Revenue from contracts with customers—the proposed revenue standard is re-exposed (includes certain industry supplements)*
- 10Minutes *on the future of revenue recognition*

Also, look for our upcoming Dataline, which will provide a more in-depth analysis of comment letter trends.

Leases

What's new?

Lessee accounting—again. The FASB and IASB now seem to be leaning in different directions on how to solve the lessee expense conundrum. The boards have recently devoted considerable time to this issue, and both seem committed to a move toward "straight-line" expense for some leases. At this juncture, the boards are taking some time to perform outreach on the pros and cons of two possible approaches. Then, they plan to revisit the conversation in May 2012.

No easy solution for lessee expense recognition

In May 2011, the boards debated the lessee model and decided to retain the original lessee expense recognition pattern, which results in a "front loading" of expense. However, constituents have remained critical of this approach, and have urged the boards to take another stab at identifying a palatable alternative—a goal that so far has proven elusive.

The FASB and IASB both agree that assets and liabilities relating to lease contracts should be recognized on the balance sheet, and that the lease liability should be measured at amortized cost using an effective interest rate method. Where the boards diverge is on the path forward for addressing the criticisms related to expense recognition. The FASB prefers having two types of leases with different methods of expense recognition, while the IASB prefers that one model be developed to handle all leases.

Just when we thought it was almost over, the lessee expense recognition debate heats up again.

FASB preference: "two types of leases" approach

Based on recent discussions, it appears the FASB would prefer a lessee model that accommodates two types of leases. The first would be "finance" leases, which would retain the front-loading expense profile. For "operating" leases, the FASB is leaning toward using an "interest-based amortization" approach.

While this may result in a lease expense similar to today's accounting model, it does retain the proposal to bring all leases on the balance sheet. In addition, in a nod toward convergence, the FASB has tentatively decided to use IFRS guidance to distinguish between the two types of leases.

IASB preference: "underlying asset" approach for all leases

In contrast, the IASB expressed support for an "underlying asset" approach for all leases. IASB members prefer this approach, as it eliminates the need to distinguish between "operating" and "finance" leases. The disadvantage? Potential complexity. The FASB raised concerns that a universal application of this approach may be difficult, particularly when the fair value of the underlying asset is not readily available.

What's the underlying asset approach?

This approach is based on the presumption that lease payments typically cover three components:

(1) a payment for the part of the asset the lessee consumes during the lease term

(2) a finance charge on the part of the asset consumed when the lease payments are made over time

(3) a return on the residual value of the leased asset (because it cannot be used by the lessor during the lease term)

The right-of-use asset is amortized with reference to each of these elements.

For more information:

See a summary of key board decisions in the Appendix to this publication.

- In brief 2012-04, *Can we talk about lessee accounting…again?*
- In brief 2011-44, *FASB and IASB make significant decisions related to lessor accounting and transition*
- In brief 2011-40, *Transition decision postponed…will this delay re-exposure of the Leases exposure draft?*

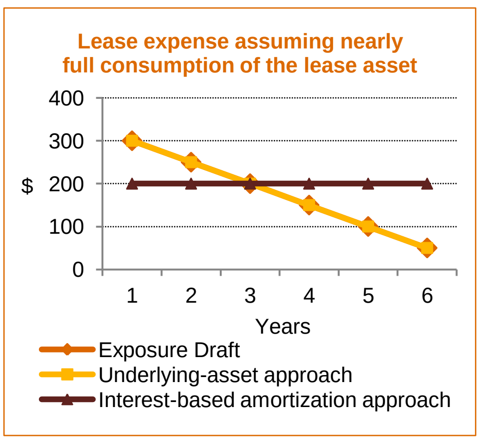
What does this mean for a lessee's lease expense? If the value of the underlying asset is not expected to decrease over the term of the lease (for example, a lease of office space), a pattern that resembles straight-line expense would be achieved. That is, when the underlying asset value is not expected to decrease, there would be no consumption of the asset by the lessee. Amortization expense on the right-of-use asset would only represent the lessor's return on the residual value of the leased asset, which increases over time. The combination of increasing amortization on the right-of-use asset and the decreasing finance charge on the lease liability over time, results in the straight-line pattern.

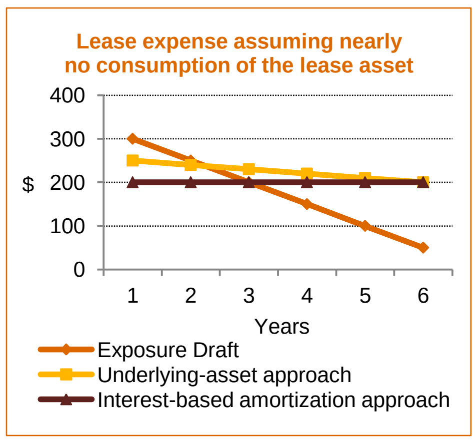
However, if the value of the underlying asset is expected to be zero at the end of the lease (for example, a lease of equipment over its useful life), the total expense profile would be front-loaded. In this case, it is assumed that the lessee fully consumes the asset, and therefore, the economic substance of the lease is a financing.

What's the interest-based amortization approach?

This approach would require a lessee, after inception, to measure the right-of-use asset at the present value of its remaining economic benefit. For a typical lease, where lease payments are made evenly over the lease term, this would result in a straight-line lease expense pattern. However, a straight-line pattern would not result for leases that contain terms such as rent-free periods, prepayments, "stepped" rent, or when consumption of the right-of-use asset is uneven over the lease term (for example, uneven use of equipment due to changes in production).

The pattern of lessee expense under the different approaches, as compared to what the boards originally proposed, is illustrated in the following charts. As depicted in the charts, the greater the consumption of the lease asset, the closer the pattern under the underlying asset approach resembles that of a "finance" lease.





What's next?

The staff will seek user and preparer input on whether the suggested approaches are operational and provide useful information. The plan is to discuss the results of this outreach this May.

The latest on lessee accounting also means that lessor accounting could be revisited by the boards. Specifically, the boards determined they would not reaffirm their decision on the scope exception for leases of investment property by lessors until the lessee expense issue is resolved. Thus, a revised exposure draft is not expected to be issued before the second half of 2012.

Insurance contracts

What's new?

The boards have recently concentrated their efforts on trying to reach agreement on a simplified measurement approach for certain insurance contracts. Do they have a consensus? For the most part yes, but some differences persist in this and other areas of the project. The boards continue to press on in an effort to finish their deliberations by mid-2012.

Finding the right ingredients for an insurance contract model

The boards have settled on the key components of their overall insurance contracts model—referred to as the building block approach. It can be described as a "current value" model, based on the present value of all expected cash inflows and outflows under the contract. Acquisition costs get added in too (although the IASB prefers a dash more of these than the FASB). The IASB also adds in a risk adjustment to reflect compensation to the insurer for bearing the uncertainty inherent in the cash flows. The boards agree that if that calculation results in net outflows, a loss should be taken immediately to the income statement. However, any expected net inflows should be deferred and recognized over future periods.

Although differences remain between the boards' models, they have temporarily accepted these areas of divergence. Is convergence out of the question? No. Their plan is to take stock at the end of their deliberations in the hopes of finding even more common ground.

Reaching agreement on the finer points of the insurance contracts model remains a challenge for the boards.

Additional challenges exist in areas where the boards are trying to provide practical accommodations. Many U.S. property/casualty preparers have recommended a simpler approach for their products (the current U.S. GAAP unearned premium model), which they argue has been satisfactory to analysts and investors for decades. As a result, the boards have been developing a simplified model (referred to as the premium allocation approach).

Premium allocation approach—one model or two?

In recent months, the boards have focused on the mechanics of the premium allocation approach, as well as eligibility criteria for use of the approach. The IASB maintains that the premium allocation approach is a proxy for the building block approach. Therefore, it would permit this approach for contracts with coverage periods of one year or less. The IASB would also allow this approach to be used for contracts longer than a year, but only if it reasonably approximates the building block model.

The FASB, however, sees the premium allocation approach as a separate model that is similar to the revenue recognition model. For this reason, the FASB would require it to be used in place of the building block approach, unless one of the following two conditions exists:

- At contract inception, it is likely that net cash flows (undiscounted) will significantly change prior to any claims
- Significant judgment is required to allocate premium to each reporting period

The bottom line? The FASB expects that short duration contracts will likely qualify for the premium allocation approach, while most life insurance and annuities would be subject to the building block approach. However, from the IASB's perspective, there may be certain property casualty contracts (for example, those with coverage periods greater than one year and long payout patterns impacted by changes in discount rates) that would not be eligible for the premium allocation approach.

What's the accounting under the premium allocation approach?

At the inception of the contract, an insurer would record a liability for the premiums received or receivable at inception. Premium revenue would then be recognized over the coverage period, which is generally consistent with U.S. GAAP today. However, when significant, discounting and accretion of the unearned amount would be required.

Once a claim is incurred, a claim liability would be recognized. However, the boards differ on their approach. The FASB would use the discounted expected cash flows, while the IASB would also add in a risk margin. As a practical expedient, discounting would not be required for contracts with coverage periods of one year or less. An onerous contract test would also be required. The onerous contract liability would be discounted only if the entity is also discounting its related claim liabilities.

Other areas still being debated

There are several areas the boards have yet to finish deliberating. Most recently, they discussed the separation of deposit elements in insurance contracts. While they have not finished this topic, the boards have changed their view on deposit components, believing that most should generally be measured under the insurance contracts model rather than the financial instruments model. They also believe that these deposit amounts—amounts received by the insurer that will be returned to the policyholder (for example, cash surrender value) irrespective of an insurable event occurring—should be excluded from premiums for income statement presentation purposes.

Previously, the boards had tentatively decided that premiums, claims, and underwriting margin should all be presented on the face of the statement of comprehensive income. As discussed above, the boards believe that premiums should not include amounts on deposit, but they still need to address how premiums will be recognized.

And finally, the boards' consideration of recording certain changes (for example, changes in discount rates) in the insurance liability within other comprehensive income will be one to watch.

What's next?

The boards plan to complete their discussions on the remaining topics by mid-2012. The FASB is scheduled to publish an exposure draft by the end of 2012. The IASB has yet to decide its next steps.

For more information:

See a summary of key board decisions in the Appendix to this publication.

- *IASB-FASB insurance contracts project summary* (as of March 7, 2012)
- Dataline 2011-14, (revised March 4, 2011), *Insurance contracts – Comment letter themes being addressed in fast paced redeliberations*
- Dataline 2010-39 (revised February 16, 2011), *Insurance contracts – Fundamental accounting changes proposed*

Consolidation

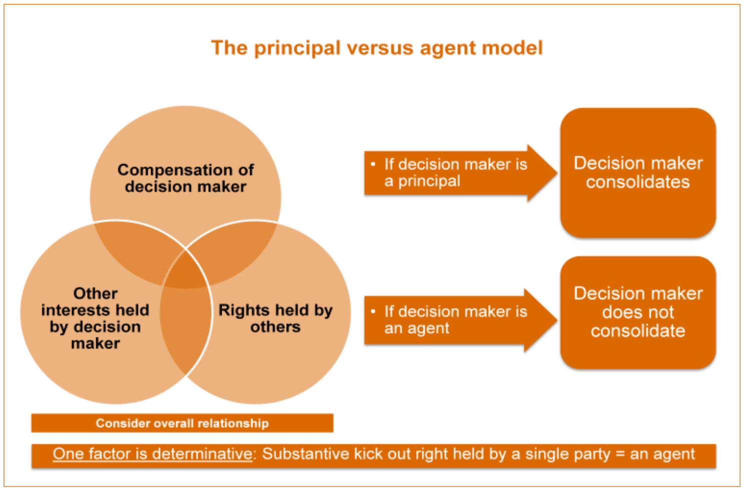
What's new?

With the comment period over, the FASB has been digesting feedback on its exposure draft. Our take so far: there appears to be general support for updating existing consolidation guidance on principal versus agent for both variable interest entities and limited partnerships. Nonetheless, most have told the FASB they would like to see a number of issues addressed before the guidance is finalized. The big question, though, is whether the FASB will make those changes since the IASB already issued its similar principal versus agency guidance almost a year ago.

What did the FASB propose?

To recap, the targeted changes provide a new framework on how to evaluate the role of a decision maker in a consolidation analysis. If a decision maker is a principal, it would consolidate. If a decision maker is an agent, it would not.

Constituents generally agree that principal versus agent guidance is needed, but that some changes to the FASB's proposal are warranted.



This evaluation would also be performed to determine: (1) whether an entity is a variable interest entity and (2) whether a general partner should consolidate a limited partnership or similar entity.

Judgment is involved, and three primary factors would be weighted in the evaluation: (1) what rights are held by parties other than the decision maker; (2) the decision maker's compensation; and (3) other economic interests held by the decision maker.

Although the proposal applies to all types of entities, it is primarily directed at asset management entities. Why? New consolidation guidance issued in 2009[3] would have affected many asset managers, often leading to a conclusion that they would be required to consolidate funds, due to their decision-making authority. Many asset managers believe this outcome is inconsistent with the nature of their role. After consideration of the issue, the FASB issued a temporary deferral of the new guidance for certain asset management entities. This deferral is proposed to be eliminated as a result of the new principal versus agent guidance.

The feedback

Given the focus of the proposal, it's no surprise that the vast majority of respondents were from the financial services industry—mostly asset managers, banks, insurers, and related trade organizations. Despite broad agreement that principal versus agent guidance is needed, the comments reveal a desire for certain changes to the proposal.

[3] In 2009, the FASB issued FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, which introduced significant changes to the consolidation model for VIEs.

Respondents provided specific feedback in the following areas:

The weighting of principal versus agent factors

The proposal provides limited guidance on how to weigh the three primary factors for evaluating whether a decision maker is a principal or agent. As a result, many are calling for more guidance. Some have also suggested a fourth factor be added to the analysis. That factor would focus on the purpose and design of the entity or scope of the decision maker's authority.

The effects of kick-out rights on the analysis

Under the proposal, substantive kick-out rights would impact the consolidation analysis, even if not held by a single party. However, less weight is placed on kick-out rights as they become more dispersed among investors and as the economic interest of the decision maker increases. While most agree that substantive kick-out rights should be considered in the analysis, they also believe that when they are substantive, the existence of kick-out rights should result in a conclusion that the decision maker is an agent—without requiring consideration of the other factors.

Money market funds

The FASB expressed its intent that money market funds should not be consolidated by their fund managers. This position was broadly embraced. However, no specific guidance or exception is provided in the proposal to achieve that outcome. Consequently, respondents have urged the FASB to either address the issue through clarifying guidance or an outright scope exception.

Other questions and issues

Questions have also been raised about: (1) when the principal versus agent analysis should be reassessed and (2) how related parties should be evaluated in the analysis. Further, some have encouraged the FASB to engage with the IASB to address differences in interpretation that appear to be emerging. One example: so-called "brain dead" entities (that is, structures where there is no ongoing decision making).

What's next?

Redeliberations are expected to begin shortly and a final standard is targeted for issuance by the FASB in the second half of 2012. An effective date has not yet been proposed. However, many respondents to the exposure draft took the opportunity to request at least 12 to 18 months subsequent to issuance to allow adequate time for implementation.

The FASB does not currently plan to hold roundtable meetings on this project. However, we expect it may conduct targeted outreach.

For more information:

- Dataline 2011-33, *Consolidation of VIEs and partnerships—more changes under consideration – FASB proposes to require principal versus agent analysis*
- Dataline 2011-29, (revised November 15, 2011), *A look at the new IFRS consolidation standard and how it compares to US GAAP – Many aspects of the IASB's consolidation guidance are now converged with US GAAP*
- In brief 2011-56, *IASB proposes amending transition guidance for new consolidation standard*

Investment companies

What's new?

The boards will have quite a bit to consider on this project, given the roughly 250 comment letters received and feedback from ongoing roundtables. Affected industry groups such as asset managers, banks, insurance companies, pension funds, and higher education institutions, represented a large portion of the respondents. At a high level, constituents appear to have given a "thumbs up" on the project objectives. Not surprisingly, though, the feedback has revealed certain concerns.

Definition of an investment company—more guidance requested

The purpose of this joint project is to develop a converged investment company accounting standard, including how an investment company should account for its investments (that is, at fair value or consolidated). The FASB is also amending its current investment company definition to reduce diversity in its application.

Despite general support for a separate model for an investment company, many commented that the definition is too "rules based" as it requires an entity to meet six prescriptive criteria. As a result, there are concerns that some investment entities would unintentionally be scoped out. Most requested that the standard provide indicators of what qualifies as an investment company, rather than a prescriptive approach. Below, we highlight the key comment themes on the proposed criteria.

Constituents are concerned that the boards' approach to defining an investment company is too prescriptive.

Nature of investment activity—the need to hold multiple investments

The proposal requires an investment company to hold multiple investments for the purpose of generating investment income, capital appreciation, or both. While most agree with the principle, they disagree with the requirement that the entity hold multiple investments. They do not believe an entity should automatically be out of scope if it holds only one investment. Instead, it should be a factor to consider.

Business purpose—more guidance needed on the "exit strategy"

The proposal would require an investment company to have a stated objective of investing only for capital returns or investment income, along with a defined exit strategy for its investments. Herein lies the concern. Constituents don't believe the "exit strategy" requirement is clear or well understood. Specifically, they are concerned that certain funds (for example, fixed income funds that hold bonds to maturity) would not qualify as having an exit strategy, even when their objective is investing for income. Most believe these and other similar funds were not intended to be excluded.

Are ownership units the only way to go?

Ownership in an investment company must be in the form of units (such as equity or partnership interests) to which a portion of the net assets are attributed. This criterion has caused some angst. Why? Many feel that investments that share significantly in the risks and rewards of the entity should qualify, regardless of their form. Examples include certain mortgage and asset backed funds, collateralized loan obligations, and other structures where investor interests are classified as liabilities for accounting purposes. As proposed, the guidance would not allow these entities to qualify as investment companies.

Pooling of funds—concern that common structures could be excluded

The pooling of funds criterion receives the prize for the most comments. The proposal would require that an entity's investors represent a pooling of interests. In other words, multiple investors, unrelated to the entity's parent, must hold a significant aggregate ownership interest. The concern? Any entities or funds that have a single investor would not qualify—often the case for pension funds, sovereign wealth funds, or non-for-profit endowments. Respondents aren't fond of this requirement and have asked the boards to consider an approach that would allow for more judgment.

As background, the boards had introduced the new pooling of funds criterion out of concern that the investment company model may be applied to achieve fair value accounting when it is not appropriate (for example, by a single investor creating a "captive" investment company for purposes of achieving a strategic investment objective). However, constituents commented that the other requirements to qualify as an investment company would negate the need for this criterion.

Fair value management—should other performance indicators count?

The proposal requires that substantially all of the investments be managed, and their performance evaluated, on a fair value basis. Most respondents agree that fair value should be an important part of the analysis. However, many don't believe that this should be the primary consideration. That's because other factors—such as credit and yield—are also commonly used to evaluate performance.

A preference for fair value reporting

Under both of the boards' proposals, an investment company must measure its investments in non-investment companies at fair value. However, the boards' approaches differ for investments in other investment companies. The FASB would require an investment company to consolidate another investment company it controls. The IASB would require such investments to be recorded at fair value.

Most support the IASB's approach, noting that funds often invest in other funds as an efficient means to achieve an investment strategy and to generate a return. Many believe that consolidation of another fund would not lead to increased transparency. In fact, some feel it could distort the investor financial statements. Operational difficulties have also been raised including:

- Potential lack of availability of underlying fund data
- The potential for frequent consolidation and deconsolidation of underlying funds based on changes in shareholder ownership activity
- Auditor issues, such as independence and cost

However, where a controlled investment fund was formed as an extension of the controlling fund's own operations (such as for tax or legal reasons), many believe consolidation would be appropriate.

For more information:

- Dataline 2011-32, *Investing in a new investment company definition—FASB proposes to align investment company definition with IFRS proposal*
- In brief 2011-37, I*ASB proposes accounting guidance for investment entities*

Accolades for retaining specialized accounting

Almost all who responded to the FASB support allowing a non-investment company parent to retain the specialized accounting of its investment company subsidiary on consolidation (that is, recording the investments at fair value). The IASB proposal does not allow this specialized accounting to be retained in consolidation. IASB respondents generally favor the FASB's approach, believing fair value information is most meaningful in the parent's financial statements.

What's next?

Joint roundtables have been occurring and will wrap up shortly. Summaries of the comment letters and roundtables are expected to be presented at the April 2012 joint board meetings. Thereafter, the boards are expected to redeliberate, with a goal of releasing a final standard before the end of 2012.

Investment property entities

What's new?

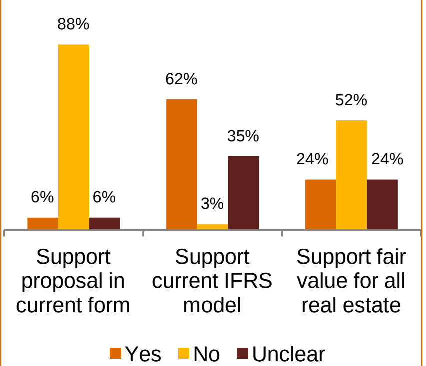
The FASB has now heard from constituents on its investment property entities exposure draft. Was the proposal well received? In short, no. Although the proposal is intended to better align U.S. GAAP with IFRS and reduce diversity in accounting for investment property, most respondents believe it will not accomplish these goals.

To start—some background on the project

A key reason for this project was to address concerns raised by lessors of investment property. They believed the proposed leasing standard would not reflect the economics of their businesses. As a result, the boards had proposed to scope out investment properties measured at fair value from the proposed lessor guidance. This was helpful for IFRS preparers, since their guidance provides an option to record investment properties at cost or at fair value. However, U.S. GAAP currently doesn't provide guidance for measuring investment properties at fair value.

To address this dichotomy, the FASB added the investment property entities project to its agenda. Subsequently, the boards tentatively decided to scope all investment property (whether or not measured at fair value) out of the lessor "receivable and residual" approach in the leases project. The result? Lease accounting by lessors of investment property would be similar to operating lease treatment today, perhaps negating the need for this project for many entities.

Comment letter trends for investment property entities



The feedback

Overall, it was pretty downbeat—but the reasons varied. Respondents were generally one of two types of entities: (1) those that consider themselves "operating entities" (for example, many public real estate investment trusts and banks, and insurance companies that invest in real estate) and (2) those that consider themselves "investment entities" (for example, pension fund investors, real estate investment advisors, real estate funds, and their sponsors).

"Operating entities" generally consider this project unnecessary given the tentative scope exception for lessors. They believe existing operating lease treatment best reflects the economics of their activities. However, many stated their response is dependent on lessor-related decisions in the leases project. Why? They would prefer fair value accounting for their investment properties if it was the only way to avoid the proposed lessor receivable and residual approach.

Convergence with IFRS—which does not currently exist in this area—is also something that "operating entities" would like to see. The current IFRS standard for the measurement of investment property is asset-based (rather than the FASB's entity-based scope). Furthermore, IFRS provides an option to record investment property at fair value or at cost, unlike the FASB's proposal, which requires fair value.

What about the "investment entities" group? Those respondents generally believe a separate project on investment property entities is redundant to the investment companies project.[4] However, they would like guidance on how real estate funds should report as an investment company. Specifically, should they present rental income and related expenses on a gross or net basis in the financial statements?

Other key themes from the comment letters:

[4] See the *Investment companies* section of this publication.

Scope—refinements and clarifications requested

Entities that meet specified criteria (similar to those in the investment companies proposal) would record their investment properties at fair value, with changes in fair value recognized in net income. The reaction? The "nature of business" criterion—which requires substantially all of an entity's activities to consist of investing in real estate—attracted a number of comments. Some noted that investments made through non-controlled joint ventures would not meet the "substantially all" test.

In addition, an entity would be required to have a defined exit strategy for its real estate investments. Similar to the comments made in response to the investment companies proposal, constituents want some clarity here. Specifically, what constitutes an exit strategy and how must it be demonstrated?

Views are mixed on consolidation requirements

The proposal would require that an investment property entity consolidate controlling financial interests in: (1) another investment property entity; (2) an investment company; or (3) operating entities providing services to the investment property entity. Other controlling financial interests would be measured at fair value.

In general, "operating entities" support these requirements. The story is different for "investment entities," where some do not support these proposed consolidation rules. Rather, they would prefer that today's consolidation guidance for investment companies be retained (that is, no consolidation and reflecting controlling financial interests at fair value on a net basis). Others, predominantly those who want to present real estate on a gross basis, do support the proposed consolidation rules.

For more information:

Dataline 2011-34, *Investment property entities – The good, the bad and the ugly*

Gross or net presentation—it depends on the nature of the assets

Investment properties would be recorded separately from any associated debt on the balance sheet (gross presentation). Rental revenue and related expenses for investment properties would also be presented gross on the income statement. Most "investment entities" seem to favor an option for gross or net presentation to allow flexibility to apply the most appropriate presentation in the circumstances. Preparers would lean toward gross presentation for "core" investments (that is, primarily invested in for income yield). For those assets that are more "opportunistic" in nature (that is, invested for potential fair value gain), net presentation might be preferred.

Measurement of liabilities—is fair value the most appropriate?

Under the proposal, an investment property entity would measure its financial liabilities (for example, debt) in accordance with applicable U.S. GAAP (not at fair value). Many "investment entities" disagree, citing that fair value is most relevant for their users. In particular, they believe their users look to the net asset value of the entity—based on fair value financial data—as a vital performance measure. "Operating entities" generally did not express concern with this proposal.

Use of net asset value (NAV)

An entity would be permitted to estimate the fair value of its investment in an investment property entity using NAV as a practical expedient, but only if the investor would transact at this value. This proposal is not supported by "investment entities." Why? It may reduce their ability to use the practical expedient, even if NAV approximates fair value.

What's next?

The FASB has been holding roundtable discussions and is expected to begin redeliberating soon. Given the feedback so far, it is unclear how the project may proceed. Stay tuned in the coming months.

Other FASB-only projects

Outside the joint projects, the FASB continues work on projects that impact U.S. GAAP. Highlights of these are included here.

Intangible assets—an opportunity for simplification

During the process leading up to the new standard for assessing impairment of goodwill, many constituents told the FASB that similar cost-benefit concerns existed regarding the impairment test for indefinite-lived intangibles. Some also believe that continuing to require an annual calculation of indefinite-lived intangibles' fair values would prevent the new goodwill guidance from fully achieving its cost savings objective. This is because many of the fair value inputs necessary to determine a reporting unit's fair value (such as cash flow projections) are also used to calculate the fair value of indefinite-lived intangibles assets.

Responding to this feedback, the FASB recently released an exposure draft that would simplify the indefinite-lived intangible asset impairment test. Similar to the new goodwill impairment guidance, the proposed approach would allow companies to elect to perform a qualitative assessment to determine if further impairment testing is necessary. The proposal would eliminate the need to calculate the fair value of indefinite-lived intangible assets unless an impairment is considered more likely than not.

Comments on the exposure draft are due April 24, 2012. Given the comments on the goodwill impairment exposure draft, we anticipate the feedback will be supportive. Assuming a positive reaction, the FASB will move this project on a fast track with a goal of issuing a final standard in second quarter 2012. It is expected the new guidance will be effective for fiscal years beginning after June 15, 2012, with early adoption permitted.

For more information:

In brief 2012-02, *FASB proposes changes to indefinite-lived intangible impairment test*

Disclosure of risks and uncertainties…to liquidation accounting

Recently, the FASB changed course on its disclosure of risks and uncertainties project (formerly referred to as the going concern project). Originally, the project would have (1) required management to assess whether the company is a going concern and make certain related disclosures and (2) provided guidance on the liquidation basis of accounting. Now, the project will only address when and how an entity should apply the liquidation basis of accounting.

Why the change?

The FASB has been working on this project for some time. Originally, its primary objective was to determine whether the evaluation of an entity's ability to continue as a going concern should be management's responsibility. Any new standard would have also provided guidance on how an entity should go about that evaluation along with related disclosures. After issuing an exposure draft in 2008, the FASB put the project on the back burner, while it focused on the joint priority projects.

During fourth quarter 2011, the FASB re-activated the project, with much of the debate centered on whether management should be required to make the going concern assertion. Ultimately, the FASB changed course and decided not to pursue either the going concern assessment or additional disclosures about risks and uncertainties. Instead, the FASB decided to address specific liquidity risk and interest rate risk disclosures in a separate project and scale back this project to address only the liquidation basis of accounting. For further information on the disclosure project, refer to the *Financial instruments* section of this publication.

The liquidation basis of accounting

This project will now be limited to providing guidance on the liquidation basis of accounting. This will include criteria to determine whether liquidation of an entity is imminent. The FASB reconfirmed its previous tentative decisions in this area:

- An entity should prepare financial statements on a going concern basis unless the decision to liquidate is imminent
- The liquidation basis of accounting should reflect relevant information about the value of an entity's resources and obligations in liquidation

What does this mean? In essence, a company reporting under the liquidation basis of accounting would present its assets and liabilities at the amounts it expects to receive or pay during liquidation. In addition, under the liquidation basis of accounting, an entity would have to prepare a statement of net assets and a statement of changes in net assets in liquidation. It would also be required to disclose all measurement bases and significant assumptions used. The FASB is scheduled to issue an exposure draft in second quarter 2012, with a 90-day comment period.

Appendix: highlights of priority project board decisions

Financial instruments: summary of FASB decisions on classification and measurement to date

Component	Current proposal
Principle for classification	Financial assets are classified into one of three categories based on: (1) the individual instrument's characteristics and (2) an entity's business strategy for the portfolio. Financial liabilities classification is also based on the individual instrument's characteristics and a more limited business strategy evaluation.
Debt investments	Classified into one of the following categories: (1) amortized cost; (2) fair value with changes in fair value recognized in other comprehensive income; or (3) fair value with changes in fair value recognized in net income. Generally, only loans and receivables would be measured at amortized cost.
Debt liabilities	Classified into one of the following categories: (1) amortized cost; or (2) fair value with changes in fair value recognized in net income.
Equity investments (not under the equity method of accounting)	Classified as fair value with changes in fair value recognized in net income. Nonpublic entities are provided a practicability exception for the measurement of nonmarketable equity securities.
Equity method of accounting	Applicable if significant influence over the investee exists, but only if the investment is not held for sale. If held for sale, equity investment accounting applies (that is, fair value).
Hybrid instruments for financial assets and financial liabilities	Embedded derivatives that are not clearly and closely related to the host contract in a hybrid instrument are separately accounted for at fair value with changes in fair value recognized in net income.
Fair value option	Only available for: (1) hybrid financial instruments, in order to avoid the complexity of separately accounting for embedded derivatives and (2) groups of assets and liabilities managed and reported on a net exposure basis.
Presentation	Fair value is presented parenthetically on the face of the balance sheet for financial assets measured at amortized cost. Amortized cost must be presented parenthetically for financial liabilities recorded at fair value (such as debt), excluding demand deposits.

Financial instruments: summary of FASB decisions on disclosures to date

	Non-financial institutions	Financial institutions
Qualitative disclosures	*Liquidity risk:* • The entity's exposure and how it arises • The entity's objectives, policies, and processes for measuring and managing the risk • Any changes in the above from previous period and reason for change	*Liquidity and interest rate risks:* • The entity's exposure and how it arises • The entity's objectives, policies, and processes for measuring and managing the risk • Any changes in the above from previous period and reason for change
Quantitative liquidity risk disclosures	• *Available liquid funds table*: shows unencumbered cash and high-quality liquid assets currently held, and available sources of borrowings (e.g., lines of credit) • *Expected cash flow obligations table*: shows the undiscounted amount and timing for all obligations, including off-balance-sheet items	• *Available liquid funds table*: shows unencumbered cash and high-quality liquid assets currently held, and available sources of borrowings (e.g., lines of credit) • *Expected maturity table:* shows amount and timing of expected settlement based on contractual terms for all financial assets and liabilities
Quantitative interest rate risk disclosures	Not applicable	• *Repricing analysis table:* shows timing of when interest rates would be reset on classes of interest-bearing financial assets and liabilities • *Interest rate sensitivity table:* shows impact on net income and equity of prospective, hypothetical interest rate shifts on an entity's interest-sensitive financial assets and liabilities • *Time deposits table (for depository institutions only):* shows total amount and average interest rate and life for issuances of classes of time deposits for the previous four quarters

Revenue recognition: summary of joint board decisions to date

Component	Current proposal

Scope	• Applicable to all industries and entities
	• Contracts scoped out:
	  • Financial instruments
	  • Insurance contracts
	  • Lease contracts
	  • Guarantees (excluding warranties)
	  • Certain nonmonetary exchanges

Contract modifications	• Considered a separate contract and accounted for prospectively if the modification results in the addition of a separate performance obligation and price is reflective of stand-alone selling price of the additional obligation • Otherwise accounted for as an adjustment to the original contract either through a cumulative catch-up adjustment or prospective adjustment as future performance obligations are satisfied

Identifying separate performance obligations	• Separate performance obligations exist if the goods or services are "distinct," meaning:
	  • The entity regularly sells the good or service separately
	  • The customer can use the good or service on its own or together with resources readily available to the customer
	• Account for a bundle of goods or services as a single performance obligation if both:
	  • The goods or services are highly interrelated and the entity provides a significant service of integrating the goods or services into the combined item
	  • The bundle is significantly modified or customized to fulfill the contract

Elements of the transaction price	• Includes fixed and variable consideration with variable consideration at a probability-weighted estimate or most likely amount of cash flows, whichever is most predictive • Time value of money is included when significant and if it exceeds a period greater than one year • Bad debts are not included; rather, they are reflected in a line item adjacent to revenue (not as an expense)
Allocation of transaction price to multiple performance obligations	• Based on relative selling price of all performance obligations • Residual technique may be used when the standalone selling price of a good or service is highly variable or uncertain • Variable consideration and discounts can be allocated to one (or more) performance obligations in some cases
Timing of revenue recognition	• Goods and licenses: when control passes • Services: as the obligation is being satisfied, if specified criteria are met. Otherwise, upon completion of the service. • Constrained to the amount that is "reasonably assured"
Customer options	• Only considered a separate performance obligation if the option provides the customer a material right (for example, a discount incremental to the range of discounts typically given to similar customers in similar markets)

Component	Current proposal
	• Recognize revenue allocated to the option when the option expires or when the additional goods or services are transferred
Warranties	• Accounted for as a separate performance obligation if the customer has the ability to purchase it separately • Considered a cost accrual if not sold separately unless a service is provided in addition to the standard warranty
Rights of return	• Generally consistent with existing guidance • Derecognize the full value of inventory, record a liability for the refund obligation, and recognize an asset representing the right to recover goods • Recognition of revenue is precluded when an entity is unable to estimate returns
Onerous contract losses	• Only for performance obligations satisfied over a period of time longer than one year • Loss equals: (1) lower of direct costs to satisfy the obligation or to cancel the contract, less (2) consideration allocated to that performance obligation
Capitalization of contract costs	• Incremental costs of obtaining a contract are capitalized if expected to be recovered. Entities may choose not to apply to short-term contracts (12 months or less). Assets are amortized over the expected period of benefit, which may exceed the contract term. • Costs to fulfill a contract are capitalized based on other applicable guidance (for example, inventory) or if specified criteria are met
Breakage (forfeitures)	• Breakage revenue is recognized in proportion to the pattern of rights exercised by the customer if expected breakage is reasonably assured • If not reasonably assured, revenue is deferred until it becomes remote the customer will exercise its rights under the contract
Gross versus net presentation	Evaluation is similar to existing guidance

Disclosure	• Significant increase in disclosure requirements such as:
	    • Disaggregation of revenue into primary categories that depict the nature, amount, timing, and uncertainly of revenue and cash flows
	    • Tabular reconciliation of the movements in capitalized costs to obtain or fulfill a contract
	    • Analysis of remaining performance obligations, including nature of goods and services, timing of satisfaction, and significant payment terms
	    • Information on onerous performance obligations and tabular reconciliation of movements in the corresponding liability
	    • Significant judgments and changes in judgments that affect the determination of amount and timing of revenue
	• Many of the disclosure requirements would apply to interim periods, if material
	• Certain exceptions are provided for nonpublic entities

Transition	Retrospective application to all periods with certain relief accommodations

Appendix, continued

Leases: summary of joint board decisions to date

Component	Current proposal
Scope	• Includes contracts in which the right to use a specified asset (explicit or implicitly identified) is conveyed, for a period of time, in exchange for consideration • Requires the lessee to have the ability to direct the use of, and receive substantially all the potential economic benefits from, the asset throughout the term of the arrangement • Excludes: (1) leases to explore for, or use, minerals, oil, natural gas, and similar non-regenerative resources, (2) leases of biological assets, (3) application of receivable and residual approach by lessors for leases of investment property
Lease term	• Includes the fixed non-cancellable term plus any options to extend or terminate when a significant economic incentive exists (for example, bargain renewal options) • Reassessment is required when there is a significant change in one of the indicators (excluding changes in market rates after lease commencement) relating to significant economic incentive

Variable lease payments	• The following variable lease elements are included within the lease payments:
	  • Future lease payments based on a rate or index
	  • "Disguised" minimum lease payments
	  • For lessees, residual value guarantees expected to be paid
	• Lease payments based on a rate or index would initially be measured at the spot rate that exists at lease commencement; reassessment is required as rates or indices change
	• Contingent rents based on usage or performance are not included, unless they are considered "disguised" minimum lease payments

Discount rate	• Lessees should discount lease payments using the rate being charged by the lessor if known; otherwise, the lessee's incremental borrowing rate should be used • Lessors should discount lease payments using the rate they charge in the lease
Lessee accounting	• At commencement, lessees recognize a liability measured at the present value of the lease payments, and a right-of-use asset equivalent to the lease liability plus initial direct costs • Leases are generally treated as financing transactions. This means that for a given lease, amortization and interest expense, rather than rent expense, will be reflected in the income statement. This will result in an accelerated income statement recognition pattern for the lease as compared to today's operating lease treatment.[5]
Lessor accounting	At lease commencement, the lessor derecognizes the leased asset and records a lease receivable and residual asset. Day-one profit is recognized related to the lease receivable, but profit related to the residual asset would be deferred and only recognized after the initial lease ends. Exception to the receivable and residual approach provided for leases of investment property.

[5] The boards are in the process of redeliberating this tentative decision. Refer to the *Leases* section within this publication for information about the current status.

Component	Current proposal
Short term leases	Lessees and lessors can elect to account for leases that have a maximum term of 12 months or less (including any renewal options) in a manner similar to today's accounting for operating leases
Impairment	• Lessees would follow existing guidance on impairment of fixed assets when evaluating the right-of-use asset • Lessors would follow existing guidance on impairment of financial instruments when evaluating the lease receivable and guidance for fixed assets when evaluating the residual asset
Separating lease and non-lease components	Lease and non-lease components in a multiple element contract should be identified and accounted for separately
Lease incentives	• Lessees would deduct incentives that meet the definition of initial direct costs from the right-of-use asset. Other upfront cash payments would be netted against total lease payments when calculating the lease liability. • Lessors would capitalize amounts paid to lessees that meet the definition of initial direct costs. Other upfront cash payments would reduce profit.
Sale leaseback	When a sale has occurred, the transaction would be accounted for as a sale and then a leaseback. Entities would apply the control criteria in the revenue recognition project to determine whether a sale has occurred.
Contract modifications	• When there is a contract modification that results in a different determination as to whether the contract is, or contains, a lease, the original contract would be considered terminated and the modified contract would be accounted for as a new contract • When there is a change in circumstances that would affect the assessment of whether a contract is, or contains, a lease, reassessment would be required and the lease would be recognized or derecognized, accordingly
Subleases	Subleases would be accounted for as two separate transactions. That is, an intermediate lessor would utilize lessee accounting on the head lease and lessor accounting on the sublease.
Presentation and disclosure	• A number of new disclosures will be required, including: a rollforward of activity for a lessee's right-of-use assets (by class) and lease liability (in aggregate), a maturity analysis showing at least the next five years of undiscounted cash flows due under recognized lease commitments with a total amount thereafter, and a table summarizing all expenses recognized during the period related to leasing activities • Lessees will be required to allocate lease payments between the portions attributable to interest and principal and classify the amounts as operating and financing cash outflows, respectively. Lessors would classify cash inflows from a lease within operating activities.
Transition	Lessees and lessors have will have the option to apply the full retrospective or modified retrospective approach. Under the modified retrospective approach, all leases will be treated as if they are outstanding from lease commencement rather than from the date of transition, however, a more simplified approach than full retrospective application will be used.

Appendix, continued

Insurance contracts: summary of joint board decisions to date

Component	Current proposal
Scope	• Applies to all entities that issue insurance contracts (as defined), not just insurance entities • Excludes certain contracts that otherwise meet the definition of insurance contracts (for example, certain warranties, residual value guarantees, and certain fixed fee service contracts)
Measurement model	The model is "current value" (that is, based on the present value of expected future cash inflows and outflows, updated each period). The IASB model includes an explicit risk adjustment while the FASB model does not.
Acquisition costs	Cash flows are reduced by the direct costs associated with selling, underwriting, and initiating contracts, although the FASB would only include costs for successful efforts and the IASB would also include costs for unsuccessful efforts
Simplified measurement model (premium allocation approach)	This approach is permitted by the IASB when it is a proxy for the current value measurement model and is required by the FASB when specified criteria are met. Used for measuring the pre-claim liability for certain short duration contracts.
Reinsurance	The same measurement model used for other contracts is applied to reinsurance, with ceding commission paid to the ceding company treated as a premium reduction
Unbundling	Certain components that are not closely related to the coverage provided by the contract would be unbundled (for example, embedded derivatives and certain services). These components would be accounted for under other guidance, or, for certain deposit elements, separated and excluded from premiums reported in the income statement.
Recognition and derecognition	Recognize at the start of coverage period unless onerous; derecognize when extinguished
Presentation and disclosure	• Requires certain specific line items to be included in the statement of comprehensive income, including premium, claims, benefits, and underwriting margin • Requires qualitative and quantitative information about the amounts recognized in the financial statements and the nature and extent of risks, as well as balance rollforwards • Boards are considering potential other comprehensive income treatment for changes in the measurement due to discount rate changes
Transition	The boards have committed to redeliberate transition in an effort to provide a practical approach to retrospective application

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