

Accounting and Reporting Update

IASB/FASB CONVERGENCE PROJECT UPDATE

April 2011



- Goal is a single set of high-quality, international accounting standards
- Path toward that goal is a collaborative effort of FASB/IASB to improve both US GAAP and IFRS and eliminate differences between them
 - Norwalk Agreement – 2002
 - Updated MOU's in 2006 and 2008
- June 2010 reprioritization announcement
- Recently pushed some projects to 3rd quarter 2011

- Deferred certain joint projects
 - Financial Statement Presentation
 - Financial Instruments with Characteristics of Equity
 - Emissions Trading Schemes
 - Reporting Entity Phase of the Conceptual Framework
 - Consolidation: Policy and Procedures
- Deferred deliberations on several independent standards setting projects – such as contingency disclosures for FASB

- SEC believes that a single set of high-quality, globally accepted accounting standards would benefit US investors
- Continued convergence of US GAAP and IFRS is encouraged
- Outlines factors important in its evaluation of IFRS
- Directed SEC staff to develop and execute a Work Plan
- Execution of the Work Plan combined with the completion of convergence projects will position the SEC to make a determination regarding IFRS for US issuers in 2011
- October 29, 2010 – Progress report issued on the Work Plan
- May see a recommendation that comes short of a full mandate

- SEC “Work Plan”
 - Sufficient Development and Application of IFRS for US Domestic reporting system
 - Independence of Standard Setting for Benefit of Investors
 - Investor Understanding & Education Regarding IFRS
 - Examination of US Regulatory Environment
 - Impact on Issuers – Including Changes to Systems, Contractual Arrangements, Corporate Governance and Litigation Contingencies
 - Human Capital Readiness

- October 2010 – Update on Work Plan
- No conclusions reached
- Sufficient development and application of IFRS
 - Comprehensiveness of IFRS
 - Auditability and enforceability of IFRS
 - Comparability of IFRS financial statements within and across jurisdictions
- Independence of Standard Setting for the Benefit of Investors
 - Funding and oversight
 - Composition of the IFRS Foundation and IASB
 - IASB standard-setting process

- Investor Understanding and Education (asked for comments by 10/18/10)
 - Investor's current knowledge and preparedness for IFRS
 - How investor's educate themselves on changes to accounting standards
 - Estimated time necessary to undertake changes to improve investor understanding of IFRS
- Regulatory environment
 - Reviewing transitional considerations related to other regulators
- Impact on issuers
 - Cost benefit analysis
 - Contractual arrangements and corporate governance impact (asked for comments on this by 10/18/10)
- Human capital readiness
 - Evaluation of education, training, auditor constraints

Current Status of select FASB/IASB Convergence Activities

Project (updated)	Expected Exposure Draft	Expected Final Standard
Accounting for Financial Instruments	Various	3rd qtr 2011
Revenue Recognition	2nd qtr 2010	3rd qtr 2011
Leases	3rd qtr 2010	3rd qtr 2011
Statement of Comprehensive Income	2nd qtr 2010	2nd qtr 2011
Fair Value Measurement	2nd qtr 2010	2nd qtr 2011
Balance Sheet - Offsetting	1st qtr 2011	2nd qtr 2011
Consolidation: Voting Interest Entities	1 st qtr 2011	3 rd qtr 2011
Consolidation: Investment Companies	2 nd qtr 2011	4 th qtr 2011
Reporting Discontinued Operations	2 nd qtr 2011	4 th qtr 2011
Effective Dates and Transition Methods	4 th qtr 2010	

- Issued October 2010, comments due January 31, 2011
- Seeks input on:
 - Effort involved in adopting convergence proposals
 - Transition methods – “big bang” or over a number of years
 - Varying effective dates for different entities?
- Goal is to issue implementation plan to manage pace and cost of change
- Also requested information on:
 - How they use financial statements
 - How the new standards will affect them

- Projects that are the subject of the discussion paper:
 - Financial instruments
 - Revenue recognition
 - Financial statement presentation
 - Financial instruments with characteristics of equity
 - Insurance contracts
 - Comprehensive Income
- FASB asked how private companies would be affected specifically

- The two boards' original approaches differed in important respects:
 - FASB – more fair value measurements than currently
 - ED issued 5/26/10 on all aspects of the project including hedging and impairment
 - IASB – retain mixed attribute approach – different criteria for amortized cost measurement
 - Issued IFRS 9 on 11/12/09 on classification and measurement-part one of three
 - EDs issued on Impairment of Financial Instruments and the use of the FVO for liabilities
 - 12/8/2010 Hedge accounting Exposure Draft

- Subsequent activities to original ED's:
 - 2/10/2011: Joint impairment supplement issued
 - 2/9/11 FASB issues discussion paper on Hedge Accounting

- Comments were due 9/30/10
- Accounting for Financial Instruments and Revisions to Accounting for Derivative Instruments and Hedging Activities
 - Significantly affects accounting for financial instruments
 - More financial instruments will be at fair value
 - Revised criteria for using amortized cost
 - New classification that replaces available for sale, held to maturity and held for investment
 - New approach for recognizing and measuring credit losses

- New classification
 - Fair value with changes in Net Income (default)
 - Fair value with changes in Other Comprehensive Income
 - If amount would be returned upon maturity, cash flows are identified
 - Intent – business strategy is to collect or pay off
 - No embedded derivative that is required to be separated
 - Amortized cost
 - Meet all requirements of Fair value with changes in OCI
 - Doesn't exceed one year
 - Measurement would create a mismatch

- Credit Impairment
 - Recognize when the entity “does not expect to collect all the contractual amounts due”, present value of **expected** cash flows
 - Do not apply probability threshold
- Hedging
 - Lowers minimum threshold from “highly effective” to “reasonably effective”
 - Qualitative assessment is sufficient

- IASB split the project into 3 stages:
- IFRS 9, *Financial Instruments* – issued on 11/12/09 – contains requirements for classifying and measuring financial assets
- ED issued 11/09 – *Amortized Cost and Impairment*
- ED issued 12/10 – *Hedge Accounting*

IASB ED

- Expected cash flow approach would replace current incurred loss model
- Time horizon covers the life of the asset
- Expectations of future economic and market conditions are considered in estimates
- Probability-weighted estimates of cash flow timing and amount

IASB ED

- Future economic events and conditions considered
- Credit losses embedded in the effective interest rate
- Initial estimate of credit losses is recognized as a reduction of interest income over life, reducing asset yield and net interest margin
- Excess of interest contractually due over income recognized – gradually builds the allowance for credit losses (vs. immediate recognition of the full allowance)

- 2,814 Comment Letters received on Exposure Drafts: 82% represented “preparers”, 1% represented “users”
- Overwhelming feedback from the exposure draft, particularly around the possibility that loan portfolios would be required to have changes in fair value go through profit and loss, as well as the significant departure from convergence with the IASB resulted in re-deliberations by the board
- Differences in the accounting and presentation of credit impairments resulted in the joint issuance of a supplement to address a solution for impairments.

- Common solution proposed for impairment accounting – issued 1/31/11 as a Supplement to the original ED’s
- Currently, US GAAP and IFRS account for credit losses using an “incurred” loss model
- Proposed model is an “expected” loss approach
- “Good book” expected losses are recognized over time, using “time-proportional” approach
 - Allowance calculated as a portion of the remaining lifetime expected losses on the portfolio, based on the age of the portfolio
 - Minimum allowance balance will be $>$ of time-proportional amount and the expected losses for the foreseeable future (floor) – no less than 12 months
- “Bad book” – Expected losses are recognized immediately
- Comments due on April 1, 2011

Other recent tentative decisions reached by the Boards:

- FASB agreed that **both** the characteristics of the financial asset and the entity's business strategy should be used to determine classification and measurement and is tentatively considering 3 categories:
 - Fair Value – Net Income (FV-NI): Fair value measurement with all changes in FV recognized in net income. This includes financial assets for which an entity's business activity is trading or holding for sale.
 - Fair Value – Other Comprehensive Income (FV-OCI): Fair value measurement with qualifying changes in fair value recognized in OCI. This includes financial assets for which an entity's business activity is investing with a focus on managing risk exposures and maximizing total returns.
 - Amortized Cost: Financial assets that an entity manages for the collection of contractual cash flows through lending or customer financing (ie: loans) should be measured at amortized cost (converged with IASB approach).

Other recent activity by the Boards:

- Hedge Accounting –
 - IASB ED 12/10 – Hedge Accounting
 - FASB – Discussion Paper issued based on IASB ED
 - Comments due 4/15/11

- On 6/24/10, FASB and IASB issued an ED, *Revenue from Contracts with Customers* – comments were due 10/22/10
 - Revenue should be recognized when a transfer of goods or services takes place
 - Focus is on the contract with the customers
 - Revenue is recognized in the amount of consideration the transferor receives or expects to receive from the customer

- Performance Obligation
 - A performance obligation is an [enforceable] promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to the customer. Each promised good or service would be accounted for separately if they are distinct (that is, if the company, or another company, sells an identical or similar good or service separately, or the company could sell the good or service separately because it has a distinct function and a distinct profit margin).
- At February 2011 meeting, the boards agreed to eliminate the word “enforceable”

- Transaction price
 - The transaction price is the amount of consideration received or expected to be received from the customer in exchange for transferring goods or services promised in the contract. If the amount of consideration is variable, a company would recognize revenue if it can be reasonably estimated. In determining transaction price at inception, [a company needs to consider the effects of collectability], the time value of money, noncash consideration and any consideration payable to the customer.
 - At March 2011 meeting – boards removed the consideration of collectability – should be recorded as “contra-revenue” vs. part of revenue

- In order to apply this principle, a company would:
 - Identify the contracts with a customer
 - Identify the separate performance obligations in the contract
 - Determine the transaction price
 - Allocate the transaction price to the separate performance obligations
 - Recognize revenue when the entity satisfies the performance obligation

- Identify the contracts with the customer
 - Combine contracts if prices are interdependent, **negotiated as a package with a single commercial objective, amount of consideration in one contract depends on the other contract, goods or services in the contracts are interrelated in terms of design, technology, or function**
 - Segment a contract if prices are independent
 - Contract modifications accounted for separately if priced independently

- Identify the separate performance obligations in the contract
 - Separate performance obligation is a promise to transfer a distinct good or service to the customer
 - A good or service is distinct if it:
 - Is sold separately **by the entity**
 - [Has a distinct function and a distinct profit margin]
 - **Customer can use on its own or together with other resources**
 - **Separate warranties only if can purchase separately**

- Determine the transaction price
 - Transaction price is the expected (probability-weighted) consideration from the customer, and reflects:
 - Reasonable estimates of contingent amounts
 - Credit risk
 - Implicit financing

- Allocate the transaction price to the separate performance obligations
 - In proportion to the standalone selling prices of the goods or services at contract inception
 - If the selling price is not directly observed, it is required to be estimated
 - Allocation updated over the life of the contract to reflect changes in circumstances
 - No residual method

- Recognize revenue as performance obligations are satisfied
 - Generally when the good or service is transferred to the customer (customer has control)
 - Customer has control when they have the ability to direct the use of and receive the benefit from the good or services
 - Control indicators
 - Customer has an unconditional obligation to pay
 - Customer has legal title
 - Customer has physical possession
 - Risks and rewards of ownership (**new**)
 - [The design/function is customer specific] - **deleted**

- Revenue recognition for services
 - Performance obligation is satisfied if:
 - Entity's performance creates or enhances an asset that the customer controls, OR
 - Entity's performance does not create an asset with an alternative use and at least one of the following is met:
 - Customer receives a benefit
 - Another entity would not need to reperform if they took over the contract
 - Entity has a right to payment for performance even if customer cancels

- Most costs of obtaining a contract would be expensed as incurred, unless eligible for capitalization in other standards (e.g., inventory) – **Boards backtracked on this – now ALL incremental costs should be capitalized and amortized (e.g., sales commissions, etc.)**
- Recognize a liability for onerous performance obligations
 - Onerous if expected costs exceed carrying amount of [performance obligation] – **Boards changed this to “contract”**
- New disclosures:
 - Disaggregation of revenue
 - Reconciliation of contract balances
 - Maturity analysis of performance obligations exceeding one year
 - Judgments in applying requirements

Revenue Recognition ED – Feedback from comment letters

- 972 Comment letters received
- Clarify the principle/indicators for determining when goods/services transferred
- Control is difficult to apply to construction and services contracts
- Clarify the principle/indicators for identifying separate performance obligations
- Risk that breaking up some contracts (e.g., construction) more than users would find useful
- Disclosure requirements are excessive
- Full retrospective transition would be too costly
- Concerns about proposals on warranties, licenses, and the onerous test at the level of each performance obligation

Next steps:

- More deliberations
- Final standards expected next quarter

- FASB issued FAS 157 (now Topic 820) in 2006, effective in 2007
- IASB issued a Discussion Paper in May 2009
- 6/29/2010 - Both FASB/IASB issued proposed updates to Fair Value Measurements, comments due 9/7/2010
- Objective is to create a converged standard
- Additional disclosures proposed
- Certain exemptions for nonpublic entities

Current standards:

- US GAAP has one fair value definition (FAS 157), IFRS has several
 - FAS 157 – how to, not when to, measure fair value
 - IASB exposed FAS 157 with some minor modifications
 - Both FASB and IASB have issued additional guidance due to financial crisis
- Proposed improvement
 - Common definition of fair value and approach to measurement
 - In US, add a disclosure about sensitivity to measurement uncertainty (similar to existing IFRS)

Key issues being redeliberated:

- Blockage & other premiums/discounts
- Fair value for certain financial instruments based on a net open risk position
- Fair value of instruments classified in shareholder's equity
- Highest & best use and valuation premise- unit of account clarity
- Measurement uncertainty analysis disclosure – disclose effects of reasonably possible alternative inputs?
- Other – current use if different from highest and best use, level in fair value hierarchy for fair value measurements disclosed, but not reported, all transfers in/out of Levels 1 and 2
- Final guidance expected by June 2011

- Lease Accounting project added to FASB/IASB agenda in June 2006
- Investor/user concern over off-balance-sheet treatment (lack of transparency)
- Lease accounting under FAS 13 – rules based – bright lines
- Application of the rules often resulted in similar leases being treated differently
- March 2009 Discussion Paper issued
- Exposure Draft issued August 2010
- Boards are proposing significant changes to both US GAAP and IFRS

- Issued 8/17/10
- Comments were due 12/15/10
- Impacts all companies that lease assets as a lessee or lessor
- No effective date proposed
 - Boards will issue a separate discussion document to solicit effective date feedback taking into consideration all joint projects currently on the agenda

- Applies to all leases, except:
 - Leases of intangible assets
 - Leases to explore for or use minerals, oil, natural gas and similar nonregenerative resources
 - Leases of biological assets
- Contracts that represent a sale of the underlying asset are also excluded, a contract would be considered a sale, if the contract transfers both of the following:
 - Control of the underlying asset
 - All but a trivial amount of the risks and benefits of the underlying asset
- Leases 12 months or less can use a simplified approach to recognition and measurement

Contracts that contain both service and lease components

- Lease payments must be allocated between the lease component and the service component when the service component is “distinct”
 - If the entity or another entity sells, or could sell, an identical or similar service separately
 - If unable to distinguish, account for the entire contract as a lease

Basis for measurement for both Lessees and Lessors

- Assets and liabilities would be measured:
 - Assuming the longest possible lease term that is [more likely than not] **reasonably assured** to occur, taking into account any options to extend or terminate the lease
 - Using an [expected outcome] **best estimate** technique to reflect the lease payments, including contingent rentals and expected payments under options, and residual guarantees specified under the lease
 - Updated when changes in facts or circumstances indicate there would be a significant change in those assets and liabilities since the previous reporting period

Lessee Accounting

- Right-of-use approach – recognize an asset and a liability for all leases
 - Asset – right to use the leased asset for the lease term
 - Liability – obligation to make lease payments
- Initial Measurement for other than short term leases
 - The liability at the present value of the lease payments, discounted using the lessee’s incremental borrowing rate, or it can be readily determined the rate the lessor charges on the lease
 - The right of use asset at the amount of the liability to make payments, plus any initial direct costs

Lessee Accounting

- Subsequent measurement for other than short term leases
 - Asset – at amortized cost, amortized on a systematic basis (recorded as amortization expense on the income statement)
 - Liability – at amortized cost using the interest method (recorded as interest expense on the income statement)

Presentation - Lessee

- Statement of financial position:
 - Liabilities to make lease payments, separately from other financial liabilities
 - Right-of-use assets as if they were intangible assets within property, plant and equipment, separately from assets that the lessee does not lease
- Either in the income statement or in the notes:
 - Amortization of the right-of-use asset , separately from other amortization
 - Interest expense on the liability to make lease payments, separately from other interest expense
- Cash payments for leases will be separately classified as financing activities in the statement of cash flows

Lessor Accounting

- Two accounting models proposed for lessors:
 - Performance obligation approach - A lessor that retains exposure to significant risks or benefits associated with the underlying asset would apply the performance obligation approach
 - Derecognition approach – all others

Lessor Accounting – Performance Obligation Approach

- At date of inception, recognize and measure:
 - Asset – right to receive lease payments at the sum of the PV of the lease payments, discounted using the rate the lessor charges the lessee, and any initial direct costs incurred by the lessor
 - Liability – the amount of the right to receive lease payments
- Subsequent measurement:
 - Asset at amortized cost using the interest method
 - Liability on the basis of the pattern of use of the underlying asset by the lessee (if unknown, use the straight-line method)

Lessor Accounting – Derecognition Approach

- At date of inception, recognize and measure:
 - Asset – right to receive lease payments at the sum of the PV of the lease payments, discounted using the rate the lessor charges the lessee, and any initial direct costs incurred by the lessor
 - Residual asset – an allocated amount of the carrying amount of the underlying asset
 - Liability – the amount of the right to receive lease payments
- Subsequent measurement:
 - Asset at amortized cost using the interest method
 - Residual asset – would not be remeasured

Disclosures

- Significantly increased disclosures required, disclose quantitative and qualitative information that:
 - Identifies and explains the amounts recognized in the financial statements arising from leases
 - Describes how leases may affect the amount, timing, and uncertainty of the entities future cash flows

Transition -Lessees

- All outstanding leases at the date of the initial application would be subject to the proposed accounting
- Simplified retrospective approach:
 - Lessee would recognize an obligation and a right-of-use asset for each lease outstanding, measured at the PV of the remaining lease payments. No adjustment required for existing capital leases that have no options, contingent rentals or residual value guarantees. The right-to-use asset would need to be adjusted for any prepaid/accrued amounts when payments are not straightlined

Transition -Lessors

- All outstanding leases at the date of the initial application would be subject to the proposed accounting
- Simplified retrospective approach:
 - Lessors would recognize a right to receive lease payments and a performance obligation measured at the PV of the remaining lease payments, discounted using the rate charged in the lease determined at the date of inception of the lease, and would reinstate any previously derecognized underlying asset at depreciated cost, under the performance obligation approach.
 - For leases under the derecognition approach, the lessor would recognize an asset for the right to receive lease payments measured at present value of the remaining lease payments, discounted using the rate charged in the lease determined at the date of inception of the lease, and would also recognize a residual asset measured at fair value as of the date of initial application.

Impact to businesses

- The new accounting model could result in lower return on capital, an increase in debt-to-equity ratios, EBITDA ratios, and may impact debt covenants
- Elimination of “off-balance-sheet” financing removes one of the advantages of leasing for lessees
 - May see shorter term leases or more purchases of assets
 - May impact lessors
- The new model will likely result in additional temporary differences for taxes
- Could have a significant impact on accounting systems
 - Lease contract management systems will need to be more closely integrated with lease accounting systems

Comments received on exposure draft

- More guidance on distinguishing between a lease and a service contract
- Including options to renew that are “more likely than not” hard to implement, and would create inconsistency
- Proposed model moves significant portions of lessor accounting away from the economic model associated with leasing
- Contingent rentals difficult to estimate
- Creates operational difficulties for operating leases that are simple and easy to understand today
- Probability weighted expected outcome approach is always wrong

Tentative decisions reached to date:

- Resurrect the “operating” lease concept
 - A **finance** lease would have a profit/loss pattern consistent with the ED
 - An **other-than-finance** lease would have a profit/loss pattern consistent with an operating lease under today’s US GAAP and IFRS
 - Establish indicators to distinguish them
- “More likely than not” criteria for determining lease term would change to “reasonably assured”
- Narrowed types of contingent rent to include
- “Best estimate” approach vs. “probability weighted expected outcome”
- May exclude leases less than one year
- May limit lessor accounting changes to just those required to conform with lessee accounting changes (definitions, etc.)

- FASB/IASB issued ED's on 1/28/11
- Objective is a common approach to offsetting financial assets and financial liabilities on the balance sheet
- Offsetting would apply when:
 - The right of set-off is enforceable at all times (including default or bankruptcy)
 - The ability to exercise that right is unconditional (not dependent on a future event)
- The entities must intend to settle with a single payment or simultaneously
- If these requirements met, offsetting is required
- Amends both IFRS and US GAAP and eliminates specific industry netting practices

- ED issued by FASB/IASB on 5/26/10
- Comments were due 9/30/10
- Originally part of the Financial Statement Presentation project – but boards decided to address it in a shorter term separate project



Colleen Cunningham, Global Managing Director

Colleen.cunningham@resources-us.com

(973)-401-2595

Follow me on twitter:

<http://www.twitter.com/colleencunningh>