

US GAAP Convergence & IFRS

What you need to know about the FASB and IASB's joint projects

March 2011



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March 7, 2011

To our clients and friends:

Memorandum of Understanding. Accounting convergence. Joint projects. These are the buzz words of today relating to the future of accounting and financial reporting. What do they mean to you? Change—and a lot of it!

The Financial Accounting Standards Board and International Accounting Standards Board are currently working on roughly a dozen joint projects designed to improve both US and international accounting standards. The scale of the proposed changes and their potential impact on US companies are unparalleled.

As standards change, companies may need new systems that can capture data, track contracts, and support processes to develop and assess complex estimates. Changes in balance sheet ratios and operating results may lead to renegotiating contracts such as debt agreements, royalty agreements and compensation agreements. Companies may want to reassess lease or buy decisions. Investor and stakeholder communication and education will be necessary, as the timing and pattern of revenue and expense recognition will change. The new standards will impact some companies more than others, but all companies will need to thoughtfully consider them.

Enclosed is a compendium of our current convergence publications designed to provide you with one single reference resource as you manage the potential impact of the proposed standards on your company. Included are an overview of the standard-setting landscape, our point of view on effective dates and transition methods, technical insights on the standard setting projects, and discussions of what you can be doing now to prepare for these changes. While all of the joint projects as well as certain other projects are addressed, our primary focus is currently on the “big three”—leasing, revenue recognition and financial instruments. These are closest to completion and will impact a broad spectrum of companies in the nearer term.

As developments unfold and standards move forward, we will post updates for you to print and add to this compendium on a dedicated website—www.pwc.com/us/jointprojects. In the meantime, if you have any questions, please reach out to your PwC engagement team or me directly.

Sincerely,

A handwritten signature in black ink, appearing to read "Jim", written in a cursive style.

James G. Kaiser

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The heart of the matter

US financial reporting
is poised to undergo
an unprecedented level
of change

US financial reporting will undergo an unprecedented level of change within the next several years. The Financial Accounting Standards Board and International Accounting Standards Board are currently working on roughly a dozen joint projects with the goal of converging and improving both US and international standards. The boards' strategy centers around a targeted completion date of June 2011 for the highest priority projects, including revenue recognition, leases, and financial instruments. The impacts will be broad and deep—well beyond financial reporting.

The proposed standards have the potential to significantly impact revenue and expense recognition patterns as well as a company's reported assets and liabilities. Under the proposed revenue standard, the recognition of some revenue streams will accelerate while others will decelerate. Irrespective of the timing of revenue recognition, gross margin erosion will occur, as a result of the proposed incorporation of credit risk into the measurement of revenue.

Under the proposed leasing standard, all leases will result in the recognition of lease assets. At the same time, increased volatility and changes in expense and revenue recognition patterns may significantly impact a number of ratios (e.g., leverage ratios) and measures (e.g., EBITDA) used by companies for a variety of purposes, ranging from determining compensation for employees to valuing a business in a structured transaction. Contracts, such as debt and compensation agreements, may require adjustment as a result of changes in financial ratios and reported results.

In addition, companies will need to ensure their systems, processes and controls can accommodate the proposed accounting models. The proposed leasing standards will require companies to capture and update detailed data for all of their leases. Many companies do not currently have a systematic method in place. The proposed revenue standard is expected to require a considerable amount of estimation, specifically related to the recognition of variable or uncertain consideration (e.g., royalty revenue, usage based fees, and trade discounts). Effective processes and controls will need to be in place around these estimates. Companies may need entirely new systems or modifications to existing systems to ensure they can capture data, track contracts and support processes to develop and assess complex estimates.

Other important stakeholders will also feel an impact. The increased level of judgment inherent in the proposed standards will make it more challenging for companies to provide guidance to analysts. Rating agencies have already started to estimate how much debt will be added to a company's balance sheet as a result of the proposed leasing standard. Communication with these stakeholders is essential, to help them understand the business implications and other effects of the changes.

Not all companies will be equally impacted by these proposed standards. Companies with less flexible systems may have a more difficult time. Complex multinational companies will have more challenges obtaining all required data than less complex or predominantly domestic companies. That being said, the adoption of these standards will take a considerable amount of time and effort for all companies. It will be important to investors that companies implement the proposed standards properly and cost effectively—the first time.

This publication is designed to help readers develop an understanding of the major convergence projects and provide a perspective on what companies can and should be doing now in relation thereto. The projects are ongoing; as new details emerge, we will post updates at www.pwc.com/us/jointprojects.

An in-depth discussion

Setting the standard: A spotlight on the FASB and IASB's joint projects*

* Reprinted from the March 4, 2011, edition of *Setting the standard*

What you need to know about the FASB and IASB's joint projects

Welcome to the current edition of *Setting the standard*, our publication designed to keep you informed about the most recent developments on the joint standard-setting activities of the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB).

In our December 2010 edition, we reported that the boards had recalibrated their work plan to focus on the priority projects. Two of those projects, fair value measurement and statement of other comprehensive income, are poised for release. Now, the “big three” remain—financial instruments, revenue recognition, and leases. The IASB is also working to slay its monster project on insurance contracts, with the FASB closely engaged in the discussion.

Whether you are a silent spectator or a vocal participant, the intensity is palpable. The boards continue their sprint toward the targeted June 30, 2011 “finish line,” carefully navigating the hurdles along the way. Developing high quality standards is a time-consuming task and unexpected bumps in the road can slow progress. Will the boards beat the clock, or will overtime be needed? Only time will tell, but the action has been fast and furious.

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Priority joint projects

Timeline for completion

Financial instruments	June 2011
Leases	June 2011
Revenue recognition	June 2011
Statement of comprehensive income	March 2011
Fair value measurement	March 2011
Insurance (IASB)	June 2011

The boards are listening

Recent activity has demonstrated the boards' willingness to listen to constituent input and change their course. For example, the FASB has softened its controversial proposal to report all financial instruments at fair value. In addition, both the IASB and the FASB went back to the drawing board to design a new impairment model for financial assets in the hopes of reaching a converged approach. Likewise, the boards appear to be making changes that will ease complexity as they work on the revenue and leasing projects. As the boards revise their proposals, the question on the minds of many remains: will the revisions require re-exposure? Surely, the prospect is there, as we have seen with the financial asset impairment proposal. If so, the June 30, 2011 targeted completion dates could be in jeopardy.

Striving to reach converged solutions

Constituents have expressed that converged solutions will best serve the capital markets. Are the boards achieving this mission? Well, progress is being made on some fronts, with the boards reaching substantial agreement on several projects including revenue recognition, leases, and fair value measurement. They are continuing their quest to reconcile fundamental differences in other projects, such as insurance and financial instruments. Will they claim victory? Too early to say, but their recent actions give hope that their differences will be limited.

With all of these moving parts, the standard-setting pace can be overwhelming and difficult to follow. In this edition of *Setting the standard*, we bring you up to speed on the most significant areas of debate and latest developments on the boards' projects. Keeping in mind the fast pace, readers should stay tuned for ongoing updates as the boards proceed.

Joint projects timeline

No big changes on the joint projects timeline...at least for now. A lot depends on the magnitude of changes in the redeliberation process and the boards' appetite for re-exposure. The following chart reflects the most recent FASB timetable and includes certain IASB-only projects that are being monitored by the FASB.¹

Effective dates and transition

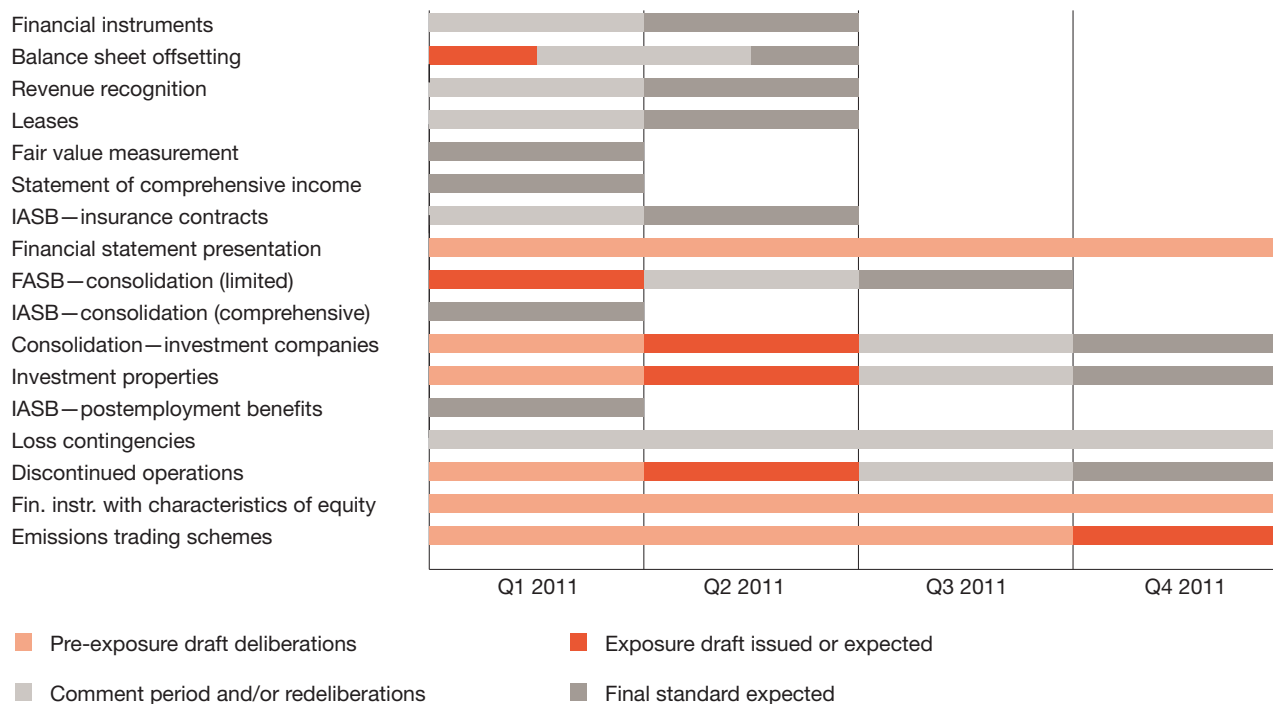
As the boards approach the finish line, they will be turning their attention to effective dates and transition methodologies. So far, no consensus has emerged

from the recent comment letter process. Many respondents preferred tackling implementation all at once to minimize the disruptive effect on financial statements. Others desired a staggered approach due to resource constraints.

How much time is needed? That's in the eye of the beholder. Responses ranged from 18 months to three years from the date that standards are finalized. Add one to two years if retrospective adoption is required. Some recommended establishing a mandatory effective date but providing flexibility by allowing for early adoption of the standards. Based

on the feedback, mandatory effective dates prior to 2015 appear unlikely for most projects.

Finally, what should transition look like? While most acknowledge the benefits of retrospective application, the boards were urged to consider other practical alternatives to alleviate costs and implementation challenges. For additional discussion of these issues, refer to PwC's Point of view: *Managing accounting change—promoting quality implementations* (within the Effective dates and transition methods volume).



¹ The timing of finalizing hedge accounting by the FASB is uncertain; however, it will likely extend beyond June 2011.

Financial instruments

What's new?

Lots. Here the FASB made headlines—literally—when it backed away from the requirement to measure substantially all financial instruments at fair value. This news was applauded as a major step forward in the measurement phase of the project. On the impairment phase, the boards are demonstrating a willingness to explore alternative approaches to achieve convergence. Is hedging next? The FASB recently issued a discussion paper seeking comments from its constituents on the IASB's hedging proposal, so we'll have to wait and see. Clearly, the boards have picked up the pace, but still face a number of obstacles.

A new approach for measuring financial assets and liabilities

Yielding to significant opposition to its original proposal to require that most financial instruments be recognized at fair value, the FASB has been making changes. The result? A new model that would require financial assets and liabilities to be classified into one of three 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. These categories may sound familiar. However, this new approach may result in a different outcome because it is based on the entity's business strategy and instrument's characteristics.

While the FASB is refining the criteria for these categories, amortized cost will likely be limited to instruments that are within an entity's lending or financing activities where the strategy is to collect (for assets) or pay (for liabilities) cash flows. Examples of

assets that may qualify include loans held for investment and accounts receivable. Other debt investments (for example, debt securities) would likely be measured at fair value each period. Debt securities held for investment and managed to meet cash flow needs or interest rate risk exposures would possibly qualify for fair value with changes recognized in other comprehensive income. Otherwise, the changes in fair value for debt instruments would be recognized in net income.

No relief has been provided however for equity securities. The FASB has decided that all equities not qualifying for the equity method of accounting be measured at fair value with changes in fair value recognized in net income, irrespective of whether or not the securities are marketable. However, the FASB is exploring whether a practical accommodation should be provided to nonpublic entities for measuring nonmarketable equity securities.

How about liabilities? Many companies are likely doing "high fives," as their plain-vanilla debt would likely qualify for amortized cost treatment. Overall, many details need to be ironed out. In addition, a number of other classification and measurement

The FASB yields on its controversial proposal to require fair value reporting for all financial assets and liabilities.

While not the preferred model of either board, the new proposed impairment approach is a compromise, combining the elements that each of the boards believe are essential.

issues are waiting in the wings such as the equity method of accounting, the fair value option, and the accounting for hybrid financial instruments.

You may also be wondering whether these changes align with the IASB's model. Although this new approach is a step toward convergence, differences remain. For example, the IASB's model contains two measurement categories: (1) amortized cost; and (2) fair value with changes in fair value recognized in net income. It is not clear where instruments within the FASB's fair value through other comprehensive income category would fall under IFRS.

Impairment—round two

Achieving convergence on the impairment model is viewed as critically important by constituents. In a positive development, the boards have crafted a compromise. The revised proposal aims to address the “Achilles’ heel” of today’s model—that is, “too little, too late” when reserving for impaired loans. The boards are

working to strike the right balance between reflecting economics and reducing operational complexity.

Here’s the new lingo: the “good book/bad book” approach. What does it mean? Expected losses on assets that are not performing (the bad book) should be fully reserved—which both boards endorse. The challenge is dealing with impairment for assets that *are* performing (the good book). The FASB prefers that entities recognize, in the period that the loan is originated or acquired, the full credit impairment for losses expected in the foreseeable future. The IASB, on the other hand, prefers that entities calculate expected losses for the entire remaining life of the asset, and then recognize these losses over that remaining life. What’s the compromise? Entities would be required to recognize the “higher of” these two impairment calculations. Companies would have flexibility in defining “the foreseeable future,” although the presumption is that at least 12 months of expected losses can be estimated.

The new approach is focused on “open” loan portfolios—portfolios that continuously change over time. The reason? Most of the angst over the previous proposal was centered on these types of asset pools. The boards have yet to consider whether the model can be applied to closed portfolios, purchased loans, and individual instruments (including securities). The boards have requested feedback on this question in their proposal.

FASB seeks input on the IASB’s hedge accounting proposal

The hedging element of the project will likely heat up soon, particularly given the FASB’s request for input on the recently-released IASB hedging proposal. If you’ll recall, the FASB included a relatively narrow reconsideration of hedging in its financial instruments exposure draft, largely aimed at simplification. Since that time, the IASB has issued a separate exposure draft solely focused on hedging, which is far broader in scope than the FASB’s proposal. The FASB plans to consider the feedback on both its original proposal and the IASB’s proposal when its redeliberations resume in second quarter 2011.

While the boards appear aligned on the goal of simplifying hedge accounting, there are numerous differences in the proposed models. The IASB has focused on aligning hedge accounting requirements with a company’s risk management strategies and adding more flexibility. One such example is the IASB’s proposal to allow companies to hedge component risks that reside within nonfinancial items. The FASB has proposed more targeted changes, such as making it easier to qualify for and maintain hedge accounting. Some believe the FASB’s proposals don’t go far enough. Whatever your view, now is the time to weigh in.

What’s next?

Comments are due on the joint impairment proposal by April 1, 2011 and on the FASB’s discussion paper on hedge accounting by April 25, 2011. In the meantime, the boards will continue to debate the other aspects of the project.

For more information :

- **In brief 2011–09**, *FASB decides on classification and measurement for financial liabilities and equity investments*
- **Dataline 2011–13**, *FASB redeliberates its financial instruments proposal—An update on significant changes as of February 24, 2011*
- **Dataline 2011–09**, *Impairment redux—FASB and IASB are seeking comments on a converged impairment model for financial assets*
- **In brief 2011–06**, *FASB seeks comments on IASB hedge accounting proposal*
- **Dataline 2011–06**, *Accounting for hedging activities—A comparison of the FASB’s and IASB’s proposed models.*

All publications listed above can be found within the Financial instruments volume.

Balance sheet offsetting

What's new?

In January 2011, the boards jointly issued their proposal on balance sheet offsetting. The proposal defines when it is appropriate to offset financial assets and financial liabilities, including derivatives. The exposure draft effectively eliminates a current exception within US GAAP that allows derivatives subject to master netting agreements to be presented on a net basis—a highly controversial outcome that promises to spark considerable debate.

A recap on the proposal

The exposure draft would *require* a company to offset a recognized financial asset and a recognized financial liability only if a company (1) has the unconditional right of offset and (2) intends to either settle the asset and liability on a net basis or realize the asset and settle the liability simultaneously. Furthermore, the right of offset must be legally enforceable in all circumstances (including default by or bankruptcy of a counterparty). Because derivatives are often governed by master netting agreements that provide for the netting of amounts only in the event of default or bankruptcy of one

This project is intended to address the largest quantitative difference between IFRS and US GAAP balance sheets.

of the counterparties, the conditions for offsetting typically would not be met. Such rights would be considered conditional rights of offset.

Even when an unconditional right of offset exists, there are questions about whether companies can operationally settle financial assets and liabilities simultaneously. The settlement of two amounts is only considered simultaneous if settlement occurs at the same *moment*. This could prove difficult to demonstrate for repurchase and reverse repurchase agreements. If the transactions are executed through a clearinghouse that settles transactions in batches, they may not be considered simultaneously settled.

Get ready for more disclosures, as the proposals go well beyond what is required today under US GAAP. Required disclosures include information about the nature of the agreements and rights to set-off, related cash and other collateral arrangements, and gross and net amounts.

Why gross presentation?

Most seem to agree that both gross and net information is needed. The tougher question is whether the information should be presented gross in the balance sheet. The current US GAAP presentation that allows for netting of derivatives in certain circumstances was developed to better portray an entity's exposure to credit risk. However, the boards have struggled to reconcile why derivative transactions should be eligible for different treatment than other types of transactions. Ultimately, the boards determined that gross presentation provides more relevant information about liquidity and market risks.

What's next?

The comment period ends April 28, 2011 and a roundtable discussion is expected in the second quarter of 2011. The boards currently plan to issue the final standard in the second quarter of 2011.

For more information:

- **Dataline 2011–10**, *Balance sheet offsetting—The FASB and IASB proposal*

The publication listed above can be found within the Balance sheet offsetting volume.

The boards are making progress working through the numerous revenue recognition issues—but many hurdles still lie ahead.

Revenue recognition

What's new?

In recent redeliberations, the boards have advanced a number of big-ticket items, including separation of performance obligations, revenue recognition for services, warranties, contract costs, and onerous contracts. The boards have shown real fortitude in muscling through these issues, but there are still many more on the docket. Can they get it all done by June 30, 2011? Stay tuned because it's going to be a close race.

Boards grapple with two threshold issues

The boards have spent considerable effort on two fundamental topics: (1) when to separately account for performance obligations within a contract and (2) revenue recognition for services. Constituents raised concerns in the comment letter process that the proposed guidance was unclear and could lead to diversity in practice or have unintended consequences. As a result, the boards are attempting to develop workable solutions in these areas.

Performance obligations—boards address separation criteria

So where do the boards stand? They tentatively decided that one

performance obligation exists when goods or services are integrated into a single item provided to a customer. The boards believe this modification alleviates a concern that contracts that are in substance one performance obligation would have to be separated. This concern was particularly prevalent from those in the construction industry.

When would separation of performance obligations be required? Fine tuning their approach, the boards would now require separation when a good or service has a distinct function and is transferred at a different time from other goods or services in the contract. Although this may sound similar to the proposal in the exposure draft, the concept of “distinct” has been narrowed. A distinct function exists if (1) the entity regularly sells the good or service separately or (2) the customer can use the good or service either on its own or together with resources readily available to the customer. In a change from the exposure draft, whether a good or service is offered by another entity or has a distinct profit margin would no longer affect the criteria for separation.

Services—a new paradigm emerges

While transfer of control remains the key driver of revenue recognition

for goods, the concept didn't play as well for many service arrangements. Consequently, the boards decided to create separate criteria for determining when service revenue should be recognized continuously. The criteria differ depending on whether or not an asset is being created or enhanced. If the service creates or enhances an asset that the customer controls, then continuous revenue recognition would be appropriate. For example, this concept would apply to construction contracts. For service arrangements that do not create or enhance an asset, the boards decided that continuous revenue recognition is still appropriate if any one of the following criteria is met:

- The customer receives a benefit as the vendor performs the task (for example, payroll processing services)
- Another entity would not need to re-perform the task if that other entity were to fulfill the remaining obligation (for example, transportation services)
- The vendor has a right to payment for performance to-date even if the contract could be cancelled (for example, consulting services)

What is meant by continuous recognition? The boards do not seem inclined to mandate a recognition method. Rather, they intend to emphasize that approaches based on output measures generally best reflect performance.

The boards have agreed to expand contract cost capitalization to align with other projects.

Warranties—what’s old is new again

Many respondents were concerned that the boards’ proposal on accounting for warranty obligations was too complex and would be difficult to apply. To address those concerns, the boards looked to existing guidance. Here’s the current track. If a customer can separately purchase the warranty from the entity, that warranty should be accounted for as a separate performance obligation. Otherwise, the warranty should be accrued as a cost of the contract, unless it provides an additional service to the customer (other than quality assurance). Although this new approach may alleviate some concerns, the treatment of certain warranties (such as long-term automobile warranties) may still be in question.

Will sales commissions be capitalized?

It looks that way. In a surprising move, the boards tentatively decided that the incremental costs of obtaining a contract should be capitalized and amortized over the period the goods or services are transferred. Why allow more costs to be capitalized than under today’s

practice? Simply put: alignment with other projects. The boards were having difficulty justifying different treatment for contract acquisition costs solely based on the nature of the contract (for example, financial instruments, leases, revenue, or insurance). Still to come—the boards have yet to hash out the definition of “incremental cost.”

Will the onerous test be less onerous?

Perhaps. Some constituents were concerned that the boards’ proposal could result in a “day one” loss on an overall profitable contract. To address this concern, the boards decided to focus the test at the contract level instead of the individual performance obligation level. However, “loss leader” contracts would not be exempt from the test. Accordingly, losses on unprofitable contracts would be recognized at contract inception. Companies would not be able to consider future potential contracts or sales when performing this test. Lastly, the boards decided to “stay the course” on its proposal that all costs directly related to satisfying a performance obligation should be included in the onerous test.

What’s next?

The project plan calls for continued redeliberations through May 2011 with the goal of completion by June 2011. Up next in March 2011: determining and allocating the transaction price (that is, variable consideration, time value of money, and collectability), and fulfillment costs. We also expect that the boards will begin field testing any significant changes to the exposed model to ensure the guidance is operational.

For more information:

- **Dataline 2011–16,** *Revenue from contracts with customers—The constituents have been heard*
- **Dataline 2010–45,** *Revenue from contracts with customers—The responses are in...*
- **Dataline 2010–28,** *Revenue recognition . . . Full speed ahead: Latest installment—A joint FASB/IASB exposure draft*

All publications listed above can be found within the Revenue recognition volume.

Leases

What's new?

The boards are tackling the tough issues head-on: lease term, variable lease payments, income and expense recognition pattern, the definition of a lease, and lessor accounting. Early decisions suggest considerable progress. However, many of the application details have yet to be worked out, which could impact completion of the project by mid-2011.

has a significant economic incentive to extend the lease. Management intent or past business practice would not affect the evaluation. The lease term would not be reassessed unless there is a significant change in the economic incentive assessment. These revisions are likely to be viewed favorably as they should improve operability, reduce volatility, and more closely align accounting recognition with the timing of the business decision to extend a lease.

contingent payments in the lease measurement:

- Those based on an index or rate (initially based on the spot rate)
- Those that are “disguised minimum lease payments” or that lack commercial substance (effectively, an anti-abuse provision)
- Those usage-based (e.g., mileage) or performance-based (e.g., lessee sales) contingencies that meet a high recognition threshold (“probable” under US GAAP)
- Portions of residual value guarantees expected to be paid

The boards have dialed back in two key areas of constituent concern: lease term and variable lease payments.

Lease term—focusing on economic incentives

The proposal to define the lease term as the longest possible term that is “more likely than not” to occur was not well received. Many believed that the proposal would result in the premature recognition of liabilities for option periods. In response, the boards have agreed to raise the threshold for including optional extensions in the lease term. Option periods would now be included in the lease term only when the lessee

Variable lease payments—will you need a crystal ball?

Some estimates will still be required under the board’s new approach, but the probability-weighted approach looks destined for the cutting room floor. Constituents thought a best estimate approach is more consistent with how companies would perform their assessment—and the boards conceded. In addition, feedback in the comment letters highlighted the complexity of having to consider all types of contingent lease payments in the calculation of the lease asset and liability. Varying views emerged on what types of contingent payments should be included in the measurement. Here, the boards made some progress by tentatively deciding to include only the following types of

Ongoing reassessment of contingent rents and the impact on income and expense recognition patterns are up next for discussion.

Is “straight-line” rent expense back in vogue?

Possibly, for some leases. The boards’ proposal results in the front-loading of expense, based on the boards’ view that a lease transaction is fundamentally a financing. Some respondents challenged this assertion and thought the resulting expense pattern did not reflect the underlying economics. The boards appear to be reconsidering their proposal and are evaluating whether there are two types of leases: financing and “other-than-financing.” The boards may decide that expense recognition on other-than-financing leases should be straight-line, similar to existing operating lease treatment. Before getting too excited, however, don’t forget that all leases would still

Momentum seems to be gaining to postpone major changes to lessor accounting. Conforming changes to align with the lessee model may be more likely.

be recognized on the balance sheet regardless of income statement recognition. Although further analysis and targeted outreach is expected, signs point to some relief in this area.

Defining a lease—tougher than it may seem

Many comment letters asked for clarity on the fundamental question of how to define a lease. The reason? For some types of service arrangements (such as those that contain embedded leases), the answer could significantly change current practice. Under today's guidance, identifying embedded leases in some service arrangements has not been critical. Many embedded leases are classified as operating leases and therefore, separation of the lease component from the service component does not significantly alter the balance sheet presentation or expense pattern. However, the proposed "right-of-use" concept—which results in lease assets and obligations—has heightened sensitivity about how to interpret the definition of a lease. The boards have started wrestling with this issue, but progress has been slow. Some have also observed that this issue may be less of a concern if relief is provided on the expense recognition pattern issue. Expect more analysis and outreach on this topic in the months to come.

Lessor accounting—no wholesale changes for now?

Almost all constituents expressed concern over the proposed lessor accounting model, with many suggesting that the boards hold off on these changes. Simply put, many do not believe it is an improvement over today's guidance. The proposed dual-approach model (that is, a derecognition or performance obligation approach) was viewed as unwieldy. Will the boards scale back on the scope? Based on initial redeliberations, it appears they are leaning toward abandoning the wholesale proposals for now. Instead, near-term changes to existing lessor accounting may be limited to those needed to conform to decisions on the lessee side of the project. For instance, the definition of a lease, aligning the criteria for determining the lease term, and treatment of variable lease payments could be likely candidates.

What's next?

The boards' redeliberations are expected to continue in earnest over the next few months. The focus will continue to be on the priority areas followed by the granular issues thereafter. At this point, a final standard remains targeted for mid-2011.

For more information:

- **10Minutes** on the future of lessee accounting
- **Dataline 2011-11, Leasing**—FASB and IASB agree on changes that will reduce complexity of the proposed leasing standard
- **Dataline 2011-05, Leasing**—The responses are in . . .
- **Dataline 2010-38, A** new approach to lease accounting—Proposed rules would have far-reaching implications

All publications listed above can be found within the Leases volume.

Insurance contracts

What's new?

Mindful of the IASB's June 2011 timeline for completion, the boards have stepped-up activity on the project. As a reminder, the IASB issued an exposure draft proposing an insurance contract standard in July 2010. Separately, the FASB issued a discussion paper in September 2010 seeking views on the IASB's approach. While the boards continue to seek the development of a converged standard, common ground remains elusive on several key areas of the project.

Progress in some areas...

The sheer volume and complexity of the issues in this project is daunting. However, progress has been made on the topics of discount rate, cash flows, and acquisition costs. In addition, clarity has been provided on employee insurance programs.

Discount rate—no one-size-fits-all answer

One critical issue embedded in the current debate is the discount rate that should be applied to a contract's cash flows. The boards' starting point: a risk free rate adjusted for contract illiquidity. Respondents raised several concerns about this proposal. Some, particularly in the United States, did not believe this rate reflects how insurers price their products. Others noted that risk free rates do not exist in many countries, raising the question of whether reliable, comparable estimates can be achieved.

The boards have decided to steer away from prescribing a specific discount rate or method while retaining their basic objective: consider the time value of money and the characteristics of the contract liability. Could a practical expedient, such as a high quality corporate bond rate, be used as an acceptable alternative? Perhaps for smaller insurers. The boards plan to discuss this topic in the near future.

Some companies asked for the ability to "lock in" the discount rate at contract inception, which the boards rejected. Thus, the discount rate will need to be updated each reporting period. The boards also decided that "long-tail" claims that are not associated with life insurance should be discounted. "Long-tail" claims are those for which the period between the incurrence and settlement of a claim is more than 12 months. Examples include general liability and environmental liability insurance. The boards also continue to explore whether to allow a practical exception to discounting for certain "short-tail" claims (for example, automobile damage claims).

What "expectations" should be included in cash flows?

The exposure draft required that the measurement of insurance contracts be based on an explicit, unbiased, and probability-weighted estimate of future cash flows from fulfilling the contract (that is "expected value"). Hmm...got that? Judging from comment letters, maybe not. Many respondents sought clarification on the "expected value" concept, including which costs should be included in that measurement. You may need to dust off your statistics textbook to keep up on this debate.

In simplified terms, expected value is supposed to be the "mean" or the probability-weighted sum of possible outcomes. However, not all possible outcomes may need to be considered. The boards also tentatively decided that the costs to be included in the cash flows should be those directly related to the fulfillment of the contract, at a portfolio level. Direct overhead costs appear to qualify based on this characterization.

With only four months to go until the IASB's targeted completion date, the boards are feverishly attacking the issues.

Welcome news to non-insurers, employer-provided health insurance is no longer within the scope of the insurance contracts project.

Acquisition costs—the saga continues

The boards tentatively decided that direct and incremental costs at the portfolio level would not require immediate expense recognition for certain activities. This goes beyond the boards' proposals, which assessed acquisition costs at the contract level. Qualifying costs would stem from the following types of activities: sales force contract selling, underwriting, medical and inspection, policy issuance, and processing functions. However, the FASB is standing firm on limiting such costs to those that relate to successful efforts. The FASB also does not support including allocations of overhead costs (such as sales office rent and depreciation). These views are in line with conclusions recently reached by the Emerging Issues Task Force on insurance acquisition costs. The IASB, on the other hand, prefers to include both unsuccessful efforts and overhead costs. Why? Because the IASB thinks it is more consistent with fulfillment cash flows at a portfolio level. Whether the boards can reconcile these differences is unclear as they appear to be at different ends of the spectrum.

Employee insurance no longer in scope

A sigh of relief. The health insurance coverage provided by employers to their employees will not be in scope. Under the original proposals, insurance contract accounting would have applied to such coverage. However, the boards agreed that such coverage is better presented as an employee benefit.

Continued discussion in other areas...

The boards have continued to seek common ground on the following critical aspects of the model: risk adjustment (composite versus explicit) and income statement presentation.

Should cash flows be explicitly adjusted for risk?

Opinions differ among constituents on whether an explicit risk adjustment should be included in the determination of the amount and timing of future cash flows. US constituents tended to support the FASB's composite margin approach (in the event of a converged standard), and a clear majority of non-US constituents supported the IASB's explicit risk adjustment approach. At a conceptual level, the boards appear to agree that an explicit risk adjustment makes sense and could provide useful information to users (either in the measurement, or possibly in the disclosures). Whether the approach is operational and cost effective remains under debate.

Income statement presentation—constituents give a “thumbs down”

The boards are grappling with the negative feedback on the proposed summarized margin presentation in the income statement. Under this approach, premium revenue would no longer be presented. Instead, the income statement would show margin, changes in estimate, and experience adjustments. However,

users are not enamored with this approach, as gross premium revenue and contract expense information is important. The boards have struggled to develop an approach that is consistent with the model while satisfying users' needs.

What's next?

The IASB continues to target a final standard by June 2011. The FASB has not announced an official timetable. One potential outcome is the release of an exposure draft simultaneous with the IASB's issuance of its final standard.

For more information:

- **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*

All publications listed above can be found within the Insurance contracts volume.

Fair value measurement

What's new?

Coming soon: final fair value measurement standards. Except for discussing effective dates and transition, the boards have completed their redeliberations and expect to finalize their respective standards in March 2011.

What's changing and who's impacted?

The new guidance provides a consistent framework for measuring and disclosing fair value when other accounting guidance requires or permits the use of fair value. This framework will be brand new for entities that report under IFRS. For US GAAP reporters, the new standard will pack a much lesser impact. However, before breathing a sigh of relief, US companies should take stock of a few new provisions.

Companies that report a substantial number of financial instruments at fair value may feel the effects of the measurement-related amendments the most. Why? The ability to measure financial assets based on their "highest and best use" has

been removed and the inclusion of premiums and discounts in a fair value measurement is narrowed.

Practically speaking, there are questions about what these changes mean. For example, should the fair value of an investment in common shares be based on the individual share or the block holding (that is, the aggregated group of shares held)? Can a premium or discount be applied to the block holding?

The answer is more straightforward when the unit of account is defined within GAAP. For an investment in common shares, fair value will often need to be determined based on each individual share, consistent with the unit of account prescribed within the guidance on accounting for equity investments. Determining the fair value based on the block holding may only be appropriate when the unit of account is defined at that level, such as when measuring the fair value of a reporting unit.

How about disclosures? Good question. Preparers have been concerned about the cost and effort that would be involved with the boards' proposal to disclose measurement uncertainty

for Level 3 fair value measurements. Because of those concerns, the boards agreed to perform more work before requiring the disclosure. In the interim, the boards added some incremental disclosures to fill the gap. These include quantitative information about unobservable inputs and assumptions used, along with a narrative disclosure about the sensitivity of the measurements. However, it is unclear what the final required disclosures will look like. As a result, questions are percolating about what exactly will be required to be disclosed.

Some of these questions may get answered once the boards issue their standards. However, like any new guidance, there are sure to be some areas that require interpretation. Companies should begin understanding how they may be impacted and developing plans for implementation.

What's next?

The boards are expected to discuss effective dates and transition soon, and finalize their respective final standards in March 2011.

Fair value is one priority project nearing completion that will be substantially converged.

For more information:

- **Dataline 2011–12**, *Fair value measurement—FASB and IASB joint project near completion*

The publication listed above can be found within the Fair value measurement volume.

Financial statement presentation

What's new?

It's back. Despite rumors of its demise, the financial statement presentation project appears to have been resuscitated. Following overwhelmingly negative sentiment from the preparer community and mounting pressure on the standard setting agenda, the boards decided in November 2010 to put a hold on this project until after

refresher on the project. The overarching principle in the proposed redesign of the financial statements was to enhance the cohesiveness of the primary financial statements and to provide disaggregated information to users.

What does cohesiveness mean? The idea is that the financial statements should report a company's operating, financing, and investing activities consistently in each of the statements.

administration). "Nature" refers to the economic characteristics or attributes that distinguish assets, liabilities, income, and expense items (for example, disaggregating cost of goods sold into materials, labor, transportation costs, and energy costs).

And let's not forget some of the other big-ticket items in the project—the direct-method statement of cash flows, more segment information, and roll-forward schedules for significant asset and liability balances. Some of these have been "lightning rod" issues in the preparer community. It will be interesting to see what unfolds when the project resumes.

The staff appears amenable to scaling back proposals to address cost and operational concerns.

June 2011. Meanwhile, the FASB and IASB staff has been working behind the scenes. Their objective: better understand (1) preparer concerns with their proposals and how costs could be mitigated and (2) how financial statement users can get the biggest bang for their buck. The staff recently met with the boards to report their outreach findings. No decisions were made at this meeting, although the boards confirmed their commitment to the project. The staff also provided a glimpse of the options that may be considered once the project resumes.

A recap

Since it's been awhile since our last update, it might be good to have a

To achieve this objective, the new format for financial statements would separate the company's financial position, performance, and cash flows by operating, financing, and investing activities.

What about disaggregation? A company would be required to disaggregate information to explain the components of its financial position and financial performance. The terminology used in the project is disaggregation by "function" and by "nature." These are not exactly intuitive terms, so here's the explanation. "Function" refers to the primary activities in which an entity is engaged (for example, selling goods, manufacturing, advertising, and

Disaggregation—how much is enough?

Preparers told the staff that disaggregating income and expense items by nature (both generally and in the segment footnote) would be costly because their systems are not currently structured to capture that information. Many also believe that this information does not align with how management evaluates the company's performance. Competitive harm was also a concern when it comes to disaggregation in the segment footnote, particularly when gross margin information is provided at a granular level (such as by segment). Users, however, are at the other end of the spectrum. They told the boards that disaggregation was one of the most useful aspects of the project, especially with respect to margins and segments.

Users told the staff a direct-method statement of cash flows and full account balance roll-forwards may not be necessary.

Statement of cash flows—is direct the only answer?

One of the more hotly debated aspects of this project is the requirement for a direct-method statement of cash flows. Cost/benefit continues to be the largest concern among preparers. Why? Today's general ledgers are typically not organized to capture the transactional-level information needed for a direct presentation. Preparers were also wary about using the boards' proposed "derived" approach to estimate the transactional-level detail. But how do users feel? Interestingly, some users did not express a strong sentiment that a direct-method cash flow statement is necessary. However, users did emphasize the importance of retaining the indirect reconciliation of operating cash flows and other "direct" information (for example, investment in fixed assets) that is provided today. As a result, the staff is looking for ways to improve cash flow information without requiring a direct-method presentation. Stay tuned, as there will be more to come on this topic.

Will roll-forward analyses remain on the table?

The proposal would require "roll-forwards" in the footnotes of changes in significant assets and liabilities. These would require detailed analysis and explanation of what is driving the changes in account balances. The staff outreach revealed that preparers are not fans of having to track and compile the movements within the balance sheet line items. Furthermore, many questioned

whether such granular information is really useful. Definitely a quandary here for the boards since users expressed that this was one of the more useful aspects of the proposals. However, there may be some prospect for middle ground, perhaps stopping short of a full roll-forward analysis.

Will changes be made for financial services companies?

The staff also targeted the financial services industry in its outreach efforts. Users generally questioned whether the proposed presentation changes to the balance sheet and income statement would be beneficial. Other feedback stressed the fact that the industry is different from others, so additional guidance would be helpful. It remains unclear whether any accommodations will be provided, but one possibility is to provide some additional industry-specific implementation guidance.

The ongoing debate about other comprehensive income

Will the meaning of other comprehensive income ever be wrestled to the ground? Some constituents have expressed that it is time to address this issue head-on. When should items be reported in other comprehensive income, and when should amounts be recycled into net income, if at all? Today, differences exist for both questions between IFRS and US GAAP. Recently, some board members expressed a view that resolving this issue is essential for success on convergence. However, other board members believe that while

important, the conceptual questions about other comprehensive income may best be addressed as a separate project.

What's next?

The boards are not expected to resume deliberations until they start knocking some of the priority projects off their list. However, their desire to continue this project appears to remain high, so stay tuned in the second half of 2011 for an update.

For more information:

- **Dataline 2010–35** (revised February 3, 2011), *Financial statement presentation—A look at the FASB and IASB's Staff Draft*

The publication listed above can be found within the Financial statement presentation volume.

Consolidation

What's new?

Following a few twists and turns, the road map on this project is coming into focus. After closely monitoring the IASB's comprehensive consolidation project, the FASB has decided to take the exit ramp on pursuing wholesale changes to its existing consolidation model. What's the current route? For variable interest entities: a new approach for determining if a party is acting as a principal or an agent. For voting interest entities: potential changes to kick-out rights.

The FASB decides not to pursue wholesale changes to its consolidation guidance, choosing targeted amendments instead.

Consolidation, investment companies, investment property? Help!

With similar terms and overlapping parts to the project, it can be hard to keep it all straight. So, here's a glossary to keep handy:

Project	Board	What it is	Status
Consolidation	IASB	Broad-based project to include structured entities and voting interest entities.	Final standard expected March 2011
Consolidation	FASB	Targeted scope amendments for variable interest entities and voting interest entities. Will eliminate deferral of variable interest entity guidance for investment entities.	Exposure draft expected March 2011
Investment companies	Joint	Narrow project that revisits the definition of an investment company, which impacts whether normal consolidation rules apply.	Exposure draft expected second quarter 2011
Investment properties (see separate section)	FASB	Not a consolidation project. Impacts which entities should report real estate at fair value.	Exposure draft expected second quarter 2011

Kick-out rights guidance for limited partnerships may be changing.

FASB decides: targeted changes in lieu of convergence—for now

The FASB decided not to join the IASB's broad consolidation project at this time, as it was not convinced that it represented an improvement. The FASB was concerned about a model that places equal weight on *potential* voting rights versus current voting rights. The FASB also did not like the prospect for consolidation based on historical voting patterns and shareholder dispersion when an entity holds less than a majority of the voting rights ("de facto control").

For now, the FASB is seeking narrow improvements to its existing guidance. What's in play? In early 2010, the FASB decided to defer the application of its new variable interest entity consolidation guidance for certain types of investment entities. The deferral applied to entities such as mutual funds, hedge funds, and private-equity funds, to name a few. As the FASB and IASB began to deliberate the broader consolidation project, it became apparent

that "principal versus agency" and "kick-out rights" were important threshold questions when analyzing consolidation for investment entities. A central issue is whether an asset manager is a principal of the fund (due to its decision-making capabilities) or simply acting as an agent of the fund's investors. Those that are deemed to be principals would consolidate the funds. By resolving these issues, the FASB expects to eliminate the deferral.

Principal versus agency

The boards appear to be aligned on this topic, tentatively deciding that the assessment should be based on the overall relationship between the decision maker, the entity being managed, and any other interest holders. An entity would consider the following factors in making this assessment:

- The scope of decision-making authority of the decision maker, considering the design of the entity and who would benefit from that design

- The rights held by others, including kick-out and liquidation rights
- The decision maker's compensation, with an emphasis on whether such compensation is market-based
- Other interests held by the decision maker in the entity

Kick-out rights

To improve consistency, the FASB plans to align the guidance for kick-out rights for voting and variable interest entities. What is the effect? Today, under the variable interest entity model, kick-out rights are only considered in the analysis when held by a single party. However, under the voting interest entity model, kick-out rights held by a simple majority are relevant to the consolidation conclusion.

The new proposal will require an entity to evaluate kick-out rights more broadly in general. If kick-out rights are held by more than one party, judgment will be required to evaluate whether they are substantive. Generally, the larger the group that holds the rights, the less likely they would factor into the analysis. These changes could impact the evaluation for entities such as limited

partnerships. Today, simple majority kick-out rights may preclude consolidation by the general partner—this may no longer be the case under the proposal.

Waiting for exposure— investment company guidance

The boards are planning to issue their proposal to redefine investment companies in the second quarter of 2011. Investment companies generally do not consolidate ownership interests in underlying investment portfolio companies. Instead, they are recorded as investments at fair value. However, if an entity does not meet the criteria to be considered an investment company, traditional consolidation guidance would apply. What aspect of the proposed definition is under debate? Simply stated, the FASB is evaluating what level of third-party investment is necessary for an entity to qualify as an investment company. Currently, this area is not well-defined and has led to some funds with little third-party investment to qualify as an investment

company. If the FASB raises the bar on the required level of third-party investment, this will precipitate a fundamental change in status for some companies.

Another important aspect of this project is whether an entity that consolidates an investment company should retain fair value accounting in consolidation. The FASB tentatively decided to retain current practice, which carries the investment company's fair value accounting up to the consolidated level. The FASB expects further discussion on this topic with the IASB, as it has yet to reconsider this matter.

What's next?

The IASB's final consolidation standard is expected in March 2011. The FASB's exposure draft on targeted amendments is also scheduled for March 2011 with a final standard in third quarter 2011. Look for the exposure draft on investment companies in the second quarter 2011 and a final standard in the fourth quarter of 2011.

Investment properties

What's new?

The scoping of this project has proven to be elusive. Recently, the FASB took another shot at an approach that captures those entities it believes should be reporting investment properties at fair value. The primary targets—real estate investment trusts, funds, and operating companies. However, it's unclear whether the FASB hit the mark with its latest attempt.

Why a project on accounting for investment properties?

With everything on its plate, some may wonder why the FASB is developing guidance for investment properties. As background, this issue surfaced during debates on the joint leasing project when the boards proposed to scope out leases of investment property carried at fair value. Except for investment companies, a US accounting standard that permits its investment property to be measured at fair value does not exist. As a result, the FASB undertook this project to address the issue.

So, what's the scoop on scope?

The FASB's approach would require that entities within the scope of the guidance report all their real estate at fair value on a recurring basis. An entity would need to meet defined criteria related to its business purpose, activities, and capital structure to be within scope of the guidance. Principally, a company's substantive activities must relate to investing in real estate for total return (including realizing capital appreciation). Entities that hold real estate for purposes other than investing would not be in scope. Examples of other purposes are to produce or supply goods and services, hold property for only rental income, or hold property for sale in the ordinary course of business. An entity would also need to have multiple investors with significant ownership interests in order to qualify.

The term "real estate" in the United States has a broad reach. In addition to "traditional" real estate such as office buildings and malls, this term also encompasses "non-traditional" real estate such as power plants and "integral equipment" such as

pipelines and cellular towers. The FASB's primary focus has been on entities that hold traditional real estate. However, based on its recent scope revision, those entities that hold non-traditional real estate or integral equipment would also appear to be within scope if the property is being held for investing purposes.

Convergence—solving the simultaneous equation

While solving for one problem, the FASB's proposal may create a further imbalance for convergence. IFRS contains guidance for investment properties that is based on the nature of the property, not the entity. In addition, the guidance allows an option to measure the investment property at cost or fair value. This differs from the FASB's entity-based approach and requirement to measure at fair value. The boards may seek to reconcile their models in the coming months, but until then, convergence remains in question.

What's next?

The FASB expects to address remaining issues in the near term including whether a pension fund that wholly-owns an entity holding real estate should be within the scope of the guidance. An exposure draft is expected in the second quarter of 2011 with a final standard by the fourth quarter of 2011. However, the genesis for this project was changes to lessor accounting. If the boards decide not to broadly tackle lessor accounting, the momentum for this project could also potentially wane.

Based on the FASB's current approach, it appears that REITs, real estate funds, and real estate operating companies would be required to report their investment properties at fair value.

Pensions and postemployment benefits

What's new?

The IASB is finalizing its redeliberations on pensions and postemployment benefits. In a surprising move, it has reversed course yet again on whether actuarial gains and losses should be reported in net income or other comprehensive income. The IASB has also clarified the accounting for plan settlements and curtailments.

Actuarial gains and losses—now in other comprehensive income

In our December 2010 edition of *Setting the standard*, we reported that the IASB had decided to allow companies the choice of whether to record actuarial gains and losses in net income or other comprehensive income. We had also reported that the IASB was somewhat divided on allowing this election. Upon further reflection, the IASB has now decided to require that actuarial gains and losses be reported in other comprehensive

income. Why the change? In the interest of comparability, some board members wanted to limit the circumstances in which entities would be allowed to record gains and losses in net income. However, the IASB was unable to develop a workable principle to achieve that objective.

Settlements and curtailments—net income approach confirmed

The IASB confirmed that settlement and curtailment gains and losses will be recognized in net income when the event occurs—with one notable exception. If the settlement or curtailment relates to a restructuring, any gain or loss would be recognized when the corresponding cost of the restructuring is recognized. This exception was provided to remove the complexity of recognizing compensation costs related to a restructuring over multiple periods.

Where does convergence stand?

From a balance sheet perspective, the FASB and IASB guidance will be converged. The income statement

is another matter. Under US GAAP, actuarial gains and losses are often recorded in other comprehensive income but subsequently amortized in determining net income. Because IFRS does not permit the recycling of actuarial gains and losses recognized in other comprehensive income, these amounts will never affect net income.

The FASB plans to reconsider its guidance once the IASB project is complete. Whether conforming changes will be made is anybody's guess. However, the IASB's decisions may motivate the boards to tackle the broader conceptual questions related to other comprehensive income.

What's next?

The IASB still needs to finalize an effective date for its final standard, but has indicated it will not be sooner than January 1, 2013. The standard is scheduled to be issued by the end of March 2011. However, given the recent changes and pending discussion on effective dates, some slippage in that timetable could occur.

Recognition of pension expense components under the IASB model

Net income	Other comprehensive income
• Net interest cost • Curtailment and settlement gains • Past and current service cost • Plan administration expenses	• Actuarial gains and losses • Actual return on assets (excluding the component within net interest cost) • Changes in asset ceiling • Asset related expenses

For more information:

- **Dataline 2011–15**, *Pension/OPEB accounting—Understanding changes expected from the IASB*

The publication listed above can be found within the Pensions and postemployment benefits volume.

Other projects on the horizon

What's new?

With the boards focused on the priority projects, there is little to report about several other projects on the agenda. For some, work continues behind the scenes with no visible board activity. That's the story for the statement of other comprehensive income and discontinued

operations projects, where the boards are drafting a final standard and an exposure draft, respectively. Limited activity is expected on a number of other projects until the intensity surrounding the high priority projects begins to subside. This holds true for contingencies, financial instruments with characteristics of equity, and emissions trading schemes. Below is a snapshot of the timing of the boards' next steps on these projects.

Project	Board	Next steps and timing
Statement of comprehensive income	Joint	Final standard March 2011
Discontinued operations	FASB	Exposure draft in second quarter 2011
Disclosure of certain loss contingencies	FASB	Review of companies' 2010 year-end disclosures by FASB post-June 2011
Contingencies	IASB	Staff draft of updated decisions to be released and redeliberations to follow post June 2011
Financial instruments with characteristics of equity	Joint	Deliberations to resume post June 2011
Emissions trading schemes	Joint	Exposure draft Q4 2011

Below, we have briefly summarized the status of these projects. If you wish to take a deeper dive into the boards' prior decisions, please refer to the October 2010 and December 2010 editions of *Setting the standard*, and the other publications noted below.

Statement of other comprehensive income

The boards are planning to issue their final standard in March 2011. Some might view this new guidance as a non-event, as the change is limited to presentation. Companies will be permitted to present net income and other comprehensive income either in a single continuous statement or in two separate, but consecutive, statements. However, presentation of other comprehensive income within the statement of equity will no longer be permitted.

Companies that report under US GAAP should plan to apply the new presentation beginning in 2012. Under IFRS, the standard is expected to be effective for fiscal years that begin on or after January 1, 2012. Early adoption would be permitted.

For more information:

- **Dataline 2011–08,**
Statement of comprehensive income—The FASB is expected to allow one continuous statement, or separate continuous statements of net income and other comprehensive income

The publication listed above can be found within the Statement of comprehensive income volume.

Discontinued operations

Companies that are planning to dispose of a significant operation should pay close attention to the FASB's project on discontinued operations. A subset of the financial statement presentation project, this project is intended to converge discontinued operations guidance between US GAAP and IFRS. The FASB plans to adopt a definition that is similar to the current IFRS definition. That guidance focuses on whether the operation is a separate major line of business or geographical area of operation. The FASB, however, will also go a step further on disclosure by requiring information for disposals of components that do not qualify as discontinued operations. The FASB is expected to release an exposure draft in the second quarter of 2011, with a final standard in the fourth quarter of 2011.

Contingencies

Although this project is on hold at the moment, there continues to be great interest in the reporting community about contingency disclosures. Clearly, the SEC has picked up the pace in its recent comment letters on this topic. Likewise, the FASB plans to scrutinize these disclosures as part of its plan to assess compliance with the existing disclosure requirements. To refresh, the FASB issued a proposal in 2010 to make improvements to loss contingency disclosures. Constituents were concerned that the suggested disclosures would potentially jeopardize legal positions by requiring too much information. Some also questioned whether the perceived shortcomings in today's disclosure practices result from deficiencies in the current standard or rather inconsistent application of current guidance. As a result, the FASB yielded and will decide on how to proceed with the project after its evaluation of 2010 year-end reporting disclosures.

Similarly, the IASB has also been seeking improvements to its contingency guidance, but has gone further by proposing changes to the accounting model. The IASB issued an exposure draft during 2010 which would have, among other things, removed the more-likely-than-not threshold for determining when contingent liabilities should be recognized. This proposal was not supported by constituents. In response, the IASB has softened its stance on some of the more controversial aspects of its proposal. For example, the IASB appears amenable to eliminating its original proposal to remove the more-likely-than-not threshold for determining when contingent liabilities should be recognized. The IASB intends to post a staff draft to its website reflecting its updated decisions for purposes of further consideration when it revisits the project after June 2011. While this is an IASB-only project, US GAAP reporting entities may want to pay close attention considering the boards' overarching convergence goal.

Financial instruments with characteristics of equity

This project has been in development for a number of years, in an attempt to improve the "patchwork" of complex guidance that exists today for liabilities and equity. Although an exposure draft was to be released in the summer of 2010, substantial concerns were raised on the draft proposals about the meaning, enforceability, and internal consistency of some of the proposed requirements. Essentially, the boards' joint deliberations had considered a variety of approaches that attempted to leverage current IFRS guidance as a starting point, and addressing known practice issues with the IFRS model. However, constituents' review of the draft proposals pointed to flaws in the proposed model. The boards considered the feedback and discussed several alternatives on how to best proceed, without any final decision. As a result, the boards may need to find a fresh approach for tackling the age-old question of when a financial instrument is a liability and when it is equity.

For more information:

- **Dataline 2010–32** (revised February 1, 2011), *Disclosure of certain loss contingencies—An analysis of the FASB's proposed changes*

The publication listed above can be found within the Contingencies volume.

Emissions trading schemes

During the fall of 2010, the emissions trading schemes project was injected with new energy, as the boards held three substantive meetings and began to make some progress. Given the lack of authoritative guidance on accounting for emission allowances under both US GAAP and IFRS, this was a welcome step forward, particularly for companies in emissions-heavy industries. However, this project experienced a slowdown when the boards decided to table their debate until the second half of 2011. Although many questions remain unanswered, companies involved in emissions trading programs might find it helpful to gain an understanding of the boards' direction.

As reported in our December 2010 edition of *Setting the standard*, the boards had tentatively decided that allocated and purchased emission allowances are assets, and the receipt of allowances under an emissions trading program creates an obligation that should be recognized as a liability. Furthermore, the boards

focused on measurement and tentatively decided that assets and liabilities recognized under an emissions trading scheme should be measured initially, and on an ongoing basis, at fair value. The liability would be capped at the amount of emission allowances the company receives.

The more difficult question, which has not yet been answered, is whether and when a company should recognize a liability when it emits more than its allocation under the emissions program. Significant debate has surrounded the issue and there is no clear direction at this time. In addition, the FASB and IASB have discussed gross versus net reporting of the asset and related liability on the balance sheet without achieving clear resolution.

At the last meeting in November 2010, the boards instructed their staff to perform additional research and outreach on a number of areas. However, given the boards' focus on priority projects, we do not expect any significant developments in the near term.

What this means for your business

A measured approach

The timing and prioritization of convergence projects continues to evolve, but the most significant elements could be effective as early as 2014 or 2015. While this seems like a ways off, there is work to be done in advance of the effective dates given the level of change as well as the impact on comparative reporting periods. Most companies need not embark upon a full-blown adoption project right away, but there are steps that companies can take in the near term that will serve as strong building blocks for future adoption of the standards.

Each company is different, and therefore the impact of the proposed standards will differ from one company to another. Industry segment and business complexity will both play a role in determining the level of impact. As a baseline, companies should remain aware of the changes that result from the joint projects and should stay close to developments in these standards as the FASB and IASB continue their deliberations. Certainly, should your company have strong views on a topic, you might consider getting involved with the standard-setting process by responding to requests for comments or taking part in round-table discussions and other standard setter outreach activities.

Companies should also start to assess, at least at a high level, how the proposed changes will impact their company and form a point of view on the level of impact. Those that are impacted more heavily by the proposed changes should also consider taking further steps to

better understand the requirements and effectively begin to manage the change process.

In the near term, such companies may consider taking the following steps:

- **Develop an initial project plan.** First, identify those who will own the project and empower them to act. These individuals should perform a more in-depth analysis of the impacts of the proposed standards and develop an initial project plan. The project plan may contain tailored immediate next steps, key project milestones to completion, and areas of significant time or financial investment.
- **Understand the accounting impact.** Begin to gather and analyze the necessary data. For example, with respect to the proposed leasing standard, a company may consider inventorying its existing leases, identifying arrangements within the scope of the standard, and beginning to determine the impact on the balance sheet (creation of the right of use asset and the lease liability) and income statement (potential acceleration of expense recognition).
- **Identify the current technology and system landscape.** Understand and determine the manner of collecting data, and develop a technology plan, taking into account system changes already contemplated. For example, determine whether your current systems have the ability to

appropriately track a large number of leases, regularly update lease-related estimates, or allocate and account for revenue with more separate performance obligations.

- **Identify the broader business impacts.** Ascertain in what other areas the proposed standards may affect your business. For example, determine what impact the proposed revenue standard will have on your company's sales strategy, resulting from potential changes in sales contracts, multiple element offerings, warranty programs, and construction contracts.
- **Establish a communications strategy.** Begin to craft a communications plan for educating key stakeholders about the accounting and business impacts of the proposed standards. Internally, senior management and audit committees should be kept informed about current assessments. Externally, companies would be well-served, at the appropriate time, to brief ratings agencies and analysts with respect to the anticipated impacts.

Collectively, these steps form the basis of a comprehensive assessment whereby companies can deepen their understanding of the impact of US GAAP convergence with IFRS. By staying focused on aspects that have a long lead time, companies can stay ahead of the game while also pursuing small one-off projects and "easy wins" where desirable.

***To have a deeper conversation
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US GAAP Convergence & IFRS

FASB and IASB extend timetable for key projects

April 2011

FASB and IASB extend timetable for key projects

What's inside:

What's new?

What's changing?

What's next?

What's new?

In an interview today, the chairmen of the FASB and the IASB (the Boards) announced that they are extending the target date for completion of their joint priority projects to the end of 2011.

Reprinted from:

In brief 2011–13

April 14, 2011

What's changing?

Until now, the Boards have targeted June 2011 for completion of their priority projects. The priority projects include revenue recognition, leases, financial instruments, and insurance contracts. On each of the projects, the Boards have received significant feedback, with many stakeholders expressing concern over the Boards' ability to deliver high-quality standards by June 2011. In today's interview, the chairmen emphasized that producing high-quality standards remains of the utmost importance. They also acknowledged the critical role of evaluating and incorporating stakeholder feedback. Given the current status of the priority projects, they agreed to extend the target completion date.

What's next?

The Boards expect to publish their next convergence progress report in the coming days. The progress report will lay out a more detailed plan for the completion of the remaining joint projects.

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US GAAP Convergence & IFRS

Effective dates and transition methods

March 2011

Managing accounting change

Promoting quality implementations

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Time, flexibility and good disclosures are key to quality

Adoption requirements must be made operational for all companies

Allowing companies to manage their own pace of change will enhance quality

Questions and answers

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Point of view

February 2011

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- New accounting standards that are expected to be issued in 2011 will have far reaching financial and business impacts.
- The proposed changes are so fundamental and pervasive that companies will need several years to develop the systems and processes necessary for implementation.
- There are no ideal solutions for transitioning to these new standards considering the varying impacts they will have on different companies.
- Companies should be able to decide what is in the best interest of their investors by being given the flexibility to manage their own pace and cost of change.

Time, flexibility and good disclosures are key to quality

- New accounting standards will be issued this year that will fundamentally change how companies account for revenue, leases, and financial instruments. Changes of this magnitude—combined with the complexity of the accounting—will require companies to devote significant time and resources to prepare for and implement the new standards.
- The minimum time required to implement the proposed changes will differ for each company. In most cases, companies will need several years to develop the necessary systems and processes. To give companies sufficient time, we believe that the standards' mandatory adoption dates should be no earlier than 2015.
- No single adoption date for all of the new standards or staggered approach will work for all companies. Since the

proposed changes will affect every company and industry differently, we believe that companies should have the flexibility to adopt any or all of the standards before their mandatory adoption dates.

- The costs to implement each new standard will depend on a company's industry, financing, sales strategies, and information technology systems. A company's operating practices and existing agreements may also be impacted by the new standards. Setting a mandatory adoption date of 2015—assuming new standards are issued by June 2011—and giving companies the flexibility to adopt standards early yields adoption sequences that are cost effective, while providing sufficient time for quality implementations.
- This approach is also beneficial for investors. Transitions that are tailored by each company will be most cost effective and the resulting implementations will be of higher quality.

To facilitate investor understanding and comparability between companies during the transition period, disclosure of the financial statement impacts caused by the changes is critical. The boards should ensure required disclosures are up to the task.

Adoption requirements must be made operational for all companies

The Financial Accounting Standards Board and the International Accounting Standards Board (the boards) are working on about a dozen joint projects designed to improve both US and international accounting standards. The scale of the proposed changes and their potential impact on companies are unprecedented.

Reprioritization of projects

Recently, the boards decided to delay certain projects and to retain the target completion date of June 2011 for projects they consider most significant. These include accounting for revenue, leases, and financial instruments. Two other projects are expected to be finalized in 2011, but will have less impact. Our views in this paper focus on the three significant projects.

The boards seek input

In October 2010, the boards issued consultation papers seeking input on when the proposed changes should be effective and

whether they should be implemented retrospectively or prospectively. The boards intend to use the feedback to decide on implementation requirements and timing, and consider the cost to companies and the needs of investors. We applaud the boards' additional efforts to seek the views of their constituents.

Impact on companies

The new standards will fundamentally change how companies account for financial instruments, lease contracts and revenue transactions. Companies may need new systems that can capture data, track contracts, and support processes to develop and reassess complex estimates. Also tax compliance systems and processes may need changes due to the new accounting. In many cases, systems that can support these changes are yet to be developed.

The proposed changes may also necessitate renegotiation of contracts, such as credit and compensation agreements, due to changes in financial ratios and reported results arising from the new accounting. Further, some companies may revise leasing, hedging, and sales strategies as a result of the new standards.

Impact on users

It's important to investors that companies implement the new standards cost effectively and correctly the first time. The reduced cost and risk of error can only be good for shareholder value. Giving companies ample time and flexibility will contribute to this goal.

Comparability and understanding the impact of the changes on each company will also be important to investors, analysts, and other users. Although some believe it may be ideal to have all companies change at once, the key to investor understanding will be clear disclosures of the changes as they occur and differentiation of the accounting effects from the performance of the business. The boards should ensure that required financial statement disclosures are up to the task.

Retrospective or prospective transition method

Often it is desirable that standards be retrospectively implemented to provide comparable information across periods.

However, each company's transition situation will be different. Factors such as the existence of long-term contracts, agreements with multiple performance obligations, or matters that require significant estimation may make retrospective application difficult or impossible. In these instances, retrospective application may require companies to make overly subjective estimates based on information that is no longer available.

We believe that the final standards should provide impracticability exceptions in a range of situations, including when the use of hindsight would require information that is unavailable or too difficult to obtain. Conversely, for the lease standard for which limited retrospective application is currently proposed, we believe full retrospective application should be available to those companies willing to undertake the exercise.

Allowing companies to manage their own pace of change will enhance quality

The core of accounting is changing

Each company is different and the impact on their financial reporting and business will also be different. Companies with older systems may choose to implement completely new reporting systems. A retailer will likely see significant changes as all leases move on to the balance sheet, while a less complex company that owns most of its fixed assets may see less change. Companies with complex long-term sales contracts will be impacted more than those that sell basic products or services. Multinational companies subject to foreign currency movements will be impacted more because of changing hedging requirements and other complexities inherent in operating in diverse environments.

Required effective dates

Because of the pervasive changes, most companies will need significant lead time. Companies have told us that implementation could take up to three and a half years after standards are issued. During the first 12 to 18 months, companies will be interpreting the new standards, working with software developers, setting accounting policies, training staff, and developing technology and operational systems. After systems have been developed, companies may need up to an additional 2 years to

implement the standards. This includes processing data, testing systems, and implementing internal controls. Contract renegotiations may also be prudent. During this period, many companies will account for transactions in parallel under existing and new standards for comparative reporting purposes.

Assuming the new standards on financial instruments, leases, and revenue are issued by June 2011, to give companies sufficient time for quality implementations, we believe that the mandatory adoption date for those three standards should be no earlier than January 1, 2015.

Early adoption considerations

Some believe implementing all of the proposed changes on a single date is preferable, because it eliminates multiple retrospective changes to comparative information over an extended period. They believe avoiding these changes to prior year presentations is more cost effective and less confusing to investors. While there are benefits to a single effective date for all, we don't believe that companies should be required to wait. This is because it may be more cost effective for some to adopt any or all of the proposed changes early.

For example, companies that can develop necessary systems quickly may want to early adopt to minimize the cost of running under old and new systems in parallel for comparative reporting purposes. Others, for which certain of the changes will have only a limited impact, may wish to put those changes behind them to focus on the

more extensive ones. First time adopters of International Financial Reporting Standards may also want to early adopt, rather than transition to current standards; only to change again for new standards shortly thereafter.

In our view, a forced single transition date or sequence will not be best for all companies. Allowing flexibility is the key.

Concerns over comparability

We acknowledge that our approach may make comparability between companies more difficult during the transition period. However, the impact on comparability can be reduced by providing disclosures for investors and clear corporate communications on the effects of the changes. More importantly, because of the scale of these changes, we believe the benefits of allowing early adoption outweigh the short-term impact on comparability. This is because companies are best positioned to determine transition plans that are most appropriate and cost effective for their particular situations. The resulting higher quality implementations combined with reduced costs will benefit investors.

In conclusion

Companies should be given sufficient time to prepare for the proposed changes and the option to manage their own pace of change. Otherwise, companies may be forced into more costly implementations that risk failing to achieve high quality financial reporting. This would not be beneficial for companies or investors.

Questions and answers

Q: Should the boards consider alternative transition options such as prospective transition?

A: The boards have proposed retrospective transition methods for the proposed standards with some exceptions. In addition, the boards provided a simplified retrospective approach for transitioning to the leases standard. While prospective adoption is the easiest way to adopt new standards, it reduces comparability between periods. Where practical, we accept retrospective transition because it provides the highest degree of comparability. However, where not practical or operational, we believe some form of prospective or modified retrospective approach makes more sense.

Q: Are there standards that should be adopted at an earlier or later date?

A: If the boards do not address many of the operational issues constituents have raised in the comment letter process on the three major proposed standards, an additional year beyond 2015 may be needed to give companies sufficient time to address the complexities.

Further, the financial statement presentation project, which would significantly change how the balance sheet, income statement, and cash flows of a company are presented, has been delayed. Accordingly, depending on when a final standard is issued, a delayed mandatory adoption date may also be appropriate for that project.

Two additional joint projects on the presentation of comprehensive income and changes to fair value measurements are also expected to be finalized before June 2011. For consistency and simplicity, the effective dates of those standards should be aligned with the other standards issued in 2011.

Q: Should private companies be allowed additional flexibility in timing and transition methods?

A: Yes. Some believe that private companies should not be given any additional flexibility as they will be impacted no more by the proposed changes than public companies. We believe that the boards should allow private companies an additional year (2016). Implementation by private companies may have additional challenges because they may not have the same depth of resources. This means it may take longer to renegotiate contracts and implement the necessary systems and accounting policy changes. Private companies can also benefit by learning from public companies that adopt first.

Q: Should the boards require the same effective dates and transition methods under US and international reporting standards?

A: Consistent transition methods would enhance comparability for investors. Using the same required effective date would set a consistent mandatory adoption date by which changes are adopted by all companies. Additionally, both boards should allow companies the same flexibility to choose which standards to adopt early for the reasons previously discussed in this paper.

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US GAAP Convergence & IFRS

Financial instruments

March 2011

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FASB decides on classification and measurement for financial liabilities and equity investments

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What are the key decisions?

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What's new?

This week the Financial Accounting Standards Board (FASB or the "Board") continued its redeliberations on the classification and measurement of financial instruments and made a number of significant decisions related to financial liabilities and equity investments not accounted for under the equity-method. These discussions are part of the FASB's redeliberation efforts on the joint project with the IASB on financial instrument accounting. All FASB decisions noted in this *In brief* are tentative and therefore subject to change, as the Board has not yet concluded its deliberations or issued a final standard. A complete summary of the Board's decisions on the financial instruments project is available on the FASB's website at www.fasb.org.

What are the key decisions?

Consistent with its recent decision on financial assets, the Board decided to allow financial liabilities to be measured at amortized cost depending on an entity's business strategy for the portfolio and the individual instrument's characteristics. Therefore, financial assets and financial liabilities would be classified into one of three categories—(1) amortized cost, (2) fair value with changes in fair value recognized in other comprehensive income (it is unclear if any liabilities would qualify for this category), or (3) fair value with changes in fair value recognized in net income. Refer to Dataline 2011–13 for the Board's previous decisions on financial assets and a description of the three classification and measurement categories.

This decision is responsive to the comment letters received on the FASB's May 2010 proposal by allowing more financial liabilities to be measured as amortized cost.

In addition, the Board affirmed its prior decision that all equity investments not accounted for under the equity method should be measured at fair value with changes in fair value recognized in net income. However, the Board is now considering the possibility of providing a practicability exception for certain nonpublic entities for their nonmarketable equity investments. This exception would allow these investments to be measured at amortized cost less any impairment. However, if observable prices are available, then the carrying amount would be adjusted to reflect those prices. The FASB will further develop this approach in future meetings.

Is convergence achieved?

The FASB's decision to allow amortized cost may be viewed as a step closer to convergence with the IASB's approach for financial liabilities. However, they are not converged at this stage, particularly since the FASB has yet to decide whether to allow a fair value option and whether embedded derivatives in hybrid financial instruments should be accounted for separately from the host contract.

The FASB approach to accounting for equity investments is similar to the IASB since these investments are measured at fair value with changes in fair value recognized in net income. However, the IASB also allows entities to irrevocably elect to have changes in fair value recognized in other comprehensive income without any subsequent recycling to net income. This option is not available in the FASB model. In addition, the IASB provides a practical expedient to determining fair value for unquoted equity investments in certain situations. The FASB, on the other hand, is considering a practicability exception for nonmarketable equity investments held by certain nonpublic entities.

Who's affected?

The final guidance will likely affect entities across all industries that hold or issue financial instruments.

What's the effective date?

The FASB must still decide on the effective date, although they have decided that early application would be prohibited.

What's next?

The FASB is continuing to refine the definition of the three classification and measurement categories and plans to test those definitions with constituents. It is unclear at this stage whether the FASB will re-expose its revised classification and measurement approach.

We will continue to keep you informed of the significant redeliberation decisions. We recently issued Dataline 2011–13 that provided a summary of all the FASB's decisions as of February 24, 2011.

FASB redeliberates its financial instruments proposal

An update on significant changes as of February 24, 2011

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Overview

Update on redeliberations

Other proposals to be reconsidered

Appendix: Other proposals contained in the FASB's May 2010 exposure draft

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February 24, 2011

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- The accounting for financial instruments is a priority convergence project for the FASB and IASB. The Boards are aiming to finalize most of their respective guidance in 2011.
- The FASB received a significant amount of input from financial statement users, preparers, and accounting firms on its May 2010 proposal. The tentative decisions the FASB has made in its redeliberations point to significant changes from the proposal.
- One significant change involves classification and measurement. The FASB tentatively decided to require that debt instrument assets be classified and measured according to three categories—(1) amortized cost, (2) fair value with changes in fair value recognized in net income, and (3) fair value with changes in fair value recognized in OCI—depending on an entity's business strategy for each portfolio and the characteristics of the individual instrument. In contrast, the IASB's finalized guidance classifies and measures debt instruments according to two categories: (1) amortized cost and (2) fair value with changes in fair value recognized in net income, and allows certain investments in equity instruments to be carried, on an elective basis, at fair with changes in fair value recognized in OCI.
- The FASB and IASB have been jointly redeliberating the accounting for credit impairments. The Boards recently issued a supplementary document in connection with their original proposals on impairment. The supplementary document proposes a common approach to recognizing credit losses on financial assets managed in an open portfolio. The supplement also affords constituents the opportunity to provide feedback on alternative approaches (comments due April 1, 2011).
- The FASB recently issued a discussion paper to seek feedback on the IASB's proposed revisions to hedge accounting (comments are due April 25, 2011). The IASB's proposal differs significantly from the FASB's proposal, in particular by proposing to extend hedge accounting to components of nonfinancial instruments. The FASB plans to consider the feedback in its redeliberations aimed at improving and simplifying hedge accounting. Those redeliberations will take place later in 2011. Consequently, the FASB will not finalize its revised hedge accounting guidance by June 2011.

The main details

1. The objective of this joint project is to improve the decision usefulness of financial statements by simplifying and harmonizing the accounting for financial instruments. However, despite being a joint project, the FASB and IASB have reached different conclusions on many aspects thus far. Once finalized, the new guidance will replace or amend most of the FASB's and IASB's respective financial instruments guidance.
2. In May 2010, the FASB proposed changes to its standards on financial instruments accounting. That proposal included an entirely new classification and measurement model for all financial instruments, a new credit impairment model for debt instruments, and significant amendments to the guidance on hedge accounting. The comment period ended on September 30, 2010. For a summary of the key elements of that proposal, refer to Dataline 2010–25, *FASB proposes changes to financial instruments accounting*.
3. The FASB received over 2,800 comment letters on its May 2010 proposal. It also hosted five roundtables in October 2010 and conducted extensive user outreach to gather further input. The FASB has posted on its website a summary of the feedback it received on classification and measurement and on impairment.
4. The FASB began redeliberating its May 2010 proposal in late 2010 and aims to finalize most of the guidance in 2011. The FASB must still decide on the effective date for the final standard. It has separately sought

input from constituents on the effective dates and transition for all of its priority projects.

5. All FASB decisions noted in this Dataline are tentative and therefore subject to change, as the Board has not yet concluded its deliberations or issued a final standard. A complete summary of the Board's decisions on the financial instruments project is available on the FASB's website at www.fasb.org.

Update on redeliberations Classification and measurement

Three categories

6. In late January 2011, the FASB decided to allow certain financial assets to be measured at amortized cost. Debt instruments would be classified and measured in one of three categories: (1) amortized cost, (2) fair value with changes in fair value recognized in other comprehensive income (OCI), and (3) fair value with changes in fair value recognized in net income.
7. This represents a significant change from the FASB's May 2010 proposal in which it called for two principal measurement categories, namely (1) fair value with changes in fair value recognized in net income and (2) fair value with changes in fair value recognized in OCI. Some exceptions to these two broad measurement categories were proposed for core deposits, certain trade receivables

and payables, certain instruments redeemable for a specified amount, and an amortized cost option for an entity's own debt under certain circumstances.

Constituent feedback: Many respondents supported two measurement categories. However, a significant number of the preparers preferred amortized cost rather than fair value with changes in fair value recognized in OCI for debt instruments for which the business strategy was to hold the assets and collect contractual cash flows. User views were more mixed, with some users, including one prominent user group, preferring fair value measurement for all financial instruments. In addition, some large financial institutions preferred three measurement categories: amortized cost, fair value with changes in fair value recognized in OCI, and fair value with changes in fair value recognized in net income. Those preparers believed that amortized cost was needed for portfolios of assets managed for the collection of contractual cash flows and that fair value with changes in fair value recognized in OCI was needed to more closely reflect their asset-liability or liquidity management strategy for holding certain debt instruments.

Criteria for classification and measurement

8. The Board also decided in late January 2011, that debt instrument assets should be classified and

measured in the three categories according to an entity's business strategy for the portfolio and the individual instrument's characteristics.

9. The Board described the three broad-based business strategies and how they line up with the proposed categories as follows:

- **Amortized cost**—would consist of assets pertaining to the advancement of funds (i.e., customer financing or lending) that are managed for the collection of the contractual cash flows
- **Fair value with changes in fair value recognized in OCI**—would consist of assets managed for an entity's investing activity in order to maximize the total return and manage the entity's risk exposures
- **Fair value with changes in fair value recognized in net income**—would consist of assets held as part of an entity's trading activities and loans held for sale

Consistent with current accounting, the FASB decided to require the recycling of gains and losses on instruments from OCI to net income that are realized due to the sale or settlement of a financial asset.

PwC observation: The FASB is continuing to work on refining these definitions of the potential business strategies. The Board indicated its intention to test these definitions with constituents by considering the application to different types of asset portfolios.

The FASB's revised business strategy definitions no longer

specifically focus on how the returns of the asset will be realized and the period for which the asset will be held. Instead the focus has shifted to the nature of an entity's activities. The FASB believes that this new focus on why a portfolio is originated or acquired as opposed to how it will be exited better reflects how entities manage their asset portfolios over the asset lives.

10. The FASB's May 2010 proposal included a requirement that financial instruments be classified and measured based on an entity's business strategy for the portfolio and the instrument's characteristics. In general, all financial instruments were to be classified at fair value with fair value changes recorded in net income unless the instrument had certain characteristics and the entity elected to recognize changes in fair value in OCI. An entity could qualify for this irrevocable election if its business strategy was to hold the financial instrument for collection or payment of contractual cash flows rather than to sell the instrument or settle it with a third party. To meet this condition, an entity would need to hold instruments within the portfolio for a significant portion of their contractual terms.

Constituent feedback: Most preparers commented that the entity's business strategy should be the primary driver of an instrument's classification. However, some expressed concern with the potential for a narrow

interpretation of the proposed criteria to qualify for fair value changes to be recognized in OCI, and called for an expansion of items that would be eligible for changes in fair value to be recognized in OCI and for more implementation guidance to be provided.

PwC observation: In their dissenting opinions on the May 2010 proposal, two FASB board members preferred adding a third criterion that would be based on whether an observable market exists for an instrument. If an instrument met both the business strategy and instrument characteristics criteria but had an observable market price, it would be classified and measured at fair value with changes in value recognized in OCI. If an observable market price did not exist for that instrument, it would be classified and measured at amortized cost. While some financial institutions agreed with the need for three classification and measurement categories, many constituents were concerned that considering marketability may result in changes in the measurement basis when an observable market ceases to exist.

11. The Board must still redeliberate the instrument characteristics criterion. In its May 2010 proposal, a debt instrument was required to meet the following criteria in order to be eligible for fair value changes to be recognized in OCI:

- It involves an amount transferred to the issuer at inception that will be returned at maturity or settlement (the principal amount adjusted for any premium or discount on issuance)
- The contractual terms of the instrument identified any additional cash flows to be paid periodically or at the end of the instrument's term
- The instrument cannot be prepaid or settled in such a way that the investor would not recover substantially all of its recorded investment, other than through its own choice
- The instrument is not a hybrid instrument with a financial host and does not contain an embedded derivative requiring bifurcation under ASC 815

Constituent feedback: Some expressed concern with certain of these criteria and the potential to require more fair value changes to affect net income. Their concerns centered on some of the FASB's criteria that did not seem consistent with a business strategy approach. For example, the existence of any embedded derivative—no matter how insignificant—that would otherwise have required bifurcation, would cause fair value changes to be recognized in net income.

PwC observation: IFRS 9 also requires an instrument to meet certain characteristics to be eligible for amortized cost measurement.

However, the characteristics under IFRS 9 differ in that they focus on the cash flow characteristics of an instrument (i.e., whether it constitutes solely payments of interest and principal), and not specifically on the existence of an embedded derivative.

- 12.** Consistent with the May 2010 proposal, the Board continues to believe that an entity's business strategy should be determined based on how the entity manages its business and portfolio of instruments rather than its intended use of a specific instrument.

Equity investments

- 13.** Under the May 2010 proposal, all equity investments that are not accounted for under the equity-method of accounting would be measured at fair value with changes in fair value recognized in net income (i.e., the option to recognize fair value changes in OCI was unavailable for equity securities). The Board has begun to discuss whether to reaffirm its May 2010 proposal for equity investments; however, no tentative decisions have been reached yet.

Constituent feedback: Some preparers were concerned with requiring all equity investments to be measured at fair value, particularly due to the operational challenges of determining fair value for nonmarketable equity investments and the resulting net income

volatility for equity investments that are viewed as more strategic.

PwC observation: The FASB began to discuss the classification and measurement of equity investments in February 2011. At this stage it appears that the Board will reconfirm its proposal to require all marketable equity investments that are not accounted for under the equity method to be measured at fair value with changes in fair value recognized in net income. For nonmarketable equity investments, there appears to be some support for allowing a practicability exception from the fair value measurement requirement. A practicability exception would allow these investments to be measured at cost less impairment. However, the resulting carrying value could be required to be adjusted when an observable price becomes available.

This practicability exception would differ from the practical expedient afforded under IFRS 9, which allows amortized cost on the basis that it may approximate fair value measurement absent any significant changes. In addition, while IFRS 9 requires fair value measurement for all equity securities not under the equity method, it diverges from the FASB's proposal by allowing entities to irrevocably elect on an individual instrument basis to have fair value changes for non-trading investments recognized in OCI with no subsequent recycling to profit or loss even upon disposal of the instrument.

Exhibit A: Comparison between today's financial assets' classification and measurement approach and the FASB's tentative decisions*

Fair value through net income	Lower of cost or market value	Fair value through other comprehensive income	Amortized cost
Today: Trading securities and derivatives	Today: Loans held-for-sale	Today: Available-for-sale securities	Today: Held-to-maturity securities, cost-method investments, and loans held-for-investment
Tentative new approach: Trading activities, derivatives, and loans held-for-sale		Tentative new approach: Investments intended to maximize return and manage risk	Tentative new approach: Lending or customer financing managed to collect cash flows

* Note that the FASB must still decide on its tentative new approach for marketable and non-marketable equity instruments not accounted for under the equity-method.

Financial liabilities

- 14.** The FASB began to discuss the classification and measurement of financial liabilities in February 2011. Initial indications are that the Board will allow certain financial liabilities that are not held as part of an entity's trading activities and are not derivatives to be measured at amortized cost. However, no tentative decisions have been reached yet.

Constituent feedback: There was little support for the FASB's May 2010 proposal to require most financial liabilities to be measured at fair value, with many respondents concerned about the effect that an entity's own credit could have on its results.

PwC observation: If the board allows some financial liabilities to be measured at amortized cost, it will need to consider whether to allow a fair value option and if it would only apply in certain situations, for example, one limitation suggested by respondents was to only permit the fair value option if amortized cost would create a

measurement mismatch with the assets being funded. The Board may then need to consider the accounting for an entity's own credit and whether, similar to IFRS 9, changes in the fair value due to changes in an entity's own credit would need to be reflected outside of net income if the fair value option is elected.

The FASB must still address the accounting for hybrid financial liabilities and, among other alternatives, could decide to require (1) the entire hybrid instrument to be measured at fair value with changes in fair value recognized in net income (consistent with its May 2010 proposal) or (2) bifurcation of the hybrid instrument into an embedded derivative (measured at fair value with changes in fair value recognized in net income) and a host contract that would be eligible for amortized cost measurement. Among other hybrid instruments, the accounting for convertible debt will be dependent on this decision.

Reclassification and tainting

- 15.** The Board has reaffirmed its May 2010 proposal to prohibit reclassifications between categories after initial recognition. Some Board members were concerned that allowing reclassifications between categories would enable entities to "cherry pick" when gains or losses should be recognized. In addition, some believe that allowing reclassifications would increase the need for some tainting notion, discussed in the next paragraph, to be incorporated in the final guidance.
- 16.** The Board also reaffirmed its May 2010 proposal to not include a tainting concept whereby subsequent sales or settlements of financial assets could impact the classification and measurement of the assets remaining in the portfolio. While subsequent sales or settlements of instruments would not taint the existing portfolio, entities would need to consider the impact of those sales or settlements on the classification of future originated or purchased assets.

Constituent feedback: Most preparers that supported the entity's business strategy as the primary driver of an instrument's classification also felt that reclassifications should be required when the business strategy changes, albeit subject to enhanced disclosures.

PwC observation: The Board acknowledged that a business strategy for a portfolio of financial assets may change, although it should be rare. However, the Board does not believe it is necessary to change the measurement attribute for that portfolio in such circumstances. Instead, the Board indicated that it may consider requiring separate presentation and additional disclosures, particularly when the strategy changes for a portfolio that was initially classified and measured at amortized cost. This decision would not be convergent with IFRS 9, which does require reclassification when the business strategy changes. IFRS 9 also does not include a tainting concept.

Impairment of financial assets

17. The FASB and IASB are working on developing an impairment approach that would be applied to all debt instruments that are not measured at fair value with changes in fair value recognized in net income. In its original proposal, issued in May 2010, the FASB had set forth an impairment model that resulted in upfront recognition of full lifetime expected

losses. In contrast, the IASB's original proposal resulted in building an allowance over the life of the financial asset. Both Boards received a significant amount of feedback from constituents on their original proposals.

- 18.** The Boards began joint redeliberations of their respective impairment proposals in November 2010. These joint redeliberations considered the input they gathered through their respective comment letter processes, input from the Expert Advisory Panel—a group formed to advise the Boards on the operational aspects of their original proposals—and their user outreach.
- 19.** As a result of these redeliberations, the IASB and FASB issued a joint supplementary document titled *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Impairment* (the “Supplementary Document”) on January 31, 2011 to gather input on new impairment approaches. The comment letter period ends April 1, 2011. For a more detailed summary of these approaches, see Dataline 2011–09, *Impairment redux—FASB and IASB are seeking comments on a converged impairment model for financial assets*.
- 20.** The Supplementary Document contains three credit impairment approaches—a common proposal and two alternative proposals. All the approaches have been developed with an open portfolio of similar financial assets in mind. The Boards must still consider whether these approaches can also be applied to closed portfolios, individual instruments, and to other assets (e.g., securities).

- **Common approach**—The objective of the common approach is to recognize an amount of allowance that reflects all expected losses (on the “bad book”) in addition to an allowance that reflects a portion of losses that are expected to occur in the future (on the “good book”). The portion of the allowance required for the “good book” is the higher of a time-proportional amount of expected losses and losses expected to occur in the foreseeable future, which would be subject to a 12-month floor.
 - **FASB alternative approach**—The FASB's alternative approach requires that the allowance be based solely on the losses expected to occur in the foreseeable future (which should not be less than 12 months) and does not incorporate a time-proportionate amount of expected losses.
 - **IASB alternative approach**—The IASB's alternative approach retains all the elements of the common approach, except that the allowance on the “good book” is calculated solely based on the time-proportional amount of expected losses over the remaining life of the assets. The objective of this portion of the allowance is to approximate how loans are priced and to reflect a credit-adjusted yield in earnings each period.
- 21.** While these three credit impairment approaches contain some elements of the FASB's and IASB's original proposals, other aspects have been modified to be responsive to the input the Boards received. The original

proposals can be summarized as follows:

- **FASB's May 2010 proposal—**

Credit impairment would be recognized in net income when an entity does not expect to collect all of the contractually promised cash flows (including both principal and interest). An entity no longer would wait until an event suggests it is probable that a loss had been incurred. Instead, an entity would consider the impact of past events and existing conditions on the collectability of contractual cash flows over the remaining life of the asset(s) without regard to the probability threshold.

Constituent feedback: Most users and preparers supported the elimination of the probability threshold. Some preferred the retention of an incurred-loss approach, but one that would be based on a lower recognition threshold. Most preparers supported the development of a single impairment model for all financial assets. In addition, most preparers felt that impairment should only include loss of principal consistent with current historical loss rates.

Further:

- In evaluating whether a credit impairment exists, the information an entity could use was limited to past events and existing conditions. As such, management would assume that economic conditions existing at the end of the reporting period will remain

unchanged over the remaining life of the financial asset.

Constituent feedback:

Preparers and users generally felt that an entity should be able to forecast economic conditions beyond the balance sheet date. Most felt that some parameters were needed on how far out to forecast. Some suggested that the forecast period should be for the foreseeable future and based on supportable data rather than being a bright line. The common and alternative approaches contained in the Supplementary Document are responsive to these views.

- The credit impairment for the full life of the financial asset would be recognized in the period in which they are estimated, rather than being allocated and recognized at a constant rate over the life of the asset.

Constituent feedback:

Views were mixed on whether the impairment amount should be calculated based on the remaining life of the asset or a shorter period, or whether it should be recognized immediately or over a period. Those who supported recognizing the allowance over a period reasoned that this approach better matches the pattern over which interest income is recognized that is intended

to compensate the entity for those losses. The time-proportional amount for the “good book” used in the common approach and under the IASB’s alternative approach is intended to reflect this view. Those who preferred immediate recognition of an amount for a foreseeable period that may be shorter than the remaining life of the asset reasoned that this approach would achieve the objective of increasing reserves while being the easiest to make operational. The common approach and the FASB’s alternative approach aim to accommodate this view.

- A methodology for measuring impairments and determining inputs into the calculations was not prescribed. For pooled assets, entities would apply an appropriate loss rate, which considers historical experience adjusted for current information, to the outstanding balance. For individual assets, the present-value technique would be used, and a decrease in the net present value of management’s expectations of cash flows to be collected from one reporting date to the next would be recognized as an impairment in net income (an increase would be recognized as a recovery). The Supplementary Document is similarly not prescriptive in defining calculation methodologies.

- The option to use the practical expedient in ASC 310-10-35 to measure the impairment based on the value of the collateral after considering costs to sell for collateral-dependent assets was retained. However, the FASB proposed broadening the definition of collateral-dependent assets. This issue is not explicitly addressed in the Supplementary Document.
- Interest income would be determined by multiplying the amortized cost less cumulative allowance for credit impairments by the financial asset's effective interest rate (EIR). Contractual amounts due in excess of accrued interest served to increase the allowance; however, if the allowance account exceeds the entity's loss estimates, the difference should be recognized in net income as a recovery (not as interest income). Specific guidance was proposed on the EIR to be used for originated financial assets versus financial assets purchased at a discount due to credit impairment.

Constituent feedback: All preparers and most users opposed the proposal to reduce the interest income recognized for the credit impairment and preferred decoupling interest income recognition and impairment. Their rationale was that users prefer to be able to analyze the net interest

margin based on contractual interest rates separately from the credit losses.

- **IASB's November 2009 proposal**—The EIR would be calculated upon initial recognition of the assets based on expected cash flows, including credit losses, over the life of the assets. This would result in a lower EIR compared with the contractual rate. By recognizing lower interest income, an allowance would be created by the difference between cash collected and the accrued interest income. The allowance is released as losses occur and loans are written off. Cash flows would need to be continually re-estimated, with changes in cash flow expectations recognized immediately in earnings.

Constituent feedback:

The IASB proposal also received significant opposition. Constituents raised a number of conceptual concerns, including the potential for an entity to be under reserved on assets where losses tend to occur during the earlier years, and the need to recognize immediately in earnings all changes in expectations, including for future periods while recognizing over time the original estimate of losses. The approaches contained in the Supplementary Document seek to address this concern

by requiring a full reserve to be established on nonperforming assets (on the "bad book"), with a minimum reserve level required for the "good book."

Constituents were also concerned with the operational challenges this model presented, including the need to integrate credit and interest computation systems and continually update cash flows expectations. The common and alternative approaches contained in the Supplementary Document would decouple the credit and interest computations. Further, the time-proportional amount calculated for the "good book" seeks to address the operational complexity associated with determining expected cash flows for the asset in each period by requiring a time-proportional calculation of the reserve.

Other proposals to be reconsidered

Classification and measurement

22. The FASB decided in October 2010 that, based on input it had received from constituents, it would also redeliberate a number of other significant aspects of its May 2010 proposal as it relates to classification

and measurement. Redeliberations on these topics have not yet begun. These include:

Initial measurement

a. Dealing with differences between the transaction price and fair value

In the FASB's May 2010 proposal, initial measurement would differ depending on the instrument's subsequent measurement. For instruments subsequently measured at fair with changes in fair value recognized in net income, the initial measurement would be fair value with any difference between fair value and transaction price recognized in net income.

For instruments subsequently measured at fair value with changes in fair value recognized in OCI, the initial measurement would be the transaction price. However, if an entity has reason to believe that the fair value differs significantly from the transaction price, it would be required to determine if reliable evidence shows that a significant difference does in fact exist. If a significant difference exists due to the existence of other elements, the entity is required to identify and separately account for those other elements in the transaction and measure the remaining financial instrument at fair value. If no other elements can be identified or valued, the entity is required to recognize the entire difference between the transaction price and the fair value in net income. For instruments subsequently measured at amortized cost, the initial measurement would be transaction price.

Constituent feedback: Most respondents agreed that significant

differences between the fair value and transaction price should be examined to determine if there are other elements that should be separately accounted for. However, most found the proposed guidance for determining whether the transaction price differs significantly from the fair value confusing. Many also disagreed with the default notion that the entire difference between the transaction price and fair value should be recognized in net income if no other elements that need to be separately accounted for could be identified.

b. The treatment of transaction costs

In its May 2010 proposal, the FASB required that for instruments measured at fair value with changes in fair value recognized in net income, transaction costs and fees associated with purchases or sales be recognized in net income (as an operating expense) immediately. For instruments measured at fair value with changes in fair value recognized in OCI, transaction costs and fees would be deferred in OCI and recognized in net income as a yield adjustment over the life of the instrument.

Constituent feedback: In their comment letters, investment managers all opposed the proposal to recognize transaction costs as operating expenses. Current practice for investment funds is to recognize explicit transaction costs, such as brokerage commissions, as part of the original cost of the investments, with all subsequent changes in fair value included in the fund's statement

of operations as a component of unrealized/realized gains or losses on investments. Consequently, expense ratios—a key performance metric for investment entities—would be impacted by the proposal. Those respondents believe that transaction costs associated with a fund's investment strategies are more appropriately captured as part of investment gains/losses rather than in recurring operating expenses of the fund. In addition, some respondents also requested further guidance on how to measure transaction costs and noted a number of challenges, such as in determining the transaction costs when it is not explicitly identified as part of the transaction (e.g., implicit in the bid-offer spread).

Enhanced risk disclosures, particularly on interest rate, prepayment, and liquidity risks

Constituent feedback: There was a recurring and consistent comment letter theme among users for financial reporting to include enhanced disclosures on risks relating to financial instruments.

PwC observation: It is unclear whether the FASB will work with the SEC to improve the existing risk disclosures contained in management's discussion and analysis (MD&A) or prefer footnote disclosure of risks, requiring them to be provided by both public and nonpublic entities and be subject to audit. Note that credit risk disclosures have already been addressed in ASU 2010-20 (see Dataline

2010–31, *New disclosure requirements for finance receivables and allowance for credit losses*, for further details).

Equity-method of accounting

The FASB proposed limiting the investments accounted for under the equity method to those where the investor has significant influence over the investee and the operations of the investee are related to the investor's consolidated operations. The proposal included factors to be considered in determining whether an investee is related to an entity's consolidated operations. These factors included the line of business in which they both operate, the level of transactions between the investee and entity, and the extent to which management are common to both parties. Additional disclosures would also be required about how management has reached its conclusion on investments in which the entity has significant influence. The fair value option would no longer be available for such investments. Currently, the existence of significant influence alone requires equity-method accounting by the investor.

Constituent feedback: Most users who commented on this aspect of the proposal were supportive of this change. However, many preparers opposed this change on the basis that their equity-method investments are generally strategic in nature and the factors provided by the FASB to identify strategic investments were too limiting. In addition, many preparers did not support the proposal to eliminate the fair value option for these investments.

Hedge accounting

23. The IASB issued its hedge accounting proposal on December 9, 2010 for public comment. Comments are due March 9, 2011. The FASB issued a discussion paper titled *Selected Issues about Hedge Accounting* on February 9, 2011 to seek feedback from US constituents on the IASB's proposal. The comment letter period ends April 25, 2011. As a result, the FASB has deferred redeliberating hedge accounting until later in 2011 when it has gathered that input. For a more detailed analysis of the IASB's hedge accounting proposal and how it compares with the FASB's May 2010 proposal, see In brief 2011–06, *FASB seeks comments on IASB hedge accounting proposal*, and Dataline 2011–06, *Accounting for hedging activities—A comparison of the FASB's and IASB's proposed models*.

PwC observation: The FASB's May 2010 hedge accounting proposal was predicated on its classification and measurement proposal, which would require most financial instruments to be measured at fair value. It remains to be seen whether the FASB will change course on hedge accounting given its recent decision to allow certain financial instruments to be measured at amortized cost. In its 2008 exposure draft, which was based on the current mixed-measurement model for financial instruments, the FASB had proposed eliminating the ability to hedge by component risk for financial instruments, other than interest rate risk on an entity's own debt at issuance and foreign currency risk. Under that approach, the entire fair

value change on the hedged item and hedging instrument would be recognized in net income.

24. The FASB's May 2010 proposal supported lowering the threshold to qualify for hedge accounting. The hedging relationship would only need to be "reasonably effective" instead of "highly effective." It also proposed replacing the current requirement to quantitatively assess hedge effectiveness each quarter with a qualitative assessment at inception and would have limited the need to reassess in subsequent periods. The proposed model also (1) eliminates the shortcut and critical-terms match methods for assessing hedge effectiveness, (2) prohibits the discretionary de-designation of hedging relationships, (3) requires the recognition of the ineffectiveness associated with both over- and under-hedges for all cash flow hedging relationships, and (4) requires the amortization of the cost of a purchased option used as a hedging instrument.

25. The IASB's December 2010 proposal also changes the threshold to qualify for hedge accounting. However, unlike the FASB's proposal, it introduces a concept of having "other than accidental offsetting," "neutrality," and an "unbiased result" as the qualifying criteria for hedge accounting. In contrast to the FASB's proposal, the IASB retained the need to assess hedge effectiveness at each reporting date or when circumstances change, but this assessment can be performed qualitatively. However, under both the IASB and FASB proposals, the effectiveness test is only a forward-looking

Appendix

Other proposals contained in the FASB's May 2010 exposure draft

test (i.e., no retrospective test would be required). The IASB's proposal also limits the ability to voluntarily de-designate a hedging relationship.

- 26.** The IASB's proposal provides greater flexibility in the designation of exposures as hedged risks, including by allowing the designation of risk components of nonfinancial items and groups of dissimilar items (including net exposures) as hedged items. The proposal would also change the presentation of fair value hedges by removing the requirement to adjust the basis of the hedged item and instead require fair value changes attributable to the hedged risk to be presented as a separate line item in the balance sheet. A corresponding entry would be recorded in OCI on a gross basis. Any ineffectiveness in the hedging relationship would then be recycled to net income.

Transition and effective date

- 27.** The Board has not decided on the effective date of these changes or the method of adoption. However, the May 2010 proposal called for entities to adopt the standard by making a cumulative-effect adjustment, calculated in accordance with ASC 250, *Accounting Changes and Error Corrections*, to the last balance sheet before the effective date. The prior-period balance sheet would be restated in the first financial statements (interim or annual) issued after the effective date to provide some comparability. Early adoption was prohibited under that proposal.

The FASB has not decided on the full extent of its redeliberations. The following content reflects the proposals not already addressed in this Dataline and is carried forward from Dataline 2010–25, *FASB proposes changes to financial instruments accounting*. Note, however, that the Board may still redeliberate these proposals. Therefore, they are subject to change as the Board has not yet issued a final standard.

Scope

The scope of the project is limited to financial instruments, as defined in the master glossary of the FASB Accounting Standards Codification. However, the following are excluded:

- Employers' and plans' obligations and the related assets within the scope of:
 - ASC 710, *Compensation*
 - ASC 712, *Compensation—Nonretirement Postemployment Benefits*
 - ASC 715, *Compensation—Retirement Benefits*
 - ASC 718, *Compensation—Stock Compensation*
 - ASC 960, *Plan Accounting—Defined Benefit Pension Plans*
 - ASC 962, *Plan Accounting—Defined Contribution Pension Plans*
 - ASC 965, *Plan Accounting—Health and Welfare Benefit Plans*
- Contracts within the scope of ASC 944, *Financial Services—Insurance*, except for investment contracts issued by insurance entities and contracts that do not transfer insurance risk and are within the scope of the deposit method of accounting as defined in ASC 944
- The following financial guarantees or indemnifications:
 - Contracts that prevent the guarantor from achieving sale accounting for an asset transfer or recognizing profit from a sale transaction
 - Guarantees or indemnifications of an entity's own future performance
 - Product warranties or other guarantees related to the functional performance (not the price) of nonfinancial assets owned by the guaranteed party
 - Guarantees issued between a parent and its subsidiary or between entities under common control
 - Guarantees issued by a parent to a third party for a subsidiary's debt, or guarantees issued by a subsidiary to a third party for its parent or another subsidiary's debt
 - Contracts that provide for payments that constitute vendor rebates
- Noncontrolling interests in consolidated subsidiaries
- Equity investments in consolidated subsidiaries
- Equity instruments issued and classified entirely in stockholders' equity. (Note that financial instruments with equity-like features that are classified as liabilities would be subject to the Board's proposal.) The scope also would not apply to equity components of hybrid financial instruments that require bifurcation.
- An interest in a variable-interest entity that the reporting entity is required to consolidate

- Forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash accounted for under ASC 480, *Distinguishing Liabilities from Equity*
- Leased assets and liabilities accounted for under ASC 840, *Leases*
- The conditional obligation under a registration payment arrangement that is accounted for separately from the debt or equity instrument
- Receivables and payables of not-for-profit entities relating to pledges arising from voluntary nonreciprocal transfers
- Investments accounted for under the equity method (ASC 323, *Investments—Equity Method and Joint Ventures*)
- Derivatives that preclude sale accounting under ASC 860, *Transfers and Servicing* (e.g., call option to repurchase the transferred assets)
- Policyholder's investments in life insurance contracts
- Investment contracts included in the scope of ASC 960, *Plan Accounting—Defined Benefit Plans*
- Contracts to enter into a business combination at a future date
- To include within the scope of the proposal:
 - Life settlement contracts, which are contracts that do not have a direct insurance element (the investor does not have an insured interest) would be measured at fair value

The board also proposed the following scope clarifications for financial instruments currently excluded from ASC 815, *Derivatives and Hedging*:

- To exclude the following from the scope of the proposal:
 - Forward contracts to purchase or sell securities that are deemed "regular way"
 - Contracts that are not exchange traded, where the underlying is (1) a climatic or geological variable (e.g., weather derivatives), (2) the price or value of a nonfinancial asset or liability of a contract party that is not readily convertible into cash, or (3) specified volumes of sales or service revenues of a contract party
- The Board also proposed to require that:
 - Contingent consideration arrangements that are based on an observable market or index be measured at fair value with changes in fair value recognized in net income. Contingent consideration arrangements that are not based on an observable market or index would be excluded from the scope.
 - All loan commitments and standby letters of credit would be recognized and accounted for by the issuers in accordance with the proposal. However, loan commitments in connection with revolving lines of credit issued under credit card arrangements would be excluded from the scope. Potential borrowers under loan commitments and standby letters of credit would be excluded from the scope.

Application to certain industries

Broker-dealers would recognize all financial assets at fair value with changes in fair value recognized in net income. However, the proposed guidance would apply to a broker-dealer's financial liabilities. Therefore, its financial liabilities could qualify for fair value measurement with changes in fair value recognized in OCI, or qualify for amortized cost measurement.

Investment companies would recognize all financial assets and liabilities at fair value with changes in fair value recognized in the net increase or decrease in net assets resulting from operations.

Entities within the scope of ASC 958, Not-for-Profit Entities, would be required to classify and measure financial assets and financial liabilities according to the proposed model even if they do not report net income or comprehensive income. Those entities that report a performance indicator similar to net income would need to report fair value changes in that performance indicator unless they are eligible and elect to have fair value changes recognized in OCI, in which case they would report those fair value changes outside of the performance indicator. Entities that do not report a performance indicator would need to report all changes in fair value as a change in the net asset class in the statement of activities. Further, all not-for-profit entities would need to initially measure all financial instruments at transaction price.

Temporary deferral for certain nonpublic entities

The Board decided to provide nonpublic entities with less than \$1 billion in total assets with an additional four years after the effective date that would apply to other companies to recognize at fair value on the balance sheet loans that are eligible for the recognition of fair value changes in OCI and core deposit liabilities. These entities would continue to recognize those loans and core deposits at amortized cost. They would also continue to account for any loan commitments under the current accounting guidance. While the fair value disclosures would still be required for these loans based on the exit price definition of fair value contained in ASC 820, *Fair Value Measurements and Disclosures*, core deposits would not be subject to the new measurement methodology for the purpose of these disclosures. Issuers of conduit debt securities that are traded in a public market are considered public entities.

Amortized cost option for own debt

An entity could irrevocably elect at issuance to measure certain types of its own debt at amortized cost if (1) the debt would otherwise qualify to have changes in fair value recognized in OCI and (2) measuring the debt at fair value would create or exacerbate a measurement attribute mismatch between recognized assets and liabilities.

A measurement mismatch exists when the liability is:

- Contractually linked to an asset that is measured at amortized cost (e.g., a mortgage loan). A financial liability that is collateralized by an asset or

must be repaid upon disposal of an asset is considered contractually linked to the asset.

Or

- Issued by and reported in, or evaluated by the chief operating decision maker as part of, an operating segment with less than 50% of that segment's assets measured at fair value on a recurring basis

Or

- A liability of a consolidated entity with less than 50% of the consolidated assets measured at fair value on a recurring basis

The assessment of whether a measurement mismatch exists is made based on the balances of recognized assets at the end of the last reporting period adjusted by (1) removing any assets that are contractually linked to liabilities and (2) including assets acquired due to the issuance of the liability. For the purposes of this calculation, cash is excluded (not considered to be measured at fair value) but cash equivalents are not.

Core deposits

Core deposits would be measured based on the present value of the average core deposit balances discounted over the implied maturity at a rate equal to the difference between the alternative funding rate and the costs of providing services to the deposit holders (the all-in-cost-to-service rate). Core deposits are likely to be eligible for recognizing remeasurement changes in OCI. Core deposits are defined as deposits that do not have a contractual maturity but that management identifies as a stable source of funds. Noncore deposits would be carried at fair value

with changes in fair value recognized in net income, although the demand amount will likely approximate fair value since the holding period is typically short. Time deposits would be measured at fair value and may be eligible for recognizing fair value changes in OCI.

Constituent feedback: There was no support from respondents for the proposed measurement attribute for core deposits.

PwC observation: Given the Board's recent decision that likely would allow most held-for-investment loans to continue to be measured at amortized cost, it would seem unlikely that the Board will retain this element of its original proposal.

Loan commitments and standby letters of credit

Loan commitments and standby letters of credit issued by potential lenders would be recognized at fair value and classified in a manner that is consistent with how the loan would be classified if and when it is funded. For example, if the potential lender plans to hold the loan for the receipt of its contractual cash flows and intends to elect that the fair value changes be recognized in OCI, then the fair value changes on the loan commitment or standby letter of credit would be recognized in OCI. If the commitment is exercised and an entity decided to recognize fair value changes in OCI for the loan, the commitment fees would adjust the amortized cost, which would be used to calculate interest income, and be recognized as a yield adjustment over the term of the funded loan.

PwC observation: The FASB's recent decision to allow certain loans to be measured at amortized cost would likely trigger a reconsideration of the appropriate measurement attribute for loan commitments that, when funded, would result in loans that are measured at amortized cost.

Short-term receivables and payables

Entities can elect to measure receivables and payables at amortized cost if they (1) are eligible for fair value changes to be recognized in OCI and (2) arose in the normal course of business and are due in customary terms of up to one year. However, this amortized cost exception is not available to lending arrangements not associated with the delivery of goods and services, such as credit card receivables and short-term debt securities.

PwC observation: Note that the FASB's recently revised business strategies guidance should allow most receivables to be classified and measured at amortized cost. Consequently, this exception may no longer be necessary. As previously noted, the Board recently began to reconsider the classification and measurement of financial liabilities but has not made any tentative decisions yet.

Investments redeemable for a specified amount

An exception from fair value measurement is also provided for certain investments that can only be redeemed with the issuer for a specified amount. If the investment meets the following criteria, it would be required to be subsequently measured at the redemption amount:

- It does not have a readily determinable fair value
- It cannot be redeemed for an amount greater than the holder's initial investment
- It is not held for capital appreciation
- It is required to enable the holder to enter into a transaction with or participate in the issuer's activities

Presentation

Financial instruments for which changes in fair value are recognized in net income would be presented on the balance sheet separate from financial instruments for which fair value changes are recognized in OCI.

The table on the following page summarizes the other FASB proposals on financial statement presentation:

Classification	Balance sheets	Statements of comprehensive income
Financial instruments for which changes in fair value are recognized in net income	Present fair value on the balance sheet, except for an entity's own debt where amortized cost also would be presented on the balance sheet. An entity may elect to present, either on the balance sheet or in the footnotes, the amortized cost and a reconciliation to fair value.	Present separately in net income an aggregate amount for realized and unrealized gains and losses. An entity may elect to present interest income/expense accruals, dividend income/expense accruals, and credit losses as separate line items. Present significant fair value changes in an entity's own credit standing in net income separately.
Financial instruments for which changes in fair value are recognized in OCI	Present as separate line items on the balance sheet: • Amortized cost (reduced for any write-offs*) • Allowance for credit losses (for assets) • Adjustment to arrive at fair value • Fair value Present the fair value/ remeasurement changes separately from other accumulated OCI items and also the portion thereof allocated to noncontrolling interests. * A write-off is a reduction in the carrying amount due to uncollectability.	Present separately in net income: • Interest income • Interest expense • Credit losses or recoveries (for assets) • Realized gains and losses Foreign currency gains or losses would continue to be reported in OCI along with other changes in fair value recognized in OCI. Present significant fair value changes in an entity's own credit standing separately.
Core deposits	Present as separate line items on the balance sheet: • Face amount (amortized cost) • Adjustment to arrive at remeasurement value • Remeasurement value	Present interest expense separately in net income if remeasurement changes are recognized in OCI. However, if remeasurement changes are recognized in net income, then, at a minimum, present aggregate unrealized gains or losses. If an entity elects OCI treatment, foreign currency gains or losses would continue to be reported in OCI along with other changes in fair value recognized in OCI.
Financial instruments (own debt) for which the amortized cost option is elected	Present amortized cost on the face of the balance sheet.	Present separately in net income: • Interest expense • Realized gains or losses

Disclosures

The FASB proposed numerous additional disclosures for inclusion in annual and interim reports. The disclosures are required to be disaggregated based on the nature, characteristics, and risks of the financial instruments. The disclosures include requiring information about:

- The reasons for significant changes in fair value due to the entity's own credit standing, and how the resulting gains or losses were determined
- The contractual maturities of instruments measured at fair value with changes recognized in OCI
- Information about financial assets purchased and measured at fair value with changes recognized in OCI
- The entity's assessment of the credit impairment and the discount/premium associated with purchased financial assets
- A roll forward (in the aggregate and by portfolio segment) of the allowance for credit losses
- How an entity determines whether a credit impairment exists, and the significant inputs and assumptions used to measure the impairment
- The average carrying amount, unpaid principal balance, fair value, amortized cost, allowance for credit losses, and interest recognized on individually impaired financial assets
- The reasons, together with cost basis, fair value, and gain/loss information, that instruments were sold or settled before contractual maturity date if measured at fair value with changes recognized in OCI
- The method(s) used to determine interest income for pools of financial assets if impairment is determined on a pool basis, and quantitative information about these pools
- The carrying amount and amortized cost for financial assets that have a negative yield (and are therefore not accruing interest)
- The key inputs and assumptions used to measure core deposit liabilities and an analysis of the uncertainty of the measurement (the effect of a 10% change in the discount rate)
- Why measuring a financial liability at fair value would create or exacerbate a measurement mismatch and the fair value of the liability if the amortized cost option is elected

Entities would need to disaggregate all the recurring fair value disclosures required under ASC 820 between those instruments where fair value changes are recognized in net income and those where fair value changes are recognized in OCI. Entities would also have to provide additional disclosures about significant inputs and the information on measurement uncertainty (proposed in the joint fair value measurement project) for all measurements classified as Level 3 in the fair value hierarchy, with the exception of unquoted equity instruments.

Impairment redux

FASB and IASB are seeking comments on a converged impairment model for financial assets

What's inside:

Overview

Key provisions

Reprinted from:

Dataline 2011–09

February 21, 2011

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- On January 31, 2011, the FASB and IASB (the boards) published a supplementary document, titled by the FASB *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Impairment*¹ (the supplement), to solicit views on a converged model to account for impairments of certain financial assets managed in an open portfolio.
- The supplement is a likely precursor to an exposure draft of a proposed accounting standard. It reflects the boards' consideration of feedback received on impairment models included in exposure drafts on financial instruments accounting issued by the IASB in November 2009 and by the FASB in May 2010.
- Through the boards' outreach on the financial instruments project, as well as feedback from groups such as the G-20 and the boards' Financial Crisis Advisory Group, impairment has been cited as the area in financial instruments accounting that is most in need of repair and where convergence is essential. The consensus among the board's constituents is that the current impairment model under US GAAP and IAS 39² did not result in the timely recognition of losses ("too little, too late") and did not adequately incorporate forward looking information.
- The supplement acknowledges the importance of reaching a common solution to accounting for impairment of financial assets and at least partly satisfying each board's original objectives for impairment accounting set out in their exposure drafts. The supplement incorporates the IASB's objective to reflect the relationship between the pricing of financial assets and expected credit losses through a loss allocation method. It also addresses the FASB's objective related to the adequacy of the allowance by establishing a minimum allowance or "floor."
- The boards plan to jointly redeliberate the proposals in the supplement based on the feedback received on it and will consider the need for public roundtables, although there is a sense that roundtables are not well suited to address the operational issues. The IASB expects to issue a final impairment standard by June 2011, and the FASB expects to issue a final ASC update that includes the credit impairment model in 2011.

¹ The IASB's version of the supplement is titled *Financial Instruments: Impairment*.

² IAS 39, *Financial Instruments: Recognition and Measurement*.

The main details

1. The supplement proposes an impairment model with two distinct methodologies for certain financial assets managed in an open portfolio, with credit losses determined based on the credit characteristics of such financial assets (the “common proposal”). The common proposal is limited to an open portfolio of assets because the boards consider the application of an impairment model to be most operationally challenging for open portfolios. This model is consistent with how many financial institutions manage credit risk. The two methodologies are referred to herein and in the supplement as a “good book” and “bad book” approach. The distinction between the categories depends on the degree of uncertainty about collectability. When collectability becomes uncertain and the entity’s credit risk management objective changes from receipt of regular payments to recovery, the allowance for the financial asset would be evaluated in the bad book. Thus, financial assets could move between two portfolios, the good book (where the higher of (i) a time-proportional allowance or (ii) the losses expected in the foreseeable future (no less than 12 months) that can be reasonably estimated would be recognized) and the bad book (where the entire amount of expected credit losses would be recognized immediately) according to the entity’s internal risk management policies.
2. The common proposal outlined in the supplement is the result of joint discussions on an impairment model that addresses the primary objectives of the individual boards. However, some members of the FASB and IASB prefer

the models that each board had been separately developing. Accordingly, the supplement also affords constituents the opportunity to provide feedback on the FASB and IASB alternative approaches. Under the IASB alternative approach, an entity recognizes the time-proportionate remaining lifetime-expected credit losses on the good book with no “floor” and the full amount of lifetime-expected losses on the bad book. Under the FASB alternative approach, an entity immediately recognizes all credit losses expected to occur in the foreseeable future, with no minimum period specified.

3. The comment period for the supplement is short at 60 days with comments due April 1, 2011. The supplement seeks comments on the common approach, and on each board’s independently developed alternative approach. The scope of the proposals is limited to financial assets in open portfolios. However, the boards are also inviting comments as to whether the proposed approach is suitable for closed portfolios, individual instruments, and any other types of instruments. At this time, the boards are not re-exposing other aspects of the impairment model, such as the methods for measuring credit losses. They will continue re-deliberating these issues based on the feedback received on their original exposure drafts while the supplement is open for comment.
4. Effective dates and transition provisions are not proposed in the supplement. The boards acknowledge, however, that even if the impairment standard is finalized in 2011, implementing the new model might require substantial lead time.

Recap of the original proposals and feedback received³

5. The models originally proposed in exposure drafts on financial instruments accounting issued by the FASB and IASB are very different. The FASB model was based on upfront recognition of credit losses that are expected over the life of the asset, while the IASB model recognized expected credit losses via an adjustment to the effective interest rate—thereby recording losses over the life of the loan—with changes in cash flow expectations resulting in a catch-up adjustment recognized in net income. The information used to forecast expected losses was also not aligned in the proposals because the FASB limited information to past events and current conditions while the IASB required use of forecasts in projecting cash flows. Both proposals required interest income recognition to be affected by credit losses.
6. Constituents criticized both models through comment letters and roundtables. The FASB proposal was mainly criticized for (i) requiring “too much too soon” and (ii) not permitting forecasts to be used in developing expectations. The IASB proposal was mainly criticized for (i) creating operational complexity in requiring explicit cash flow forecasting based on probability-weighted expectations and (ii) potentially resulting in the loss being recorded after it was

³ For further details on the original proposals, refer to PwC Dataline 2010–25, *FASB proposes changes to financial instruments accounting*.

incurred, thus giving rise to a negative allowance (due to the fact that the charge-off would be debited to the allowance account before all the expected losses were credited to that account). Both models were criticized for requiring interest income to be commingled with credit losses. Users that responded to the boards' proposals generally preferred to retain the current method for establishing net interest margin on the basis that it was well-established and understood. They also objected to the subjectivity associated with determining the allowance balance affecting both the interest and provision lines in the performance statement.

7. The IASB sponsored the formation of an Expert Advisory Panel (EAP) comprising credit risk experts to consult on the operational issues of both models. Although the EAP was set up to provide feedback on the operational aspects of each board's approach, the panel also explored alternative models and provided feedback to the boards that helped establish the groundwork for the common approach in the supplement.

Key provisions

8. This section highlights the key provisions of the common proposal in the supplement. All decisions noted in this Dataline are tentative and therefore subject to change, as the boards have not yet concluded their deliberations or issued a final standard.

Scope

9. The objective of issuing the supplement is to obtain feedback on an

impairment model for open portfolios, one of the most operationally complex areas of impairment. The supplement defines a portfolio as a "grouping of financial assets with similar characteristics that are managed by a reporting entity on a collective basis." An *open portfolio* is further described as a portfolio where "assets are added to the portfolio through its life by origination or purchase and removed through its life by write-offs, transfers to other portfolios, sales, and repayment."

PwC observation: Current US GAAP and IFRS do not include specific guidance on how an entity should group financial assets for the purpose of building up the allowance levels. In addition, although the discussion in the supplement focuses on loan portfolios, portfolios of debt securities may also be considered open portfolios.

10. The scope of the common proposal covers financial assets measured at amortized cost under IFRS 9 and, for the FASB, financial assets that are not measured at fair value with changes in fair value recognized in net income (FV-NI).⁴ Thus, for the FASB, the model in the supplement would apply to financial assets measured at fair value with changes in fair value recognized in other comprehensive income (FV-OCI) and financial assets measured at amortized cost.

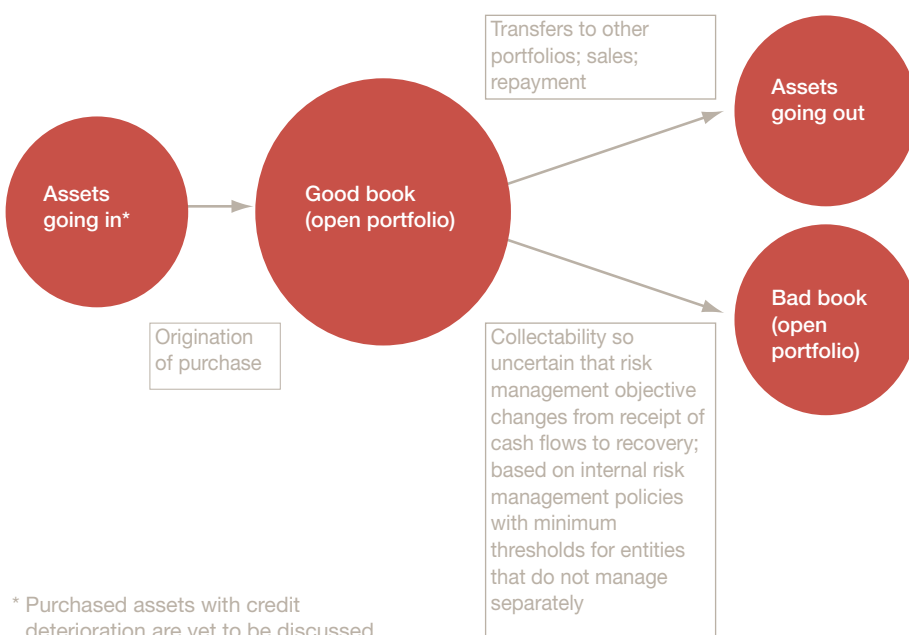
PwC observation: During the FASB's redeliberations of its exposure draft on financial instruments,

some board members raised concerns about the interaction between the impairment model and proposed classification and measurement of the financial instruments. One significant issue still to be discussed is how and when to measure the impairment of instruments measured at fair value with changes in fair value recognized in other comprehensive income. The issue is whether measurement should be based on the fair value or should be based on credit losses, similar to the current US GAAP other-than-temporary impairment model for debt instruments.

11. The supplement further clarifies that:
 - Equity investments are excluded from the supplement. Part of the simplification effort in the financial instruments project is to eliminate the need to assess impairment of equities. The FASB originally proposed in the May 2010 exposure draft that all equity investments be recognized at FV-NI. Although the FASB has not finalized that model, if the FASB chooses to move away from FV-NI for equities, then a different impairment model will likely be required for equity investments.
 - Short-term trade receivables are excluded from the IASB's but not the FASB's supplement. Given the complexities of the interaction with the revenue recognition project, the IASB decided that it would discuss impairment of short-term trade receivables at the beginning of its redeliberations on the revenue recognition project. The FASB has not yet discussed this issue.

⁴ Refer to PwC In brief 2011–02, *FASB changes course on financial asset classification and measurement*.

Exhibit A: Distinction between good book and bad book



- Although the closed portfolios are excluded from the supplement, the boards are seeking feedback on whether the proposed model can be applied to such portfolios. Run-off loan books are typically evaluated for impairment on a portfolio basis; therefore, the open portfolio model could apply. Debt securities currently subject to impairment under ASC 320–10 may be within the scope of the supplement if credit risk is managed in a portfolio, i.e., grouped based on similar characteristics, although this may be rare.
- Individual debt securities and loans not evaluated for impairment in a portfolio or group are excluded from the supplement. The boards are asking for feedback on whether and how the proposed model can be applied to assets evaluated for impairment on an individual basis.

PwC observation: It may not be intuitive to apply a statistical method that is generally used for portfolios (e.g., based on loss rates) to an individual asset, such as a large, unique loan or a debt security. However, if pooling is applied to such assets, then a good book allowance would need to be recognized. Whether recognition of a good book allowance for an individual asset provides decision-useful information is to be debated. It may be more intuitive to apply only the bad book approach to an individual debt investment, such as a corporate bond where collectability is uncertain. A bad book-only approach would be similar to the FASB’s current model for

recognizing impairment on debt securities under ASC 320–10, where the entity has the intent and ability to hold the investment.

- Loan commitments and financial guarantees not accounted for at FV-NI are excluded from the supplement. The IASB is asking for feedback on whether the proposed model (i) should be applied to loan commitments and (ii) will be operational if applied to financial guarantee contracts.

PwC observation: The boards’ prefer to develop a single impairment model that would apply to all financial assets. However, the accounting for impairment of the financial instruments discussed above has not been addressed. Furthermore, the supplement does not address purchased credit impaired assets subject to ASC 310–30 (formerly SOP 03-3) and troubled debt restructurings in ASC 310–40 (formerly FAS 15)—two operationally complex areas that respondents to the FASB’s exposure draft recommended it address. Also not addressed in the supplement is the impairment of certain

redeemable instruments that the holder is required to own to benefit from the investee’s operations, e.g., FHLB stock and an interest in cooperatives.

The common proposal

- The common proposal should achieve a total amount of allowance that reflects an entity’s expectations for credit losses based on management’s credit risk strategy. The remainder of this subsection describes the elements of and some additional considerations related to the proposed model: the distinction between good book and bad book, the information set, the bad book allowance, the good book allowance, transfers between good and bad books, and interest income recognition.

Distinction between good book and bad book

- Although the supplement does not define *bad book* and *good book* portfolios, the terms are used in the supplement’s introduction and basis for conclusions and have been used extensively in the boards’

redeliberations of their exposure drafts on financial instruments accounting. Accordingly, this Dataline distinguishes between the two portfolios using those shorthand terms. Exhibit A on the previous page illustrates the distinction between good book and bad book and the interaction with an open portfolio.

14. The total allowance is built up by computing two separate components: an allowance for the bad book and an allowance for the good book, with each component measured differently. Whether an asset is in a good book or bad book depends on the degree of uncertainty about its collectability. When collectability becomes so uncertain that the entity's credit risk management objective changes from receiving regular payments to recovering the financial asset, an allowance is created for the entire amount of expected losses over the remaining life of the asset; this is referred to as the "bad book allowance." For the remaining assets in the portfolio where management of the assets is not focused on recovery, an allowance is created using a calculation methodology described below under the heading "good book allowance."
15. Whether an asset belongs in the bad book or good book for accounting purposes should reflect how the entity manages the credit risk of the asset. For example, a bank typically uses internal credit ratings to monitor credit risk. When a debtor's rating falls below a certain threshold, such action may trigger additional credit risk management procedures and also trigger movement into the bad book for purposes of the common proposal.

For entities that do not differentiate credit risk based on uncertainty of collectability, a process will need to be developed—for example, based on days past due.

Information set

16. The proposed model retains one key element from the initial models exposed by the boards: the elimination of a recognition threshold ("probable" under US GAAP and "objective evidence" under IFRS). The information used to determine expected losses (for both good book and bad book allowances) should be forward-looking. All information, based on both internal and external data, should be considered, including historical data, current economic conditions, and forecasts of future conditions. The latter should be based on reasonable and supportable information that is consistent with currently available information that management uses for internal purposes.

PwC observation: Regarding its original proposed impairment model, the FASB received strong negative feedback—from users, preparers, and the EAP—on limiting the information that can be used in projecting expected losses. Those who commented supported the element of the IASB exposure draft, which required expected losses to be based on expectations. The FASB's original objective was to limit the information set to exclude unobservable future economic conditions. However, as noted in the basis for conclusions, many other areas of accounting

require forecasting, most notably in accounting for non-financial asset impairment, fair value, and pensions.

Bad book allowance

17. Once an asset is determined to be in the bad book (as described above in the section "Distinction between good book and bad book"), the proposed model for the bad book allowance requires recognition of the entire amount of remaining lifetime expected losses. The common proposal does not permit recognition of losses over time when management believes that there is uncertainty regarding collectability of such assets. The supplement does not provide additional guidance on the measurement of the bad book allowance. For example, it is unclear whether the "entire amount of remaining lifetime expected losses" is discounted or undiscounted, and if discounted, at what discount rate. Also, the consideration of collateral values is not specifically addressed in the supplement.

PwC observation: The bad book was introduced into the IASB's original proposal by the EAP (i) to address the problem of deferring actual losses while recording a negative allowance and (ii) to reflect that entities manage those assets differently than performing assets. Relative to the current impairment guidance, the introduction of a bad book is not new; US GAAP addresses specific impairment in ASC 310-10 (formerly FAS 114), and IAS 39 makes a distinction between specific and collective provisioning.

Good book allowance

- 18.** The proposed model requires an allowance for the good book to be based on the *higher of* (i) a time-proportional allowance or (ii) the losses expected in the foreseeable future, which should not be less than 12 months. For financial assets with an expected life that is less than 12 months, the foreseeable future timeline should be the remaining average life of the portfolio. Each calculation is described below, along with a discussion of the loss estimation process for the good book allowances.

Time-proportional expected credit loss

- 19.** The IASB alternative approach of a time-proportional allowance is calculated by multiplying the expected losses over the remaining life of the portfolio (expected lifetime losses, herein referred to as *ELL*) by a ratio, the numerator of which is the weighted average age of the portfolio (WAA) and the denominator is the weighted average life of the portfolio (WAL). As *ELL*, WAA or WAL changes, the time-proportional allowance will also change, resulting in a catch-up for the past and spreading for the future, similar to the reassessment approach in the revenue recognition project.
- 20.** The above description of the time-proportional allowance assumes that an entity chooses to calculate the allowance using an undiscounted, straight-line method. The supplement provides entities the flexibility to use either a discounted or undiscounted estimate on a straight-line method

or use an annuity method (which inherently uses a discounted estimate). While, it appears to be a policy choice under the IASB proposal, both boards are seeking comments on the flexibility provided. This issue is also discussed in the section titled “Interest income recognition.”

PwC observation: The EAP developed the time-proportional allowance method as an operational simplification of the IASB’s original proposed impairment model. This approach assumes an entity can calculate an *ELL* with sufficient accuracy. Some preparers believe the *ELL* will require a significant effort to calculate. The IASB’s decision not to require discounting of the time-proportional allowance provides some operational relief and is consistent with current US GAAP under ASC 450.

Losses expected in the foreseeable future

- 21.** Losses expected in the foreseeable future are losses expected based on a time period that management can reasonably estimate—although *reasonably estimate* is not defined in the supplement. While the supplement does not propose a bright line time period, the period should not be longer than and does not need to coincide with the expected life of the asset. Whether such a time period should be stable or change based on other factors—such as macroeconomic conditions or availability of data—is an issue on which the boards are asking for comment. If the foreseeable future loss is applicable pursuant

to the “higher of” test, the amount will be recognized immediately, typically in the reporting period when the allowance is updated. The supplement does not address discounting.

- 22.** The allowance calculated pursuant to this method represents a “floor” on the good book allowance. In addition, the common proposal states that the foreseeable future time period should not be less than 12 months.

PwC observation: The floor serves the purpose of addressing the concerns expressed by FASB members during redeliberations of its exposure draft that the time-proportional allowance may be lagging when there is an adverse change in expectations. For example, when economic conditions worsen, losses in the good book likely will occur sooner, but a time-proportionate method continues to spread the higher losses. As part of the boards’ outreach, the board’s understood that constituents were generally supportive of a floor on the good book allowance.

- 23.** During redeliberations of their exposure drafts on financial instruments accounting, the boards discussed an earlier version of the common approach that included a bright line 12-month period for calculating the floor. This amount would be consistent with the allowance for loan losses related to loan portfolios (excluding credit card portfolios) that would be provided under the Basel II framework (a set of international standards and best practices that define the minimum capital requirements for

international active banks), as well as the amount provided for by US banks for regulatory capital purposes and financial reporting today (at a minimum). As such, concern was expressed by the FASB staff that a 12-month floor may not address the “too little, too late” problem.

PwC observation: In the basis for conclusions, the boards state

that they were concerned that a 12-month bright line would prevent entities from considering events beyond the 12-month period and therefore delay recognition of expected losses. For example, the interest rate in a hybrid adjustable rate mortgage may reset in three years. Therefore, using a foreseeable future period would require an entity to consider the borrower’s

ability to repay when the interest rate resets. However, if the foreseeable future is defined by management as a 12-month period, limiting the loss to a 12-month time horizon may not consider the effect of a known future event.

24. An example of the good book allowance is provided below.

Example: Good book allowance under the common proposal

The following assumptions are used in this example:

Principal amount in the pool	\$10,000
Weighted average life (WAL)	5
Weighted average age (WAA)	1
ELL, at the end of year one	\$1,200
Foreseeable future losses—Expected losses in the next two years, at the end of year one	\$900

The target allowance for the good book at the end of year one is based on the higher of the time-proportional allowance or expected losses in the foreseeable future that is not less than 12 months.

(A) Time-proportionate allowance	
ELL	\$1,200
WAA / WAL	1/5
Target time-proportionate allowance	\$240
(B) Foreseeable future losses	
Expected losses in the next two years	\$900
Higher of (A) or (B) is the target good book allowance	\$900

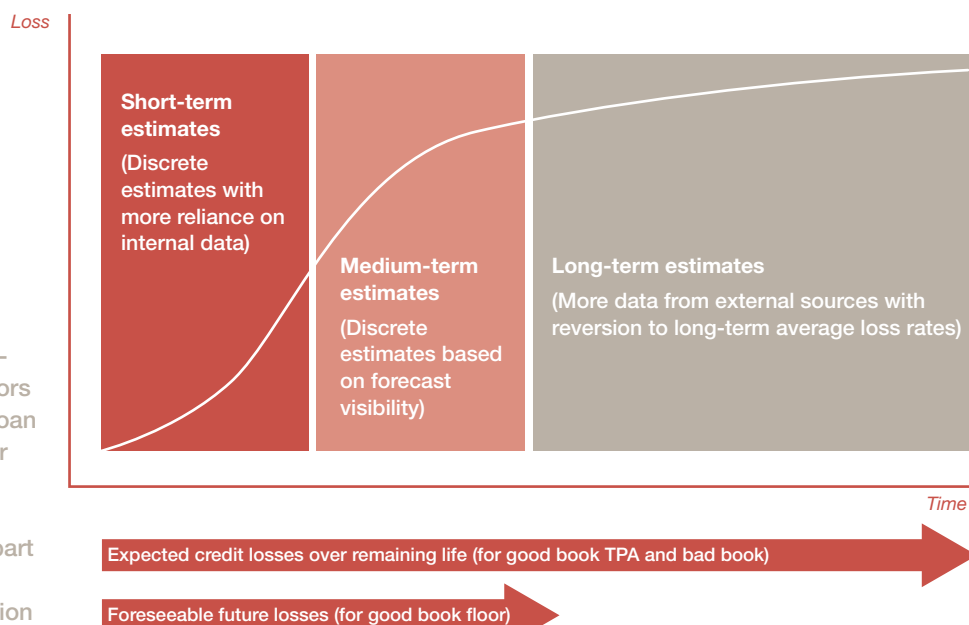
Note that the foreseeable future losses estimated using a two-year time period is 75% of the ELL in this example. This percentage will vary by asset type, but such a high concentration of losses in the earlier life of the asset is typical for many loan products.

Exhibit B: Forecasting expected losses

PwC observation: During redeliberations, the US banking regulators presented loss data for various loan asset types, e.g., auto, consumer mortgages, and commercial real estate. For many types, losses tend to occur during the earlier part of the life of the asset. Based on these empirical findings, a question arises as to whether the good book allowance will effectively default to the foreseeable future losses calculation for many portfolios because it would produce a higher loss. However, many variables will impact the shape of a loss curve, including the WAL and WAA of the portfolio, economic conditions, and loan origination and mitigation activities. Because of these variables it is possible that the allowance levels will be based on either the time-proportional approach or foreseeable future approach from period to period rather than always the foreseeable future approach.

Loss estimates

25. The supplement acknowledges that the common proposal requires entities to make two loss estimates for the good book—for the time-proportional allowance, the losses expected over the remaining life of the portfolio (the ELL); and for the floor, the losses expected in the foreseeable future. As discussed under the section “Information set” (paragraph 16 above) the common proposal requires entities to use



forecasts when developing estimates. However, the supplement does not mandate a specific approach for developing loss estimates. For assets with longer expected lives, the supplement suggests an entity may make discrete forecasts of expected losses over the short and medium term and then revert to a long-term average loss rate. Exhibit B illustrates how the foreseeable future loss may interact with the ELL.

PwC observation: In the supplement, the loss expected in the foreseeable future is not described explicitly as a “subset” of the ELL. However, in other areas of forecasting, e.g., forecasting cash flows for calculating the fair value of equities under the income approach, valuation professionals start with a discrete forecasting period for the near term, trend the forecast in the medium term, and use a long-term growth rate for the terminal value. A similar process may be considered for calculating the two loss estimates for the good book under the common approach, absent current clarification from the boards.

Summary of the allowance calculation for the common proposal

26. Exhibit C on the next page illustrates the buildup of the total allowance and summarizes the approach in the common proposal.

Transfers between good book and bad book

27. The IASB appendix to the supplement prescribes a method for transferring the allowance from the good book to the bad book when an asset or group of assets has been identified as impaired; these amounts would be disclosed as part of the proposed disclosures of allowance roll-forwards. An example of how this calculation is performed is provided in the IASB supplement. Furthermore, the IASB supplement specifies that transfers can be made from the bad book to the good book. The FASB has not yet addressed this issue.

PwC observation: The requirement in the IASB supplement to identify the amount of allowance

Exhibit C: Summary of common proposal



Information for loss estimate	Timing of loss	Objective
Consider all available information, including internal and external data and expectations of future conditions based on reasonable and observable information that is consistent with currently available information Life of loan expected loss is a reference point (foreseeable future could be a subset)	Bad book: entire amount of expected credit loss Good book: higher of (i) time-proportional expected credit loss (ii) losses expect to occur within the foreseeable future, but no less than 12 months	The time-proportional allocation is intended to approximate the IASB ED but with two “floors”: (i) bad book—to prevent “negative allowance” (ii) losses expected in foreseeable future no less than 12 month—to build allowance for losses before they develop rather than as they develop

transferred from good book to bad book could be operationally challenging. Current methods do not specifically identify allowances that should be transferred once an asset is individually identified as impaired. The ability to transfer from the bad book to the good book may be welcomed by US GAAP reporting entities that have assets in the scope of ASC 310–40 (troubled debt restructuring); however, the FASB likely will be addressing the effect of a new impairment model on TDRs separately.

Interest income recognition

28. Although not specifically addressed in the supplement, both boards’ original impairment models required commingling of interest income and impairment. The IASB did so to reflect a credit-adjusted yield, while the FASB did so to prevent interest income from being recognized on cash flows not expected to be collected. Feedback from comment letters, roundtables,

and the EAP roundly objected to commingling interest income and impairment. The reason for the strong objection is that the collective provision determined under current accounting frameworks is calculated independently from interest income, with the loan subledger tracking interest income on a contractual basis and credit risk systems calculating the appropriate allowance for portfolios. The operational complexity is significant in getting the systems to interact (e.g., accounting for purchased credit impaired assets under ASC 310–30.). Moreover, users strongly objected to commingling because net interest margin is a key performance indicator and commingling would introduce uncertainty from impairment into interest recognition; users would prefer uncertainty be limited to the allowance and provision for credit losses.

29. As a result of this feedback, the boards agreed that the proposed model will not commingle interest income and impairment, which is referred to as

“decoupling.” However, to preserve an objective of the original IASB proposal, i.e., to reflect a credit-adjusted yield, the supplement permits the allocation of ELL for the time-proportional allowance to be based on (i) an undiscounted straight-line approach, (ii) a discounted straight-line approach, or (ii) an annuity approach, which is inherently discounted. If discounting is elected, the discount rate may be a rate between (and including) the risk-free rate and the ASC 310–20/IAS 39 effective interest rate. The proposed policy choice described above reflects a decision reached by the IASB; the FASB has not deliberated this issue.

PwC observation: It appears that by requiring decoupling of interest income and impairment, the boards have conceded on one of their objectives in creating a new impairment model. However, it is unclear to what extent interest income recognition will be re-deliberated and whether any current practice issues will be addressed. Separately, the boards are asking for feedback on the policy choices in calculating the time-proportional allowance. Moving away from an undiscounted straight-line approach will introduce operational complexity.

The alternative approaches
IASB alternative approach

30. The IASB alternative approach incorporates all of the elements of the common proposal, except it does not incorporate the foreseeable future or

Exhibit D: Reconciling the common proposal to the IASB alternative approach

Information for loss estimate	Timing of loss	Objective
Consider all available information, including internal and external data and expectations of future conditions based on reasonable and observable information that is consistent with currently available information	~~Bad book: entire amount of expected credit loss~~ ~~Good book: higher of~~ (i) time-proportional expected credit loss (ii) losses expected to occur within the foreseeable future, but no less than 12 months	The time-proportional allocation is intended to approximate the IASB ED but with two a “floors”: (i) bad book—to prevent “negative allowance” (ii) losses expected in foreseeable future no less than 12 month—to build allowance for losses before they develop rather than as they develop
Life of loan expected loss is a reference point (foreseeable future could be a subset)		

IASB alternative model

12 month floor concept for the good book allowance. Exhibit D illustrates the modifications to the common proposal to arrive at the IASB alternative approach.

31. During the redeliberations, some IASB members voiced support for the good book-bad book distinction and the time-proportional allowance for the good book but objected to a floor on the good book allowance. Some

of these board members questioned whether the floor reflects “prudence,” which is not an objective of financial reporting in the *Conceptual Framework*. Also, these IASB members did not believe a loss should be recognized immediately when an asset is originated.

FASB alternative approach

32. The alternative model retains some elements of the common proposal. There is no good book-bad book distinction and losses are based solely on those losses expected to occur in the foreseeable future without a 12-month minimum period. Exhibit E illustrates the modifications to the common proposal to arrive at the FASB alternative approach.

33. During redeliberations of the FASB’s exposure draft on financial instruments accounting, some FASB members did not support the common proposal because they believe expected losses over the life of the asset should be recognized immediately. The FASB alternative approach is closer to the originally proposed FASB impairment model with a few changes: (i) the information set includes forecasts using future expectations and (ii) the expected loss is not required to be recognized based on the life of the asset but rather the losses expected in the foreseeable future (which can be shorter than the asset’s expected life). The FASB alternative approach does not address the distinction between good book and bad book because board members do not believe the FASB has sufficiently deliberated the distinction and the implication of the distinction.

PwC observation: The common proposal comprises elements of both alternative approaches. Although a majority of board members of both boards supported the common proposal, there were strong dissenting views. In a comparison of the three potential models, the highest allowance is

Exhibit E: Reconciling the common proposal to the FASB alternative approach

Information for loss estimate	Timing of loss	Objective
Consider all available information, including internal and external data and expectations of future conditions based on reasonable and observable information that is consistent with currently available information	~~Bad book: entire amount of expected credit loss~~ ~~Good book: higher of~~ (i) time-proportional expected credit loss (ii) losses expected to occur within the foreseeable future, but no less than 12 months	The time-proportional allocation is intended to approximate the IASB ED but with two “floors”: (i) bad book—to prevent “negative allowance” (ii) losses expected in foreseeable future no less than 12 month—to build allowance for losses before they develop rather than as they develop
Life of loan- Foreseeable future expected loss is a reference point (foreseeable future could be a subset)		

FASB alternative model

expected to be achieved under the common proposal because the allowance is effectively based on the “higher of” the allowance calculated pursuant to the IASB and FASB alternatives.

The FASB alternative approach may represent a less operationally complex change compared with the changes required for the good book’s time-proportional allowance in both the common proposal and the IASB alternative approach. However, a concern that will likely be raised for both the common proposal and the FASB’s alternative approach is the comparability of foreseeable future expected losses; such concerns may be mitigated with robust disclosures.

Presentation and disclosure

34. The IASB included presentation and disclosure requirements as part of its supplement, while the FASB did not. The most significant disclosures proposed include the ELL and foreseeable future expected losses and their respective changes during the reporting period, including detail on the inputs, assumptions,

and methodologies used to arrive at those amounts. Also, significant changes in allowance from a particular portfolio or geographic area would be disclosed. The disclosures do not include a sensitivity analysis or a requirement to present losses by vintage as proposed in the original IASB exposure draft. However, quantitative information regarding back-testing is required if performed internally; otherwise, a qualitative discussion is required to be disclosed of expected losses versus actual outcomes. Current US GAAP (as amended by ASU 2010-20⁵), requires comprehensive disclosures by portfolio segment and asset classes; disclosures are required of activities and changes in the allowance between reporting periods and would include robust discussions regarding accounting policy, methodology, and assumptions used by the entity to develop the allowance.

Proposals yet to be redeliberated

35. The supplement lists many issues that the boards will redeliberate in connection with finalizing the impairment model. Also, issues were addressed in the comment letters on the original

proposals that have not yet been redeliberated. The following list highlights some of those issues:

- Scope—financial assets that are not part of open portfolios or are evaluated individually, other problem loans, purchased loans with credit deterioration, short-term trade receivables, and any issues specific to investments in debt securities.
- Scope—loan commitments and financial guarantees.
- Methods of measuring credit losses, including discounting.
- Interaction with classification and measurement (particularly, application to amortized cost, FV-OCI, and held for sale).
- Interest income recognition, e.g., revisit ASC 310-20/IAS 39, application issues for floating rate instruments.
- Definitions, including *write-off* and *nonaccrual*.
- Presentation and disclosure requirements, e.g., stress testing, by vintage.

36. The list above is not intended to be exclusive, and the boards believe that comments received on the original exposure drafts will be a starting point to address these issues as part of the redeliberation efforts.

⁵ Refer to PwC Dataline 2010–31, *New disclosure requirements for finance receivables and allowance for credit losses*.

FASB seeks comments on IASB hedge accounting proposal

What's inside:

What's new?

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Reprinted from:

In brief 2011–06
February 11, 2011

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

What's new?

On February 9, 2011, the Financial Accounting Standards Board (FASB) issued a *Discussion Paper* seeking feedback from its constituents on the International Accounting Standards Board's (IASB) proposed revisions to hedge accounting. The IASB issued its exposure draft on revisions to hedge accounting on December 9, 2010. The FASB had previously issued its own proposals on changes to hedge accounting as part of its overall exposure draft on the accounting for financial instruments, in May 2010.

The FASB plans to use the feedback it receives on the Discussion Paper to help it in its own deliberations about how to improve and simplify hedge accounting under US generally accepted accounting principles (US GAAP).

What are the key provisions?

The Discussion Paper outlines the FASB's purpose for inviting comments and includes a copy of the IASB's hedge accounting exposure draft with a summary comparison to current and proposed US GAAP.

More importantly, the FASB has directed several questions at its constituents. These questions supplement those within the IASB's exposure draft and touch on the key areas for which the IASB is proposing changes to hedge accounting. The questions are intended to draw feedback on aspects of the IASB's proposal that would represent changes to US GAAP.

At a high level, the questions focus on whether respondents believe that the following key changes are understandable, operable, and have conceptual merit:

- The linkage of hedge accounting to an entity's risk management strategies
- The broadening of what qualifies as a hedging instrument and hedged item or risk, including the ability to hedge

nonfinancial risk components that are separately identifiable and reasonably measurable

- The removal of the "highly effective" threshold for determining hedge effectiveness and the shift to a method that requires an "unbiased" result that is expected to achieve "other-than-accidental" offset
- The requirement to rebalance hedge relationships over time
- Accounting for the time value of options
- New financial statement presentation requirements for fair value hedges
- Additional disclosures, including disclosures about risks that an entity decides to hedge

The FASB has also asked whether the changes proposed by the IASB would be a better starting point for any changes to hedge accounting in US GAAP than what the FASB had proposed. In addition, the FASB is interested in understanding views on whether it should focus on targeted improvements or convergence of hedge accounting.

Is convergence achieved?

Despite being part of an overall joint project on the accounting for financial instruments, there are many differences between the IASB's proposed hedge accounting standard and hedge accounting guidance under current and proposed US GAAP. Whether the boards converge on hedge accounting depends on the results of their redeliberations.

Who's affected?

All entities that prepare their financial statements in accordance with US GAAP and engage in risk management activities regardless of whether they use hedge accounting today could potentially be affected. The FASB intends to use the feedback from the Discussion Paper to help it in its redeliberations of its own hedge accounting proposal.

What's next?

The comment deadline for the Discussion Paper is April 25, 2011. The deadline for responding on the IASB's exposure draft is March 9, 2011. The IASB will begin its redeliberations after its comment period ends. The FASB plans to participate with the IASB in its discussions and to consider the feedback it has received, beginning in the second quarter of 2011. Therefore, entities should consider responding to the FASB, even if they are planning to separately send a comment letter to the IASB on its proposal.

For further details on the IASB's hedge accounting proposal, including a comparison to current and proposed US GAAP, refer to Dataline 2011-06, *Accounting for hedging activities—A comparison of the FASB's and IASB's proposed models*.

Accounting for hedging activities

A comparison of the FASB's and IASB's proposed models

What's inside:

Overview

Key provisions

Reprinted from:

Dataline 2011–06

February 1, 2011

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- In December 2010, the IASB released for public comment an exposure draft of proposed changes to the accounting for hedging activities, resulting from the third phase of the IASB's project to revise financial instruments accounting. Comments are due by March 9, 2011.
- The proposed IFRS model is more principles-based than the current IASB and US GAAP models and the US GAAP proposal, and aims to simplify hedge accounting. It would also align hedge accounting more closely with the risk management activities undertaken by companies and provide decision-useful information regarding an entity's risk management strategies.
- The IASB plans to issue a final standard by mid-2011, with an effective date of January 1, 2013. However, the IASB recently issued a discussion paper on effective dates and transition for major projects. Its deliberations of the issues raised in the discussion paper could impact the effective date of the proposed hedge accounting guidance.
- The IASB's exposure draft proposes changes to the general hedge accounting model only. The macro hedge accounting principles will be addressed in a separate exposure draft, which is expected to be released in the second quarter of 2011.
- The FASB is planning to seek feedback from its constituents on the IASB's exposure draft. In May 2010, the FASB issued an exposure draft that proposed fundamental changes to the accounting for financial instruments, including certain changes to hedge accounting.

The main details

1. The existing guidance on hedge accounting under IFRS and US GAAP is considered highly rules-based, complex, and inflexible. The detailed rules have, at times, made achieving hedge accounting difficult, even when transactions are entered into in connection with a rational risk management strategy, and costly. Users have also found that the current hedge accounting model does not adequately portray an entity's risk management activities.
2. In the FASB's and IASB's outreach efforts, an overwhelming majority of preparers and users who provided input to the boards requested a more principles-based approach that would promote closer alignment of hedge accounting with an entity's risk management strategies. In addition, users asked for better disclosures regarding an entity's risk management activities and the effectiveness of such strategies.
3. There are currently significant differences between the existing hedge accounting rules under IFRS and US GAAP. One of the objectives of the financial instruments project is to harmonize the accounting for hedging activities under both frameworks. Despite starting as a joint project, the IASB and FASB have taken fundamentally different approaches to address the feedback received during their outreach efforts. Broadly speaking, the FASB focused on selected issues to address the concerns related to complexity and inflexibility of the hedge accounting model, while the IASB undertook a more

comprehensive review of its hedge accounting model.

PwC observation: The two boards have so far moved in different directions on the hedge accounting project, as they have for the first two phases of the financial instruments project (i.e., classification and measurement and impairment). This may widen the gap between the hedge accounting requirements under the two frameworks. However, given the fact that the broad objective is to reach a converged standard in this area, we expect the boards will be focusing on reconciling their differences as they complete their redeliberations.

4. The FASB's exposure draft includes, but is not limited to, the following major changes:
 - Relaxation of the rules pertaining to the assessment of hedge effectiveness by reducing the effectiveness threshold from highly effective to reasonably effective
 - Elimination of the short-cut method and critical terms match method as techniques to assess effectiveness
 - Recognition of hedge ineffectiveness resulting from under-hedges of cash flows
 - Elimination of the ability to voluntarily de-designate hedging relationships

For a detailed discussion of the significant changes proposed by the FASB, refer to Dataline 2010–25 dated June 10, 2010.

5. In contrast, the following fundamental changes are proposed by the IASB:
 - Introduction of concepts of “other than accidental offset” and “neutral and unbiased” hedging relationships, which will replace the “highly” effective (80% to 125%) threshold as the qualifying criteria for hedge accounting
 - Ability to designate risk components of non-financial items as hedged items
 - More flexibility in hedging groups of dissimilar items (including net exposures)
 - Accounting for the time value component as a “cost” of buying the protection when hedging with options in both fair value and cash flow hedges
 - Prohibition of voluntary de-designation of the hedging relationship unless the risk management objective for such relationship changes
 - Changes to the presentation of fair value hedges
 - Introduction of incremental disclosure requirements to provide users with useful information on the entity's risk management practices
6. The IASB's exposure draft primarily provides guidance on the micro (“one-to-one”) hedging model with some guidance on hedges of groups and hedges of net positions. A separate exposure draft is expected to propose guidance and/or an alternative model for macrohedging strategies. Accordingly, this Dataline does not cover the existing IFRS and US GAAP differences related to macrohedges.

Key provisions

Qualifying for hedge accounting

Qualifying for hedge accounting at inception

7. This is an area where both the IASB and FASB are proposing to significantly relax the current rules to allow more hedging relationships to qualify for hedge accounting. Currently, both frameworks require that the hedge must be expected to be highly effective (a “prospective” test) at inception and on an ongoing basis. Additionally, the relationship must be demonstrated to have actually been highly effective (a “retrospective” test) at each subsequent reporting date. “Highly effective” is defined as a “bright line” quantitative test of 80% to 125%.
8. Under the FASB’s proposal, to qualify for hedge accounting, a company will need to demonstrate and document at inception that:
 - An economic relationship exists between the derivative and the hedged item in a fair value hedge (or hedged forecasted transaction in a cash flow hedge)
 - The changes in fair value (or cash flows) of the hedging instrument would be reasonably effective in offsetting changes in the hedged item’s fair value or variability in cash flows of the hedged transaction. The term “reasonably effective” is not defined and is open to judgment. Many constituents asked for more guidance on this threshold in their comment letters.
 - The risk management objective of the hedging relationship and how

effective the hedging instrument is in managing those risks. While this assessment needs to be performed only qualitatively, the proposal notes that a quantitative assessment may be necessary in certain situations.

9. The IASB’s exposure draft also would eliminate the “highly effective” requirement. However, the IASB concluded that replacing highly effective with reasonably effective (as proposed by the FASB) would still result in the use of a quantitative threshold. Therefore, it introduced a concept of having “other than accidental offsetting,” “neutrality,” and an “unbiased result” as the qualifying criteria for hedge accounting. Hence, the hedge relationship should be such that it minimizes expected ineffectiveness, and should not reflect a deliberate mismatch between the hedged item and the hedging instrument. The objective of the IASB is to allow greater flexibility in qualifying for hedge accounting but also to ensure that entities do not systematically under-hedge to avoid recording any ineffectiveness. This is important because the IASB has retained the current guidance that only ineffectiveness resulting from over-hedges is recorded in net income. In assessing whether the hedge relationship would minimize expected ineffectiveness, an entity’s risk management function would determine the expected sources of ineffectiveness and the optimal hedge ratio.

Example

An entity wants to hedge a forecast purchase of 100 tons of a commodity in Location A. That commodity for delivery point

Location A usually trades at about 90% of the price for the exchange-traded benchmark grade of the same commodity in Location B. If the entity wants to hedge the forecast purchase of 100 tons with exchange-traded forward contracts, then a forward contract to purchase 90 tons of the benchmark grade of the commodity in Location B would be expected to best offset the entity’s exposure to changes in the cash flows for the hedged purchase. Hence, a hedge ratio of 1.11:1 would minimize expected hedge effectiveness (assuming a perfect correlation between changes in the hedged item and the changes in the hedging instrument).

PwC observation: The new concepts of neutrality and unbiased result may not necessarily be viewed as simplifying the accounting for hedging activities. It may simply result in the replacement of the 80% to 125% threshold with another accounting-only measure. An alternative may be to rely on risk management policies (with a requirement to have an economic relationship between the hedged item and the hedging instrument) or require that all ineffectiveness be recorded in net income (including ineffectiveness arising from underhedging).

Maintaining the hedging relationship on an ongoing basis

10. The IASB’s proposal requires an entity to determine and document the optimal hedge ratio that would result in minimizing expected hedge ineffectiveness. However, the board

acknowledges that this ratio may change over time due to market conditions and other factors. In such cases, the entity would determine whether the risk management objective remains the same and the hedge relationship still meets the other qualifying criteria for hedge accounting. If so, the entity is required to rebalance the hedging relationship.

11. An entity would be required to monitor the hedging relationship to ensure that the designated hedge ratio remains optimal. If circumstances lead to a change in the optimal hedge ratio, then rebalancing would be required to minimize any expected ineffectiveness. On rebalancing, any ineffectiveness of the hedging relationship is determined and recognized immediately in net income before adjusting the hedge relationship. Fluctuations around an optimal hedge ratio cannot be minimized by adjusting the hedge ratio in response to each particular outcome. Hence, in such circumstances, the change in the extent of offset is a matter of measuring and recognizing hedge ineffectiveness (i.e., it does not result in rebalancing).

Example

Assume an entity's risk management function has originally determined an optimal hedge ratio of 0.9. In arriving at that ratio, the risk management function performed a regression analysis. Fluctuations in the originally determined optimal hedge ratio do not require rebalancing. However, if it is determined that there is a new trend that would lead away from that hedge ratio, then a new ratio would result in minimizing

ineffectiveness. In such a case, rebalancing would be required.

12. Rebalancing is a continuation of the hedging relationship. That is, the hedge is not reset by de-designation and re-designation, and hence does not require setting up a new hypothetical derivative or amortization (in the case of an interest rate hedge) of an effective portion of fair value changes to net income. The IASB's proposal permits rebalancing to be effected by increasing or decreasing the volume of the hedged item or hedging instrument in the relationship.

PwC observation: The risk management function may not necessarily adapt the hedging relationship to reflect an optimal hedge ratio on a regular basis. Therefore, having a requirement to rebalance will likely add unnecessary burden on the entity. This can be a cumbersome process and may be viewed as negating the objective of simplifying hedge accounting.

Frequency and nature of effectiveness tests

13. The FASB's proposal would change the existing requirement to test the effectiveness on a quarterly basis to a requirement to test only if circumstances suggest that the hedging relationship may no longer be effective. The IASB, on the other hand, proposes to retain the periodic assessment criterion (at least at each reporting date or when circumstances change). However, under both proposals, the effectiveness test is only a forward-looking test (i.e., no retrospective test would be required).

14. Like the FASB's proposal, the IASB's exposure draft would allow an entity to demonstrate effectiveness qualitatively or quantitatively, depending on the characteristics of the hedging relationship. For example, in a simple hedge where all the critical terms match, a qualitative test might be sufficient. On the other hand, in highly complex hedging strategies, some type of quantitative analysis may need to be performed.

Measuring ineffectiveness

15. Currently, for cash flow hedges, both frameworks require performing a "lower-of" test to determine the effective portion of the hedge. Only the amount of ineffectiveness related to any over-hedges (i.e., where the cumulative changes in fair value of the hedging instrument over-compensates those of the hedged item) is recorded in net income. The IASB's exposure draft has retained this "lower-of" test. However, under the FASB's proposal, any ineffectiveness, whether resulting from over- or under-hedges, would be recognized in earnings. A significant number of respondents to the FASB's exposure draft expressed concern over the requirement to record all ineffectiveness, whether resulting from over- or under-hedges.

16. In addition, the IASB's proposal requires that, in measuring ineffectiveness, entities should take into consideration the impact of the time value of money on the hedged item.

PwC observation: The IASB staff believes that this is not a change in guidance, and hence should not have any practical implications.

However, this may affect hedges involving forward contracts. Currently, in practice, many entities separate the forward points from the forward contract and designate only the spot element as the hedged risk. The spot is not discounted; hence, the impact of the timing of cash flows is ignored, which is a critical factor in rolling strategies and partial-term hedges.

Discontinuation of hedging relationships

Voluntary de-designation

- 17.** Currently, the hedge accounting guidance under both frameworks allows an entity to voluntarily de-designate the hedging relationship. However, the proposed IASB and FASB models restrict entities from voluntarily de-designating the hedging relationships.
- 18.** Under the FASB's proposal, an entity would only be able to discretionarily discontinue hedge accounting by entering into an offsetting derivative

instrument or by selling, exercising, or terminating the derivative instrument. If an entity enters into an offsetting derivative instrument for purposes of discontinuing the hedging relationship, the derivative must be expected to "fully offset" future fair value changes or cash flows. In addition, the entity must concurrently document the effective termination of the hedging relationship. In such an event, neither derivative instrument could be designated as a hedging instrument in a subsequent hedging relationship.

- 19.** In contrast, the IASB's proposal allows termination of the hedging relationship only if it is no longer viable for risk management purposes, or the hedging instrument is sold, expired, exercised, or terminated.

PwC observation: This may result in the use of some commonly used strategies being discontinued—for example, an entity hedging the foreign currency risk of forecasted foreign currency sales. Once the sale and the related receivable are recognized, the fair value changes

of the derivative and the receivable would achieve a natural offset. Thus, it is common to discontinue hedge accounting at that point. However, under the IASB's proposal, this would no longer be possible.

The FASB's proposal to remove the ability to voluntarily de-designate a hedging relationship lacked support from those who responded to the exposure draft. Whether the IASB will receive support from its constituents remains to be seen.

Eligible hedged items

- 20.** Overall, the IASB's proposal provides greater flexibility in the designation of exposures as hedged risks. It will allow designating risk components of non-financial items and groups of dissimilar items (including net exposures) as hedged items. The following table provides a summary of the key changes introduced by the IASB's proposal and a comparison with the current and proposed US GAAP:

Hedged item	Current and proposed US GAAP	Current IFRS	Proposed IFRS
Components of non-financial items	Prohibited	Prohibited	Permitted if the risk component is separately identifiable and reliably measurable
Derivatives	Derivatives cannot be designated as hedged items	Similar to US GAAP	Permits hedging a synthetic risk exposure

Hedged item	Current and proposed US GAAP	Current IFRS	Proposed IFRS
Groups of similar items	Permitted only if fair value change for each individual item is proportional to the overall change in the group's fair value	Similar to US GAAP	Designation permitted without regard to the fair value changes of the individual items
Groups of dissimilar items (net positions)	Not permitted, except when hedging with internal derivatives in limited circumstances, as discussed in paragraph 39 below.	Not permitted	Permitted with certain restrictions
Layers, including "bottom" layers and layers of groups of items	Layers are permitted for cash flow hedges. Hedges of bottom layers or "last of" are not allowed.	Similar to US GAAP	Permits hedges of layers, including bottom layers for fair value hedges

Hedging risk components of non-financial items

21. Currently, the FASB and IASB allow hedges of components for financial items only. However, the IASB's proposal permits entities to hedge risk components for non-financial items, provided such components are separately identifiable and reliably measurable. This is an area of significant interest for risk management functions in non-financial service organizations.

22. In assessing whether a risk component of a non-financial item is eligible for designation as a hedged risk, an entity would take into consideration factors such as:

- The particular market structure to which the risk relates and where the hedging activity takes place
- Whether the risk component is a contractually specified component (where the contract entails a formula-based pricing structure (e.g., commodity A plus a margin)

Example

Entity A has a long-term supply contract for natural gas that is priced using a contractually specified formula that references commodities (e.g., gas oil, fuel oil) and other factors such as transportation charges. Entity A can hedge the gas oil component in the natural gas supply contract using a gas oil forward contract.

- Whether the risk component is implicit in the fair value or cash flows of the item (non-contractually specified risk components, for example, where the contract includes only a single price instead of a pricing formula)

Example

Entity A buys jet fuel for its consumption and is therefore exposed to changes in the price of jet fuel. Entity A can hedge the crude oil component of its forecast jet fuel purchases with crude oil

forward contracts. Even though crude oil is not contractually specified in the pricing of the jet fuel, Entity A concludes that there is a relationship between jet fuel prices and crude oil prices. The relationship results from different refining margins that allow the entity to look at the hedging relationship as a building block and consider itself exposed to two different risks, the crude oil price and the refining margins.

PwC observation: The ability to hedge risk components will be welcomed by many companies that may not have been able to achieve hedge accounting in this area for the reasons discussed above. It will be easy to demonstrate that the risk component is separately identifiable and reliably measurable when it is contractually specified; however, this may prove more challenging outside the contractually specified area. For example, brass comprises

copper, zinc, and conversion costs. An entity may wish to hedge the copper component of its fixed-price brass purchases with a copper forward contract. However, the fair value movements of the brass component may be partially offset by the fair value movements of zinc (because copper and zinc are impacted by different demand curves). This may indicate ineffectiveness that will not get measured if an entity concludes that the hedge of the copper risk component with a copper forward was perfectly effective. We believe that is an area where further outreach may be required to ensure that the principles are operational and any ineffectiveness can be appropriately measured and recorded.

Derivatives as hedged items

23. Currently, derivatives are not permitted to be designated as hedged items under both IFRS and US GAAP. The FASB's proposal would not change this. However, the IASB has proposed permitting designation of aggregate exposures resulting from a combination of a derivative and another exposure (a "synthetic" position). This is generally the case when entities seek to manage risk on a layering basis.

Example

Entity A has a USD functional currency. It entered into a 10-year fixed-rate financing denominated in EUR. At the inception of the financing, the entity's risk management objective is to have a fixed-rate exposure in its

functional currency for the first three years and a floating rate exposure thereafter. Hence, the entity enters into a 10-year fixed-to-floating cross currency interest rate swap ("CCIRS") at the time the debt is issued. This would swap the fixed-rate debt with a variable-rate exposure in the functional currency of the entity. Under the proposal, the entity can hedge the combined exposure (synthetic variable debt exposure created as a combination of the fixed-rate debt with the fixed-to-floating CCIRS) with a three-year floating-to-fixed interest rate swap to have a fixed-rate exposure in USD for the first three years.

Groups of items

24. Currently, IFRS and US GAAP allow hedges of groups of items only if all items within the group are subject to similar risks and if changes in the fair value of each individual item are proportional to the overall change in fair value of the group. In addition, IFRS allows a fair value hedge of interest rate risk in a portfolio of dissimilar items. The IASB is proposing significant changes in this area to provide better alignment of the accounting with risk management strategies. The FASB, on the other hand, has not proposed any changes affecting groups of items as eligible hedged items.

25. The IASB's proposal would allow hedges of: (1) groups of similar items without a requirement that the fair value change for each individual item be proportional to the overall group (e.g., hedging a portfolio of S&P 500 shares with an S&P 500 future)

as well as (2) groups of offsetting exposures (e.g., exposures resulting from forecast sale and purchase transactions).

26. However, the IASB's exposure draft stipulates additional qualifying criteria for such hedges of offsetting exposures. These include:

- The group should consist of items that are eligible as hedged items on an individual basis.
- The items in the group are managed together for risk management purposes.
- In the case of a cash flow hedge of net exposures, any offsetting cash flows within the group should affect net income in the same reporting period (including, any interim reporting periods).

Example

Assume an entity is forecasting purchases of inventory and sales of GBP150 and GBP100, respectively. The entity will only be allowed to hedge the net exposure of 50 if both the purchases and sales are expected to affect net income in the same reporting period.

PwC observation: The ability to hedge net exposures is in line with common risk management practices and would remove the need to identify specific gross cash flows (e.g., a specific amount of sales that matches the net open position), which is currently required under IFRS. However, the requirement for the hedged items in the net position to affect net income in the same period would limit the use of net position hedges. As a result, this

change may not provide as much flexibility as many companies expected.

27. Further, for net position hedges the IASB's exposure draft specifies that the impact of the hedge should be reflected as a separate line within the income statement. For example, if an entity is hedging sales and cost of

sales, the impact of the hedge would be shown as a separate line after the sales and cost of sales lines.

Example

Assume an entity with a EUR functional currency has sales of USD 100 and expenses of USD 80 (both forecasted in three months) and wants to hedge against the fluctuations in exchange rates. It

hedges USD 20 with a forward contract at a rate of 1.33, accordingly locking its margin at EUR 15. The spot rate on settlement is 1.25, which gives a loss on the forward of EUR 1. The following table depicts how the proposed IFRS presentation would compare with how a similar hedge is reflected under current IFRS:

Hedged item	Existing accounting (Reflect the hedge impact only on the gross identified position)	Proposed IFRS accounting (Reflect hedge impact as a separate line)
Sales	79	80
Expenses	64	64
Hedge result	-	(1)
Operating profit	15	15

The presentation under current and proposed US GAAP would be similar to the existing accounting under IFRS in a hedge of a percentage of gross revenue. However, if internal derivatives are used, then a gross presentation would be allowed and the hedge impact would be reflected in each of the sales and expenses lines.

PwC observation: Showing the hedge impact separately does not necessarily reflect the risk management strategy for the items that are hedged. Risk managers typically view all items within the net position as hedged, and hence may like to present those items at the hedged rate. However, presentation at the hedged rate would not be permitted by the IASB's proposal.

Hedges of "layers"

28. Currently, IFRS and US GAAP allow cash flow hedges of a proportion (percentage) or a portion ("layer") of a specific item or groups of items. However, in the case of a fair value hedge, this is restricted to a proportion of specific items (including groups). If a layer approach is used, the layer should be identified in the relationship with sufficient specificity so that when the transaction occurs it is clear whether that transaction is or is not the hedged transaction. The FASB has not proposed any changes in this area.

29. The IASB, on the other hand, has proposed to permit more flexibility in this area. Hence, an entity would have the ability to enter into a fair value hedge for a percentage or a

portion of the specific item or groups of items without many restrictions, such as, hedges of the bottom layer of a fixed-rate debt. However, if an item includes a prepayment option, a layer of such item is not eligible to be designated as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk. For example, a layer component of a prepayable debt cannot be a hedged item.

Other differences

30. In addition, there are numerous other differences between existing IFRS and US GAAP related to the designation of hedged items that have not been addressed by the recent proposals. Some of the key differences are discussed on the next page:

Hedged item	Current and proposed US GAAP	Current and proposed IFRS
Components of financial items	Permitted for benchmark interest rate, credit risk, and foreign exchange risk. “Benchmark” is restricted to US government borrowing rates and LIBOR.	Permitted; definition of benchmark is not restricted
Partial-term hedging (fair value hedges)	Not permitted	Permitted
Hedging more than one risk with a single derivative	Not permitted, except for basis swaps	Permitted
Hedges of intragroup royalty	Permitted	Permitted only if the royalty payments are linked to an external transaction

Hedging risk components of financial items

31. IFRS permits any risk components of financial instruments to be eligible hedged items, provided the types of risk are separately identifiable and reliably measurable. In contrast, current (and proposed) US GAAP specifies that the designated risk must be the changes in one of the following: (1) overall fair value or cash flows, (2) benchmark interest rates, explicitly limited to specified benchmark interest rates (interest rate on treasury obligations of the US federal government or LIBOR in the United States and comparable rates for non-US instruments), (3) foreign currency exchange rates, or (4) credit risk. Additionally, practice has developed in the United States such that measurement of benchmark interest rates is very restrictive. The IFRS model is therefore already more flexible in this area than US GAAP.

32. The calculation of ineffectiveness also differs in this area between IFRS and US GAAP. For example, when hedging a fixed-rate debt for changes in benchmark interest rate, US GAAP

(existing and proposed) requires that the fair value of the hedged item be determined using the “contractual interest rate.” This results in ineffectiveness recorded in income. IFRS, on the other hand, allows using the swap rate for calculating the fair value of the hedged risk. This difference is illustrated in the following example:

Example

Assume an entity issues a fixed-rate debt instrument at 7%. The swap rate on a receive fix-pay LIBOR swap is 5% at issuance date. The entity designates the swap as a hedging instrument in a fair value hedge of changes in LIBOR in the fixed-rate debt.

Under IFRS, the designated hedged risk is the swap rate of 5%; therefore, effectiveness is assessed, and ineffectiveness is measured, with reference to the 5% portion of the total 7% fixed rate. Under US GAAP, the cash flows used to calculate ineffectiveness must be based on the contractual cash flows of the entire hedged item (unless the shortcut method is used). Therefore, while the designated

risk is a benchmark interest rate, effectiveness is assessed and ineffectiveness is measured with reference to the contractual 7% fixed rate; as such, ineffectiveness will arise.

33. A significant number of respondents to the FASB’s financial instruments exposure draft expressed concern that the definition of “benchmark” is very restrictive. Respondents requested that the FASB expand the definition, especially in light of the fact that the short-cut method would be eliminated.

Partial term hedging

34. IFRS is more permissive than US GAAP with respect to a partial-term fair value hedging relationship. It permits designating a derivative as hedging only a portion of the time period to maturity of a hedged item, if effectiveness can be measured reliably and the other hedge accounting criteria are met.

Example

Entity A acquires a 10%, fixed-rate government bond with a remaining

term to maturity of 10 years. Entity A classifies the bond as available for sale. To hedge itself against fair value exposure on the bond associated with the first five years of interest payments, Entity A acquires a five-year, pay-fixed/receive-floating swap. The swap may be designated as hedging:

- The fair value exposure of the interest rate payments for five years
- The change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap

In other words, IFRS allows imputing a five-year bond from the actual 10-year bond. US GAAP does not permit defining the hedged risk in a similar way.

Hedging multiple risks with a single hedging instrument

- 35.** IFRS allows a single hedging instrument to be designated as a hedge for more than one type of risk,

provided that:

- The risks hedged can be identified clearly
- The effectiveness of the hedge can be demonstrated
- It is possible to ensure that there is specific designation of the hedging instrument and different risk positions

Accordingly, under IFRS, a single derivative may be separated into two components by inserting (hypothetical) equal and offsetting legs, provided that they are denominated in the entity's own functional currency. US GAAP, however, does not permit creation of hypothetical components in a hedging instrument, and hence does not allow such a hedging strategy (except in a cash flow hedge using a basis swap). The following example illustrates a situation in which hedge accounting would be permitted under IFRS but not under US GAAP.

Example

Entity A's functional currency is EUR, and it wishes to hedge the following two items with one swap as the hedging instrument:

- Hedged items: (1) 10-year, 5%, fixed-rate USD borrowing and (2) 10-year, six-month LIBOR + 80 bp loan receivable denominated in Swiss francs (CHF).
- Hedging instrument: 10-year cross-currency interest rate swap (CCIRS) under which Entity A will receive fixed interest in USD and pay variable interest in CHF at six months LIBOR (the rate representing a six-month interbank deposit in CHF).

For IFRS, a single swap may be separated by imputing hypothetical equal and offsetting legs. These legs may be fixed or floating, provided either one of the alternatives qualifies for hedge accounting. In addition, IFRS does not necessarily require the two hedge relationships to be of the same type; as such, an entity could have two different hedge relationships (i.e., a cash flow and a fair value hedge).

In this example, the original CCIRS may be separated in either of two ways:

Hedging instrument	Hedged item	Hedge type
ALTERNATIVE A: INSERT EUR FLOATING LEGS TO THE SWAP		
Receive fixed USD/pay floating EUR	Currency and interest rate risk on USD debt	Fair value hedge of interest rate and currency risk
Receive floating EUR/pay floating CHF	Currency risk of CHF loan receivable	Cash flow hedge of currency risk
ALTERNATIVE B: INSERT EUR FIXED LEGS TO THE SWAP		
Receive fixed USD/pay fixed EUR	Currency risk on USD debt	Cash flow hedge of currency risk
Receive fixed EUR/pay floating CHF	Currency and interest rate risk of CHF receivable	Cash flow hedge of interest and foreign currency risk

Hedging intragroup royalty

36. Under current US GAAP, forecasted intragroup royalty payments are sometimes hedged in cash flow hedge relationships. While the FASB proposal issued in 2008 had proposed some changes in this area, the financial instruments exposure draft issued in May 2010 did not include any changes. IFRS is currently viewed as more restrictive in allowing such a hedging relationship. Under IFRS, forecasted intragroup royalty payments are

not allowed to be designated as hedged items unless there is a related external transaction. The IASB's proposal carries forward this guidance without any changes.

37. This is a significant difference between the proposed IFRS and the practice that has developed in the United States. The FASB's 2008 exposure draft, which was viewed by many as potentially limiting the ability to hedge forecasted intragroup royalties, did not receive support from the respondents.

Hedging instruments

38. The IASB's proposal entails allowing cash instruments, which are classified at fair value with changes in fair value recognized in net income (referred to in IFRS as fair value through profit or loss), to be eligible for hedging different types of risks. Currently, under IFRS, cash instruments are restricted to the hedges of foreign exchange exposures only. In addition, the IASB's exposure draft includes significant changes to the accounting for the time value of options. These proposals are discussed in more detail in the following table:

Instrument	Current and proposed US GAAP	Current IFRS	Proposed IFRS	Implications
Cash instruments	Permitted only for hedging foreign exchange risk in limited circumstances	Permitted for hedging foreign exchange risk	Instruments classified at fair value through profit or loss are permitted to be used as hedging instruments for all types of risks. Debt instruments classified at amortized cost can be hedging instruments for foreign exchange risk only.	Proposed IFRS allows greater flexibility in designating cash instruments as hedging instruments

Instrument	Current and proposed US GAAP	Current IFRS	Proposed IFRS	Implications
Embedded derivatives	Permitted under current US GAAP if embedded derivative is bifurcated Not permitted for hybrid financial instruments under proposed US GAAP (since embedded derivatives are no longer bifurcated from financial hosts)	Similar to current US GAAP	Not permitted for embedded derivatives in hybrid financial assets under IFRS 9 (since they are no longer bifurcated)	This change results from the proposed amendments to the classification and measurement of financial instruments. Under current IFRS, embedded derivatives bifurcated from hybrid financial liabilities can still be designated as hedging instruments. Embedded derivatives bifurcated from non-financial hosts would also remain eligible as hedging instruments.
Options	Current US GAAP permits time value for certain qualifying cash flow hedge relationships to be deferred in OCI and subsequently released into net income. Proposed US GAAP is similar to current guidance, except that it requires amortization of the time value component over the life of the hedging relationship.	The time value component of an option is marked to market through net income, resulting in income statement volatility.	Any time value paid is treated similar to an insurance premium for both fair value and cash flow hedges. Accounting for the premium depends on whether the hedged item is transaction or time related. Subsequent changes in time value are deferred in OCI.	Proposed IFRS may yield a comparable result to the current US GAAP treatment for several transactions. However, the proposed IFRS model would apply to fair value and cash flow hedge relationships (proposed and current US GAAP models are limited to certain cash flow hedge relationships only).
Internal derivatives	Permitted for foreign exchange risk only in limited circumstances	Not permitted	Not permitted	Current US GAAP is more flexible in this area. The IASB's proposal does not include any changes in this area.

Accounting for the time value of options

39. Under US GAAP for certain qualifying cash flow hedge relationships, the time value component of a purchased option can be deferred in OCI and subsequently released to net income when the hedged item affects net income. The FASB proposal would require that such changes be taken to income rationally over the term of the hedging relationship.

40. Currently, IFRS allows only the intrinsic value of the option to be designated as the hedging instrument, while the time value is marked to market through net income. The IASB's proposal introduces significant changes to the guidance related to the accounting for the time value of options. It analogizes the time value to an insurance premium. Hence, the time value would be recorded as an asset on Day 1 and then released to net income based on the type of item the option hedges. For example, if the hedge is for a forecasted purchase of inventory (i.e., it is transaction related), the option premium would be recognized in income when the hedged item affects net income. However, if the entity is using options to cap interest payments on a debt instrument, the premium would be recognized in earnings on a time proportion basis (time related). Any changes in the fair value of the option attributable to the time value would be recorded in OCI (along with changes in intrinsic value). The proposed IFRS treatment would also apply to fair value hedges.

PwC observation: Overall this will be a welcome change for many

IFRS preparers, and may result in an increased usage of purchased options in hedge accounting since the income statement volatility of the time value can now be avoided. However, prescribing two different methods to record the initial option premium may introduce unnecessary complexity. Another approach could be to require recognition of such premium in net income when the hedged item affects net income, rather than based on the type of hedging relationship. This approach would be consistent with the current US GAAP model for cash flow hedges.

Internal derivatives

41. Under current and proposed IFRS, only instruments that involve a party external to the reporting entity can be designated as hedging instruments. As internal derivative contracts are eliminated in consolidation, they do not qualify under IFRS for hedge accounting in the group's consolidated financial statements. The restrictions under IFRS compel entities to either:

- Enter into separate third-party hedging instruments for the gross amount of foreign currency exposures in a single currency rather than on a net basis (as a typical treasury center would do to hedge group exposure)
- Enter into hedging instruments with third parties on a net basis and designate such contracts as a hedge of a portion of one of the gross exposures

The "gross" approach may not be desirable given the cost of entering

into multiple external derivative contracts. The IASB is not proposing any changes in this area.

42. Similar to IFRS, US GAAP generally permits only those instruments that involve an unrelated external party to be eligible as hedging instruments. However, US GAAP permits internal derivatives in cash flow hedges of foreign currency risk if certain conditions are met. These include:

- All the criteria for hedge accounting are met by the entity with the hedged exposure
- The treasury center must either:
 - (a) Enter into a derivative contract with an unrelated third party to offset the exposure that results from the internal derivative, or
 - (b) If certain additional conditions are met, enter into derivative contracts with unrelated third parties that would offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts

PwC observation: The issue was discussed by the IASB while developing the exposure draft; however, the board decided not to allow internal derivatives to be used as hedging instruments because these do not mitigate the risks of the consolidated group. Additionally, the board believes that changes in the guidance related to net positions will, in part, help the issues that treasury centers may face from not having the ability to use internal derivatives.

Presentation

Fair value hedges

43. Currently, both IFRS and US GAAP require a “basis” adjustment to the hedged item for changes in fair value attributable to the hedged risk. This results in the measurement of the hedged item on a basis that neither represents fair value nor amortized cost (unless the hedge is designated as hedging the total changes in fair value of the hedged item). The FASB has not proposed any changes to these requirements. However, the IASB proposal would remove the requirement to adjust the basis of the hedged item. Instead, fair value changes attributable to the hedged risk would be presented as a separate line item in the balance sheet. A corresponding entry would be recorded in OCI on a gross basis. Any ineffectiveness in the hedging relationship would then be recycled to net income.

Example

Assume an entity has a fair value hedge of foreign exchange risk in a firm commitment to purchase machinery from a UK supplier. The fair value change on the forward contract to hedge the purchase is USD 60, whereas the fair value change on the hedged item related to the hedged risk is USD 50.

Currently, under both IFRS and US GAAP, the fair value movements on the hedged risk and hedging instrument are reflected in the income statement. Additionally, there is a basis adjustment of 50, which would affect the hedged item.

The following presentation would be required under the IASB proposal:

Balance sheet (extract)

Assets

Machinery	-	
Basis adjustment (separate line)	50	Debit

Liabilities

Derivative liability	60	Credit

Other comprehensive income

Changes in fair value of hedging derivative	(60)	Debit
Changes in fair value of hedged item	50	Credit
Ineffective portion transferred to net income	10	Credit

Income statement

Ineffective portion of FV hedge	(10)	Debit

Mandatory basis adjustment— Cash flow hedges

44. In addition, for hedges of forecasted purchases of non-financial assets (e.g., a depreciable asset), the IASB has proposed a mandatory basis adjustment of the hedged item once it is recognized. Accordingly, fair value changes of the hedging instrument deferred in OCI would be adjusted against the value of the hedged item on its initial recognition. Currently, IFRS provides a choice to adjust the basis of the hedged item or continue to defer the fair value changes in equity and release them to net income when the hedged item affects net income. Current and proposed US GAAP prohibits adjusting the basis of the hedged item and requires the fair value changes deferred in OCI to be released out of OCI.

Example

Assume that an entity is hedging the foreign currency risk in the forecasted purchase of machinery using a forward contract. There is a cumulative gain of 100 on the derivative deferred in equity at the date the machinery is purchased. If the price paid for the forecasted purchase of machinery is 500, the initial amount recognized on the balance sheet under current IFRS will be 400 (500 less 100) when the basis adjustment policy is elected. Under the proposed IFRS model, the machinery would be recorded at 400 (mandatory basis adjustment). Under the current and proposed US GAAP, the machinery must be recognized at 500 with the 100 gain deferred in equity and released to net income when the hedged item affects net income.

Transition and effective date

45. The IASB has proposed that the new requirements be applied prospectively for accounting periods beginning on or after January 1, 2013, with earlier application permitted. The FASB's proposal also requires prospective application but does not specify an effective date. It is also pertinent to note that both boards have issued discussion papers on effective dates and transition for their major projects. Their deliberations of the issues raised in those discussion papers could impact the effective date of the proposed hedge accounting guidance.

***To have a deeper conversation
about how this subject may affect
your business, please contact:***

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US GAAP Convergence & IFRS

Revenue recognition

March 2011

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Revenue from contracts with customers

The constituents have been heard . . .

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Next steps

Reprinted from:

Dataline 2011–16
March 1, 2011

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- The FASB and IASB (the “boards”) received over 960 comment letters in response to their June 24, 2010 exposure draft, *Revenue from Contracts with Customers*. The comment period closed on October 22, 2010.
- A number of recurring themes were noted in the comment letters, even across industries. Areas of focus included transfer of control, identification of performance obligations, determining the transaction price, transition, segmentation, accounting for warranties, licenses of intellectual property, and disclosures.
- At the January and February 2011 meetings, the boards began redeliberating their proposals, focusing on the common themes in the comment letters, and reached a number of tentative decisions.
- The boards expect to issue the final standard in 2011, with a likely effective date no earlier than 2014. Full retrospective application will be required unless the boards change their current position.

Background

1. The exposure draft proposes a new revenue recognition standard that could significantly change the way entities recognize revenue.
2. The proposed standard employs an asset and liability approach—the cornerstone of the FASB's and IASB's conceptual frameworks. Current revenue guidance under both frameworks focuses on an “earnings process,” but difficulties often arise in determining when an entity earns revenue. The boards believe a single, contract-based model that reflects changes in contract assets and liabilities will lead to greater consistency in the recognition and presentation of revenue.

PwC observation: The proposed standard will be a significant shift in how revenue is recognized in many circumstances. It moves away from specific measurement and recognition thresholds and removes industry-specific guidance. The effect could be considerable, requiring management to perform a comprehensive review of existing contracts, business models, company practices, and accounting policies.

The proposed standard may also have broad implications for an entity's processes and controls. Management may need to change existing IT systems and internal controls in order to capture different information than in the past. The

effect could extend to other functions such as treasury, tax, and human resources. For example, changes in the timing or amount of revenue recognized may affect long-term compensation arrangements, debt covenants, and key financial ratios.

3. The proposed standard takes a contract-based asset and liability approach, applicable to almost all industries. Revenue is recognized when an entity satisfies its obligations to its customers, which occurs when control of an asset (a good or service) transfers to the customer.
4. This Dataline summarizes key aspects of the proposed standard, certain themes identified in the comment letters, and decisions made during recent board meetings. The boards' conclusions are tentative and subject to change until a final standard is issued.

Key provisions

5. Entities will perform the following five steps in recognizing revenue:
 - Identify the contract with the customer
 - Identify the separate performance obligations in the contract
 - Determine the transaction price
 - Allocate the transaction price to distinct performance obligations
 - Recognize revenue when each performance obligation is satisfied

PwC observation: The steps in the proposed standard may appear simple, but significant judgment will

be required to apply the principles. Determining whether a good or service is distinct, and should be accounted for separately, will require judgment.

Management will need to consider a number of variables to estimate the transaction price, including the effects of variable consideration, collectability, and time value of money.

Revenue is recognized when control of the good or service is obtained by the customer. Management will need to assess whether the customer has the ability to direct the use of and receive the benefit from the good or service to determine when revenue should be recognized. This might be difficult in some circumstances, such as service arrangements.

6. Refer to Dataline 2010–28 and the related industry supplements for a detailed discussion of the key aspects of the proposed model, as well as PwC's response letter submitted to the boards on October 20, 2010.

Current developments

7. The boards have considered many of the concerns raised by constituents as part of the comment letter process in their redeliberations. The boards recently reached a number of key decisions regarding the proposed revenue recognition model. Areas of focus so far include the following:
 - Transfer of control
 - Performance obligations

- Segmentation
- Contract combination
- Warranties
- Onerous performance obligations
- Contract costs
- Breakage

Transfer of control

8. The exposure draft stated that revenue should be recognized when a promised good or service is transferred to the customer. An entity transfers a promised good or service and satisfies a performance obligation when the customer obtains control of that good or service. A customer obtains control of a good or service when it has the ability to direct the use of and receive the benefit from the good or service.
9. Respondents generally agreed with recognizing revenue when control transfers. However, many requested clarification to help assess when control transfers continuously, especially in service contracts.

Tentative decisions

10. The boards reaffirmed the core principle that an entity should recognize revenue to depict the transfer of goods and services to a customer, but modified the guidance as follows:
 - Added “risks and rewards of ownership” as an indicator of control
 - Eliminated “the design or function of the good or service is customer-specific” as an indicator of control
11. The boards reaffirmed that an entity should recognize revenue for the sale

of a good when the customer obtains control of the good.

12. The boards decided that an entity should recognize revenue for the performance of a service if:
- The entity's performance creates or enhances an asset that the customer controls, or
 - The entity's performance does not create an asset with alternative use to the entity, and at least one of the following:

- The customer immediately receives a benefit from each task performed,
- Another entity would not need to reperform the task(s) if that other entity were required to fulfill the remaining obligation to the customer, or
- The entity has a right to payment to date even if the customer could cancel the contract for convenience.

13. The boards concluded that an entity should recognize revenue for a service only if the entity can reasonably measure its progress toward completion of the service. Further discussions are expected regarding which method an entity should use to measure its progress (e.g., an output method, an input method, or a method based on the passage of time), but the boards continue to indicate that output measures might be the most representative of transfer of control in many situations.

14. An entity first determines whether the goods and services are distinct (in accordance with the guidance on identifying separate performance

obligations) if more than one good or service is promised in the contract.

15. Distinct goods and services would be accounted for as separate performance obligations. The entity would account for the bundle of goods and services as a service if they are not distinct.

PwC observation: We agree that an entity should distinguish between situations when an asset is being created and when one is not, to determine how revenue is recognized. This will make the accounting for services easier to apply and potentially more consistent with existing guidance than the model outlined in the exposure draft.

It is unclear whether the performance obligation should be viewed from the perspective of the vendor or the customer, which could create diversity in practice. This could be clarified by adding that a performance obligation represents the good or service that the customer reasonably expects to receive when entering into the contract based on the contract terms and the vendor's customary business practices.

There may still be arrangements that are not clearly the sale of a good or a service that will require judgment to determine the appropriate recognition model.

Performance obligations

16. The exposure draft defined a performance obligation as an enforceable promise (whether explicit or implicit) in a contract with a customer to

transfer a good or service to the customer. Performance obligations may be explicit in contracts, but they may also arise in other ways. Legal or statutory requirements may create performance obligations even though such obligations are not explicit in the contract. Customary business practices, such as a practice of providing customer support, might also create a performance obligation.

17. Many respondents objected to the subjectivity in identifying performance obligations and the potential for similar transactions to be accounted for differently. Most agreed with the principle, but wanted further clarification on how to identify a performance obligation. There were mixed responses regarding the concept of "distinct" performance obligations and many respondents disagreed that profit margin is relevant in assessing separation of performance obligations.

Tentative decisions

18. The boards did not fundamentally change the definition of a performance obligation, but they did delete "enforceable" from the definition. They also clarified that promises implied by an entity's business practices are performance obligations if they create expectations of performance.
19. The boards concluded that the objective of separating distinct performance obligations is to depict the transfer of goods or services and the profit margin attributable to them. The boards retained the principle of "distinct goods or services" as the

basis for identifying separate performance obligations, but revised the criteria for determining if a good or service is distinct.

- 20.** A performance obligation is distinct if the entity regularly sells the good or service separately. A good or service might be distinct if not sold separately if the customer can use the good or service on its own or together with resources readily available to the customer.
- 21.** The boards decided that an entity should account for a bundle of goods or services as one performance obligation if the entity provides a significant integration service. The entity should consider whether the goods or services are sold separately if an integration service is not included. Otherwise, an entity should assess whether the good or services have a distinct function.
- 22.** The boards also decided that it is not necessary to include additional requirements on accounting for perfunctory, incidental, or other similar obligations.

PwC observation: We agree that distinct performance obligations should be identified and accounted for separately and support the boards' decision to eliminate the requirement that a performance obligation have a distinct profit margin in order to be considered distinct when not sold on a standalone basis. We are concerned, however, that contracts that include bundled goods or services may be inappropriately accounted for as a single performance obligation when an integration service is included

in the contract. Bundling distinct goods and services together when the integration service is not significant might result in the accounting not reflecting the underlying economics.

Segmentation

- 23.** The exposure draft required a single contract be segmented into two or more contracts if some goods or services within the contract are independently priced from other goods or services in that contract. Goods or services are priced independently if:
- The entity, or another entity, regularly sells the goods or services on a standalone basis, and
 - The price for all goods or services in the contract approximate the sum of the standalone selling price for each good or service (i.e., there is not an inherent discount for the purchase of bundled goods and services).
- 24.** Some constituents recommended that current segmentation guidance be retained for long-term contracts, but many respondents noted that segmentation guidance is not needed if the principle for identifying performance obligations is clear.

Tentative decisions

- 25.** The boards concluded that an entity separates a contract only if separate performance obligations are identified in the contract. The boards eliminated the proposed requirement to account for one contract as two or more contracts if the price of some goods or

services in the contract is independent of the price of other goods or services in the contract. The boards will discuss further the implications of this decision on allocating the transaction price.

PwC observation: Eliminating the contract segmentation guidance from the final standard will simplify the model. We believe it is not necessary to segment a single contract into two or more contracts, and note that the proposed accounting for segmentation was difficult to understand and apply. Clear and well understood guidance for the separation of distinct performance obligations, treatment of contract modifications and adjustments to variable consideration should be sufficient.

Contract combination

- 26.** The exposure draft proposed that two or more contracts would be combined into one if the prices of those contracts are interdependent. The following characteristics were identified to support interdependent pricing:
- Entered into at or near the same time
 - Negotiated as a package with a single commercial objective
 - Performed concurrently or consecutively
- 27.** The price of a contract would not be interdependent with the price of another contract solely because the customer receives a discount on goods or services in the contract as a result

of an existing customer relationship arising from previous contracts.

Tentative decisions

28. The boards decided that interrelated contracts should be combined. To be interrelated, the contracts should be entered into at or near the same time with the same counterparty. The boards also decided that the following indicators should be considered to determine if contracts are interrelated:

- Whether the contracts are negotiated as a package with a single commercial objective
- Whether the amount of consideration received in one contract depends on the performance of the other contract
- Whether the goods and services in the contracts are closely interrelated or interdependent in terms of design, technology, or function

PwC observation: Combining two or more contracts as a single contract if they are interrelated should promote accounting that reflects the economics of the entire arrangement. The criteria identified by the boards for combining contracts is consistent with today's guidance and should be well understood in practice.

Warranties

29. The proposals distinguished between a warranty for latent defects and a warranty for post-transfer defects. A latent defect warranty provides a

customer with coverage for defects that exist when the asset is transferred to the customer, but that are not yet apparent. This warranty would not give rise to a separate performance obligation but recognizes the possibility that the entity did not satisfy its performance obligation. In other words, the entity did not provide an asset that operated as intended at the time of delivery. An entity would not recognize revenue at the time of sale for a defective product that it would subsequently replace in its entirety. Revenue would be deferred for warranties that require replacement or repair of components of an item, but only for the portion of revenue attributable to the components that must be repaired or replaced.

30. The proposals also required that a warranty that provides the customer with coverage for faults that arise after the entity transfers control to the customer (e.g., normal "wear and tear") gives rise to a separate performance obligation. The entity would allocate a portion of the transaction price to the warranty obligation at contract inception.

31. Many respondents disagreed with the distinction between a warranty for latent defects and a warranty that provides coverage for faults that arise after transfer of control, noting the operational difficulties in distinguishing between the different types of warranties. Some also suggested that the current warranty models should be retained (both for standard and extended warranties) as they are understood in practice and reflect the substance of the warranty obligations.

Tentative decisions

32. The boards decided that an entity should account for some warranties as a warranty obligation (that is, a cost accrual) in accordance with the guidance on provisions and contingencies (IAS 37 and ASC 450). The following criteria should be considered to determine whether a warranty should be accounted for as a cost accrual:

- If a customer has the option to purchase a warranty separately from the entity, the entity should account for the warranty as a separate performance obligation. The entity would allocate revenue to the warranty service.
- If a customer does not have the option to purchase a warranty separately from the entity, the entity should account for the warranty as a cost accrual unless the warranty provides a service to the customer in addition to assurance that the entity's past performance was as specified in the contract (in which case the entity would account for the warranty service as a separate performance obligation).

33. The boards will develop implementation guidance to help an entity determine when a warranty provides a service to the customer in addition to assurance that the entity's past performance was as specified in the contract.

PwC observation: The revised proposal provides a practical expedient to accounting for warranties which is consistent with current guidance. However, operational

difficulties may be encountered in separating warranties that cover latent defects from those that cover both latent defects and future defects. Determining the estimated stand-alone selling price for the latter category when such warranty service is not sold separately could also be challenging.

Onerous performance obligations

34. The exposure draft required assessment of performance obligations at contract inception and at each reporting date to determine whether the obligation was onerous. A performance obligation was onerous if the present value of the probability-weighted direct costs to satisfy the obligation exceeded the transaction price allocated to it. The assessment would be updated each reporting period using current estimates. Any changes in the measurement of the liability would be recorded as an expense or a reduction of an expense.
35. Respondents generally disagreed with the proposed accounting for onerous performance obligations, and commented specifically that the proposed guidance may not reflect the underlying economics of the transaction. Respondents also suggested that if an onerous provision is included in the final standard, such assessment should be performed at the contract level as opposed to the performance obligation level.

Tentative decisions

36. The boards proposed to change the unit of account to the contract level for onerous contract provisions.
37. The boards also determined that direct costs should be used to perform the onerous test. If a contract is subsequently cancelled, the entity would account for the cancellation based on the terms of the contract or in accordance with IAS 37 or ASC 450.

PwC observation: We continue to believe that provisions for onerous contracts are cost accruals, not an issue in the recognition or measurement of revenue, and should be addressed in the relevant liability or contingency standards. Measuring provisions for onerous contracts using all of the direct costs that relate to satisfying that contract will result in more onerous loss provisions being recorded than using only the direct incremental costs of fulfilling the obligation. There are a number of operational challenges beyond determining the appropriate costs to consider in the assessment, such as the effect of accelerating losses for “loss-leader” contracts.

Contract costs

38. The exposure draft included specific guidance for accounting for costs associated with fulfilling contracts with customers. An entity would recognize costs to obtain a contract

(e.g., costs of selling, marketing, or advertising) as incurred.

39. Respondents generally agreed with the proposed accounting for contract costs, but were concerned about expensing all contract acquisition costs.

Tentative decisions

40. The boards tentatively decided that an entity should recognize an asset for the incremental costs of obtaining a contract that the entity expects to recover. Incremental costs of obtaining a contract are costs that the entity would not have incurred if the contract had not been obtained.
41. An asset recognized for the costs of obtaining a contract should be presented separately on the statement of financial position and subsequently amortized on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates.
42. The boards will discuss the accounting for the costs of fulfilling a contract at a future meeting.

PwC observation: We agree with the tentative decisions made by the board regarding contract acquisition costs. We believe certain costs of obtaining a contract, whether paid to a third party or directly to the customer, should be capitalized if such costs are incremental and will be recovered under the contract. The boards have not determined which contract

acquisition costs may be considered for capitalization or whether there should be a probability threshold for determining whether costs are recoverable. We expect further discussion on these topics at future meetings.

While not specifically addressed in the boards' redeliberations, we believe this guidance would also apply to payments made to a customer in order to enter into a customer-vendor relationship.

Breakage

43. The accounting for breakage (forfeitures) under the proposed standard may impact the timing of revenue recognition. Entities would consider the impact of breakage in determining the transaction price allocated to the performance obligations in the contract.

Tentative decisions

44. The boards agreed that two models may be applied when considering breakage in a contract—a proportional model and a remote model.
45. The proportional model should be applied when an entity can reasonably estimate breakage. Under the

proportional model, an entity recognizes expected breakage as revenue in proportion to the pattern of transfer of the goods or services to the customer.

46. An entity should apply the remote model when it is unable to reasonably estimate breakage. This model precludes an entity from recognizing the breakage as revenue until the likelihood of the customer exercising their right under the contract becomes remote.

PwC observation: We agree with the boards' proposed accounting for breakage, and expect practice to generally remain consistent with today's application.

Next steps

47. The boards' timeline indicates a final standard in June 2011. The boards will continue to redeliberate over the next few months and perform targeted consultation with key industries and other interested parties for some of the more significant changes.
48. Several issues remain to be redeliberated, including allocation of transaction price, measurement of consideration, accounting for licenses, disclosure and transition.

Revenue from contracts with customers

The responses are in . . .

What's inside:

Overview

Key provisions

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Industry themes

Reprinted from:

Dataline 2010–45
December 20, 2010

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- The FASB and IASB (the “boards”) received over 960 comment letters in response to their June 24, 2010 exposure draft, *Revenue from Contracts with Customers*. The comment period closed on October 22, 2010.
- A number of recurring themes were noted in the comment letters, even across industries. Areas of focus included transfer of control, identification of performance obligations, determining the transaction price, transition, segmentation, accounting for warranties, licenses of intellectual property, and disclosure requirements.
- The boards expect to issue the final standard in 2011, with a likely effective date no earlier than 2014. Full retrospective application will be required.

Background

1. The exposure draft proposes a new revenue recognition standard that could significantly change the way entities recognize revenue.
2. The proposed standard takes a contract-based asset and liability approach, applicable to almost all industries, in which revenue is recognized when an entity satisfies its obligations to its customers, which occurs when control of an asset (a good or service) transfers to the customer.
3. This Dataline summarizes key aspects of the proposed standard as well as the themes in comment letters received by the boards.
4. The boards' conclusions are tentative and subject to change until a final standard is issued.

Key provisions

Asset and liability model

5. The proposed standard employs an asset and liability approach, the

cornerstone of the FASB's and IASB's conceptual frameworks. Current revenue guidance under both frameworks focuses on an “earnings process,” but difficulties often arise in determining when an entity earns revenue. The boards believe a single, contract-based model reflecting changes in contract assets and liabilities will lead to greater consistency in the recognition and presentation of revenue.

PwC observation: In many circumstances, the proposed standard will be a significant shift in how revenue is recognized. It moves away from specific measurement and recognition thresholds and removes industry specific guidance. The effect could be considerable, requiring management to perform a comprehensive review of their existing contracts, business models, company practices and accounting policies.

The proposed standard may also have broad implications for an entity's processes and controls.

Management may need to change existing IT systems and internal controls in order to capture information to comply with the proposed guidance. The effect may also extend to other functions such as treasury, income tax, and human resources. For example, changes in the timing or amount of revenue recognized may affect long-term compensation arrangements, debt covenants, and key financial ratios.

The proposed standard may also affect mergers and acquisitions in a number of ways, including deal models (e.g., amount and timing of revenue recognition may be different) and how earn-out payments are triggered if determined based on revenue.

Applying the model

6. Entities will perform the following five steps in applying the proposed standard:
 - Identify the contract with the customer
 - Identify the separate performance obligations in the contract
 - Determine the transaction price
 - Allocate the transaction price to distinct performance obligations
 - Recognize revenue when each performance obligation is satisfied

PwC observation: Although the steps included in the proposed standard may appear to be simple, significant judgment will be required to appropriately apply the principles. The determination of whether a good or service is

distinct, and should be accounted for separately, will require management judgment and an understanding of how other goods or services sold in the market interact with the entity's products.

Management will need to consider a number of variables to determine whether the transaction price can be reasonably estimated, specifically when considering the effect of variable consideration, collectability, and time value of money.

Revenue is recognized when control of the good or service is obtained by the customer. Although the boards have identified indicators to consider, management will need to assess whether the customer has the ability to direct the use of and receive the benefit from the good or service in determining when revenue should be recognized. This might be difficult in some circumstances, such as service arrangements.

7. Refer to Dataline 2010–28 for a detailed discussion of the key aspects of the proposed model as well as PwC's response letter submitted to the boards on October 20, 2010.

Comment letters

8. The boards received over 960 comment letters (mainly from corporations but covering a wide range of constituents) from respondents in 35 different countries.
9. The majority of respondents supported the project's overall objectives, but had

a number of concerns over some of the key provisions, including:

- Transfer of control
- Performance obligations
- Transaction price
 - variable consideration
 - time value of money
- Transition
- Segmentation
- Warranties
- Licenses
- Onerous performance obligations
- Credit risk
- Contract costs
- Disclosure

Transfer of control

10. Revenue should be recognized when a promised good or service is transferred to the customer. An entity transfers a promised good or service and satisfies a performance obligation when the customer obtains control of that good or service. A customer obtains control of a good or service when it has the ability to direct the use and receive the benefit from the good or service.
 11. Respondents generally agreed with recognizing revenue when control transfers. However, many requested additional clarification in assessing whether control transfers continuously, especially in service contracts.
- PwC observation:** We agree that revenue from goods and services should be recognized when control transfers. However, further clarification is needed to determine when control transfers in service

arrangements. We recommend that the proposed standard include indicators that clarify when control transfers for services such as: (1) when the customer obtains the benefit, (2) whether tasks performed represent progress towards completion and do not need to be repeated, and (3) whether the customer's obligation to pay is unconditional once services are performed.

Performance obligations

12. 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. Performance obligations may be explicit in contracts, but they may also arise in other ways. Legal or statutory requirements may create performance obligations even though such obligations are not explicit in the contract. Customary business practices, such as an entity's practice of providing customer support, might also create a performance obligation.

13. Many respondents objected to the subjectivity in the proposed guidance and the potential for similar transactions to be accounted for differently. Most agreed with the principle, but requested further clarification in identifying the performance obligations. There were mixed responses regarding the concept of "distinct" performance obligations and many respondents disagreed with the distinct profit margin concept.

PwC observation: We generally agree with the proposed definition

of a performance obligation, but, it is unclear whether the existence of a performance obligation should be determined based on the perspective of the vendor or the customer or both. We believe the definition of a performance obligation could be clarified by adding that:

A performance obligation represents the good or service that the customer reasonably expects to receive when entering into a contract based on the contract terms and customary business practices.

We recommend that separate performance obligations be identified by disaggregating the contract into distinct performance obligations rather than aggregating all individual performance obligations into "distinct" performance obligations. We also recommend that distinct profit margin be omitted from the list of indicators for both practical and conceptual reasons.

Transaction price

14. The transaction price in a contract reflects the consideration the customer promises to pay in exchange for goods or services.

15. The transaction price may include an element of consideration that is variable or contingent on the outcome of future events, including (but not limited to) discounts, rebates, refunds, credits, incentives, and performance bonuses. When a contract includes variable consideration, the transaction price includes the probability-weighted estimate

of variable consideration receivable. This estimate requires management to assess the probability of each possible outcome.

16. There was some concern about recognizing revenue prior to a contingency being resolved, but many respondents agreed that variable consideration should be included in the transaction price. However, a significant number of respondents noted that a probability-weighted approach is not practical and may not be appropriate in certain circumstances (e.g., binary outcomes). They suggested that a "best estimate" approach be permitted in addition to the probability-weighted approach.

PwC observation: We agree that revenue should be recognized using an estimated transaction price. Although it may be difficult to estimate variable consideration in some circumstances, we expect vendors may often have a reasonable estimate of the amount of consideration expected to be received. We suggest emphasizing that variable consideration can be reasonably estimated unless insufficient history exists to make a reasonable estimate. We understand the theoretical merits of the probability-weighted approach, but recommend that a "best estimate" approach be permitted in addition to a probability-weighted approach.

17. The transaction price should reflect the time value of money whenever the effect is material. Management should use a discount rate that reflects a financing transaction between the entity and its customer that does not

involve the provision of other goods or services.

- 18.** Many respondents agree with the principle but noted that the operational difficulties of applying it in practice will outweigh the benefits. Many also struggled with applying the principle to prepayments when a material financing component exists for a number of reasons, including the inconsistency it creates between the consideration received and the revenue recognized (i.e., revenue recognized will exceed consideration received). Constituents overwhelmingly suggested that time value of money should only be considered in contracts that clearly include a financing component. Those that agree with the concept asked for further clarification of key inputs into the calculation, including the discount rate.

PwC observation: We understand the conceptual merits of adjusting the transaction price to reflect the time value of money if the contract includes a material financing component, but the practical challenges will likely outweigh the benefit to users. The transaction price should not be adjusted for the time value of money in most circumstances. The transaction price should only reflect the time value of money when payment of cash is significantly delayed after control of the good or service transfers.

Transition

- 19.** The proposed standard requires full retrospective application, including application to those contracts that

do not affect current or future periods, but affected previously reported periods.

- 20.** In October 2010, the boards issued Discussion Papers seeking feedback from stakeholders about the time and effort involved in adopting a number of proposed accounting standards, including revenue recognition. As part of this outreach effort, the boards are particularly interested in obtaining views on effective dates and transition methods. The boards intend to use the feedback received to develop implementation plans to help entities manage the pace and cost of change. Although the boards have not yet decided on the effective date for the proposed standard, they have discussed possible effective dates no earlier than 2014.

- 21.** Most respondents expressed concerns with full retrospective application, suggesting prospective application might be a better alternative in cases where full retrospective application is impractical.

- 22.** Those respondents that agreed with full retrospective application noted that implementing the standard would require significant management resources. They requested an extended lead time between the issue of the final standard and the effective date to allow adequate time to implement the standard.

PwC observation: We understand the theoretical merit of applying the proposed requirements retrospectively to achieve consistency and comparability across periods presented, but there are a number of situations where retrospective

application may be difficult to apply. Furthermore, it may not be cost beneficial. Companies will need to closely monitor this requirement as it could result in significant incremental efforts in restating historic information.

Segmentation

- 23.** A single contract should be segmented into two or more contracts if some goods or services within the contract are independently priced from other goods or services in that contract. Goods or services are priced independently if:

- The entity, or another entity, regularly sells the goods or services on a standalone basis, and
- The price for all goods or services in the contract approximate the sum of the standalone selling price for each good or service (i.e., there is not an inherent discount for the purchase of bundled goods/services).

- 24.** Some constituents recommended that current segmentation guidance should be retained for long-term contracts. However, respondents consistently noted that segmentation guidance is not needed, so long as the principle for identifying performance obligations is clarified. Most comment letters also noted that the segmentation guidance is too prescriptive and not principles based.

PwC observation: We believe it is not necessary to segment a single contract into two or more contracts, and find the proposed accounting for segmentation

difficult to understand and apply. The proposed standard is based on recognizing revenue when separate performance obligations are satisfied. There would be no need to segment contracts if distinct performance obligations are accounted for separately and there is clear and well understood guidance for the treatment of contract modifications and adjustments to variable consideration.

Warranties

25. The proposed standard distinguishes between a warranty for latent defects and a warranty for post transfer defects. A latent defect warranty provides a customer with coverage for defects that exist when the asset is transferred to the customer but that are not yet apparent. This warranty does not give rise to a separate performance obligation but recognizes the possibility that the entity has not satisfied its performance obligation. In other words, the entity has not provided an asset that operates as intended at the time of delivery. An entity does not recognize revenue at the time of sale for a defective product that it will subsequently replace in its entirety. Revenue will be deferred for warranties that require replacement or repair of components of an item, but only for the portion of revenue attributable to the components that must be repaired or replaced.
26. A warranty that provides the customer with coverage for faults that arise after the entity transfers control to the customer (e.g., normal “wear and tear”) give rise to a separate

performance obligation. The entity allocates a portion of the transaction price to the warranty obligation at contract inception.

27. Many respondents disagreed with the distinction between a warranty for latent defects and a warranty that provides coverage for faults that arise after transfer of control noting the operational difficulties in distinguishing between the different type of warranties. Some also suggested that the current warranty models should be retained (both for standard warranties and extended warranties) as they are understood in practice and reflect the substance of the warranty obligations.

PwC observation: We agree with the concept that a warranty for latent defects is, in substance, a failed sale while a warranty for post transfer defects is a separate performance obligation, but we believe it may be impractical to determine whether defects are latent or the result of wear and tear. The proposed accounting would be more operational if all warranties are accounted for as a distinct performance obligation, with revenue recognized as the warranty obligation is satisfied. As a practical alternative, current guidance could be retained (i.e., account for standard warranties as a cost accrual and extended warranties as a separate performance obligation).

Licenses

28. The recognition of revenue for the license of intellectual property depends on whether the customer obtains

control of the asset. The contract is a sale (rather than a license or a lease) of intellectual property if the customer obtains control of the entire licensed intellectual property (e.g., the exclusive right to use the intellectual property for its economic life). The entity recognizes revenue when control of the intellectual property transfers if the transaction is a sale.

29. The performance obligation is satisfied over the term of the license if the customer licenses intellectual property on an exclusive basis but does not obtain control for the entire economic life of the property. The entity generally recognizes revenue over the term of the license in this situation.
30. A contract that provides a non-exclusive license for intellectual property (e.g., off-the-shelf software) is a single performance obligation. An entity recognizes revenue when the customer is able to use the license and benefit from it (i.e., when control transfers but no earlier than the beginning of the license period).
31. Respondents generally disagree with the proposed guidance, specifically the fact that exclusivity determines the timing of revenue recognition. Comment letters also focused on the need for further clarification around the identification of the performance obligation in a license of intellectual property. Many respondents noted that revenue should be recognized once the performance obligation has been satisfied, regardless of whether the license is exclusive or non-exclusive.

PwC observation: The accounting for licenses of intangible assets

and leases of tangible assets should be consistent, as these arrangements are economically similar. The proposed standard is inconsistent with the proposals for lease accounting and also appears inconsistent with the performance obligation concept underpinning the revenue exposure draft. We recommend the boards describe the performance obligation that exists when an exclusive license has been transferred. There is currently diversity in practice in accounting for licenses, and we accept the proposal as a pragmatic interim solution that should achieve greater consistency. However, a more comprehensive solution that can be applied to both tangible and intangible assets should be developed.

Onerous performance obligations

32. Performance obligations are assessed at contract inception and at each reporting date to determine whether the obligation has become onerous. A performance obligation is onerous when the present value of the probability-weighted direct costs to satisfy the obligation exceed the consideration (i.e., the transaction price) allocated to it. The assessment of onerous performance obligations should be updated each reporting period using current estimates. Any changes in the measurement of the liability would be recorded as an expense or a reduction of an expense. The entity reduces the expense previously recorded on satisfaction of the onerous performance obligation.

33. Respondents noted general disagreement with the proposed accounting for onerous performance obligations, specifically, that the proposed guidance may not reflect the underlying economics of the transaction. It was also noted that if an onerous provision is included in the final standard, such assessment should be performed at the contract level as opposed to the performance obligation level.

PwC observation: We do not agree with the inclusion of onerous performance obligation guidance in the revenue standard. Provisions for onerous performance obligations are cost accruals, not an issue in the recognition of revenue or measurement of revenue, and thus should be addressed in the relevant liability or contingency standards. We strongly disagree with the boards' statement that the proposed standard will not result in significant change to existing practice for most entities. The proposals will have a significant effect on current practice and will likely be impractical to apply in many circumstances.

We are concerned that the proposed guidance might not reflect the underlying economics of transactions in a number of situations, particularly when an individual performance obligation is not profitable but the overall contract is profitable.

If the boards' decide to retain this guidance in the final standard, we recommend that the assessment of whether an onerous provision

exists be performed at the contract level or higher. The requirement to consider or remeasure onerous performance obligations each reporting period will likely be impractical for many entities and we believe the benefits of doing so will not outweigh the costs or efforts. The boards should also consider whether measuring provisions for onerous performance obligations using all of the direct costs that relate to satisfying that performance obligation reflects the economics of these arrangements, or whether provisions for onerous performance obligations should be measured using only the directly incremental costs of fulfilling the obligation.

Credit risk

34. Credit risk refers to the customer's ability to pay the consideration agreed in the contract. The transaction price is adjusted to reflect the customer's credit risk by recognizing the consideration expected to be received on a probability-weighted basis. Changes in assessment of consideration to be received due to changes in credit risk are recognized as income or expense, separately from revenue.

35. Many respondents disagreed that credit risk should be recorded as a reduction of revenue with subsequent changes in the assessment included in other income or expense. Rather, subsequent changes in the amount of consideration to be received should be recorded in revenue, consistent with other changes in the transaction price.

PwC observation: We agree conceptually that a customer's credit risk should affect the measurement of revenue rather than the recognition of revenue. We disagree, however, with the proposal to require subsequent changes in the assessment of credit risk in other income or expense. Subsequent adjustments should be recorded in revenue. This will align the revenue recognized with cash ultimately received from the customer, consistent with other areas of the model, such as changes in variable consideration. This information is beneficial for financial statement users who are interested in reconciling revenue with net cash ultimately received from the customer and would be more operational.

It might be difficult, however, for some entities to implement the proposed guidance because it will require changes to systems and processes, and the benefit might not outweigh the cost. We suggest the boards consider a simpler solution that allows entities to continue to record bad debt expense separately from revenue. This would avoid the need to make changes to systems and other processes for what will primarily be a change in the geography of where bad debt expense is recorded.

Contract costs

36. The proposed standard includes specific guidance for accounting for costs associated with fulfilling contracts with customers. An entity

recognizes costs to obtain a contract (e.g., costs of selling, marketing, or advertising) as incurred.

37. Respondents generally agreed with the proposed accounting for contract costs. However, concerns were raised regarding the expensing of all contract acquisition costs.

PwC observation: We believe cost guidance ideally should not be included in a revenue standard. It should be included in other standards containing asset or cost guidance. We understand, however, the effect the proposed standard will have on existing cost guidance, particularly under US GAAP. We therefore accept the inclusion of cost guidance in the revenue standard as a pragmatic interim measure.

The proposed standard requires that costs of obtaining a contract be expensed as incurred. This might contradict existing guidance for intangible assets in some situations. We do not believe costs of obtaining a contract, whether paid to a third party or directly to the customer, should be expensed as incurred in all situations. We recommend that the boards consider all relevant guidance to determine whether consideration paid to acquire a customer creates an intangible asset.

Disclosure

38. The boards believe that the proposed disclosures will assist users of financial statements in understanding the amount, timing and uncertainty of

revenue and cash flows arising from contracts with customers. Required disclosures include:

- Qualitative and quantitative information about performance obligations, rights to consideration, and onerous performance obligations to help users understand the characteristics of the entity's contracts with customers.
- The significant judgments and changes in judgments that will explain the effect on the timing and amount of revenue recognized in the financial statements. These disclosures should include (a) the effect on the amount of revenue recognized in the current period, and (b) an indication of the expected effect on the timing and amount of revenue that will be recognized in future periods.

39. There were mixed views from respondents on whether the proposed disclosures achieved the boards' stated objectives. A majority of respondents viewed the proposed disclosures as excessive and not decision useful for users of financial statements. Respondents also noted that the time and cost necessary to prepare the proposed disclosures would be a major obstacle. There was also some concern over duplication with segment reporting disclosures.

PwC observation: We understand the boards' objectives of improving disclosures. However, the proposed disclosure requirements will not meet the boards' objectives and will not improve existing disclosures. The volume of detailed disclosures required by the

proposed standard may obscure useful information. We suggest that appropriate disclosures might include:

- the principle sources of revenue and the accounting policies applied to each;
- significant estimates, judgments made in the recognition, measurement of revenue, and the extent to which revenue is affected by changes in estimates; and
- a quantitative analysis of the revenue derived from each principal source.

Industry themes

40. In addition to the general themes noted above, we have summarized the responses by key industries. The summaries below explain industry specific themes in the comment letters submitted to the boards.

Aerospace and defense

41. Respondents noted the need for additional guidance, including indicators for when performance obligations are satisfied on a continuous basis. Cost guidance, consistent with today's guidance, was also requested. Key themes in responses from the industry focused on (i) satisfaction of performance obligations for continuous transfer of control; (ii) contract costs and onerous performance obligations; (iii) identification of performance obligations including contract management services; (iv) combining

and segmenting contracts, and contract modifications; (v) variable consideration; and (vi) transition provisions.

Engineering and construction

42. There was broad support for the boards' objectives, however, both preparers and users do not believe that the proposed model improves existing accounting under US GAAP or IFRS. Responses centered around (i) retention of percentage-of-completion accounting; (ii) the importance of achieving comparability among industries rather than across industries; and (iii) operational difficulties in applying many aspects of the proposed standard including identification of performance obligations, continuous transfer of control, determination of the transaction price, contract costs and onerous performance obligations, disclosure requirements, and transition provisions.

Technology

43. Technology companies agreed with the boards' efforts to create a consistent standard on a global basis that will enhance comparability in the financial statements, and generally support the proposed standard. However, there were concerns with some of the concepts in the exposure draft including (i) identification of distinct performance obligations; (ii) measurement of transaction price (i.e., probability-weighted amounts, variable consideration, collectability,

and time value of money); (iii) distinguishing between a quality assurance and insurance warranty; (iv) presentation and disclosure requirements; and (v) transition provisions.

Retail and consumer

44. Most retail and consumer companies strongly opposed classifying certain payments to customers as an expense, rather than a reduction of revenue, as they do not agree that the payments are for distinct services and would not be made without the related product sale. Franchisors generally did not agree with the proposed accounting for license arrangements and variable consideration. There was specific concern with recognizing royalty revenue prior to the related sale by the franchisee. Further clarification was requested regarding how to apply the proposed license model to franchise rights.

Entertainment and media

45. Most respondents noted that revenue for licenses of intellectual property should not be based on exclusivity but on transfer of control of the intellectual property. Many respondents strongly suggested that variable consideration be included in the transaction price only once the related contingencies have been resolved and that a best estimate should be used, not the probability-weighted amount. Comment letters also noted concern with (i) the proposed accounting for collectability; (ii) transition provisions; and (iii) disclosure requirements.

Pharmaceutical and life sciences

46. Constituents were primarily concerned with the recognition of revenue that is contingent upon a future event. This may result in significant income statement volatility, systems costs to calculate probability-weighted estimates, and may result in less transparent financial statements. Other concerns included (i) consideration of credit risk in determining the amount of revenue to recognize; (ii) presentation and disclosure; (iii) transition provisions; and (iv) the need for additional implementation guidance.

Industrial products

47. Two areas of focus were noted—determination of the transaction price and accounting for warranties. There was a general preference that management's best estimate should be used to determine the transaction price as the probability-weighted estimate may result in a transaction price that is not indicative of the amounts expected to be received, and could result in significant volatility. There was also concern with recording subsequent changes in credit risk outside of revenue. Most respondents noted that it is impractical to determine whether defects are latent or the result of wear and tear and recommended that current guidance be retained (i.e., account for standard warranties as a cost accrual and extended warranties as a separate performance obligation).

Telecommunications

48. Telecom respondents noted that existing guidance regarding contingent consideration should be retained (i.e., use of the "cash cap"). That is, the amount recognized as revenue for the delivered performance obligation should be limited to the amount that is not contingent upon the future satisfaction of additional or undelivered performance obligations. Comment letters also focused on concerns with (i) the identification of performance obligations; (ii) collectability; (iii) contract modifications; (iv) time value of money; (v) transition requirements; (vi) variable consideration; (vii) accounting for licenses; and (viii) accounting for warranties.

Asset management

49. Respondents supported a standardized revenue recognition model but suggested several changes to the model to better reflect the economics of their contracts. Further clarification was requested regarding identification of performance obligations and variable consideration to allow earlier recognition of revenue for performance fees. Asset managers were generally opposed to accounting for onerous performance obligations as well as the proposed transition requirements.

Transportation and logistics

50. Key areas of concern included (i) more indicators are needed for the satisfaction of performance obligations for service transactions; (ii) onerous performance obligations; (iii) accounting for customer credit risk; (iv) disclosures; and (v) transition provisions.

Financial services

51. Respondents noted that loyalty programs provided by financial institutions (credit card companies) should not be within the scope of the exposure draft.

Automotive

52. Three areas of focus were noted—implementation guidance, transition, and accounting for warranties. Respondents requested additional implementation guidance specific to the industry and noted that retrospective adoption would not be operational. Respondents noted that determining whether defects are latent or the result of wear and tear is not practical. They recommended that current guidance be retained (i.e., account for standard warranties as a cost accrual and extended warranties as a separate performance obligation).

Revenue recognition . . . full speed ahead

Latest installment:
A joint FASB/IASB
exposure draft

What's inside:

Overview

Key provisions

Other considerations

Timing for comments

Industry insights

Reprinted from:

Dataline 2010–28
July 9, 2010

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

The above-referenced webpage also includes several industry-specific supplements to Dataline 2010–28.

Overview

At a glance

- The FASB and IASB (the “boards”) released an exposure draft on June 24, 2010 proposing a new revenue recognition standard that could significantly change the way entities recognize revenue.
- The proposed standard is a single, contract-based asset and liability approach in which revenue is recognized when an entity satisfies its obligations to its customers, which occurs when control of an asset (whether a good or service) transfers to the customer.
- The boards expect to issue the final standard in 2011, with a likely effective date no earlier than 2014. Full retrospective application will be required.
- Management will need to evaluate how the proposed standard might change current business activities beyond accounting, including contract negotiations, key metrics (including debt covenants), budgeting, controls and processes, and information technology requirements.

The main details

1. The boards' objective in issuing a converged standard is to increase the consistency of revenue recognition for similar contracts, regardless of industry. The boards noted that existing guidance under US generally accepted accounting principles (US GAAP) may, in some cases, provide different revenue recognition models for contracts with similar economic characteristics. Existing International Financial Reporting Standards (IFRS) contain less guidance than US GAAP on revenue recognition and the boards noted it is sometimes difficult to apply beyond simple transactions, leading to diversity in practice.

PwC observation: The proposed guidance will affect some companies more than others, although all

companies should expect some level of change. The boards have identified the following areas which may be significantly affected:

- Recognition of revenue based solely on the transfer of goods or services
- Identification of separate performance obligations
- Licensing and rights to use
- Effect of credit risk
- Increased use of estimates
- Accounting for contract related costs

2. This Dataline explores the proposed standard. The comment period ends on October 22, 2010.
3. The boards' conclusions are tentative and subject to change until they issue a final standard.

PwC observation: Since the discussion paper comment period ended in June 2009, the boards have continued to seek feedback through forums and direct interaction with constituents. The boards plan to hold public roundtable meetings once the comment period ends to solicit views and obtain additional information from interested parties. We encourage management to engage with the boards, comment on the exposure draft, and continue to monitor the boards' progress toward a final standard.

Key provisions

Asset and liability model

4. The proposed standard employs an asset and liability approach, the cornerstone of the FASB's and IASB's conceptual frameworks. Current revenue guidance under both frameworks focuses on an "earnings process," but difficulties often arise in determining when an entity earns revenue. The boards believe a single, contract-based model based on changes in contract assets and liabilities will lead to greater consistency in the recognition and presentation of revenue.

PwC observation: The proposed standard will represent a significant shift in how revenue is recognized in certain circumstances. It moves away from specific measurement and recognition thresholds and removes industry specific guidance. The effect could be significant, requiring management to perform a comprehensive review of

their existing contracts, business models, company practices and accounting policies.

The proposed standard may also have broad implications for an entity's processes and controls. Management may need to change their existing IT systems and internal controls in order to capture information to comply with the proposed guidance. The effect may also extend to other functions such as treasury, income tax, and human resources. For example, changes in the timing or amount of revenue recognized may affect long-term compensation arrangements, debt covenants, and other key ratios.

The proposed standard may also affect mergers and acquisitions in a number of ways, including deal models (e.g., amount and timing of revenue recognition may be different) and how earn-outs are triggered if determined based on revenue.

5. A contract with a customer includes a right to receive consideration and an obligation to provide goods or perform services. The entity has a contract asset when the rights exceed the obligations and a contract liability when the obligations exceed the rights. If an entity receives no consideration at inception of the contract, the contract position is zero and no entries are recorded.
6. An entity records a contract asset when it has a right to consideration from a customer due to the transfer of goods or services. A contract liability is recorded when the entity has received

consideration prior to transferring goods or services to the customer.

PwC observation: A contract asset or contract liability is recorded when consideration is received or performance obligations are satisfied. A contract asset exists when an entity satisfies a performance obligation, even though it might not have an unconditional right to receive the consideration. The contract asset is transferred to receivables when the right to receive consideration is dependent only on the passage of time.

Scope

7. The proposed standard focuses on an entity's contracts with customers. It defines a contract as *"an agreement between two or more parties that creates enforceable rights and obligations"*. A customer is *"a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities."* A contract can be written, verbal, or implied.
8. The proposed standard applies to an entity's contracts with customers, except for:
 - Lease contracts
 - Insurance contracts
 - Certain contractual rights or obligations within the scope of other standards, including financial instrument contracts
 - Certain guarantees (other than product warranties) within the scope of other standards
 - Nonmonetary exchanges whose purpose is to facilitate a sale to another party

9. Some contracts include components that are in the scope of the revenue standard and other components that are in the scope of other standards (e.g., a lease contract that also includes maintenance services). An entity applies the other standard first if that standard specifies how to separate or measure components of a contract. Otherwise, the principles in the revenue standard are applied.

PwC observation: The proposed standard addresses contracts with customers across all industries rather than focusing on specific industries. Industry-specific guidance will be replaced by the proposed standard. As part of the comment letter process, the boards are requesting feedback on whether any aspects of the proposed standard should be different for nonpublic companies, including private companies and not-for-profit organizations.

Most transactions accounted for under existing revenue standards will be within the scope of the proposed standard. Transactions in industries that recognize revenue without a contract with a customer (e.g., certain biological, agricultural, or extractive industries) are not in the scope.

10. Management will need to carefully assess performance obligations in contracts to ensure they have identified the appropriate standard to follow for separation of performance obligations and the measurement of consideration allocated to those obligations. For example, the proposed standard requires use of relative

selling price for allocation of consideration to performance obligations, while other standards may require use of fair value or other measures. This difference will affect the consideration allocated to a performance obligation at inception of a contract.

Applying the model

11. Entities will perform the following five steps in applying the proposed standard:
- Identify the contract with the 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 each performance obligation is satisfied

PwC observation: A *performance obligation* is similar to what is known today as a deliverable, element, or component of an arrangement. See further discussion of performance obligations at paragraph 19 below.

The *transaction price* is the consideration the seller expects to receive from the buyer in exchange for providing goods or services. See further discussion of measuring the transaction price in an arrangement at paragraph 26 below.

Identify the contract with the customer

12. The proposed standard applies to contracts with customers, whether

written, verbal or implied. There is a wide array of common business practices and legal requirements associated with customer contracts, across geographical and business boundaries. Management will need to consider not only written contracts, but also customary practices to determine whether a contract exists.

13. A contract exists only if:

- The contract has commercial substance
- The parties to the contract have approved the contract and are committed to satisfying their respective obligations
- The entity can identify each party's enforceable rights regarding the goods or services to be transferred (i.e., determine the performance obligations)
- The entity can identify the terms and manner of consideration to be paid by the customer

14. An entity may need to combine two or more contracts, or segment (i.e., divide) one contract into two or more contracts, to properly reflect the economics of the underlying transaction.

15. An entity should combine two or more contracts into one if the prices of those contracts are interdependent. Contracts generally have interdependent pricing if they are:
- Entered into at or near the same time
 - Negotiated as a package with a single commercial objective
 - Performed concurrently or consecutively

16. The price of a contract is not interdependent with the price of another contract solely because the customer receives a discount on goods or services in the contract as a result of an existing customer relationship arising from previous contracts.

17. Management should segment one contract into two or more contracts if some goods or services priced within the contract are independently priced from other goods or services in that contract. Contracts have goods or services with independent pricing if:

- The entity, or another entity, regularly sells the goods or services on a standalone basis, and
- The price for all goods or services in the contract approximate the sum of the standalone selling price for each good or service (i.e., there is not an inherent discount for the purchase of bundled goods/services).

PwC observation: The boards believe that contract segmentation ensures that the accounting reflects the economics of the underlying transaction. For example, the segmentation of a contract may be important when variable consideration included in the transaction price relates to only one obligation in a contract (see further discussion in paragraphs 28–30 below). Changes in variable consideration for separate contracts are allocated only to the contract to which the variable consideration relates. Changes in variable consideration in a single contract are allocated to all performance obligations based on the ratio used to allocate the

transaction price to performance obligations at inception.

18. A contract modification is combined with the original contract if the prices of the original contract and the modification are interdependent (i.e., treat the modification and original contract as one contract). Management first considers the factors in paragraph 13 above to determine whether a contract modification exists. Management then considers the factors in paragraphs 15 and 17 above to determine whether a modification is priced interdependently or independently of the original contract.

PwC observation: Contract modifications come in a variety of forms. A modification can be a change in the scope of work, a change in pricing, or both. It is unclear how the proposed standard applies to some modifications. For example, it is common in some industries (such as aerospace and defense, and engineering and construction) for the parties to agree on a modification to the scope of the work, but agree subsequently on pricing (i.e., unpriced change orders). Significant judgment has been and will continue to be required to determine whether a change order, particularly an unpriced change order, is interdependent or independent of the original contract.

Modifications that are priced interdependently with the original contract may result in a cumulative catch up adjustment to revenue at the time of the modification.

Identify and separate performance obligations in the contract

19. 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. A contract may explicitly state performance obligations, but they may also arise in other ways. Legal or statutory requirements may create performance obligations even though such obligations are not explicit in the contract. Customary business practices, such as an entity's practice of providing customer support, might also create a performance obligation.

PwC observation: Identifying the performance obligations in a contract is critical in applying the proposed standard, as the identification of performance obligations affects:

- How the transaction price is allocated
- The timing of revenue recognition, which is based on satisfaction of performance obligations
- The recognition of onerous performance obligations (see paragraphs 43–44 below for further discussion of onerous performance obligations)

20. The objective of identifying and separating performance obligations is to ensure that revenue is recognized when such obligations are satisfied (i.e., when goods and services are transferred to the customer). Careful evaluation is required to identify all performance obligations in a contract.

21. It is not generally necessary to account for performance obligations separately if they are satisfied at the same time or over the same period of time. An entity might need to account for performance obligations separately if it transfers the promised goods or services at different times (or continuously).

PwC observation: Separation of performance obligations may be necessary in other situations, even if not required for revenue recognition purposes. For example, management may need to separate a contract that provides for the concurrent transfer of goods or provision of services for income statement presentation or segment disclosures.

22. An entity recognizes revenue from performance obligations separately if they are *distinct* from other goods or services promised in the contract and are delivered separately.

23. A good or service is distinct and accounted for separately if the entity or another entity sells an identical or similar good or service separately. A good or service that has a distinct function *and* a distinct profit margin from the other goods or services in the contract is also distinct, even if not sold separately.

24. A good or service has a distinct function if it provides utility either on its own or together with other goods or services available in the marketplace. A good or service has a distinct margin if it is subject to distinct risks and the entity can identify the

resources needed to provide the good or service.

PwC observation: The determination of whether a good or service is distinct will require judgment on the part of management and an understanding of how other goods or services sold in the market may interact with the entity's products.

Each performance obligation does not have to have a different profit margin (i.e., a different amount or percentage) to be distinct. Rather, a profit margin must be identifiable for each performance obligation in order for them to be distinct. The proposed standard does not specify how to determine whether a good or service is subject to distinct risks or how this determination relates to a good or service having a distinct margin.

Consider an example where an entity sells specialized electronic equipment. The entity's contract price for the equipment includes delivery and installation at the customer's site. The equipment does not require any modifications or enhancements (other than installation) in order to be used by the customer. The entity typically installs the electronic equipment, although other entities could install the equipment.

The entity has two separate performance obligations if control of the equipment transfers upon delivery and the equipment is distinct from the installation. The entity would not account for the two performance obligations separately if

control of the equipment transfers only upon successful installation.

The equipment has a distinct function because it has utility together with installation services that are available from other entities. Assuming the entity can separate the costs of the electronic equipment from the costs of installation, the profit margin on the equipment is also distinct from the margin on the installation.

The equipment and the installation are distinct in this example.

25. Management combines goods or services that are not distinct with other goods or services until there are bundles of goods or services that are distinct. The combination of goods or services that are not distinct on their own may result in an entity accounting for all the goods and services promised in the contract as a single performance obligation.

PwC observation: Management will need to consider carefully which performance obligations are combined to create a "distinct" performance obligation and should not default to combining all performance obligations in a contract. Each contract must be assessed to determine the risks, margins, and the timing of the transfer of control of individual performance obligations. Performance obligations that have different risks or margins and for which control transfers at different times should not be combined.

Determine the transaction price

26. The transaction price in a contract reflects the consideration the customer promises to pay in exchange for goods or services.

27. The transaction price is readily determinable in some contracts because the customer promises to pay a fixed amount of cash due when the entity transfers the promised goods or services. In other contracts, management will need to consider a number of variables when determining the transaction price, such as:

- Variable consideration
- Collectability
- Time value of money
- Noncash consideration
- Consideration paid to a customer

PwC observation: Companies will need to apply significant judgment to determine the transaction price when it is subject to the variables noted above.

Amounts collected on behalf of third parties (e.g., sales taxes) will not be presented in revenue under the proposed standard. Such amounts are excluded from the transaction price.

Variable consideration

28. The transaction price may include an element of consideration that is variable or contingent on the outcome of future events, including (but not limited to) discounts, rebates, refunds, credits, incentives, and performance bonuses. When a contract includes variable consideration, the transaction

price includes the probability-weighted estimate of variable consideration receivable. This estimate requires management to assess the probability of each possible outcome.

PwC observation: Variable consideration, also commonly referred to as contingent consideration, can come in a variety of forms. Some contingencies may relate to future performance by the seller that is fully within the seller's control, while other contingencies may only be resolved by the actions of the buyer or other third parties. The amount of judgment needed to estimate variable consideration will depend on the nature and terms of the contingency.

29. An estimate of variable consideration is included in the transaction price when management can make a reasonable estimate of the amount to be received. The proposed standard states that an estimate is reasonable only if an entity:

- Has experience with similar types of contracts (or can refer to the experience of other entities if it has no experience of its own); and
- Does not expect circumstances surrounding those types of contracts to change significantly (i.e., experience is relevant to the contract)

30. Management should assess whether circumstances may reduce the relevance of an entity's experience, including:

- The impact of external factors
- The length of time until the uncertainty is expected to be resolved

- The extent of the experience
- The number of possible consideration amounts

PwC observation: Some industries and entities may experience a significant change in the timing of revenue recognition due to the proposed treatment of variable consideration. Variable consideration that management can estimate reasonably is included in the transaction price at the probability-weighted amount. The proposed standard requires an assessment of variable consideration at contract inception and at each reporting period. Entities might recognize revenue earlier than under existing guidance when management can reasonably estimate variable consideration. Significant change may also arise in industries where revenue is currently restricted to the cash received because revenue is contingent on a future event.

Throughout the contract life management will assess variable consideration that cannot be reasonably estimated at contract inception. Revenue is recorded when a reasonable estimate can be made. An entity might recognize revenue before the contingency is resolved in most cases, which may increase the volatility of reported results.

The boards have included factors to consider in determining whether management can make a reasonable estimate of variable consideration. Entities with similar transactions may recognize revenue at different times if one entity determines that it can reasonably

estimate variable consideration while another entity concludes it cannot. These differences may be the result of entities having different levels of experience or operating in different markets.

Collectability

- 31.** Collectability refers to the customer's ability to pay the consideration agreed in the contract. The transaction price is adjusted to reflect the customer's credit risk by recognizing the consideration expected to be received on a probability-weighted basis.
- 32.** Changes in the assessment of consideration to be received due to changes in credit risk are recognized as income or expense, separately from revenue.

PwC observation: Current guidance requires that revenue is recognized when payment is reasonably assured (or probable). As collectability is no longer a recognition threshold, revenue may be recognized earlier than current practice. Collectability affects the measurement of revenue under the proposed standard, as credit risk is reflected as a reduction of the transaction price at contract inception rather than as bad debt expense. Subsequent changes to the assessment of collectability will be recognized as income or expense, rather than as revenue.

Time value of money

- 33.** The transaction price should reflect the time value of money whenever the effect is material. Management should use a discount rate that reflects

a financing transaction between the entity and its customer that does not involve the provision of other goods or services.

PwC observation: Management will need to consider the time value of money for a contract that includes a material financing component. However, the proposed standard does not specify the length of time to consider when determining whether a financing component is material. Management should consider the credit characteristics of the customer to determine the discount rate used.

The following example illustrates the accounting for a customer payment made in arrears when a material financing component exists:

An entity sells a product for \$50,000 with payment due two years after delivery of the product. The entity determines that an 8 percent discount rate is appropriate based on the two year term and the credit characteristics of the customer. Revenue of \$42,867 ($\$50,000 / (1.08 \times 1.08)$) is recognized when the entity transfers the product to the customer. The entity has an unconditional right to consideration upon transfer of the product and records a receivable, rather than a contract asset.

The following example illustrates the accounting for customer payment made in advance when a material financing component exists:

An entity sells a product to a customer for €10,000 with payment due one year before the delivery of the product. The entity recognizes

a contract liability of €10,000 when the customer pays the consideration. The entity determines that a 5 percent discount rate is appropriate based on the one year term and the credit characteristics of the entity. The entity recognizes interest expense of, and increases the measurement of the performance obligation by, €500 ($(€10,000 \times 1.05) - €10,000$) during the year before it transfers the product. The carrying amount of the contract liability is €10,500 ($€10,000 + €500$) immediately before the performance obligation is satisfied. The entity records revenue of €10,500 when the product is transferred to the customer. This is a significant change from current practice.

The accounting for the time value of money may result in a significant change for certain entities, particularly in situations where consideration is paid in advance as the amount of revenue to be recognized could be greater than the amount of consideration ultimately received. Determining whether the time value element in a contract is material could be particularly challenging in long-term or multiple-element arrangements where product/service delivery and cash payments may occur throughout the arrangement.

Noncash consideration

- 34.** An entity measures noncash consideration received for satisfying a performance obligation at its fair value. When management cannot estimate fair value reliably, the entity

measures the noncash consideration received indirectly by reference to the standalone selling price of the goods or services transferred in exchange for the consideration.

Consideration paid to a customer

- 35.** Consideration paid to a customer (e.g., cash or credit) is assessed to determine if the amount should be reflected as a reduction of the transaction price or as a payment for discrete goods or services received from the customer.
- 36.** An entity reduces revenue when it pays consideration to a customer at the later of when:
- The entity transfers the promised goods or services to the customer; or
 - The entity promises to pay the consideration (even if the payment is conditional on a future event). That promise may be implied by customary business practice.

PwC observation: The underlying concepts for both noncash consideration and consideration paid to a customer (e.g., rebates expected to be paid to customers) are consistent with current revenue guidance under US GAAP and IFRS. We do not anticipate a significant change in these areas upon adoption of the proposed standard.

Allocate the transaction price to the separate performance obligations

- 37.** Consideration should be allocated to separate performance obligations in a

contract based on relative standalone selling prices.

PwC observation: The proposed standard will significantly affect entities that currently use the residual method to allocate arrangement consideration. The proposed standard does not permit this method. Management will need to make an estimate of selling price for each separate performance obligation when the standalone selling price is not available. Use of estimated selling prices will often result in earlier revenue recognition for entities currently applying the residual method. The residual method allocates the discount inherent in an arrangement to the first performance obligation satisfied rather than spreading the discount ratably over all performance obligations. The proposed standard requires the discount to be spread ratably.

Estimating standalone selling prices

- 38.** The best evidence of standalone selling price is the observable price of a good or service when the entity sells that good or service separately. Management will need to estimate the selling price if a standalone selling price is not available. In doing so, management should maximize the use of observable inputs. Possible estimation methods include:
- Cost plus a reasonable margin
 - Standalone sales prices of the same or similar products, if available
 - Cash flow models or other valuation techniques

PwC observation: Estimating the standalone selling price of performance obligations is a key aspect of applying the proposed standard. Management should not presume that a contractual price (i.e., list price) reflects the standalone selling price of a good or service. The proposed standard should result in a better reflection of the economics of the transaction, but it may create challenges in developing, documenting, and supporting the estimated standalone selling price. It is important that management consider whether new internal systems and processes (and related internal controls) are required to support the process of developing estimates and allocating transaction price.

Recognize revenue when performance obligations are satisfied

- 39.** Revenue should be recognized when a promised good or service is transferred to the customer. An entity transfers a promised good or service and satisfies a performance obligation when the customer obtains control of that good or service. A customer obtains control of a good or service if it has the ability to direct the use of and receive the benefit from the good or service.
- 40.** Performance obligations can be satisfied at a point in time or continuously over time. Management should use judgment to assess the transfer of control for each separately identified performance obligation in a

contract. Indicators that the customer has obtained control of the good or service may include:

- The customer has an unconditional obligation to pay
- The customer has legal title
- The customer has physical possession
- The customer specifies the design or function of the good or service

PwC observation: These indicators are not a checklist nor are they exhaustive. Management should consider all relevant facts and circumstances to determine whether the customer has obtained control of the good or service. Other potential indicators that control may be transferring continuously might include: (1) whether the customer has the unilateral ability to sell or pledge the asset, for example, as collateral; or (2) whether the customer has custodial risk of loss associated with the asset.

Continuous transfer of goods and services

- 41.** An entity may transfer control of a good or service to the customer continuously as it manufactures the goods or performs the services. Management should consistently apply the method that best depicts the transfer of goods or services to determine how much revenue to recognize when control is transferred continuously. This may be a straight-line basis if the entity transfers goods or services continuously and evenly over time to the customer throughout the contract.

Management should apply the same method to similar contracts.

PwC observation: Management that currently use the percentage of completion method should review their contracts to determine whether control transfers continuously during construction. The percentage of completion method, as a standalone model, will no longer exist. Entities that transfer control of the asset under construction continuously will recognize revenue as control transfers, not using a completed contract method. The resulting revenue recognition may be similar to today's accounting if an entity currently recognizes revenue based on the transfer of assets to the customer.

- 42.** Methods for recognizing revenue when control transfers continuously include:
- Output methods that recognize revenue on the basis of units produced, units delivered, contract milestones, or surveys of work performed
 - Input methods that recognize revenue on the basis of costs incurred, labor hours expended, or machine hours used
 - Methods based on the passage of time

PwC observation: Management will need to consider the relevant facts and circumstances to determine whether there is continuous transfer of control. Careful consideration is also needed to determine which measurement method most

appropriately reflects transfers of goods or services to the customer. In particular, use of input methods or recognition based on the passage of time need to reflect the transfer of control of the good or service to the customer, rather than simply reflecting the activities of the entity. A consistent measurement method might not be applicable for all types of contracts an entity enters into if the contracts differ.

Subsequent measurement

- 43.** Performance obligations are assessed at contract inception and at each reporting date to determine whether the obligation has become onerous. A performance obligation is onerous when the present value of the probability-weighted direct costs to satisfy the obligation exceed the consideration (i.e., the amount of transaction price) allocated to it. Prior to recognizing a liability for an onerous performance obligation, the entity should recognize any impairment loss on assets directly related to the contract.
- 44.** Onerous performance obligations should be updated each reporting period using current estimates. Any changes in the measurement of the liability would be recorded as an expense or a reduction of an expense. The entity reduces the expense previously recorded on satisfaction of the onerous performance obligation.

PwC observation: Direct costs include direct materials, direct labor, indirect costs that are either specifically attributable to

the contract or specifically reimbursable under the terms of the contract, and those costs that are incurred only because the entity entered into the contract.

The proposed standard may represent a significant change for US GAAP and IFRS. US GAAP does not permit accounting for onerous contracts outside of certain specific guidance (e.g., construction contract guidance). IFRS guidance generally requires an assessment of onerous contracts at the contract level, not the performance obligation level. An assessment at the performance obligation level may lead to an entity recognizing a liability for performance obligations that are onerous even though the overall contract is profitable. Management may be reluctant to enter into contracts that include loss-making performance obligations with the expectation of overall profitability in light of this proposed guidance.

It is not necessary to account for performance obligations separately if they are satisfied at the same time. However, it is unclear how a contract to provide services concurrently would be accounted for if one of the obligations is onerous. The proposed standard does not address whether the entity would be required to separate concurrent services to account for one performance obligation that was onerous.

- 45.** Management must remeasure the contract asset each reporting period, or as circumstances change, to reflect

changes in the transaction price. An entity should allocate these changes to separate performance obligations on the same basis as at contract inception (i.e., using the same allocation percentages) and recognize those changes in the revenue allocated to satisfied performance obligations as revenue in the period of change.

Disclosure

- 46.** The boards believe that the proposed disclosures will assist users of financial statements in understanding the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

- 47.** Disclosures will focus on:

- Qualitative and quantitative information about performance obligations, rights to consideration, and onerous performance obligations to help users understand the characteristics of the entity's contracts with customers.
- The significant judgments and changes in judgments that will explain the effect of those judgments on the timing and amount of revenue recognized in the financial statements. These disclosures should include (a) the effect on the amount of revenue recognized in the current period, and (b) an indication of the expected effect on the timing and amount of revenue that will be recognized in future periods.

PwC observation: The disclosure requirements are more detailed than currently required under US GAAP or IFRS and focus

significantly on the judgments made by management.

Management should carefully consider how much information should be disclosed about the anticipated impact of the proposed standard on the entity's financial statements before the effective date. Management may need to include increasing disclosure about the impact of adoption as the adoption date approaches.

Transition

- 48.** The proposed standard requires full retrospective application, including application to those contracts that do not affect current or future periods, but affect reported historical periods.

PwC observation: The boards have not decided on the effective date for the proposed standard, but they have discussed possible effective dates no earlier than 2014 to provide management adequate time to prepare for and implement the proposed standard. The boards plan to seek separate feedback on the effective date because of the volume of proposed standards expected in 2011.

The boards intend that retrospective application will drive consistency in reporting among periods presented as well as among entities. The transition requirements may affect some entities more than others, depending on the number of reporting periods included in an entity's financial statements as well as the number and nature of contracts outstanding at adoption of

the proposed standard. We expect the effort and cost required for full retrospective application will have a significant impact on some entities.

Although the proposed standard does not address early adoption, the FASB prefers to prohibit early adoption while the IASB proposes that first time adopters of IFRS be allowed to adopt early.

Other considerations

Identification of performance obligations

49. The boards considered the impact of the following items on the identification of performance obligations in a contract:

- Principal versus agent
- Options to acquire additional goods or services
- Licenses and rights to use
- Rights of return
- Product warranties and product liabilities
- Nonrefundable upfront fees

Principal versus agent

50. Management will need to consider whether the entity is acting as a principal or an agent in a contract. An entity would recognize revenue gross if it is the principal, and net if it is acting as an agent. The entity is acting as a principal if its performance obligation is to provide the goods or services. It is acting as an agent if it is arranging for another party to provide those goods or services.

51. The entity acting as the principal should recognize revenue gross when it obtains control of the goods or services of another party in advance of transferring those goods or services to the customer.

52. An entity that does not obtain control of the goods or services should consider whether it is acting as an agent. Indicators that the company is acting as an agent include:

- The other party has primary responsibility for fulfillment of the contract (i.e., primary obligor)
- The entity does not have inventory risk
- The entity does not have discretion in establishing prices
- The entity does not have customer credit risk
- The entity's consideration is a commission

PwC observation: This proposed principle and list of indicators is consistent with current guidance under US GAAP and IFRS. We do not anticipate significant change in this area.

Options to acquire additional goods or services

53. An entity may grant a customer the option to acquire additional goods or services. That promise gives rise to a performance obligation if the option provides a material right to the customer that the customer would not receive without entering into the contract. The entity should recognize revenue allocated to the option when the option expires or when it

transfers additional goods or services to the customer.

54. The estimate of a standalone selling price for a customer's option to acquire additional goods or services will reflect the discount the customer obtains when exercising the option. The estimated selling price is adjusted for:

- The discount that the customer would receive without exercising the option
- The likelihood that the option will be exercised (i.e., breakage/forfeiture)

55. A contract may include renewal options (i.e., an option for goods or services similar to the original goods or services) or cancellation clauses. An entity may allocate the transaction price to the optional goods or services by reference to the goods or services it expects to provide and the expected consideration.

56. An option to acquire additional goods or services at their standalone selling price does not provide the customer with a material right, even if it arises only because the customer entered into the previous contract. Such an option is a marketing offer, which does not provide the customer with a material right.

PwC observation: Options come in a variety of forms including sales incentives, customer award credits (or loyalty points), contract renewal options, volume discounts, and other discounts on future goods or services. The accounting for these options as separate performance obligations may be a significant change from existing guidance.

The following example illustrates the accounting for a customer loyalty program.

An entity provides a customer loyalty program to its customers. The program grants customers one point per £10 spent on purchases. Each point earned has a cash value of £1, which the customer may redeem against future purchases. Customers purchase products for £1,000 and earn 100 points redeemable against future purchases. Management expects that customers will redeem 95 of the 100 points earned. Management also estimates that the standalone selling price of one point is £0.95 based on the history of redemption. The standalone selling price of the products to customers without the points is £1,000.

The option (i.e., the points) provides a material right to the customer, so the entity will allocate the transaction price between the product and the points on a relative estimated selling price basis as follows:

Product	£913	$(1,000 \times 1,000 \div 1,095)$
Points	£87	$(95 \times 1,000 \div 1,095)$

Customers redeem 65 points at the end of the first year and management continues to expect that customers will ultimately redeem 95 points. The entity therefore recognizes revenue of £60 $(65 \div 95 \text{ points}) \times (£87)$ related to the option.

Customers redeem an additional 20 points in the second year (cumulative points redeemed are 85). Management has revised its estimate of total redemptions from

95 points to 98 points. Cumulative revenue for the option is £75 $(85 \div 98) \times (£87)$. Because the entity previously recognized option revenue of £60 in year one, it recognizes £15 $(£75 - £60)$ of incremental revenue in year two for the option.

Customers have redeemed 98 points at the end of the third year. Management continues to expect that customers will redeem only 98 points. Cumulative revenue at the end of the third year is £87. The entity recognizes an additional £12 $(£87 - £75)$ for the option in year three.

Licenses and rights to use

57. The recognition of revenue for the license of intellectual property depends on whether the customer obtains control of the asset. The contract is a sale (rather than a license or a lease) of intellectual property if the customer obtains control of the entire licensed intellectual property (e.g., the exclusive right to use the license for its economic life). The entity recognizes revenue when control of the intellectual property transfers if the transaction is a sale.
58. The performance obligation is satisfied over the term of the license if the customer licenses intellectual property on an exclusive basis but does not obtain control for the entire economic life of the property. The entity generally recognizes revenue over the term of the license in this situation.
59. A contract that provides a nonexclusive license for intellectual property (e.g., off-the-shelf software) is a single performance obligation. An

entity recognizes revenue when the customer is able to use the license and benefit from it (i.e., when control transfers but no earlier than the beginning of the license period).

PwC observation: A license is accounted for as a sale if it is for substantially all of the intellectual property's economic useful life or if the license of the intellectual property is granted on a non-exclusive basis. A license is accounted for over the term of the license only when it is provided on an exclusive basis for less than the asset's economic life.

Entities may grant exclusive rights by reference to time, geography, or distribution channel or medium. The proposed standard clarifies when a license is exclusive, but it is unclear how an entity should determine the economic life of the asset when it can re-license the intellectual property subsequently in the same window or territory once the existing license expires. Determination of the licensed asset (i.e., the unit of account) and the related economic life will be crucial in determining when revenue is recognized.

Rights of return

60. An entity will account for the sale of goods with a right of return as follows:
 - Revenue is not recognized for goods expected to be returned and a liability is recognized for the refund to be paid to customers, using a probability-weighted approach

- The refund liability is updated for changes in expected refunds
- An asset and corresponding adjustment to cost of sales is recognized for the right to recover goods from customers when the entity settles the refund liability. The asset is initially measured at the original cost of the goods less any expected costs to recover those goods (that is, the former carrying amount in inventory less costs to recover the products)

61. A contract that provides the customer with the right to exchange one product for another product of the same type, quality, condition, and price (e.g., a red shirt for a blue shirt), does not provide the customer with a return right.

PwC observation: The accounting for return rights is similar to today's failed sale model (i.e., an entity does not recognize revenue for goods it expects customers to return). Entities that are unable to estimate returns will be precluded from recognizing revenue prior to the lapse of the return right. The proposed standard will require full derecognition of inventory that an entity has sold and recognition of an asset for the entity's right to recover goods from the customer. The return right (i.e., the asset) is assessed for impairment in accordance with existing standards.

Product warranties and product liabilities

62. The proposed standard draws a distinction between quality assurance warranties and insurance warranties.

A quality assurance warranty provides a customer with coverage for latent defects (i.e., those that exist when the asset is transferred to the customer but that are not yet apparent). This warranty does not give rise to a separate performance obligation but recognizes the possibility that the entity has not satisfied its performance obligation. In other words, the entity has not provided an asset that operates as intended at the time of delivery. Management will need to determine the likelihood and extent of defects in the products it has sold to customers at each reporting period to determine the extent of unsatisfied performance obligations. An entity does not recognize revenue at the time of sale for defective products that it will subsequently replace in their entirety. Management will defer revenue for warranties that require replacement or repair of components of an item, but only for the portion of revenue attributable to the components that it must repair or replace.

63. An insurance warranty provides a customer with coverage for faults that arise after the entity transfers control to the customer (e.g., normal "wear and tear"). Insurance warranties give rise to a separate performance obligation. The entity allocates a portion of the transaction price to insurance warranties at contract inception.

64. Management will need to consider the following factors to determine whether a warranty provides coverage for latent defects or for faults that arise subsequent to the transfer of the product to the customer:

- Whether the warranty is required by law

- Whether the product could have been sold without the warranty
- The length of the warranty coverage period

65. A warranty required by law to protect the customer from the risk of purchasing defective products is not a performance obligation. A warranty sold on a standalone basis or as an optional extra (e.g., an extended warranty) is a performance obligation. Products that cannot be sold without a warranty suggest that the warranty is not a performance obligation. A longer coverage period suggests that the warranty or part of the warranty is a performance obligation.

66. Product liability obligations (e.g., when an entity is legally obligated to pay consideration if its products cause harm or damage), are not performance obligations. An entity accounts for these liabilities in accordance with ASC 450-20, *Loss Contingencies*, or IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

PwC observation: Management will need to use significant judgment to determine whether a defect is latent or has arisen subsequent to a sale. It may also be difficult to apply the guidance for quality assurance warranties when the entity is required to repair or replace only a component of the asset sold. For example, the contract may have only one performance obligation (e.g., the sale of a car) but the entity may be required to determine the amount of consideration associated with individual components of the car

(e.g., the seats or the brakes) that are expected to be defective and subsequently repaired.

An insurance warranty includes standard and extended warranties that the entity uses to provide the customer with coverage for faults that arise after control of the product has transferred. Management will be required to allocate a portion of the transaction price to the insurance warranty at the inception of the contract regardless of whether the insurance warranty is standard with the sale of a product or an extended warranty.

The accounting for warranties is a significant change from current practice under both frameworks. Entities currently account for standard warranties as a liability for the expected costs to repair defective products based on experience with similar contracts. Entities will not recognize revenue for defects that exist at the time of the original sale under the proposed standard.

It may be necessary to separate a warranty between a quality assurance warranty and an insurance warranty when an entity provides coverage for defects that may exist when the product is transferred to the customer as well as for defects that arise after control of the asset has transferred. This may require a significant amount of estimation and judgment. Entities may be required to allocate revenue to the portion of the standard warranty that provides coverage for defects arising after sale (i.e., insurance warranties), which will alter the

timing of revenue recognition for certain product sales.

It is unclear how an entity would account for situations in which a customer can receive either cash or require specific performance in the satisfaction of an obligation (e.g., a cash settled warranty).

Nonrefundable upfront fees

67. Management will need to determine whether a nonrefundable upfront fee relates to a separate performance obligation.

68. A nonrefundable upfront fee may relate to an activity undertaken at or near contract inception, but it does not indicate satisfaction of a separate performance obligation if the activity does not result in the transfer of a promised good or service to the customer.

69. If the nonrefundable upfront fee relates to a performance obligation, management will need to determine whether that performance obligation is distinct from the other performance obligations in the contract.

PwC observation: Entities currently account for nonrefundable upfront fees separately when they result in the culmination of a separate earnings process. The terminology has changed under the proposed standard, but we expect the accounting for nonrefundable upfront fees to be consistent with current practice.

A nonrefundable upfront fee that is not related to a separate performance obligation is included in the transaction price and allocated to

the separately identified performance obligations.

Satisfaction of performance obligations

70. The boards also considered the impact of the following items on the satisfaction of performance obligations in a contract:

- Determining whether a good or service is transferred continuously
- Bill-and-hold arrangements
- Consignment arrangements
- Sale and repurchase of a product
- Customer acceptance

Determining whether a good or service is transferred continuously

71. Many contracts clearly identify when a good or service is transferred to the customer. It may, however, be difficult to determine when a good or a service is transferred to the customer in contracts that include the production, manufacture, or construction of an asset.

72. If the customer has the ability to direct the use of and receive the benefit from the work in process (rather than the completed asset), control of the good or service may transfer continuously and revenue is recognized as the services are performed.

73. If the customer does not control the asset as it is produced, manufactured, or constructed, control of the completed asset transfers and thus revenue is recognized when the customer obtains control of the completed asset.

PwC observation: Revenue is recognized when control transfers to the customer. Management should carefully consider how and when control transfers. The point at which control transfers will be clear in many contracts, however, it may be difficult to determine when control transfers in certain contracts. For example, a contract may require an entity to issue a report at the end of a consultation or investigative period. Does control transfer as the services are being performed or when the report is issued? This will depend on the facts and circumstances of the arrangement and the nature of the services. Management will need to consider if the services have utility to the customer without the report.

Consider, for example, a consulting services agreement in which a final report will be issued at the end of the contract period. The consulting services are intended to identify efficiencies in the accounting and financial reporting function and will be performed over a one year period. The scope of services is determined by the customer and may be changed at any time during the contract term. The customer will pay the consultant \$25,000 per month for services provided and is entitled to any analysis or insight developed by the consultant throughout the contract period. The customer has the ability to specify the scope of work performed, change the scope at any point, access information obtained, and is required to pay for services performed, so the customer has the ability to direct the use of, and benefit from, the consulting

services as they are performed. Therefore, the consultant's performance obligation is to provide consulting services over a one year period on a continuous basis.

Bill-and-hold arrangements

74. In some contracts, an entity bills a customer for a product but does not ship the product until a later date (a bill-and-hold arrangement).
75. Revenue is recognized under the proposed standard on transfer of control of the asset to the customer, so management will therefore need to consider the following factors in determining whether the customer has obtained control in a bill-and-hold arrangement:
 - The customer must have requested the contract be on a bill-and-hold basis;
 - The product must be identified separately as the customer's;
 - The product must be ready for delivery at the time and location specified by the customer; and
 - The entity cannot have the ability to sell the product to another customer.
76. Management should also consider the following indicators in determining whether the customer has obtained control in a bill-and-hold arrangement:
 - Whether the entity's usual payment terms have been modified;
 - The possibility that the customer may cancel the contract before delivery occurs; and
 - Whether the arrangement meets the definition of a contract explained in paragraph 12 above.

77. If an entity recognizes revenue on a bill-and-hold transaction, management will need to consider whether the custodial services are a material separate performance obligation to which it should allocate some of the transaction price.

PwC observation: This proposed principle and list of indicators is consistent with current revenue guidance under US GAAP and IFRS, but management will need to consider all relevant facts and circumstances and use significant judgment to determine whether control has transferred in a bill-and-hold arrangement. We do not anticipate a significant change in this area upon adoption of the proposed standard.

Consignment arrangements

78. Certain industries transfer goods to dealers or distributors on a consignment basis. The transferor typically owns inventory on consignment until a specified event occurs, such as the sale of the product to a customer of the distributor, or until a specified period expires.
79. Management will need to consider the following factors to determine whether revenue should be recognized on transfer to the distributor or on ultimate sale to the customer:
 - Whether the dealer is obligated to pay for the goods only if the dealer sells them
 - Whether the dealer can return the products
 - Whether the dealer obtains a commission for selling the products to the end customer

PwC observation: This proposed principle and list of indicators is consistent with current revenue guidance under US GAAP and IFRS. We do not anticipate a significant change in this area on adoption of the proposed standard. However, the proposed standard focuses on transfer of control rather than the transfer of risks and rewards, so some entities may experience a change in their accounting.

Sale and repurchase of a product

80. When an entity sells a product to a customer that includes an unconditional right to require the entity to repurchase that product in the future, the entity should account for the transaction as a sale of a product with a right of return (see paragraphs 60–61 above).

81. When the entity has an unconditional obligation or unconditional right to repurchase the asset (a forward or a call option), the buyer does not obtain control of the asset and the entity accounts for the transaction as follows:

- A lease, if the entity repurchases the asset for less than the original sales price of the asset; or
- A financing arrangement, if the entity repurchases the asset for an amount that is equal to or more than the original sales price of the asset.

82. The entity continues to recognize the asset, together with a financial liability, for any consideration received from the buyer in a financing transaction. It records the difference between the amount of consideration received from the customer and the amount of consideration paid as interest expense.

PwC observation: An entity may enter into an agreement to repurchase goods sold to a customer. Management will need to consider whether control of the goods transferred to the customer in the intervening period to assess whether a sale has occurred or whether the arrangement is in substance a lease.

Customer acceptance

83. Management will need to determine whether the customer has obtained control of the good or service prior to acceptance if the contract includes a customer acceptance provision.

84. Customer acceptance may be a formality if the entity can objectively determine that the good or service has been transferred to the customer in accordance with the specifications in the contract.

85. The entity does not recognize revenue prior to acceptance if it is unable to objectively determine that the good or service transferred to the customer meets the contract specifications. This is because management cannot determine whether it has satisfied the performance obligation.

86. When a contract allows the customer a trial or evaluation period, control transfers either upon customer acceptance of the good or at the end of the trial or evaluation period.

PwC observation: The proposed principle for accounting for contracts that include customer acceptance clauses is similar to current revenue guidance. Management will need to carefully consider the terms of the contract and whether they have the ability to objectively determine whether the

good or service meets the contractual terms in order to support that control has transferred prior to customer acceptance.

Factors that may support management's ability to determine objectively that it has met the contract specifications include:

- The entity's historical experience with meeting specified terms
- Whether outside factors could affect acceptance
- The entity's history regarding acceptance clauses

Contract costs

87. The proposed standard includes specific guidance for accounting for costs associated with contracts with customers. An entity recognizes costs to obtain a contract (e.g., costs of selling, marketing, or advertising) as incurred.

PwC observation: Expensing costs to obtain a contract as they are incurred may significantly affect entities that previously capitalized certain pre-contract costs (e.g., acquisition costs or legal costs). Management should carefully review its cost capitalization methods in order to understand the potential effects of these changes.

88. An entity may capitalize the costs to fulfill a contract in certain circumstances. Management will need to evaluate whether the costs incurred in fulfilling a contract are in the scope of other standards (i.e., inventory, fixed assets, intangibles) to determine which costs may be recognized as an asset. These costs will be accounted for in accordance with the relevant standards.

89. An entity will recognize an asset for costs that are not within the scope of another standard only if the costs relate directly to a contract, will generate or enhance a resource that the entity will use to satisfy future performance obligations in a contract, and are expected to be recovered under a contract. Entities might capitalize the following costs under the proposed standard:

- Direct labor, including salaries and wages
- Direct materials, including inventory
- Allocations of costs, including contract management and depreciation
- Costs that are explicitly chargeable to the customer under the contract
- Other costs incurred only due to entering into the contract

90. Capitalized costs should be amortized (and recognized as cost of sales) as the entity transfers the underlying goods or services that relate to the asset.

91. The entity recognizes an impairment loss when the present value of the expected (future) direct costs of satisfying the remaining performance obligations in the contract exceeds the transaction price allocated to those performance obligations. Management should recognize a loss if the expected costs exceed the carrying amount of the asset.

Sales of assets that are not an output of an entity's ordinary activities

92. An entity should apply the recognition and measurement principles of

the proposed standard to contracts for the sale of nonfinancial assets that are not an output of the entity's ordinary activities (e.g., property, plant and equipment within the scope of Topic 360 or IAS 16, *Property, Plant and Equipment*, IAS 38, *Intangible Assets*, or IAS 40, *Investment Property*). The proposed standard will amend existing requirements for the recognition of a gain or loss on the sale of nonfinancial assets that are not an output of the entity's ordinary activities.

93. The entity will derecognize the asset when the buyer obtains control of the asset and recognize a gain or loss equal to the difference between the transaction price and the carrying amount of the asset. The transaction price will be limited to amounts that management can reasonably estimate at the date of the transfer.

Timing for comments

94. Comments on the exposure draft are due by October 22, 2010. We encourage management to engage in the comment letter process and suggest that entities respond formally to the questions included in the exposure draft. Entities that would like to participate in the boards' future roundtables should notify the boards by October 1, 2010.

Industry insights

95. Extensive industry-specific revenue recognition guidance exists under current US GAAP, while limited revenue guidance exists under IFRS.

However, even under IFRS, certain industry practices have developed over time. The proposed standard is likely to have a more significant effect on some industries than others. The following supplements discuss some of the more significant implications for the following industries to help readers of this Dataline identify and consider the implications of the proposed standard on their specific industries.

- Engineering and Construction
- Entertainment and Media
- Healthcare
- Industrial Products and Manufacturing
- Retail and Consumer
- Technology

96. The supplements, examples, and related assessments are based on the Exposure Draft, *Revenue from Contracts with Customers*, which was issued on June 24, 2010. The provisions of the proposed standard are subject to change at any time until a final standard is issued. The examples included in the supplements reflect the potential affect of the proposed standard and any conclusions noted are subject to further interpretation and assessment based on the final standard.

97. We encourage management to read the topics discussed in the supplements and consider the potential effects that the proposed standard could have on their existing revenue recognition practices. The issues discussed in the supplements are intended to assist companies in formulating feedback to the boards that can help in the development of a high-quality final standard.

***To have a deeper conversation
about how this subject may affect
your business, please contact:***

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US GAAP Convergence & IFRS

Revenue recognition: FASB and IASB “march” closer to completion on key revenue recognition issues

March 2011

FASB and IASB “march” closer to completion on key revenue recognition issues

What’s inside:

What’s new?

What are the key decisions and developments?

Is convergence achieved?

Who’s affected?

What’s the effective date?

What’s next?

What’s new?

The FASB and IASB (“the boards”) met three times in March to discuss their joint project on revenue recognition. The boards reached tentative decisions on the impact of collectibility and the time value of money on the transaction price, and the accounting for onerous contracts. These decisions are tentative and subject to change. The boards also discussed the impact of variable consideration on the transaction price and will continue debating the issue in April. A number of other key issues remain to be redeliberated, including allocation of transaction price, contract costs, accounting for licenses, disclosure and transition.

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In brief 2011–11

March 25, 2011

What are the key decisions and developments?

Collectibility

Collectibility refers to risk that the customer will not pay the promised consideration. Many respondents disagreed with the proposal that revenue should be adjusted for credit risk, with subsequent changes in other income or expense. The boards affirmed that collectibility of the transaction price will no longer be a hurdle to revenue recognition as it is under today’s guidance. However, in a change to the proposal in the exposure draft, the boards agreed that the transaction price will be presented without adjustment for credit risk. An allowance for the expected impairment loss on receivables will be presented in a separate line item adjacent to revenue. Both the initial impairment assessment and any subsequent changes in the estimate of collectibility will be recorded in this line.

Time value of money

The boards affirmed the proposal in the exposure draft that the transaction price should reflect the time value of money when the contract includes a significant financing component. The boards intend to provide additional factors for when a significant financing component exists to address respondents’ concerns about practical issues. The boards have also tentatively decided that, as a practical expedient, an entity will not need to reflect the time value of money in the measurement of the transaction price when the period between payment by the customer and the transfer of the goods or services is less than one year.

Onerous contracts

Onerous contract losses will be assessed at the contract level, rather than the performance obligation level. This includes contracts that are intentionally priced at a loss with the expectation of profits on

subsequent contracts with the customer (for example, loss leaders). The boards also concluded that direct costs should be used to determine whether a contract is onerous. Costs to terminate a contract will not be reflected until the entity is committed to cancelling it and has the contractual right to do so. Cancelling the contract may also give rise to other obligations to be accounted for in accordance with provisions and contingencies guidance. The onerous contract guidance will generally result in earlier recognition of losses compared to today's accounting.

Variable consideration

The transaction price is the consideration the customer promises to pay in exchange for goods or services. It may include an element that is variable or contingent on the outcome of future events. Some respondents were concerned about recognizing revenue before a contingency is resolved. The boards have extensively discussed alternative approaches, but have not reached a conclusion. The boards did not conclude on how to address situations where consideration is based on future sales of the customer's products to another party (for example, sales-based royalties) or on an index value in the future (for example, performance-based fees for assets under management). These arrangements are common in certain industries, including pharmaceutical, entertainment and media, and asset management. The boards will continue redeliberations on variable consideration in April.

Is convergence achieved?

Convergence is expected for revenue recognition, since the same principles should be applied to similar transactions under both frameworks.

Who's affected?

The proposal will affect most entities that apply US GAAP or IFRS. Entities that currently follow industry-specific guidance should expect the greatest impact.

What's the effective date?

We anticipate the final standard to have an effective date no earlier than 2014.

What's next?

The boards' timeline indicates a final standard in June 2011. The boards will continue to redeliberate over the next few months and perform targeted consultation with key industries and other interested parties for some of the more significant changes.

***To have a deeper conversation
about how this subject may affect
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US GAAP Convergence & IFRS

Revenue recognition: Automotive industry supplement

March 2011

Revenue recognition . . . full speed ahead

Automotive industry supplement

What's inside:

Overview

Product warranties

**Revenue from tooling
arrangements**

Customer incentives

Contract costs

Financing arrangements

Contract modifications

Repurchase options

Reprinted from:

Dataline 2010–28 (Supplement)
November 22, 2010

Overview

The automotive sector includes a broad group of participants, including suppliers, original equipment manufacturers (OEMs), and dealers. Entities in the automotive sector will likely be affected by the proposed revenue recognition guidance, which will replace current US GAAP and IFRS guidance on revenue recognition. Key areas that may be affected by the proposed guidance include the accounting for product warranties, pre-production activities (e.g., pre-production tooling arrangements), marketing incentives (e.g., cash rebates), volume rebates, repurchase options, contract costs, and lease financing arrangements.

This paper, examples, and related assessments are based on the Exposure Draft, “Revenue from Contracts with Customers,” issued in June 2010. The examples reflect the potential impact of the proposed standard. The conclusions are subject to further interpretation and assessment based on the final standard. For a more comprehensive description of the proposed standard, refer to PwC’s Dataline 2010–28 or visit www.fasb.org.

Product warranties

Product warranties are commonplace in the automotive industry. Both OEMs and suppliers routinely provide product warranties to their customers. For example, suppliers generally provide a standard warranty to all customers that

the product is free of latent defects (that is, those that exist when the product is transferred to the customer but not yet apparent) for a specified, usually short, period. OEMs provide a standard warranty on vehicles for a certain number of years or a specified mileage. OEMs might provide an extended warranty in addition to the standard warranty coverage.

The proposed standard draws a distinction between warranties that protect against latent defects and warranties that provide coverage for faults that arise after the product is transferred to the customer (e.g., normal wear and tear).

Proposed standard	Current US GAAP	Current IFRS
A product warranty that provides coverage for latent defects does not give rise to a separate performance obligation but may indicate that the entity has not satisfied its performance obligation to transfer the product to the customer. Management will need to determine the likelihood and extent of defects in products sold to customers at each reporting date to determine the extent of unsatisfied performance obligations. Revenue is not recognized at the time of sale for defective products that will be replaced in their entirety. Revenue is not recognized for components of a product that will have to be replaced. Revenue for these products is recognized when control transfers, which is generally the earlier of when the products are replaced or repaired or when the warranty period expires. A product warranty that provides coverage for faults arising after the product is transferred is a separate performance obligation. A portion of the transaction price is allocated to that separate performance obligation at contract inception. Revenue is recognized as the warranty services are provided.	Entities typically account for warranties that cover latent defects in accordance with existing loss contingency guidance. An entity recognizes revenue and concurrently accrues any expected warranty cost when the product is sold. Revenue from separately priced extended warranty contracts is deferred and recognized over the expected life of the contract.	IFRS addresses two types of warranties: • standard warranties; and • extended warranties. Revenue is typically recognized at the time of sale for a standard warranty, with a corresponding provision recognized for the expected warranty cost. A product sold with an extended warranty is treated as a multiple element arrangement. Revenue from the sale of the extended warranty is deferred and recognized over the period covered by the warranty. No costs are accrued at the inception of the extended warranty agreement.
Potential impact: The proposal will have a substantial impact for OEMs and suppliers that provide warranties. Accounting for warranty costs has historically required estimates, but the proposed standard may increase the subjectivity by requiring management to determine the objective of product warranties and allocate a portion of the transaction price to those warranties. A standard warranty provided by an OEM today might have the objective of covering both latent defects and faults arising after the product is transferred, for example. Revenue associated with products with latent defects will be deferred under the proposed standard. A liability is recorded for the deferred revenue and an asset is recorded for the cost of the inventory that has not yet transferred to the customer in the condition promised. Management will need to consider the value of the defective products when measuring and recording the asset. For example, if the defective product would be scrapped and has little or no value, the asset would be impaired. There is generally a matching between the recognition of revenue and the accrual of warranty expense under existing guidance. The proposed guidance requires the deferral of the margin on products with latent defects until the earlier of when the warranty obligation is fulfilled (that is, the products are replaced or repaired) and when the warranty period expires.		

Example 1—Accounting for warranties intended to cover latent defects

Facts: An entity sells its product with a 90-day standard warranty covering latent defects. The entity will repair or replace defective components of the product under the standard warranty. How does the entity account for the warranty?

Discussion: The standard warranty is not a separate performance obligation because it is intended to cover latent defects. The entity will need to estimate at contract inception the selling price of the product components that will require repair or replacement based on available information and the entity's experience. The warranty provides for repair or replacement of the components that are defective (rather than complete product replacement). Contract revenue is therefore allocated to the components expected to be defective on a relative selling price basis. Revenue is deferred for the components expected to be defective until the customer receives control of those components without defects, which is generally the earlier of when the defects are repaired or replaced or when the warranty period expires.

Example 2—Accounting for warranties intended to cover normal wear and tear

Facts: An entity sells its product with a 90-day standard warranty covering latent defects. The customer also purchases an extended warranty that provides for an additional 18 months of coverage. The extended warranty is intended to cover normal wear and tear. How does the entity account for the extended warranty?

Discussion: The standard warranty is accounted for consistent with the standard warranty described in Example 1 above because it covers latent defects. The extended warranty is a separate performance obligation because it covers faults that arise after the product is transferred to the customer. The entity will allocate the transaction price (that is, contract revenue) on a relative estimated selling price basis to the product and the extended warranty. Revenue allocated to the extended warranty is recognized over the expected term of the extended warranty contract.

Revenue from tooling arrangements

Tooling arrangements are common between OEMs and suppliers. A supplier may construct a tool for sale to the OEM and also enter into a supply arrangement to sell the output from the tool to the OEM, for example. Consideration for the tooling

might be received through an increase in the sales price of the output from the tool in this situation. Revenue is generally recognized today as the parts are delivered by the supplier to the OEM when tooling is recovered through an increase in the sales price of the output from the tool. Revenue might also be recognized following the percentage-of-completion or completed-contract method.

The proposed standard includes criteria that should be considered to determine whether two or more contracts should be combined and accounted for as one. The proposed standard also requires the identification of the distinct performance obligations in the contract, which is important to determine when revenue is recognized.

Proposed standard	Current US GAAP	Current IFRS
Combining/segmenting contracts Two or more contracts are combined and accounted for as one contract if their prices are interdependent. A contract is segmented into more than one contract and accounted for separately if prices for goods and services within that contract are independent.	For arrangements in the scope of contract accounting, combining contracts is permitted provided certain criteria are met, but it is not required as long as the underlying economics of the transaction are fairly reflected. Arrangements with multiple deliverables that are not in the scope of contract accounting are required to be combined if they are with same or related entities and are negotiated at the same time. Arrangements with multiple deliverables that are not in the scope of contract accounting are divided into separate units of accounting if the deliverables in the arrangement meet specific criteria. Separation is appropriate when the delivered item(s) has value to the customer on a stand-alone basis, there is objective and reliable evidence of the fair value of the undelivered item(s) and the delivery of the undelivered item(s) is probable and substantially within the control of the vendor.¹	For arrangements in the scope of contract accounting, combining contracts is required where two or more transactions are linked and combination is necessary to reflect the commercial (that is, economic) substance of the transactions. Separating the components in a contract may be necessary to reflect the economic substance of a transaction. Separation is appropriate when the identifiable components have stand-alone value and their fair value can be measured reliably.
	Potential impact: We anticipate that the proposed guidance related to combining contracts will not result in a substantial change in practice.	

1 New multiple element guidance (required to be adopted for calendar year-end companies effective January 1, 2011) eliminates the requirement for objective and reliable evidence of the fair value of the undelivered item(s).

Proposed standard	Current US GAAP	Current IFRS
Identifying performance obligations and recognizing revenue The proposed standard requires entities to identify the distinct performance obligations in an arrangement and allocate the transaction price to each performance obligation. An entity recognizes revenue from performance obligations separately if they are distinct from other goods or services promised in the contract and are delivered separately. A good or service is distinct if the entity or another entity sells an identical or similar good or service separately. A good or service that has a distinct function and a distinct profit margin from the other goods or services in the contract is also distinct, even if not sold separately. A good or service has a distinct function if it provides utility either on its own or together with other goods or services available in the marketplace. A good or service has a distinct margin if it is subject to distinct risks and the entity can identify the resources needed to provide the good or service. Revenue is recognized upon the satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. Control can transfer at a point in time or continuously over the contract period. Factors to consider in assessing control transfer include, but are not limited to: • The customer has an unconditional obligation to pay • The customer has legal title • The customer has physical possession • The customer specifies the design or function of the good or service The ability to borrow against the asset, for example, may be another control transfer factor to consider. No one factor is individually determinative.	For arrangements in the scope of contract accounting, revenue is recognized using the percentage-of-completion method when reliable estimates are available. When reliable estimates cannot be made, but there is an assurance that no loss will be incurred on a contract (e.g., when the scope of the contract is ill-defined but the contractor is protected from an overall loss), the percentage-of-completion method based on a zero profit margin is used until more precise estimates can be made. The completed-contract method is required when reliable estimates cannot be made. For arrangements not in the scope of the contract accounting guidance, revenue is generally recognized once the risks and rewards of ownership have transferred to the customer. For arrangements with multiple deliverables (not in the scope of contract accounting), consideration is allocated among the separate units of accounting based on their estimated stand-alone selling prices. The applicable revenue recognition criteria are considered separately for separate units of accounting.	For arrangements in the scope of contract accounting, revenue is recognized using the percentage-of-completion method when reliable estimates are available. When reliable estimates cannot be made, but there is an assurance that no loss will be incurred on a contract (e.g., when the scope of the contract is ill-defined, but the contractor is protected from an overall loss), the percentage-of-completion method based on a zero profit margin is used until more precise estimates can be made. The completed contract method is not permitted. For arrangements not in the scope of the contract accounting guidance, revenue is recognized once the following conditions are satisfied: • The risks and rewards of ownership have transferred. • The seller does not retain managerial involvement to the extent normally associated with ownership nor retain effective control. • The amount of revenue can be reliably measured. • It is probable that the economic benefit will flow to the entity. • The costs incurred can be measured reliably. For arrangements with multiple deliverables, revenue is allocated to individual deliverables of a contract, but specific guidance is not provided on how the consideration should be allocated. The applicable revenue recognition criteria are considered separately for the separate deliverables.
	Potential impact: The proposed guidance will require suppliers that enter into tooling arrangements to use judgment to determine when it is appropriate to recognize revenue. This will include identifying the performance obligations, determining the transaction price, and allocating the transaction price to the performance obligations. The overall effect of the proposed standard to a supplier will depend largely on the terms of the arrangements and the existing accounting practices for such arrangements. For example, when the price of tooling constructed by a supplier for an OEM is recovered through the sales price of parts supplied to the OEM, there are likely to be two performance obligations. We expect that identifying separate performance obligations for tooling and for the production of parts may result in revenue recognition earlier than under existing guidance. Today, revenue is generally recognized under these arrangements as the parts are delivered by the supplier. Revenue for the tooling is likely to be recognized before the transfer of parts under the proposed standard if control of the tooling transfers to the OEM.	

Example 3—Combining contracts

Facts: On January 1, 200X, Supplier enters into a contract with OEM to construct tool Y. Ownership of tool Y will transfer from Supplier to OEM. Separately, on January 23, 200X, Supplier enters into a contract to provide OEM with part Z, which is produced using tool Y. Supplier will recover the sales price for tool Y though the sales price for part Z. Production of part Z will begin once tool Y has been constructed to the specifications agreed between Supplier and OEM. Should Supplier combine the contract to construct tool Y with the contract to produce part Z?

Discussion: Supplier will need to consider a number of factors to determine whether the contracts are price interdependent and need to be combined. The contracts were entered into near the same time. It is likely that the contracts were negotiated with a single commercial objective, because Supplier is both constructing tool Y and providing part Z. The two contracts cannot be performed concurrently, but the production of part Z begins as soon as tool Y has been constructed. We believe Supplier would likely combine the contracts for tool Y and part Z based on consideration of these factors.

The next step is to identify the separate performance obligations in the contract(s).

Example 4—Identify the performance obligations—combined contracts

Facts: Assume the contract to construct tool Y should be combined with the contract to produce part Z. Supplier is one of five suppliers with the ability to construct tool Y and subsequently produce part Z. What are the performance obligations under the combined contract?

Discussion: Supplier has promised to transfer both tool Y and part Z to OEM. When an entity promises to provide more

than one good or service, each promised good or service is a separate performance obligation if it is distinct. A good or service is distinct and should be accounted for separately if the entity, or another entity, sells (or could sell) an identical or similar good or service separately.

Tool Y and part Z are distinct because there are four suppliers in addition to Supplier that could separately construct the tool and produce the part. Supplier will recognize revenue for each distinct performance obligation when control of the good is transferred to the OEM and the performance obligation is satisfied.

Example 5—Recognizing revenue—control of the tool transfers during the contract term

Facts: Assume the same facts as in Example 3 above, except:

- Tool Y must be constructed to OEM's specifications, which may be changed at OEM's request during the term of the contract;
- Non-refundable, interim progress payments are required to finance the contract to construct tool Y;
- OEM can cancel the contract to construct tool Y at any time (with a termination penalty); any work in process is the property of OEM; and
- Title does not pass until completion of the contract for the construction of tool Y and physical possession does not pass until completion of the contract for the production of part Z.

How should Supplier recognize revenue in this example?

Discussion: The customer specifications (and ability to change those specifications), non-refundable progress payments, termination penalty, and ability to retain work-in-process suggest that control

of the tool is being transferred and the performance obligation is being satisfied continuously over the term of the contract for construction of the tool. Supplier will need to select the most appropriate measurement model (either an input or output method) to measure continuous transfer of control. Supplier might elect to follow a labor hours input method, for example. The transaction price allocated to tool Y will be recognized as revenue based upon the number of labor hours incurred as a percentage of the estimated total to be incurred over the life of the contract.

Example 6—Recognizing revenue—control of the tool transfers after completion of the contract term

Facts: Assume the same facts as in Example 3 above, except:

- The majority of the payments are due after tool Y has been constructed;
- OEM can cancel the contract at any time (with a termination penalty) and any work is the property of Supplier; and
- Title of tool Y passes upon completion of its construction. Physical possession of tool Y does not pass until completion of the contract for construction of part Z.

How should Supplier recognize revenue in this example?

Discussion: The payment upon completion and the inability to retain work-in-process suggest control of the tool is transferred when construction of the tool is complete. Supplier recognizes revenue when control has transferred to the customer. Control is likely to transfer when title to the tool transfers from Supplier to OEM, which is likely to be before physical possession of the tool passes from Supplier to OEM because the tool will be used to construct part Z.

Customer incentives

OEMs and suppliers commonly offer various forms of customer incentives that reduce the transaction price. Two examples of incentives are cash rebates offered by OEMs and volume discounts offered by suppliers. There are various accounting standards applicable currently that provide guidance on accounting for customer incentives and, as a result, there is likely diversity in practice in accounting for such incentives.

The proposed standard requires management to identify the distinct performance obligations in an arrangement and allocate the transaction price to each performance obligation. The allocation should reflect the impact of customer incentives and other discounts, which may be a separate performance obligation or may affect the total transaction price.

Proposed standard	Current US GAAP	Current IFRS
An entity recognizes revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. The transaction price can be reasonably estimated if both of the following criteria are met: • The entity has experience with similar types of contracts; and • The entity's experience is relevant to the contract because the entity does not expect significant changes in circumstances. When a contract includes variable consideration, the transaction price includes the probability-weighted estimate of variable consideration receivable. Amounts paid to a customer are: (a) a reduction to the transaction price; (b) a payment for distinct goods or services that the entity receives from the customer; or (c) a combination of (a) and (b).	Sales incentives offered to customers are typically recorded as a reduction of revenue at the later of the date at which the related sale is recorded by the vendor and the date at which the sales incentive is offered. Volume rebates are recognized as each of the required revenue transactions that results in progress by the customer toward earning the rebate occurs. Cash consideration given by a vendor to a customer is a reduction of revenue earned from the customer, unless the vendor receives an identifiable benefit (goods or services) from the customer and the fair value of such benefit can be reasonably estimated.	Revenue is measured at the fair value of the consideration received or receivable. This is normally the price specified in the contract, taking into account the amount of any trade discounts and volume rebates allowed by the entity. For contracts that provide customers with volume discounts, revenue is measured by reference to the estimated volume of sales and the corresponding expected discounts. If estimates of the expected discounts cannot be reliably made, revenue recognized should not exceed the amount of consideration that would be received if the maximum discounts were taken. Cash consideration given by a vendor to a customer is a reduction of revenue earned from the customer, unless the vendor is purchasing goods or services from the customer.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i> If consideration paid is a reduction of the transaction price, management reduces the amount of revenue it recognizes at the later of when: (a) the entity transfers the promised goods or services to the customer; and (b) the entity incurs the obligation to pay the consideration to the customer (even if payment is conditional on a future event). That promise might be implied by the entity's customary business practice.	Potential impact: The proposed standard will affect some US GAAP reporting entities, as it will require incentives to be accounted for similar to current IFRS. The proposed standard will require an entity to assess the transaction price including the impact of the incentive program. Incentives that provide the customer with a material right (e.g., a discount on future purchases) that would not have been obtained without entering into the contract are separate performance obligations. The transaction price allocated to the option (that is, the future discount) is deferred and recognized as revenue when the obligation is fulfilled or the right lapses. Incentives that create variability in the pricing of the goods or services provided in the contract (as with volume discounts) require management to determine the probability weighted estimate of possible outcomes to determine the transaction price. Variable consideration is included in the transaction price if the entity can reasonably estimate the amount of consideration to be received. Consideration paid to a supplier that is a reduction of the transaction price (e.g., cash rebates offered to end consumers by an OEM through their distribution network) is likely to continue to be accounted for as a reduction of revenue. The promise to pay consideration might be implied based on an entity's customary business practice. Compared to current practice, revenue may be reduced at an earlier point in time based on the proposal's requirement to consider customary business practice.	

Example 7—Variable consideration

Facts: A supplier sells a component to an OEM for C100 for each component. The price for each component purchased in excess of 1,000 is C50 (that is, components 1 through 1,000 are C100; components 1,001 and on are C50). The supplier believes there is a 25% probability that the OEM will purchase 1,000 components; a 50% probability that the OEM will purchase 1,500 components; and a 25% probability that the OEM will purchase 2,000 components. The supplier's assumptions are based on experience with this OEM with similar contracts, as well as their ongoing relationship with the OEM and insight they have to the OEM's planned production. There is no customer credit risk. How should the supplier determine the transaction price and recognize revenue?

Discussion: The supplier has the ability to reasonably estimate the transaction price. The supplier will recognize revenue for the sale of components to the OEM when control of each component transfers to the OEM. The supplier should consider the volume discount in determining the transaction price to be allocated to each component sold. The transaction price is C83.33 for each component, determined using the probability weighted average of the expected outcomes. Revenue is recognized based on this estimated transaction price, which will be monitored and adjusted, as necessary, using a cumulative catch-up approach.

Contract costs

Entities in the automotive industry may incur costs to design and develop products and tooling. Suppliers might incur costs to develop tooling, for example, in anticipation of a long-term supply arrangement. A contract might exist prior to the costs to develop the tooling being incurred

in some cases; in others, a contract may not be agreed to until after costs have been incurred. These costs may be either expensed as incurred or capitalized and amortized to expense as the related revenue is recognized under current guidance. The accounting treatment depends on a number of considerations including the nature of the costs and the tooling

being developed, whether the supplier has a non-cancellable right to use the tooling and whether the supplier will be reimbursed for the costs incurred.

The proposed standard includes guidance on both costs to obtain and costs to fulfil a contract and may change today's practice.

Proposed standard	Current US GAAP	Current IFRS
All costs of obtaining a contract, costs relating to satisfied performance obligations, and costs related to inefficiencies (that is, abnormal costs of materials, labor, or other costs to fulfil) are expensed as incurred. Other direct costs incurred in fulfilling a contract are expensed as incurred unless they are within the scope of other standards (e.g., inventory, intangibles, fixed assets). If so, the entity should account for such costs in accordance with those standards. If not, the entity should recognize an asset only if the costs relate directly to a contract, relate to future activity and are probable of recovery under a contract. These costs are then amortized as control of the goods or services to which the asset relates is transferred to the customer.	There is a significant amount of guidance on the accounting for contract costs. Costs that are incurred for an anticipated contract generally may be deferred only if the costs can be directly associated with a specific contract and if their recoverability from that contract is probable. Pre-production costs incurred in long-term supply arrangements related to design and development of molds, dyes, and other tools that an automotive supplier will own are capitalized as part of property, plant and equipment. If the costs relate to new technology, such costs are expensed as incurred. Pre-production costs incurred related to molds, dyes, and other tools that a supplier will not own but that will be used in producing products for its customer may only be capitalized if they meet certain criteria. Those criteria include the supplier having a non-cancellable right to use the molds, dyes, and tools during the supply arrangement or a legally enforceable contractual guarantee for reimbursement. Otherwise, such costs are required to be expensed as incurred.	There is some guidance for contract costs in construction contract accounting. Costs that relate directly to a contract and are incurred in securing the contract are included as part of contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. Costs incurred on arrangements not in the scope of contract accounting are capitalized if they are within the scope of other asset standards (e.g., inventory, property, plant and equipment, or intangible assets).
Potential impact: We do not expect a significant change in the accounting for contract costs associated with tooling. Entities that currently capitalize and amortize contract acquisition costs will experience a change because all costs of obtaining a contract will be expensed as incurred under the proposed guidance.		

Example 8—Accounting for costs to obtain a contract

Facts: A salesperson earns a 5% commission on a contract that was signed in January 20X1. The product(s) purchased under the contract will be delivered throughout the next year. How should the entity account for the commission paid to its employee?

Discussion: The commission payment is expensed as incurred (i.e., at inception of the contract if the commission is owed to the salesperson upon signing), as it represents a cost of obtaining the contract.

Example 9—Accounting for costs to fulfil a contract

Facts: A supplier incurs C1,000,000 in costs to design and develop tooling, which will be used to produce part Z. There is not a separate contract for the tooling, but the costs were incurred related to a supply contract with the OEM. The title for the tooling will transfer from the supplier to the OEM and the supplier does not have a non-cancellable right to use the tooling. How should the costs incurred for tooling be accounted for?

Discussion: The tooling is necessary to construct the parts and to fulfil the performance obligation that exists under the supply contract. For this reason, we believe the costs would likely be considered costs to fulfil a contract. Under the proposal, the supplier should first consider whether the costs give rise to an asset in accordance with other applicable guidance (for example, ASC 340, “Other assets and deferred costs,” or IAS 16, “Property, plant and equipment”). If not, an asset may be still be recognized if the costs (1) directly relate to the contract, (2) generate or enhance resources that will be used to satisfy performance obligations, and (3) are expected to be recovered.

If the determination was made that the costs could not be capitalized in accordance with another standard, it is likely that the costs would be capitalized under the proposal unless the determination was made that such amounts were not recoverable under the contract. The capitalized costs would then be amortized as the parts were supplied to the OEM.

Financing arrangements

Many OEMs have finance arms that serve as a potential finance source for customers that lease or buy vehicles from dealers. Where vehicles sold to dealers are financed

through the OEM's financing division, the OEM must meet certain conditions under current US GAAP to recognize revenue at the time of vehicle delivery to the dealer. These specific conditions are not included within IFRS; rather revenue is generally recognized from sales to dealers or

distributors when the risks and rewards of ownership have passed.

The proposed standard does not contain the same conditions that exist under current guidance.

Proposed standard	Current US GAAP	Current IFRS
The proposed standard requires revenue to be recognized when control transfers to the customer. Refer to the discussion of "Revenue from tooling arrangements" for details on the proposed model and factors to consider in assessing control transfer.	When an OEM sells a vehicle to a dealer who in turn leases it to an end customer, and the end customer finances the lease through the OEM (or its finance affiliate), the OEM may recognize revenue upon sale to the dealer if certain conditions are met, including: • The dealer is an independent entity; • The OEM has delivered the product to the dealer and the risks and rewards of ownership have passed to the dealer; • The finance affiliate of the OEM has no legal obligation to provide a lease arrangement to a potential customer of the dealer; and • The customer has other financing alternatives available and controls the selection of the financing alternative.	IFRS does not contain the same specific criteria as US GAAP to be considered when an OEM sells a vehicle to a dealer who in turn leases it to an end customer, and the end customer finances the lease through the OEM. Under IFRS, revenue from sales to distributors, dealers or others for resale is generally recognized when the risks and rewards of ownership have passed. However, when the dealer is acting, in substance, as an agent, the sale is treated as a consignment sale.
	Potential impact: OEMs generally meet the criteria in US GAAP to recognize revenue at the time of sale to the dealer. We do not expect a significant change in the timing of revenue recognition as a result of the elimination of the criteria in current US GAAP. The proposal may result in earlier revenue recognition for OEMs that do not meet the criteria under current US GAAP.	Potential impact: We do not expect a significant change in the timing of revenue recognition. Transfer of control and risks and rewards generally occurs when a vehicle is sold from the OEM to the dealer.

Example 10—Lease financing arrangements

Facts: An OEM sells a vehicle to a dealer. The dealer has legal title and an obligation to pay the OEM upon receipt of the vehicle. The dealer intends to sell or lease the vehicle to a third party. The third party may finance the purchase or lease of the vehicle from the dealer through a finance affiliate of the OEM or through an unrelated third party. When should revenue be recognized for the sale of the vehicle to the dealer?

Discussion: The dealer has physical possession, legal title, and an obligation to pay the OEM upon receipt of the vehicle. Control transfers and the OEM should recognize revenue when the dealer receives the vehicle. The fact the OEM might provide financing to the end consumer that ultimately purchases or leases the vehicle from the dealer does not impact the assessment of whether control has transferred.

Contract modifications

Contract modifications are common in the automotive industry, particularly changes

in pricing. Contract modifications may need to be combined and accounted for together with the existing contract under the proposed standard.

Proposed standard	Current US GAAP	Current IFRS
A contract modification is any change in the scope or price of a contract. Examples include changes in the nature or amount of the goods or services to be transferred, changes in the method or timing of performance and changes in the previously agreed pricing in the contract. An entity may be required to account for a contract modification together with the existing contract if the prices of the modification and the existing contract are interdependent. In making this determination, the entity should consider when the contracts were entered into, whether the objective of the contracts is related, and whether performance under the contracts occurs at the same time or successively. If the prices of the contract modification and the existing contract are not interdependent, the entity accounts for the contract modification as a separate contract.	There is no clear guidance on accounting for contract modifications. In practice, we believe many entities account for contract modifications prospectively unless the contract modification is explicitly tied to prior performance.	There is no clear guidance on accounting for contract modifications. In practice, we believe many entities account for contract modifications prospectively unless the contract modification is explicitly tied to prior performance.
Potential impact: Contract modifications will continue to require judgment to determine when they are combined with the original contract. We do not expect current practice in this area to be significantly changed by the proposed standard.		

Example 11—Contract modification

Facts: Supplier and OEM have an existing contract for the sale and purchase of 1,000 parts at a price of C10. Total contract revenue under the existing contract would be C10,000. OEM purchases 500 parts at that price, then negotiates a price change from C10 to C7.50. The price change only relates to the remaining purchases, is based on the OEM’s willingness to increase the volume of purchases to 1,500 and is

not available to any other OEM. Should the contract modification to reduce the price from C10 to C7.50 and increase the volume be combined with the existing contract?

Discussion: Determining whether the contract modification should be combined with the existing contract will require judgment. Supplier will account for the contract modification as a separate contract if it determines that the prices of the contract modification and the existing

contract are not interdependent. However, if Supplier determines that the contract modification and the existing contract are price interdependent, it would combine the contract modification and the existing contract and recognize the cumulative effect of the contract modification as a reduction to revenue of C833 $(((C12,500 \text{ total consideration} / 1,500 \text{ goods}) * 500 \text{ goods provided already}) - C5,000 \text{ revenue recognized to date})$.

Repurchase options

OEMs sell vehicles to customers (e.g., rental car entities) and often provide residual value guarantees to the purchaser as part of the contract. Under these contracts, the OEM contractually guarantees that the purchaser will receive a minimum resale amount at the time the vehicle is disposed of, contingent on certain requirements. This guarantee is provided by agreeing to (1) reacquire the vehicle at a guaranteed price at specified time periods as a means to facilitate its resale or (2) pay the purchaser for the deficiency, if any, between the sales proceeds received for the vehicle and the guaranteed minimum resale value.

There is specific US GAAP guidance that requires these contracts to be treated as lease transactions. The boards have issued an exposure draft on lease accounting that will substantially change the accounting for lease transactions. As a result, a question arises as to whether the contracts described above are in the scope of the revenue recognition guidance or the leasing guidance. We believe that, as currently drafted, the exposure drafts

suggest that these contracts are in the scope of the revenue recognition guidance. This view is based on the following considerations: (a) the transaction results in an outright sale, not a lease; (b) the current leasing guidance that provided for these contracts to be accounted for as leases is being superseded; and (c) the leasing exposure draft does not provide guidance on accounting for these contracts that is comparable to the guidance that will be superseded.

The economics of these contracts could be approximated by a structured lease arrangement that would be in the scope of the proposed lease guidance. As a result, some might argue that these arrangements should be accounted for under the proposed lease model. Additional guidance may be necessary to conclude whether these contracts will be accounted for in accordance with the revenue recognition or leasing guidance.

***To have a deeper conversation
about how this subject may affect
your business, please contact:***

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US GAAP Convergence & IFRS

Revenue recognition: Engineering and construction industry supplement

March 2011

Revenue recognition . . . full speed ahead

Engineering and construction industry supplement

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Overview

Entities in the engineering and construction (E&C) industry applying US GAAP or IFRS have primarily been following either Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (SOP 81-1, as codified in Topic 605-35), or International Accounting Standards 11, *Construction Contracts* (IAS 11), to account for revenue. These standards were developed to address particular aspects of long-term construction accounting and provide guidance on a wide range of industry specific considerations including:

- Defining the contract, such as when to combine or segment contracts, and when and how to account for change orders and other modifications
- Defining the contract price, including variable consideration, customer furnished materials and claims
- Recognition methods, such as the percentage-of-completion method (and in the case of US GAAP, the completed contract method) and input/output methods to measure performance
- Accounting for contract costs, such as pre-contract costs and costs to fulfill a contract
- Accounting for loss making contracts

Once the new revenue recognition standard becomes effective, SOP 81-1 and IAS 11 and all existing revenue recognition guidance under US GAAP and IFRS will be replaced. This includes the percentage-of-completion method and the related construction cost accounting guidance as a standalone model.

The following items common in the E&C industry may be significantly affected by the new revenue recognition standard. This paper, the examples, and the related assessments contained herein, are based on the Exposure Draft, *Revenue from Contracts with Customers*, which was issued on June 24, 2010. These proposals are subject to change at any time until a final standard is issued. For a more comprehensive description of the model, refer to PwC Dataline 2010–28 or visit www.fasb.org.

* This Dataline Supplement was revised on September 3, 2010 to reflect certain editorial revisions. None of the revisions resulted in substantive changes to the assessments of the proposed model contained herein.

Defining the contract

Current guidance covers:

- When two or more contracts should be combined and accounted for together
- When one contract should be segmented and accounted for separately as two or more contracts
- When a contract modification should be recognized

These situations and, in particular, contract modifications such as change orders, are commonplace in the E&C industry.

The proposed standard applies only to contracts with customers when such contracts:

- Have commercial substance
- Have been approved by the parties to the contract and such parties are committed to satisfying their respective obligations
- Have enforceable rights that can be identified regarding the goods or services to be transferred
- Have terms and manners of payment that can be identified

We do not expect current practice in the area of contract combinations and segmentation to be significantly affected by the proposed standard. Construction companies currently exercise significant judgment to determine when to include change orders and other contract modifications in contract revenue and, there is diversity in practice. We expect that the use of judgment will continue to be required and do not expect current practice (or existing diversity) in this area to be significantly affected by the proposed standard, including the accounting for unpriced change orders.

Proposed standard	Current US GAAP	Current IFRS
Combining and segmenting contracts Two or more contracts should be combined and accounted for as one contract if their prices are interdependent. A contract should be segmented into more than one contract and accounted for separately if prices for goods and services within that contract are independent. Contracts with interdependent prices are typically: • Entered into at or near the same time • Negotiated as a package with a single commercial objective • Performed either concurrently or continuously Prices for goods and services within a contract are independent if: • The entity (or another entity) sells an identical or similar good or service separately; and • The customer does not receive a significant discount for buying a bundle of goods and services.	Combining and segmenting contracts is permitted provided certain criteria are met, but it is not required so long as the underlying economics of the transaction are fairly reflected.	Combining and segmenting contracts is required when certain criteria are met.

Proposed standard	Current US GAAP	Current IFRS
Contract (modifications (for example, change orders)) Consistent with the contract combination and segmentation principle above, a contract modification is combined with the original contract, recognizing the cumulative effect of the contract modification in the period in which the modification occurs, if the prices are interdependent. A contract modification is accounted for as a separate contract if it is priced independently of the original contract (consider the factors above).	A change order is generally included in contract revenue when it is probable that the change order will be approved by the customer and the amount of revenue can be reliably measured. US GAAP also includes detailed revenue and cost guidance on the accounting for unpriced change orders (or those in which the work to be performed is defined, but the price is not).	A change order (known as a variation) is generally included in contract revenue when it is probable that the change order will be approved by the customer and the amount of revenue can be reliably measured. There is no detailed guidance on the accounting for unpriced change orders.

Example 1—Unpriced change orders

Facts: A contractor has a history of executing unpriced change orders; that is, those change orders where price is not defined until after scope changes are agreed upon. When would these change orders be included in contract revenue?

Discussion: An entity would first assess whether the change order meets the definition of a contract as defined above, and next assess whether such change order is priced interdependently with the original

contract. Many unpriced change orders do not specify the consideration to be exchanged for goods or services at the time of execution, making it difficult to assess whether the change order is priced interdependently with the original contract. This might result in delayed recognition compared to today's model under both US GAAP and IFRS. There are situations, however, where contractors may be able to identify the amount of consideration to be received using various estimation

methods based on historical experience. We believe it is possible in these situations for a contractor to include unpriced change orders in contract revenue, as such modifications would (a) typically meet the definition of a contract and (b) are likely to be priced interdependently, as the modifications are often negotiated considering the original contract, with a single commercial objective, and relate to activities that are performed either concurrently or continuously.

Determining the transaction price

The transaction price (or contract revenue, as it is called today in the E&C industry) is the amount of consideration the contractor expects to receive in exchange for satisfying its performance obligations. When

the contract price is fixed, this determination is simple. When the contract price is not fixed, however, the determination is more complex. Common considerations in this area for the E&C industry include the accounting for awards/incentive payments, customer-furnished materials, claims, and time value of money. Revenue

related to awards/incentive payments might be recognized earlier under the proposed standard. We do not expect a significant change in practice as it relates to customer furnished materials, claims, or time value of money (except for contracts where payment terms materially vary from performance).

Proposed standard	Current US GAAP	Current IFRS
Awards/incentive payments Awards/incentive payments are included in contract revenue using a probability-weighted approach when such payments can be reasonably estimated. Such amounts can be reasonably estimated when the contractor has experience with similar types of contracts and that experience has predictive value (i.e., experience is relevant to the contract because the entity does not expect significant changes in circumstances).	Awards/incentive payments should be included in contract revenue when the specified performance standards are probable of being met or exceeded and the amount can be reliably measured.	Awards/incentive payments should be included in contract revenue when the specified performance standards are probable of being met or exceeded and the amount can be reliably measured.
Customer furnished materials If a customer contributes goods or services (for example, materials, equipment, or labor) to facilitate the fulfillment of the contract, the value is included in contract revenue if the entity controls these goods or services. Any non-cash consideration is measured at fair value unless fair value cannot be reasonably estimated, in which case it is measured by reference to the selling price of the goods or services transferred.	The value of customer furnished materials is included in contract revenue when the contractor has the associated risk for these materials.	There is no explicit guidance on the accounting for non-cash consideration in the construction contracts standard. Management would follow general principles on nonmonetary exchanges, which generally require companies to use the fair value of goods or services received in measuring the amount to be included in contract revenue.
Claims Claims should be included in contract revenue, using a probability-weighted approach, only when such revenue can be reasonably estimated.	A claim is recorded as contract revenue (to the extent of contract costs incurred) only if it is probable and reliably estimable (determined based on specific criteria). Profits on claims are not recorded until they are realized.	A claim is included in contract revenue only if negotiations have reached an advanced stage such that it is probable the customer will accept the claim and the amount can be reliably measured.

Proposed standard	Current US GAAP	Current IFRS
Time value of money Contract revenue should reflect the time value of money whenever the effect is material. Management should use a discount rate that reflects a separate financing transaction between the entity and its customer and factors in credit risk.	Revenue is discounted in only limited situations, including receivables with payment terms greater than one year. When discounting is required, the interest component should be computed based on the stated rate of interest in the instrument or a market rate of interest if the stated rate is considered unreasonable.	Revenue is discounted when the inflow of cash or cash equivalents is deferred. An imputed interest rate should be used to determine the amount of revenue to be recognized as well as the separate interest income to be recorded over time.

Example 2—Variable consideration

Facts: A contractor enters into a contract for the expansion of an existing two-lane highway to a three-lane highway in a heavily congested area. The contract price is \$65 million plus a \$5 million award fee if completed before the holiday travel season. The contract is expected to take one year to complete. The contractor has a long history of performing this type of highway work. The award fee is binary. That is, if the job is finished before the holiday travel season, the contractor receives the full award fee. If it is not finished before the holiday travel season, the contractor does not receive any award fee. The contractor believes, based on significant past experience, that it is 95 percent likely that the contract will be completed in advance of the holiday travel season.

Discussion: The contractor is likely to conclude that it can reasonably estimate the amount of expected award fee. This is because:

- The contractor has a long history of performing this type of work;
- It is largely within the contractor's control to complete the work before the holiday travel season;
- The uncertainty will be resolved within a relatively short period of time; and
- The possible outcomes are not highly variable.

The contract's transaction price is therefore \$69.75 million; the fixed contract price of \$65 million, plus \$4.75 million award fee (probability-weighted amount of \$5 million). This estimate is continuously revised and adjusted, as appropriate, using a cumulative catch-up approach, which is consistent with current practice.

Example 3—Claims

Facts: Assume the same fact pattern as Example 2, except that due to reasons outside of the contractor's control (e.g., owner-caused delays), the cost of the contract far exceeds original estimates (but a profit is still expected). The contractor submits a claim against the owner to recover a portion of these costs. The claim process is in its early stages, but the contractor has a long history of successfully negotiating claims with owners.

Discussion: Claims are highly susceptible to external factors (such as the judgment of third parties), and the possible outcomes are highly variable. The contractor may have experience in successfully negotiating claims, but it might be challenging to assert that such experience has predictive value in this fact pattern (because of the highly uncertain variables that warrant consideration). The contractor might therefore conclude that such a claim, in the early stages, cannot be reasonably estimated. The claim is excluded from the transaction price until it can be reasonably estimated (this is likely to be closer to the date when the claim is expected to be resolved).

Accounting for multiple performance obligations

Performance obligations are defined as promises to deliver goods or perform services. Today, contractors often account for each contract at the contract level; that is, contractors account for the macro-promise in the contract—to build a road or build a bridge, etc. Current guidance permits this, although a contractor effectively promises to provide a number of different goods or perform a number of different services in delivering such macro-promises. Clearing, grading and paving, for example, may qualify as separate performance obligations within

the macro-promise to build a road. Determining when to separately account for these performance obligations under the proposed model is, therefore, a key determination and will require a significant amount of judgment.

Under the proposed model, it is possible to account for the contract at the contract level (e.g., macro-promise to build a road), but we expect that contractors might have to separately account for more obligations within each contract compared to current guidance. This is an area that we expect will continue to evolve and that contractors should pay particular attention to. Applying the proposed separation principle will be challenging for many

construction companies. We believe the final standard should be clear about how to apply this principle to long-term contracts to ensure it meets the proposed standard’s objectives of providing consistent, decision-useful information for economically similar contracts.

Proposed standard	Current US GAAP	Current IFRS
Performance obligations—separation An entity should separately account for performance obligations only if they are transferred at different times and are distinct. An entity will otherwise combine goods or services with other promised goods or services until it identifies a bundle of goods or services that are distinct. A good or service is distinct if either: • The entity or another entity sells an identical or similar good or service separately. • The entity could sell the good or service separately because it: (a) has a distinct function (utility on its own or together with other goods or services); and (b) has a distinct profit margin (subject to distinct risks and the resources needed can be separately identified).	The basic presumption is that each contract is the profit center for revenue recognition, cost accumulation, and income measurement. That presumption may be overcome only if a contract or a series of contracts meets the conditions described above for combining or segmenting contracts. There is no further guidance for separately accounting for more than one deliverable in a construction contract.	The basic presumption is that each contract is the profit center for revenue recognition, cost accumulation, and income measurement. That presumption is overcome when a contract or a series of contracts meets the conditions described for combining or segmenting contracts. There is no further guidance around separately accounting for more than one deliverable in a construction contract.

Example 4—Design/build contract

Facts: A contractor enters into a construction contract with an owner to design and build a new runway at a small airport. The build stage primarily includes clearing, excavation, grading and paving activities. The contractor often sells similar design and build services together but also sells them separately. How many performance obligations is the contractor required to account for separately?

Discussion: We believe that application of the proposed separation principle remains unclear for many long-term contracts. However, based on the principles described above, it is likely that this design/build contract has at least two performance obligations; that of providing design services and that of building the runway. This is because they are transferred at different times and are distinct, as the contractor has a history of selling similar design services separate from the build. The build aspect of the contract, however, may require further separation. In making this determination, the contractor may have to assess whether the clearing, excavation, grading, and paving activities (or activities at an even lower level than these) are sold (or could be sold) by the contractor or others, such as subcontractors. For example, identical or similar activities that are sold separately by subcontractors may be considered distinct and require separation. Construction contracts to deliver a good often also include a significant construction management service. Assessing whether such management services are distinct from other aspects of the contract (i.e., the design service and construction of the good) will require significant judgment.

Example 5—Construction management contract

Facts: A contractor enters into a construction contract with an owner to provide construction management services, overseeing the construction of a new runway at a small airport. How many performance obligations is the contractor required to separately account for?

Discussion: The contractor might only have one performance obligation in this example; that of providing the construction management service to supervise and coordinate the construction activity on the project.

Allocating the transaction price to multiple performance obligations

Performance obligations are measured at the amount of consideration the contractor expects to receive (i.e., the transaction

price as described above). This consideration must then be allocated to the performance obligations in a contract that require separate accounting. We expect that contractors will have to separately account for more performance obligations than today, so the allocation of the transaction price (i.e., contract revenue) will be new to many E&C companies. Of

particular interest will be the allocation of variable consideration (e.g., award/incentive payments) associated with only one separately accounted for performance obligation, rather than the contract as a whole. This is an area that is currently unclear in the proposed standard and we believe is an important area that requires further consideration.

Proposed standard	Current US GAAP	Current IFRS
Allocating the transaction price For performance obligations that require separate accounting, contract revenue is allocated to each performance obligation based on relative actual or estimated selling prices. An estimation method will not be prescribed nor will any method be precluded. For example, a contractor might use cost plus a reasonable margin in estimating selling price of a good or service. This initial measurement is not revisited unless performance obligations become onerous.	Except for allocation guidance related to contract segmentation, there is no explicit guidance on allocating contract revenue to multiple deliverables in a construction contract, given the presumption that the contract is the profit center for determining revenue recognition.	Except for allocation guidance related to contract segmentation, there is no explicit guidance on allocating contract revenue to multiple deliverables in a construction contract, given the presumption that the contract is the profit center for determining revenue recognition.

Example 6—Allocating contract revenue to more than one performance obligation

Facts: A contractor enters into a contract to build both a road and a bridge (assume for this example that there are only two performance obligations: to build the road and to build the bridge). The contractor determines at inception that the contract price is \$150 million, which includes a \$140 million fixed price and an estimated \$10 million of award fees if the contact as a whole is finished 30 days ahead of schedule.

Discussion: In allocating the contract consideration (including both the fixed and variable amounts), a contractor must first assign a selling price to both the road and the bridge. The contractor typically

constructs both roads and bridges of a similar type and nature to those required by the contract, on a stand-alone basis. The stand-alone selling price to build this road, based on prior experience, is \$140 million. The stand-alone selling price to build this bridge, based on prior experience, is \$30 million. There is, therefore, an inherent discount of \$20 million built into the bundled contract. Using a relative allocation model, the \$150 million transaction price is allocated as follows:

Road:	\$124m (\$150m * (\$140m/\$170m))
Bridge:	\$26m (\$150m * (\$30m/\$170m))

Example 7—Allocating contract revenue to more than one performance obligation—changes in the transaction price

Facts: After contract inception, the amount of variable consideration changes from an expected \$10 million to an expected \$12 million. Performance obligations are not remeasured after contract inception, so the additional \$2 million would be allocated to the road and bridge using the initially developed allocation percentages as follows:

Road:	\$1.6m ($\$2\text{m} * (\$140\text{m}/\$170\text{m})$)
Bridge:	\$.4m ($\$2\text{m} * (\$30\text{m}/\$170\text{m})$)

Discussion: Such changes are recognized using a cumulative catch-up approach. For example, if the road was completed before the change in estimated variable consideration, the full amount of \$1.6m would be recognized as revenue when the estimate was revised.

Recognize revenue

Revenue recognition under existing guidance is based on the activities of the contractor; that is, provided reasonable estimates are available, revenue can be recognized as the contractor performs (known as the percentage-of-completion method). The boards have proposed that revenue is recognized upon the satisfaction of a contractor's performance obligations,

which occurs when control of an asset (good or service) transfers to the customer. Control can transfer either at a point in time or continuously over the contract period. The change to a control transfer model will require careful assessment of when a contractor can recognize revenue. We expect that many construction-type contracts will transfer control of a good or service continuously to the owner over the contract term and therefore, might

produce similar results compared to today. This should not, however, be assumed. Contractors will not be able to default to the method used today. Cost-to-cost may be used today, for example, to measure revenue under an activities based recognition model. It may not be appropriate for measuring the extent to which control has transferred under a continuous transfer model.

Proposed standard	Current US GAAP	Current IFRS
Recognize revenue Revenue is recognized upon the satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. Control can transfer at a point in time or, perhaps most important for the E&C industry, continuously over the contract period. Factors to consider in assessing control transfer include, but are not limited to: • The customer has an unconditional obligation to pay • The customer has legal title • The customer has physical possession • The customer specifies the design or function of the good or service This list is not intended to be a checklist or all-inclusive. The ability to borrow against the asset, for example, may be another control transfer factor to consider. No one factor is determinative on a stand-alone basis.	Revenue is recognized using the percentage-of-completion method when reliable estimates are available. In circumstances in which reliable estimates cannot be made, but there is an assurance that no loss will be incurred on a contract (e.g., when the scope of the contract is ill defined, but the contractor is protected from an overall loss), the percentage-of-completion method based on a zero-profit margin is used until more precise estimates can be made. Where reliable estimates cannot be made, the completed-contract method is required.	Revenue is recognized using the percentage-of-completion method when reliable estimates are available. In circumstances in which reliable estimates cannot be made, but there is an assurance that no loss will be incurred on a contract (e.g., when the scope of the contract is ill defined, but the contractor is protected from an overall loss), the percentage-of-completion method based on a zero-profit margin is used until more precise estimates can be made. The completed-contract method is prohibited.

Proposed standard	Current US GAAP	Current IFRS
Measuring continuous transfer of control For contracts where control transfers continuously, a contractor can use either an input method (e.g., cost-to-cost, labor hours, labor cost, machine hours, material quantities), an output method (e.g., physical progress, units produced, units delivered, contract milestones) or the passage of time to measure the extent to which control has transferred. The method that best depicts the transfer of goods or services to the customer should be applied consistently throughout the contract and to similar contracts with customers. Once the metric is calculated to measure the extent to which control has transferred, it must be applied to total contract revenue to determine the amount of revenue to be recognized. This is currently referred to as the Revenue method. The use of the Gross Profit method is prohibited. Estimates to measure the extent to which control has transferred (e.g., estimated cost to complete when using a cost-to-cost calculation) should be continually evaluated and adjusted using a cumulative catch-up method.	A contractor can use either an input method (e.g., cost-to-cost, labor hours, labor cost, machine hours, material quantities), an output method (e.g., physical progress, units produced, units delivered, contract milestones), or the passage of time to measure progress towards completion. Once a “percentage-complete” is derived, there are two different approaches for determining revenue, cost of revenue and gross profit; the Revenue method and the Gross Profit method.	A contractor can use either an input method (e.g., cost-to-cost, labor hours, labor cost, machine hours, material quantities), an output method (e.g., physical progress, units produced, units delivered, contract milestones), or the passage of time to measure progress towards completion. Once a “percentage-complete” is derived, IFRS requires the use of the Revenue method. The Gross Profit method is prohibited.

Example 8—Recognizing revenue

Facts: A contractor enters into a construction contract with an owner to build an oil refinery. The contract has the following characteristics:

- The oil refinery is highly customized to the owner’s specifications and owner changes to these specifications are expected over the contract term
- Non-refundable, interim progress payments are required as a mechanism to finance the contract

- The owner can cancel the contract at any time (with a termination penalty); any work in process is the property of the owner
- Physical possession and title do not pass until completion of the contract

How would a contractor recognize revenue in this example (assume only for these examples that there is one performance obligation—that of building the refinery)?

Discussion: The preponderance of evidence suggests control of the oil refinery is being transferred continuously over the contract term. In such cases, the contractor will have to select either an input or output method (or, less likely, passage of time) to measure the extent to which control has transferred.

Example 9—Recognizing revenue—use of cost-to-cost

Facts: Assume the same fact pattern and assumptions as above. Additional contract characteristics are:

- Contract duration is three years
- Total estimated contract revenue is \$300 million
- Total estimated contract cost is \$200 million
- Year one cost is \$120 million (including \$20 million related to contractor caused inefficiencies)

The contractor has concluded that cost-to-cost is a reasonable proxy for measuring the extent to which control has transferred.

How much revenue and cost does the contractor recognize at the end of year one?

Discussion: In determining the amount of revenue to be recognized under a cost-to-cost model, the contractor would have to exclude any costs that do not depict the transfer of goods or services; in this case, the costs associated with contractor caused inefficiencies. The amount of contract revenue and cost recognized at the end of year one is:

Revenue:	\$150m ($\$300\text{m} * (\$100\text{m}/\$200\text{m})$)
Contract cost:	<u>\$100m</u>
Gross contract margin:	\$ 50m
Contract inefficiencies:	<u>\$ 20m</u>
Net contract margin:	\$ 30m

Example 10—Recognizing revenue—use of cost-to-cost with changes in estimates

Facts: Assume the same fact pattern and assumptions as above, except that total estimated cost to complete increases at the end of year two to \$250 million due to an unexpected increase in the cost of materials. Actual cumulative cost incurred at the end of year two (excluding year-one inefficiencies) is \$200 million.

The contractor has concluded that cost-to-cost is a reasonable proxy for measuring the extent to which control has transferred. How much revenue and cost does the contractor recognize at the end of year two?

Discussion: The amount of contract revenue and cost recognized at the end of year two is:

Cumulative revenue:	\$240m ($\$300\text{m} * (\$200\text{m}/\$250\text{m})$)
Revenue recognized year one:	<u>\$150m</u>
Revenue recognized year two:	\$ 90m
Cumulative costs (excluding inefficiencies):	\$200m
Costs recognized year one (excluding inefficiencies):	<u>\$100m</u>
Costs recognized year two: (excluding inefficiencies):	\$100m
Gross contract margin year two:	\$(10m)
Gross contract margin to-date:	\$40m ($\$240\text{m} - \$200\text{m}$)
Net contract margin to-date:	\$20m ($\$240\text{m} - \$200\text{m} - \$20\text{m}$)

Other considerations

Warranties

The proposed standard draws a distinction between warranties that protect against latent defects and warranties that protect

against defects that arise after the product is transferred to the customer, such as normal wear and tear. Many warranties in the E&C industry protect against latent defects. We therefore expect practice could significantly change in this area,

resulting in delayed revenue recognition and complex accounting calculations. However, contractors will need to use significant judgment to determine whether a defect is latent, or has arisen subsequent to the sale.

Proposed standard	Current US GAAP	Current IFRS
Warranties Warranties that protect against latent defects do not give rise to a separate performance obligation. They acknowledge the possibility that the contractor has not satisfied its performance obligation. Management will need to determine the likelihood and extent of defects in the products it has sold to customers at each reporting period to determine the extent of unsatisfied performance obligations. A portion of the contract revenue should be deferred at the time of sale for defective products that will be replaced either in part or in their entirety. A warranty that protects against defects that arise after the product is transferred gives rise to a separate performance obligation. A portion of the transaction price is allocated to that separate performance obligation at contract inception.	Contractors typically account for warranties that protect against latent defects outside of the contract and in accordance with existing loss contingency guidance. A contractor recognizes revenue and concurrently accrues any expected cost for these warranty repairs. Revenue is deferred for warranties that protect against defects arising through normal usage and recognized over the expected life of the contract.	Contractors are required to account for the estimated costs of rectification and guarantee work, including expected warranty costs, as contract costs. However, contractors typically (due to materiality considerations) account for standard warranties protecting against latent defects outside of the contract and in accordance with existing provisions guidance. A contractor will recognize revenue and concurrently accrue any expected cost for these warranty repairs. Revenue is deferred for warranties that protect against defects arising through normal usage and recognized over the expected life of the contract.

Example 11—Accounting for warranties

Facts: Assume the same fact pattern and assumptions as Example 8. The contractor also provides a 60-day warranty that covers latent defects for certain components of the oil refinery. How would the contractor account for such a warranty?

Discussion: The contractor would have to estimate, at contract inception using all available information such as historical experience, the selling price of each of the oil refinery components that will require repair or replacement. Once determined, contract revenue would be allocated at inception on a relative selling price basis to those components and revenue deferred until the owner received control of those components without defects (i.e., generally the earlier of when the defects are repaired/replaced or when the warranty period expires).

Contract costs

Existing construction literature contains a substantial amount of cost capitalization guidance, both related to pre-contract costs and costs to fulfill a contract.

The proposed model includes contract cost guidance, but we expect a significant change from today's practice, in particular around the accounting for pre-contract costs.

Proposed standard	Current US GAAP	Current IFRS
Contract costs All costs of obtaining a contract, costs relating to satisfied performance obligations, and costs related to inefficiencies (i.e., abnormal costs of materials, labor, or other costs to fulfill) should be expensed as incurred. Other direct costs incurred in fulfilling a contract are expensed as incurred unless they are within the scope of other standards (e.g., inventory, intangibles, fixed assets), in which case the entity should account for such costs in accordance with those standards. If the costs are not within the scope of other standards, the entity should recognize an asset only if the costs relate directly to a contract, relate to future performance, and are probable of recovery under a contract. These costs would then be amortized as control of the goods or services to which the asset relates is transferred to the customer.	There is a significant amount of detailed guidance relating to the accounting for contract costs. This is particularly true with respect to accounting for pre-contract costs. Pre-contract costs that are incurred for a specific anticipated contract generally may be deferred only if their recoverability from that contract is probable. Other detailed guidance is also prescribed in the standard and should be appropriately considered.	There is a significant amount of detailed guidance relating to the accounting for contract costs. Costs that relate directly to a contract and are incurred in securing the contract are included as part of contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. Other detailed guidance is also prescribed in the standard and should be appropriately considered.

Example 12—Accounting for contract costs

Facts: Assume the same fact pattern and assumptions as Example 9. At the beginning of the contract, the contractor incurs certain mobilization costs amounting to \$1 million. The contractor has concluded that

such costs should not be accounted for in accordance with existing asset standards (e.g., inventory, fixed assets, or intangible assets). How should these costs be accounted for?

Discussion: These costs to fulfill a contract would be eligible for capitalization so

long as they: (a) relate to the contract; (b) relate to future performance; and (c) are probable of recovery. Using the fact pattern in Example 9 above, \$500,000 would be amortized at the end of year one (coinciding with 50 percent control transfer using a cost-to-cost method).

***To have a deeper conversation
about how this subject may affect
your business, please contact:***

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US GAAP Convergence & IFRS

Revenue recognition: Entertainment and media industry supplement

March 2011

Revenue recognition . . . full speed ahead

Entertainment and media industry supplement

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Reprinted from:

Dataline 2010–28 (Supplement)

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Overview

The entertainment and media sector is comprised of various subsectors, such as filmed entertainment, television, music, video games, publishing, radio, and internet. Each subsector has unique product and service offerings and, in certain subsectors, industry specific revenue recognition guidance exists under US GAAP. IFRS does not have industry specific guidance.

The following items common in the entertainment and media industry may be significantly affected by the proposed revenue recognition standard. This paper, examples, and related assessments contained herein are based on the Exposure Draft, *Revenue from Contracts with Customers*, which was issued on June 24, 2010. These proposals are subject to change at any time until a final standard is issued. The examples reflect potential effects based on the proposed standard and any conclusions are subject to further interpretation and assessment based on the final standard. For a more comprehensive description of the model refer to PwC's Dataline 2010–28 or visit www.fasb.org.

* This Dataline Supplement was revised on September 3, 2010 to reflect certain editorial revisions. None of the revisions resulted in substantive changes to the assessments of the proposed model contained herein.

Licenses and rights to use

Many entertainment and media companies license intellectual property to third parties. Such licenses may include the right to exploit a motion picture in various markets and territories or the rights to exploit a character to be used in a video game or other consumer product.

Proposed standard	Current US GAAP	Current IFRS
The recognition of revenue for the license of intellectual property depends on whether the customer obtains control of the asset. The contract is considered a sale (rather than a license or a lease) of intellectual property if the customer obtains control of the entire licensed intellectual property (e.g., the exclusive right to use the license for its economic life). If the transaction is a sale, revenue is recognized when control transfers. If the customer licenses intellectual property on an exclusive basis but does not obtain control for the entire economic life of the property, the performance obligation is satisfied over the term of the license. Revenue will be recognized over the term of the license. A contract that provides a nonexclusive license for intellectual property contains a single performance obligation. Revenue is recognized when the customer is able to use the license and benefit from it (i.e., when control transfers).	Sale of episodic television series in syndication Current guidance requires that the following conditions be met prior to the recognition of revenue: • Persuasive evidence of an arrangement exists • The film is complete, has been delivered or is available for immediate delivery • The license period has begun and the customer can begin its exploitation, exhibition, or sale • The arrangement fee is fixed or determinable • Collection of the arrangement fee is reasonably assured Delivery may occur on a daily or weekly basis, even though all of the episodes are complete and ready for delivery, in order to allow for the insertion of advertisements into the filmed product. A contractual provision allowing the producer to insert its national advertising spots is not considered a provision that would preclude revenue recognition. If the criteria noted above are met, the net present value of the entire syndication contract is recognized as revenue upon commencement of the license term.	IFRS does not contain any industry specific accounting for media and entertainment entities. Revenue is not generally recognized under licensing agreements until performance under the contract has occurred and the revenue has been earned. The assignment of rights for a non-refundable amount under a non-cancelable contract permits the licensee to use those rights freely. Where the licensor has no remaining obligations to perform, the transaction is in substance a sale. A fixed license term is an indicator that the revenue should be recognized over the period because the fixed term suggests that the license's risks and rewards have not been transferred to the customer. However, the following indicators should be considered in determining whether a license fee is recognized over the term or upfront: • There is a fixed fee or non-refundable guarantee • The contract is non-cancellable • The customer is able to exploit the rights freely • The vendor has no remaining performance obligations

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>	Licenses and right to use motion pictures It is common in certain territories for a producer to license a film to a counterparty in several markets, such as theatrical, home video, and television. Such contracts typically have predefined dates when the title can be exploited in each of the markets. Each contract also typically specifies an overall minimum guarantee (e.g., payment) that may be paid up front or be allocated to the various components by market. For amounts allocated to the various markets, revenue is generally recognized as each market becomes available. Although current practice is mixed, generally the license fee is allocated to the various markets (e.g., theatrical, home video, and television) on a relative fair value basis and revenue is recognized when each window is available for exploitation. Licensor accounting of a record master or music copyright Under today's accounting, the license of a record master or music copyright may be considered an outright sale if the licensor has signed a non-cancelable contract, has agreed to a fixed fee, has delivered the rights (as well as the recording) to the licensee, and has no remaining significant obligations to furnish music or records (i.e., the contracted recordings have been transferred). The earnings process is complete and the licensing fee is recorded as revenue if the license is, in substance, an outright sale and if collectability is reasonably assured. If the licensor is unable to determine the amount of the license fee earned (i.e., the license allows for a continued amount of additional music to be provided), the consideration received should be recognized as revenue equally over the remaining performance period, which is generally the period covered by the license agreement.	When receipt of a license fee or royalty is contingent on the occurrence of a future event, revenue is recognized only when it is probable that the fee or royalty will be received, which is normally when the event has occurred.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>	Impact: The timing of revenue recognition for the license of an episodic television series, filmed entertainment and music may be affected by the proposed standard. If the licensee obtains an exclusive license for less than the economic life of the intellectual property, revenue is recognized over the contractual term (i.e., license term) rather than upfront as currently allowed. If the licensee obtains a non-exclusive license to the intellectual property, revenue is recognized once control of the licensed content is transferred, which is expected to be upon delivery. The timing of revenue recognition may be affected if the licensor is able to reasonably estimate the amount of consideration to be received for licensing content when some or all of the consideration is variable. If the fee to be received can be reasonably estimated, variable consideration is included in the transaction price. If variable consideration cannot be reasonably estimated at contract inception, revenue is not recognized until such amounts can be reasonably estimated. The timing of recognition of revenue depends on whether the license is exclusive or non-exclusive. Based on the numerous markets and territories in which content is licensed, the application of the terms “exclusive” and “non-exclusive” in this industry may be challenging to apply under the proposed standard. It is unclear why exclusivity should determine whether revenue is recognized at a point in time or over a period of time if the performance obligation is the same. That is, if the performance obligation is the license of intellectual property (IP) and the licensor has no further obligations, it’s unclear why the pattern of revenue recognition would be different. The determination of the unit of account (i.e., the asset being licensed) will also be a key factor in determining the appropriate license model to apply under the proposed standard. The underlying IP (e.g., a motion picture) will exist in perpetuity, so it is unclear if many exclusive licenses in the entertainment and media industry will be recognized over the license term, as the term will normally be less than the economic life of the IP, or if the IP may be divided into distinct assets (e.g., theatrical window for a motion picture).	

Example 1—Sale of episodic television series in syndication

Facts: Studio XYZ licenses 100 of its completed episodes of an episodic television series to a cable channel for a four-year period commencing January 1, 20XX on an exclusive basis. The cable channel pays an annual fee of \$4,000,000 in equal monthly installments and is contractually obligated to broadcast this program each

weeknight. Studio XYZ also has the right to insert two 30-second advertising spots into each broadcast of the show. How is revenue recognized by Studio XYZ?

Discussion: The net present value of the payment stream is currently recognized as revenue when the series is available for exploitation by the cable channel. If the license is exclusive and the term is for a period less than the economic life of the

property (i.e., the completed episodes may be re-licensed once the current license expires), the proposed standard requires that the revenue be recognized as the licensee obtains control of the property during the license term. Straight-line recognition is appropriate if the license is transferred continuously and evenly over time.

Example 2—Licenses and rights to use motion pictures

Facts: Studio Z licenses certain international windows for Film A to a customer for a ten-year period in return for £10 million to be paid as follows: £4 million on theatrical availability; £4 million on the date six months after the theatrical release date (which is also the home video availability date), and £2 million on the date one year after the theatrical release date (which is also the television availability date). The contractual arrangement prohibits the licensing of Film A in the same markets and territory during the original license term. How is revenue recognized by Studio Z?

Discussion: Studio Z will need to determine if one license (i.e., a ten-year license for multiple windows—theatrical, home video, and television) is granted to the customer or if three distinct licenses are granted (i.e., theatrical, home video, and television). Assuming Studio Z determines that each release coincides with a distinct license (i.e., a license for theatrical, home video, and television), the transaction price of £10 million is allocated to each license based on the relative standalone selling price. The contractual arrangement prohibits the licensing of Film A in the same markets and windows during the ten-year contractual term, so each license is exclusive. Studio Z therefore determines the economic life of the underlying asset being licensed in each window. If it determines that the term of the license in a window (e.g., the home video window) is for a period less than the economic life of the asset, revenue is recognized over the license term as control of the performance obligations are transferred.

Example 3—Non-exclusive license of record master or music copyright

Facts: Record Label enters into a non-exclusive license agreement with a retailer. Under the terms of the license, the retailer may use Song X for a period of two years in advertisements produced by the retailer. The terms of the agreement do not require Record Label to provide the retailer with any additional content or deliverables. How does Record Label recognize revenue?

Discussion: Record Label has licensed Song X on a non-exclusive basis and there are no further performance obligations. Revenue is therefore recognized once control of the license is obtained by the retailer. That is, revenue is recognized once the retailer could exploit Song X under the terms of the license agreement.

Example 4—Exclusive license of record master or music copyright

Facts: Record Label enters into an exclusive license agreement with a retailer. Under the terms of the license, the retailer may use Superstar's Song X for a period of two years in advertisements produced by the retailer. The terms of the agreement do not require Record Label to provide the retailer with any additional content or deliverables. How does Record Label recognize revenue?

Discussion: Record Label has licensed Song X on an exclusive basis for a period that is expected to be less than the economic life of Song X due to Superstar's continuing popularity. Revenue is therefore recognized over the term of the license agreement rather than upfront, as control transfers throughout the license term.

Variable consideration

Many arrangements in the entertainment and media industry include minimum guarantees with additional potential variable consideration in the form of royalties or other incremental payments.

Management will need to assess variable consideration in determining the transaction price to be allocated to the performance obligations. When consideration is not fixed, the transaction price is the probability-weighted estimate of consideration to be received. Inclusion of

variable consideration in the transaction price requires management to assess the probability of each possible outcome. An estimate of variable consideration is only included in the transaction price if it can be reasonably estimated.

Proposed standard	Current US GAAP	Current IFRS
The transaction price is the amount of consideration that an entity receives, or expects to receive, from the customer in exchange for transferring goods or services. For contracts that include variable consideration, the transaction price is estimated at contract inception and at each reporting period. Variable consideration is included in the transaction price if the entity can identify the potential outcomes of a contract. If the entity has experience with similar types of contracts and does not expect significant changes in circumstances, variable consideration is included in the transaction price.	International sales of films for a minimum guarantee and potential variable upside consideration In a licensing arrangement, a licensee may commit to pay a minimum nonrefundable license fee up front. The licensor may also include a provision stipulating that the licensor is entitled to a percentage of the licensee's revenues once the variable rate exceeds the amount of the fixed minimum guarantee. The consideration from the non-refundable fixed minimum guarantee is allocated to each market being licensed on a relative selling price basis and is generally recognized once that market is available for the licensee, presuming all of the revenue recognition conditions have been met. Revenue to be paid by a licensee in excess of any fixed non-refundable minimum guarantee is typically recognized by the licensor once the variable fee exceeds the total minimum guarantee.	Revenue is recognized for a license fee or royalty that is contingent on the occurrence of a future event only when the revenue is reliably measurable and it is probable that the fee or royalty will be received, which may be when the event has occurred. However, if the license fee or royalty is probable of being received and is reliably measurable, revenue is recorded when the license is available for exploitation.
	Impact: The proposed standard may significantly affect the timing of revenue recognition, as variable consideration will need to be assessed for inclusion in the transaction price if it can be reasonably estimated. The licensor may be able to reasonably estimate the possible outcomes, including the impact of the variable consideration, if it has historical experience with similar contracts. Significant judgment will be required to determine whether variable consideration can be reasonably estimated and to determine the amount of variable consideration to be included in the transaction price. Entities that currently restrict revenue recognition to the non-contingent amount may experience significant change, depending on the nature of the contingency. An entity might recognize revenue under the proposed standard before the contingency is resolved in some cases, which might be earlier than under today's models.	

Example 5

Facts: Studio Z enters into a single contract with a customer to license certain international windows for Film A for a ten-year period in return for a minimum guarantee of £10 million plus a royalty of 10% of revenues once total revenues from exploitation of Film A exceeds \$100 million. The guarantee is to be paid as follows: £4 million on theatrical availability; £4 million on the date six months after the theatrical release date (which is also the home video availability date), and £2 million on the date one year after the theatrical release date (which is also the television availability date). The contractual arrangement prohibits the licensing of Film A in the same markets and territory during the original license term. How does Studio Z recognize revenue?

Discussion: Currently, variable consideration is generally recognized once the amount is earned and known. Variable consideration is included in the transaction price under the proposed standard if it can be reasonably estimated and is allocated to the separate performance obligations based on the relative estimated selling price. Studio Z will need to consider if there is experience with similar types of contracts and whether the studio expects significant changes in possible outcomes in considering whether the potential upside can be reasonably estimated.

Accounting for multiple performance obligations

Performance obligations are defined as an enforceable promise to deliver goods or perform services. Determining when to separately account for these performance obligations under the proposed standard is key and will require a significant amount of judgment.

Management will need to determine whether performance obligations in a contract need to be accounted for separately from other performance obligations in the contract. The separation criteria may result in more performance obligations being identified than under current practice. This is an area that we expect will continue to evolve and that management should pay particular attention to. Applying the separation principle in the proposed standard may be challenging in some circumstances.

Proposed standard	Current US GAAP	Current IFRS
The model requires performance obligations that are “distinct” to be accounted for separately (assuming the performance obligations are delivered at different times). A good or service is distinct and should be accounted for separately if the entity or another entity sells an identical or similar good or service separately. Performance obligations could be distinct if not sold separately if the good or service has a distinct margin and a distinct function.	Additional functionality included in software products, including video games Certain software and video game arrangements may include software deliverables, non-software deliverables, accessories, and related services (including online services and multi-player functionality). Management must identify the deliverables that are within the scope of the software literature in such arrangements as well as those accounted for following non-software revenue literature. Management must determine if the deliverables are essential to the functionality of the more than incidental software. Deliverables essential to the software are within the scope of the software literature. Deliverables not essential to the functionality of the more than incidental software are accounted for in accordance with other, non-software revenue literature. For non-software deliverables, management may need to consider whether the deliverables are inconsequential and perfunctory, thus permitting no accounting for such items.	For transactions that contain separately identifiable components, it is necessary to apply the revenue recognition criteria to each separately identifiable component of a single transaction in order to reflect the transaction’s substance. The customer’s perspective is key in determining whether the transaction should be accounted for as one element or multiple-elements. If the customer views the purchase as one element, the arrangement may be accounted for as one transaction. When elements in a single contract are separated, fair value is used to allocate the transaction price to the separate elements. Entities are not precluded from separating elements in a single contract if the elements are not sold separately.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>	Impact: Video game developers will need to determine whether the video game and the additional services should be accounted for as separate performance obligations under the proposed standard. Management will need to determine whether the game and additional services are distinct from one another. The transaction price is allocated to the separate performance obligations if they are distinct. The video game is typically delivered at a single point in time while the services are delivered over a future service period, so the timing of revenue recognition may be impacted. Software as a service in the video game industry Revenue for sales of software products playable on hosted servers on a subscription-only basis is generally recognized ratably over the estimated service periods, beginning when the software is activated and delivery of the related services begins. Impact: Contracts with only one performance obligation may not be significantly affected by the proposed standard. However, video game publishers will need to determine whether there are multiple performance obligations in a contract that provides for use of games through a hosted subscription model. Advertising arrangements Advertising arrangements often include more than one type of advertisement placement, ranging from print to TV, to internet banners and impressions. Current guidance requires deliverables in contracts to be accounted for separately if each deliverable has stand-alone value and there is objective and reliable evidence of fair value of the undelivered element. Determining whether objective and reliable evidence of fair value of the undelivered element exists is currently restrictive and often limits the separation of deliverables in a multiple-element arrangement.	Impact: Multiple-element arrangements may be affected because the performance obligations will need to be accounted for separately if they are distinct from other performance obligations in the contract. Relative estimated selling prices are used to allocate the transaction price to the separate performance obligations rather than the relative fair values.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>	Impact: Advertisers will need to assess whether advertising contracts include more than one performance obligation. The separation criteria in the proposed standard is less restrictive than current GAAP, which may result in more performance obligations being accounted for separately, affecting the timing of revenue recognition. This change in the separation criteria may impact some entities more than others, depending on the guidance currently applied to the entity under US GAAP.	

Example 6—Online functionality included in software products

Facts: Company A develops and sells video games. The video games include additional services that enhance the user experience by allowing multi-player game formats and other online services. The additional services are not sold on a stand-alone basis by Company A. Company A therefore has historically accounted for the sale of a video game together with additional services that enhance the user experience, recognizing revenue over the service period. How will Entity A account for revenue under the proposed standard?

Discussion: Company A will need to determine if the video game and the additional services are distinct and therefore should be accounted for separately. They are separate performance obligations if the game and the services each have a distinct function and if the margins are also distinct (i.e., Company A can separately identify the resources needed to

provide the video game and the additional services). The transaction price is allocated to the separate performance obligations if the game and the services are distinct and revenue is recognized for the video game once control transfers (presumably upon delivery) and for the services over the service period.

Example 7—Advertising arrangements

Facts: Advertiser A provides multiple forms of internet advertising to customers, including impression-based advertising and activity-based advertising in stand-alone arrangements and in bundled arrangements. Advertiser A enters into a single contract with Customer X to provide three advertising campaigns. Advertiser A will provide 100,000 click-throughs, two banners, and 50,000 impressions during the term of the contract. The total arrangement consideration is \$100,000. Advertiser A has established a rate card, which is to be used as a starting point in negotiating

pricing. However, discounts are commonly granted to customers and the range of pricing is not consistent. Advertiser A has historically accounted for the deliverables as one unit of accounting when sold on a combined basis as there was no objective and reliable evidence of the fair value of the undelivered advertising spots due to the inconsistency in pricing. How does Advertiser A account for revenue under the proposed standard?

Discussion: Advertiser A will need to consider whether the advertising campaigns included in the contract should be accounted for separately. Assuming the campaigns are delivered at different times, Advertiser A will need to assess whether the campaigns are distinct from one another. The advertising spots are distinct, as they are sold separately, so the transaction price is allocated to each of the three campaigns based on a relative estimated selling price allocation. Revenue is recognized as the advertising spots are delivered during the campaign.

Options to acquire additional good or services

An entity may grant a customer the option

to acquire additional goods or services. Often such options provide a discount on subsequent purchases. It is not uncommon in filmed entertainment to include the option to renew a series for incremental

seasons. Licensors will need to determine if that promise gives rise to a material right to the customer to determine the appropriate accounting for the option.

Proposed standard	Current US GAAP	Current IFRS
If a contract includes an option to acquire additional goods or services, such an option is a separate performance obligation if the option provides a material right to the customer that the customer would not have received without entering into the contract. The transaction price is allocated to the option based on the estimated stand-alone selling price of the option.	Options to renew a series for incremental seasons Producers of episodic television series often enter into licensing agreements that allow the licensee the ability to license additional seasons. The option to acquire additional seasons is usually considered to be at fair value and no allocation of consideration is made to the option.	The recognition criteria are usually applied separately to each transaction (i.e., the original purchase and the separate purchase associated with the option). However, it is necessary in certain circumstances to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. If an entity grants to its customers, as part of a sales transaction, an option to receive a discounted good or service in the future, the entity accounts for that option as a separate component of the arrangement. It therefore allocates consideration between the initial good or service provided and the option.
	Impact: Options to renew a series for incremental seasons may impact the original transaction price if the option provides a material right to the customer that the customer would not have received without entering into the contract. The producer will need to consider factors such as the pricing for the incremental seasons in determining whether a material right has been granted to the licensee. If a material right was granted, revenue will need to be allocated to the option and deferred until delivery of the second item or when the right expires.	

Example 8—Options to renew a series for incremental seasons

Facts: Studio X produces an episodic television series and licenses the 13 episodes to be produced in season one to Network Y for a license fee of €1.5 million per episode. The contractual arrangement also includes an option that allows Network Y, at its sole discretion, to require Studio X to produce seasons two and three for a license fee of €2 million and €2.5 million

per episode, respectively. How does Studio X account for its revenue?

Discussion: Studio X currently recognizes revenue under US GAAP of €1.5 million as it delivers each episode to Network Y. No specific accounting consideration is given to the existence of the option to acquire subsequent seasons. These options will be exercised only if Network Y believes that the series has some reasonable level of consumer acceptance. In evaluating

these options under the proposed standard, Studio X determines that the option provides a material right to the licensee, as fixed pricing establishes significant upside for Network Y if the series becomes a “hit” (that is, if a new license was entered into, the pricing would be materially different). The estimated transaction price for the license of the television series therefore includes the probability weighted amount of consideration expected to be received from the exercise of the option to license the two additional seasons.

Accounting for return rights

Return rights are common in sales transactions that include physical goods sold to retailers. Some of these rights may be articulated in contracts with customers

or distributors, while some are implied during the sales process. These rights take many forms and are driven generally by the buyer's desire to mitigate technological risk or the risk that the product will not sell, and the seller's desire to promote goodwill with its customers.

Proposed standard	Current US GAAP	Current IFRS
The sale of goods with a right of return is accounted for similarly to today's failed sale model. That is, revenue is not recognized for goods expected to be returned; rather, a liability is recognized for the expected amount of refunds to customers using a probability-weighted approach. The refund liability is updated for changes in expected refunds. An asset and corresponding adjustment to cost of sales is recognized for the right to recover goods from customers on settling the refund liability, with the asset initially measured at the original cost of the goods (that is, the former carrying amount in inventory).	Sales of digital or physical music Revenue is recognized for sales of physical music products (e.g., compact discs, etc.) once the product is available for release (i.e., at the street date) which is typically after the product has been shipped by the producer to the retailer. The amount of revenue recognized is affected by the estimated returns that are expected. Revenue is recognized for the sale of digital music once the consumer downloads the song or album. The sale of digital music does not include the right of return.	Currently, revenue is typically recognized net of a provision against revenue for the expected level of returns, provided that the seller can reliably estimate the level of returns based on an established historical record and other relevant evidence.
	Impact: Accounting for returns will be largely unchanged under the proposed standard. However, the balance sheet will be grossed up to include the refund obligation as a liability and the asset for the right to the returned goods. The timing of revenue recognition may be affected for the sale of a physical product as recognition currently occurs once the retailer has the ability to sell the product to consumers (at the "street date"). Under the proposed standard, recognition is predicated on the transfer of control of the good and satisfaction of the performance obligation. The record label should consider whether the customer has the ability to direct the use of, and benefit from, the merchandise in determining whether control has transferred. Revenue recognition may occur earlier than current practice if control transfers once the customer obtains the physical product (rather than at the "street date"). The accounting for the sale of digital music is not expected to change under the proposed standard as revenue recognition will occur once the consumer obtains control of the download.	

Example 9—Sale of physical product by music producer

Facts: A record label sells 100 compact discs for \$10 each. The products cost \$2 to produce and the sale includes a return right. The retailer takes physical possession of the compact discs and is contractually obligated to pay for the inventory once the discs are received. Based upon historical sales patterns, the record label determined that the estimated sales returns associated with this transaction is 10%. In establishing the 10% return rate, the company estimated a 32% probability that seven discs would be returned, a 40% probability that nine discs would be returned, and a 28% probability that 15 discs would be returned. The record label estimates that the costs of recovering the products will be immaterial and expects the returned products can be resold at a profit. How does the record label account for this transaction?

Discussion: Once control transfers to the retailer, \$900 of revenue ($\$10 \times 90$ products (100 less the 10% expected returns)) and cost of sales of \$180 ($\$2 \times 90$ products) is recognized. An asset of \$20 (10% of product cost) is recognized for the anticipated sales returns while a liability of \$100 (10% of product sale price) is recognized for the refund obligation (rather than recording an allowance against accounts receivable). The estimate of returns is re-evaluated at each reporting date. Any changes in the probability require an adjustment to the asset and liability. Adjustments to the liability recorded to revenue and adjustments to the asset recorded against cost of sales.

Contract costs

Existing US GAAP literature includes a substantial amount of guidance related to the capitalization of costs specific to many of the entertainment and media subsectors, both related to pre-contract costs

and costs to fulfill a contract. No industry-specific information is provided under IFRS. The proposed standard includes contract cost guidance, and management will need to consider whether the accounting for contract costs will be affected by the proposed standard.

Proposed standard	Current US GAAP	Current IFRS
All costs of obtaining a contract, costs relating to satisfied performance obligations and costs related to inefficiencies are expensed as incurred. Other direct costs incurred in fulfilling a contract are expensed as incurred unless they are within the scope of other standards (e.g., inventory, intangibles, fixed assets). Costs in the scope of other standards are accounted for in accordance with those standards. If they are not, the entity recognizes an asset only if the costs relate directly to a contract, relate to future activity and are probable of recovery under a contract. These costs are then amortized as control of the goods or services to which the asset relates is transferred to the customer.	Filmed entertainment The production of motion pictures and episodic television series require significant upfront investment. Projects to produce content can include significant development stage expenditures, including those to acquire intellectual property such as film rights to books or original screenplays. Currently, such development costs are typically capitalized and included in the film asset balance. Such costs would typically be written-off if the project is not green-lit within three years of the date of initial cost capitalization. Impact: The accounting for costs to produce an episodic television series and film costs (i.e., capitalization and amortization) including direct negatives, overall deal costs, rights to film properties, costs incurred for significant changes, as well as the allocations of production overhead and capitalization of interest is not anticipated to be affected by the proposed standard.	There is no specific guidance for recognizing costs in relation to selling goods or rendering services. However, for the rendering of services, construction accounting guidance generally is applied to the accounting for revenue and associated expenses. It may be appropriate to capitalize costs if the entity can recognize an asset under the inventory, fixed asset, or intangible asset standards, or if the costs otherwise meet the definition of an asset. Costs such as training costs are typically not capitalized because they do not meet the definition of an asset. However, certain initiation or pre-contract costs may be capitalized when they can be separately identified, reliably measured and it is probable that the contract will be obtained. Such costs can only be capitalized if they meet the definition of inventory, property, plant and equipment, intangible assets, or an asset within the IFRS Framework. Certain costs associated with filmed entertainment may be capitalized. They are accounted for as intangible assets. Costs that are not capitalized are expensed as incurred. Any capitalized costs are subject to the impairment requirements.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>	Video games Software development costs typically include payments made to independent software developers under development agreements, as well as direct costs incurred for internally developed products. Software development costs are capitalized once technological feasibility of a product is established and such costs are recoverable. Technological feasibility encompasses both technical design and game design documentation, or the completed and tested product design and working model. Costs incurred to establish the technological feasibility of a computer software product to be sold, leased, or otherwise marketed are expensed as incurred as research and development costs. Costs related to support or maintenance are expensed at the earlier of when the related revenue is recognized or when the costs are incurred. Impact: The accounting for software development costs is not anticipated to change under the proposed standard. Music Advance royalties paid to artists are capitalized if the past performance and expected future performance of the artist provide a sound basis for estimating that the amount of the advance will be recoverable from future royalties earned by the artist. The portion of the record master costs incurred by the record company is capitalized if the past performance and expected future performance of the artist provide a sound basis for estimating that the cost will be recoverable from future sales. Impact: The accounting for advance royalties and record master costs is not anticipated to change under the proposed standard.	Impact: The accounting for some contract costs might not be significantly affected. However, the accounting for other costs (e.g., commissions) may be affected, as such costs are expensed as incurred under the proposed standard.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>	Publishing Pre-publication costs represent direct costs incurred in the development of a book or other media, and include costs for the associated delivery method when such media is digital. Costs that are typically capitalized include both internal and external costs, but are limited to those that are directly attributable to a specific title. Impact: The accounting for many pre-publication costs is expected to remain consistent with current practice. There may be some exceptions such as sales commissions, which will be expensed as incurred. Cable television Many costs incurred in the cable television business are capitalized including franchise application fees, certain direct selling, subscriber related costs, and costs incurred for the construction of a cable television plant. Direct selling costs include commissions, salaries, and targeted advertising while subscriber related costs include costs incurred to obtain and retain customers. Construction costs that may be capitalized include: • Direct costs incurred during the prematurity period for the construction of the cable television plant, including materials, direct labor, and construction overhead. • Programming costs incurred in anticipation of servicing a fully operating system and that will not vary significantly regardless of the number of subscribers are capitalized. • Initial subscriber installation costs, including material, labor, and overhead costs related to the hookup of subscriber are capitalized. Impact: The accounting for certain cable television costs may be affected under the proposed standard as franchise application costs and commissions will likely be expensed as incurred. However, costs incurred during the prematurity period are not anticipated to be impacted by the proposed standard.	

***To have a deeper conversation
about how this subject may affect
your business, please contact:***

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US GAAP Convergence & IFRS

Revenue recognition: Healthcare industry supplement

March 2011

Revenue recognition . . . full speed ahead

Healthcare industry supplement

What's inside:

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Reprinted from:

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Overview

In certain countries, healthcare is a service that is government-operated and government-funded. In contrast, the US healthcare system resides primarily within the private sector, with government serving as the largest purchaser of healthcare services. As a result, US GAAP contains specific guidance and information relating to industry-specific revenue recognition principles for hospitals and other healthcare provider organizations, as well as for health plans such as health maintenance organizations (HMOs) that arrange for healthcare services to be provided to their members. Outside of the US, healthcare industry-specific guidance generally resides within public sector (i.e., governmental) GAAP and is therefore not addressed here.

In the US, a major difference between healthcare organizations and other types of service operations is that, in most cases, the recipient of healthcare services—the patient—does not pay directly for the services. Instead, payment is made by some other organization, referred to as a “third-party payer.” The third party may be Medicare, Medicaid, an insurance company, or an HMO. The actual amount received by the hospital will vary depending on the contractual arrangements between the hospital and the third-party payer, and such contracts typically do not provide for payment at the hospital’s established charges. The patient is responsible for paying his or her own bill if the patient does not have insurance or is not covered by a government program.

The following items common in the healthcare industry may be significantly impacted by the proposed revenue recognition standard. The impact of the proposed standard on the revenue recognition of continuing-care retirement communities is expected to be similar to the impact on other organizations whose contracts involve multiple-element arrangements and are not discussed within this supplement. This paper, examples, and related assessments contained herein, are based on the Exposure Draft, *Revenue from Contracts with Customers*, which was issued on June 24, 2010. These proposals are subject to change at any time until a final standard is issued. The examples reflect potential impacts based on the proposed standard reflected in the exposure draft and any conclusions noted are subject to further interpretation and assessment based on the final standard. For a more comprehensive description of the model refer to PwC’s Dataline 2010–28 or visit www.fasb.org.

Uncollectable Accounts

The most significant implications of the proposed standard for healthcare organizations will likely be associated with uncollectable patient accounts. Under both existing US GAAP and IFRS, uncertainties associated with the collectability of receivables are viewed as “day 2” loss contingencies associated with a recognized asset (accounts receivable). Under the proposed standard, the potential that an account will not be collected is dealt with in measuring the amount of revenue and contract asset

or receivables initially recorded. Bad debt expense would no longer be recognized for those accounts not expected to be fully collected at the time services are rendered. Instead, the type of analysis historically employed in establishing an allowance for uncollectable accounts will be used as a tool in evaluating the amount of revenue to initially recognize. Any changes in the amount of consideration expected to be received are reflected as income or expense, rather than as an adjustment to revenue. The proposed standard does not specify where subsequent changes should

reside on the face of the income statement or whether they should be reflected separately in operations.

The vast majority of uncollectable accounts and bad debt expense are usually associated with services provided to uninsured patients who do not qualify for charity care (self-pay patients). Thus, the most significant of the measurement difference will be encountered in dealing with this category of patients.

Proposed standard	Current US GAAP	Current IFRS
Incorporating collectability into initial measurement The transaction price should be adjusted to reflect the customer’s credit risk (the ability to pay the consideration) by recognizing the consideration expected to be collected on a probability-weighted basis, if it can be reasonably estimated.	Revenue associated with services provided to all non-charity patients is recognized in the financial statements, regardless of whether the organization has an expectation of collectability. Revenue and receivables are recorded at the organization’s established rates. If a receivable subsequently proves to be uncollectable, the account is written-off to bad debt expense. Impact: By assessing the expectation of collectability in connection with initial measurement of self-pay revenue, the historical “gross-up” of revenue and bad debt expense associated with accounts with a high degree of uncertainty of collectability would be eliminated.	No healthcare industry-specific guidance currently exists. Existing revenue guidance requires that an entity determine whether it is probable that the economic benefit associated with the transaction will flow to the entity. If it is not probable, revenue is not recognized until it is probable of being received. Impact: For those accounts not probable of being paid, but for which there is a possibility of receipt of some consideration, more revenue may be recognized than under existing guidance given the requirement to follow a probability-weighted approach.

Example 1

Facts: Hospital Y has \$10,000 in gross charges related to self-pay patients during the month of October. Hospital Y has a demonstrated history of collecting approximately 7% of overall charges associated with self-pay patients (that is, collections from the self-pay group as a whole); however, the hospital cannot predict the specific individuals that will ultimately remit payment.

Discussion: Historically, Hospital Y would have recorded \$10,000 in revenues and, over time, written off \$9,300 to the provision for bad debts. The proposed standard requires Hospital Y to make a probability-weighted assessment of expected collections that will be received from this group of patients if such amounts are reasonably estimable. Such an estimate requires management to assess the probability of each possible outcome. Based on Hospital Y's historical experience with self-pay patients, the following outcomes have been identified:

Possible collection amounts	Probability	Probability-weighted amounts
\$0	1%	\$0
\$250	16%	40
\$500	25%	125
\$750	45%	338
\$1,000	13%	130
\$2,000	0%	0
		\$633

Based on the probability-weighted estimation process, Hospital Y would expect to collect \$633 from the group of self-pay patients treated in October. Therefore, Hospital Y's financial statements would reflect \$633 in revenues and a contract asset of \$633 for the month of October. If Hospital Y ultimately collects only \$600, the \$33 of additional write-off would be reflected as an other expense, rather than reducing revenue previously recognized.

Third-party settlement estimates

The largest purchasers of healthcare services in the US are the federal and state governments, which purchase services through programs such as Medicare and Medicaid. Revenue earned by healthcare

providers under annual contracts with these programs is determined under complex government rules and regulations that subject the healthcare organization to the potential for retrospective adjustments in future years. Because several years may elapse before all potential government adjustments related to a particular

contract year are known, management must estimate the effects of future program audits, administrative reviews and billing reviews in the year that the services are provided. Uncertain amounts to be earned from government contracts would be viewed as “variable consideration” under the proposed standard.

Proposed standard	Current US GAAP	Current IFRS
Variable consideration When the amount of consideration that a customer pays is variable (rather than fixed) due to contingencies, the transaction price is the probability-weighted estimate of consideration to be received, assuming that it can be reasonably estimated.	Because the amount to be earned under contracts with government payers will not be known with certainty for several years, providers must estimate the cash flows ultimately expected to be received for services provided during a contract period and report that amount as revenue. Impact: Currently, management makes its “best estimate” of the third-party settlement adjustment required based on its knowledge and experience about past and current events. Under the proposed standard, that process will be modified to incorporate probability-weighting techniques. Single best estimates of amounts to be received will not be acceptable.	No healthcare industry-specific guidance currently exists. Entities follow existing revenue recognition guidance which requires that revenue be measured at the fair value of amounts received or receivable. To the extent that management has reliable settlement history and experience, management recognizes revenue based on its best estimate of consideration to be received. Impact: A change to a probability-weighted approach will likely impact the amount of revenue entities record, particularly if management currently uses a single best estimate approach.

Example 2

Facts: Hospital X participates in the Medicare program. Medicare pays Hospital X at rates it establishes for services rendered to Medicare beneficiaries during a contract year that coincides with the hospital’s fiscal year. Typically, it takes three years from the year that services were rendered for Medicare to validate the claims and to issue the notice of final program settlement which will close out that contract year. Each year, management estimates the impact of program adjustments based on its knowledge and experience about past adjustments and its assumptions about adjustments that are required based on current conditions. It accrues a third-party settlement asset or liability to adjust the revenue estimate for that contract year.

During the contract year 20X1, Hospital X tentatively earned \$50 million of net patient service revenue associated with Medicare patients; however, it has not yet made a provision for estimated future program adjustments.

Discussion: Historically management has made a single best estimate of the adjustment required, which typically has been a recoupment (i.e., additional amounts were owed to Medicare). Under the proposed standard, management must make a probability-weighted estimate of the adjustment required, assessing the probability of each possible outcome. Based on Hospital X’s experience with Medicare, the following possible outcomes have been identified:

Possible recoupment amounts	Probability	Probability- weighted amounts
\$0 million	1%	\$0 million
\$5 million	45%	2.3 million
\$10 million	30%	3.0 million
\$12 million	24%	2.9 million
		\$8.2 million

Based on the results of the probability-weighted assessment, management would record an estimated third-party settlement liability of \$8.2 million to reduce the estimated revenue earned for the contract year to \$41.8 million.

Loss contracts

The primary source of income for HMOs is premium payments. In exchange for premiums, HMOs agree to provide (or arrange for provider organizations to supply) healthcare services to the covered individuals. If its premiums are set too low or if utilization by plan members is higher than expected, an HMO may sustain an economic loss in fulfilling a particular contract.

Proposed standard	Current US GAAP	Current IFRS
Measuring contract losses A performance obligation is considered onerous (and therefore, a loss contract exists) when the direct costs to satisfy a performance obligation exceeds the consideration allocated to it. The “onerous” test should be applied at the level of the individual performance obligation rather than at the contract level. Only “direct” costs are considered in measuring contract losses. Direct costs may include: • Direct labor • Direct materials • Allocations of costs that relate directly to the contract or contract activities • Costs explicitly chargeable to the customer under the contract • Other costs incurred only because the entity entered into the contract	To determine whether a loss accrual is necessary, contracts are grouped in the same manner used by the HMO for establishing its premium rates, and the aggregate costs and revenues are projected for each group. The costs considered include all direct costs of the contracts along with any indirect costs identifiable with or allocable to the contracts. If the aggregate group expenses for the contract period are expected to exceed the aggregate group revenues, the excess is accrued as a loss. Only when the group as a whole is unprofitable would a loss be recognized. Impact: HMOs will no longer include indirect costs when evaluating whether a loss accrual is required, thus reducing the likelihood of recognizing a loss. However, HMOs may be negatively impacted by the requirement that the “onerous” test be performed at the level of the individual performance obligation (that is, the individual contract). Thus, a loss could be recognized at the individual performance obligation level, even if the group as a whole is profitable.	No healthcare industry-specific guidance currently exists. Existing provisions guidance addresses the accounting for onerous losses. Onerous losses are assessed at the contract level, and are measured by comparing the economic benefits under the contract to the least net costs to exit it. Least net costs may be either the costs to fulfill the contract or the cost of cancelling or breaching the contract. Impact: Existing guidance does not permit the inclusion of indirect costs that are not directly attributable to the contract in the measurement of an onerous contract, therefore the impact will be less significant under IFRS than US GAAP.

Example 3

Facts: HMO Z establishes its rates using the community rating method. Thus, rates to be charged to the entire population are based on the experience of the entire population, rather than on the experience of an individual employer group. HMO Z's enrolled population and its projection of the related revenues and costs associated with that population are as follows:

Members	Estimated revenue	Projected expenses	Direct costs	Indirect costs
Employer A	\$10 million	\$11.00 million	\$9.50 million	\$1.50 million
Employer B	10 million	7.75 million	6.50 million	1.25 million
Employer C	10 million	10.25 million	9.25 million	1.00 million
	\$30 million	\$29.00 million	\$25.25 million	\$3.75 million

Discussion: Under existing US GAAP, HMO Z would not recognize a loss because the estimated revenues exceed the projected expenses for the group of contracts. Under the proposed standard, it may at first appear that HMO Z would be required to recognize a loss on its contracts with Employers A and C. However, because the proposed standard considers only direct costs, none of the employer contracts individually would represent an onerous performance obligation.

Current IFRS specifies that the unit of account for which an onerous loss should be calculated is the contract level. If the contracts with Employers A, B and C are unrelated, the onerous contract analysis is performed at the individual contract level. Even so, as only the direct costs will be considered relative to the revenue, no loss would be recognized. A similar result is expected under the proposed standard, and as a result, entities currently following IFRS may not see a significant change in this area.

***To have a deeper conversation
about how this subject may affect
your business, please contact:***

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US GAAP Convergence & IFRS

Revenue recognition: Industrial products and manufacturing industry supplement

March 2011

Revenue recognition . . . full speed ahead

Industrial products and manufacturing industry supplement

What's inside:

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Overview

The Industrial Products (IP) sector comprises a range of companies involved in the production of goods and delivery of services across a diverse industry base. This includes industrial manufacturing, metals, chemicals, and forest, paper and packaging companies. IP companies typically recognize revenue based on the transfer of risks and rewards. Current US GAAP and IFRS guidance on revenue recognition will be withdrawn when the proposed standard becomes effective.

Each industry in the IP sector has different product and service offerings, but there are a number of common revenue recognition issues. These include the accounting for long-term construction-type contracts, warranties, bill and hold arrangements, consignment transactions, incentives, and contract costs. IP companies will need to carefully assess the proposed standard to determine the extent of its impact on their business.

The following items common in the IP industry may be significantly affected by the proposed revenue recognition standard. This paper, examples, and related assessments contained herein are based on the Exposure Draft, *Revenue from Contracts with Customers*, which was issued on June 24, 2010. These proposals are subject to change at any time until a final standard is issued. The examples reflect potential impacts based on the proposed standard reflected in the exposure draft and any conclusions noted are subject to further interpretation and assessment based on the final standard. For a more comprehensive description of the model refer to PwC's Dataline 2010–28 or visit www.fasb.org.

*This Dataline Supplement was revised on September 3, 2010 to reflect certain editorial revisions. None of the revisions resulted in substantive changes to the assessments of the proposed model contained herein.

Contract accounting

Many IP companies have contracts where they provide a service (installation or customization) along with their products. The products and services are delivered over a period ranging from several months to several years. Revenue is currently recognized based on the activities of the vendor; that is, revenue is recognized as

the vendor performs, provided reasonable estimates are available. The change to a control transfer model will require careful consideration to determine when a vendor can recognize revenue. We expect that, in many contracts, control will transfer continuously to the owner over the contract term and might, therefore, produce results similar to today. This should not, however, be assumed.

Management will not be able to default to the method used today but will need to evaluate their arrangements under the proposed standard. For example, the use of the cost-to-cost method to measure revenue under an activities based recognition model might not be an appropriate measure for revenue arising from the continuous transfer of control.

Proposed standard	Current US GAAP	Current IFRS
Revenue is recognized upon the satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. Control can transfer at a point in time or continuously over the contract period. Factors to consider in assessing control transfer include, but are not limited to: Factors to consider in assessing control transfer include, but are not limited to: • The customer has an unconditional obligation to pay • The customer has legal title • The customer has physical possession • The customer specifies the design or function of the good or service This list is not intended to be a checklist or all-inclusive. The ability to borrow against the asset, for example, may be another control transfer factor to consider. No one factor is conclusive on a stand-alone basis.	For transactions in the scope of contract accounting, revenue is recognized using the percentage-of-completion method when reliable estimates are available. When reliable estimates cannot be made but there is an assurance that no loss will be incurred on a contract (e.g., when the scope of the contract is ill defined, but the contractor is protected from an overall loss), the percentage-of-completion method based on a zero profit margin is used until more precise estimates can be made. The completed-contract method is required when reliable estimates cannot be made. For transactions not in the scope of the contract accounting guidance, revenue is recognized once the risks and rewards of ownership have transferred to the customer.	For transactions in the scope of contract accounting, revenue is recognized using the percentage-of-completion method when reliable estimates are available. When reliable estimates cannot be made but there is an assurance that no loss will be incurred on a contract (e.g., when the scope of the contract is ill defined, but the contractor is protected from an overall loss), the percentage-of-completion method based on a zero profit margin is used until more-precise estimates can be made. The completed contract method is not permitted. For transactions not in the scope of the contract accounting guidance, revenue is recognized once the following conditions are satisfied: • The risk and rewards of ownership have transferred • The seller does not retain managerial involvement to the extent normally associated with ownership nor retain effective control • The amount of revenue can be reliably measured • It is probable that the economic benefit will flow to the entity • The costs incurred can be measured reliably

Proposed standard	Current US GAAP	Current IFRS
Measuring continuous transfer of control For contracts where control continuously transfers, a contractor can use either an input method (e.g., cost-to-cost, labor hours, labor cost, machine hours, material quantities), an output method (e.g., physical progress, units produced, units delivered, contract milestones), or the passage of time to measure such continuous transfer. The method that best depicts the transfer of goods or services to the customer should be applied consistently throughout the contract and to similar contracts with customers. Once the measurement is determined, it is applied against total contract revenue to determine the amount of revenue to be recognized. This is currently referred to as the Revenue method. The use of the Gross Profit method¹ is prohibited. Estimates used in measuring continuous transfer of control (e.g., estimated cost to complete when using a cost-to-cost calculation) are continually evaluated and adjusted using a cumulative catch-up method.	Entities applying contract accounting can use either an input method (e.g., cost-to-cost, labor hours, labor cost, machine hours, material quantities), an output method (e.g., physical progress, units produced, units delivered, contract milestones), or the passage of time to measure progress towards completion. Once a “percentage-complete” is derived, there are two different approaches for determining revenue, costs of revenue and gross profit; the Revenue method or the Gross Profit method. Service revenue from transactions not in the scope of contract accounting may be recognized by applying the proportional performance method.	Entities applying contract accounting can use either an input method (e.g., cost-to-cost, labor hours, labor cost, machine hours, material quantities), an output method (e.g., physical progress, units produced, units delivered, contract milestones) or the passage of time to measure progress towards completion. Once a “percentage-complete” is derived, IFRS requires the use of the Revenue method. The Gross Profit method is not permitted. Service revenue from transactions not in the scope of contract accounting is recognized based on the stage of completion if the transaction’s outcome can be estimated reliably.

Example 1—Recognizing revenue—control transfers during the contract term

Facts: A vendor enters into a contract to customize several of its products and install those products at the customer’s location. The installation service is available in the marketplace. The contract has the following characteristics:

- The customization is specific to customer specifications and may be changed at the customer’s request during the contract term;
- Non-refundable, interim progress payments are required to finance the contract;
- The customer can cancel the contract at any time (with a termination penalty) and any work in progress is the property of the customer; and
- Physical possession and title do not pass until completion of the contract.

How should the vendor recognize revenue?

Discussion: The terms of the contract, in particular the customer specifications (and ability to change the specifications), non-refundable progress payments, termination penalty, and ability to retain work-in-progress, suggest that control of the products is being transferred continuously over the contract term. The vendor determines if the product and the installation are distinct performance obligations, which are accounted for separately. Assuming the installation is a distinct performance obligation (because it has utility on its own), the vendor will need to select the most appropriate measurement model (either an input or output method or, less likely, passage of time) to measure the revenue arising from the continuous transfer of control of the products. The transaction price allocated to the installation performance obligation is recognized upon completion of the installation service.

Example 2—Recognizing revenue—control transfers after completion of the contract term

Facts: A vendor enters into a contract to construct several of its products and install those products at the customer's location. The installation is not available from other vendors. The contract has the following characteristics:

- The majority of the payments are due after the products have been installed;
- The customer can cancel the contract at any time (with a termination penalty) and any work in progress remains the property of the vendor; and
- Physical possession and title do not pass until completion of the contract.

How does the vendor recognize revenue?

Discussion: The terms of the contract, in particular payment upon completion, cancellation with penalty, and the inability to retain work-in-progress, suggest control of the products is transferred at the time of installation at the customer location. The vendor will need to determine if the product and the installation are distinct performance obligations, which are accounted for separately. Assuming the product and installation are accounted for together, the vendor will not recognize revenue until the products have been installed at the customer site and control has transferred to the customer.

Warranties

Many IP companies provide standard warranties with their products. The standard warranty is given to all customers and protects against latent defects for a specific time period. Many companies also offer extended warranties, which provide for coverage beyond the standard warranty period. An extended warranty is sometimes offered to the customer for an incremental fee.

The proposed standard draws a distinction between warranties that protect against latent defects and warranties that provide protection for defects that arise after the product is transferred to the customer, such as normal wear and tear. The accounting for extended warranties is similar to existing practice, but standard warranty accounting could be significantly different in that it may delay revenue recognition and require complex accounting calculations.

Proposed standard	Current US GAAP	Current IFRS
Warranties Warranties whose objective is to protect against latent defects do not give rise to a separate performance obligation but acknowledge the possibility that the contractor has not satisfied its performance obligation. Management will need to determine the likelihood and extent of defects in the products sold to customers at each reporting period to determine the extent of unsatisfied performance obligations. A portion of the contract revenue is deferred at the time of sale for defective products that will be replaced either in part or in their entirety. A warranty that protects against faults that arise after purchase (i.e., normal “wear-and-tear”) gives rise to a separate performance obligation. A portion of the transaction price is allocated to that separate performance obligation at contract inception.	Companies typically account for standard warranties protecting against latent defects outside of the contract and in accordance with existing loss contingency guidance. A company will recognize revenue and concurrently accrue any expected cost for these warranty repairs. Warranties that protect against defects arising through normal usage are separate deliverables for which revenue is deferred and recognized over the expected life of the contract.	Companies typically account for certain standard warranties protecting against latent defects outside of the contract and in accordance with existing provisions guidance. Management recognizes revenue and concurrently accrues any expected cost for these warranty repairs. Revenue is deferred for warranties that protect against defects arising through normal usage and recognized over the expected life of the contract.

Example 3—Accounting for standard warranties

Facts: A company sells its product, which includes a 90-day standard warranty that covers latent defects (e.g., defects that exist at the time of sale) in the product. The company will replace defective components of the product under the standard warranty. How does management account for such a warranty?

Discussion: Management will need to estimate the selling price of the product components that will require repair or replacement at contract inception based on available information and the entity's experience. Contract revenue is allocated at inception on a relative selling price basis and revenue is deferred until the customer receives control of those components without defects (i.e., generally the earlier of when the defects are repaired/replaced or when the warranty period expires) because the warranty provides for repair or replacement of the components that are defective (rather than complete product replacement).

Example 4—Accounting for extended warranties

Facts: A company sells its product, which includes a 90-day standard warranty that covers latent defects in the product. The customer also purchases an extended warranty that provides for an additional 18 months of coverage. How does management account for the extended warranty?

Discussion: The standard warranty is accounted for consistently with the standard warranty offered in Example 3 above because it covers latent defects. The extended warranty is a separate performance obligation. Management allocates the transaction price (i.e., contract revenue) on a relative-estimated selling price basis to the product and the extended warranty. Revenue allocated to the extended warranty is recognized over the warranty coverage period (starting on day 91 for the following 18 months).

Contract costs

IP entities frequently incur costs prior to finalizing a contract or at the time the contract is finalized. Many of these pre-contract costs are capitalized and recognized over the term of the contract as revenue is recognized. The most significant costs are typically sales commissions or other marketing costs. We expect a significant change from today's practice around the accounting for pre-contract costs.

Proposed standard	Current US GAAP	Current IFRS
Contract costs All costs of obtaining a contract, costs relating to satisfied performance obligations and costs related to inefficiencies (i.e., abnormal costs of materials, labor or other costs to fulfill) are expensed as incurred. Other direct costs incurred in fulfilling a contract are expensed as incurred unless they are within the scope of other standards (e.g., inventory, intangibles, fixed assets) or if other specified criteria are met. Costs that are in the scope of other standards are accounted for in accordance with those standards. An asset is recognized for costs outside the scope of other standards when the costs relate directly to a contract, relate to future performance and are probable of recovery under a contract. These costs are then amortized as control of the goods or services to which the asset relates is transferred to the customer.	There is a significant amount of detailed guidance on the accounting for contract costs, particularly for pre-contract costs. Pre-contract costs that are incurred for a specific anticipated contract may be deferred only if the costs can be directly associated with a specific anticipated contract and if their recoverability from that contract is probable.	There is a significant amount of detailed guidance around accounting for contract costs in construction contract accounting. Costs that relate directly to a contract and are incurred in securing that contract are included as part of contract costs that can be capitalized if they can be separately identified, measured reliably and it is probable that the contract will be obtained. Costs associated with transactions that are not in the scope of contract accounting are capitalized if such costs are within the scope of other asset standards (e.g., inventory, PP&E or intangible assets) or the Framework.

Example 5—Accounting for sales commissions

Facts: A salesperson earns a 5% commission on a contract that was signed during January 20X1. The products purchased in the contract will be delivered throughout the next year. How should management

account for the commission paid to its employee?

Discussion: The commission payment is expensed as incurred (i.e. at inception of the contract if the commission is owed to the salesperson upon signing), as it represents a cost of obtaining the contract.

Variable consideration

The transaction price (or contract revenue) is the amount of consideration the manufacturer or service provider receives, or expects to receive, in exchange for satisfying its performance obligations (i.e., delivery of goods/services). Determining the transaction price is simple when the contract price is fixed and paid at the time goods are provided or services delivered. Determining the transaction price may be more complex if the consideration contains an element of variable or contingent consideration.

Common considerations in this area for the IP industry include the accounting for awards/incentive payments, volume rebates, claims and time value of money. Manufacturers today generally take a conservative approach in making the determination of when awards/incentive payments are included in contract revenue. We expect such consideration may be recognized earlier under the proposed standard. Otherwise, we do not expect a significant difference from current practice.

Proposed standard	Current US GAAP	Current IFRS
Volume rebates Volume rebates are generally receivable by the customer when specified cumulative levels of revenue are earned during a defined period. Volume rebates may be considered performance obligations under the proposed standard, as the customer has an option to access discounts on future sales. Hence, a portion of the transaction price is allocated to the obligation to provide discounts or issue price reductions on future orders. Revenue is measured using a probability-weighted approach when payments can be reasonably estimated. The amounts can be reasonably estimated when the seller has experience with such volume rebates and the experience is relevant to the contract. Otherwise, revenue is limited to the amount of consideration that management can reasonably estimate.	Volume rebate payments are recognized as the customer earns the rebate. The accrued cost is limited to the estimated rebates potentially due. If the rebate cannot be reliably estimated, revenue is reduced by the maximum rebate.	Volume rebate payments are systematically accrued based on discounts expected to be taken. The rebate is then recognized as a reduction of revenue at the best estimate of the rebate. If the rebate cannot be reliably estimated, revenue is reduced by the maximum rebate.

Proposed standard	Current US GAAP	Current IFRS
Awards/Incentive payments Awards/incentive payments are included in contract revenue using a probability-weighted approach when such payments can be reasonably estimated. Such amounts can be reasonably estimated when the contractor has experience with similar types of contracts and that experience is relevant to the contract because the entity does not expect significant changes in circumstances.	Awards/incentive payments are included in contract revenue when the specified performance standards are probable of being met and the amount can be reliably measured.	Awards/incentive payments are included in contract revenue when the specified performance standards are probable of being met and the amount can be reliably measured.
Claims As with awards/incentive payments, claims are included in contract revenue, using a probability-weighted approach, only when such revenue can be reasonably estimated.	A claim is recorded (only to the extent of contract costs incurred) as contract revenue only if it is probable and can be reliably estimated (determined based on specific criteria). Profits on claims are not recorded until they are realized.	A claim is included in contract revenue only if negotiations have reached an advanced stage such that it is probable the customer will accept the claim and the amount can be reliably measured.
Time value of money Contract revenue reflects the time value of money whenever the effect is material. Management uses a discount rate that reflects a separate financing transaction between the entity and its customer, and factors in credit risk.	The discounting of revenues is required in only limited situations, including receivables with payment terms greater than one year. When discounting is required, the interest component is computed based on the stated rate of interest in the instrument or a market rate of interest if the stated rate is considered unreasonable.	Discounting of revenues to present value is required in instances where the effect of discounting is material. In such instances, an imputed interest rate is used for determining the amount of revenue to be recognized, as well as the separate interest income component to be recorded over time.

Example 6—Accounting for variable consideration

Facts: A chemical company has a one-year contract with an car manufacturer to deliver high performance plastics. The contract stipulates that the chemical company will give the car manufacturer a rebate when certain levels of future sales are reached, according to the following scheme:

Rebate	Sales volume
0%	0–10,000,000 lbs
5%	10,000,001–30,000,000 lbs
10%	30,000,001 lbs and above

The rebates are calculated on gross sales in a calendar year and paid at the end of the first quarter of the following year. Based on past experience, the chemical company expects that: the likelihood that it would not have to pay a rebate is 20%; the likelihood that it will have to pay a 5% rebate is 50%; and the likelihood that it will have to pay a 10% rebate is 30%. How does the chemical entity recognize revenue?

Discussion: Management is able to reasonably estimate the amount of expected rebates to be provided to the car manufacturer. The company also has a history of performing this type of work, the uncertainty will be resolved within

a relatively short period of time and the possible outcomes are not highly variable. Management therefore recognizes revenue, based on a probability-weighted approach, of 94.5% of the contract value as goods are provided to the car manufacturer (assuming no customer credit risk). This estimate is monitored and adjusted, as necessary, using a cumulative catch-up approach, consistent with current practice.

Consignment sales

When goods are shipped under a consignment arrangement, title typically passes and payment is expected only when the purchaser (e.g., distributor) resells the inventory to a customer or uses it in production. It is common for IP companies to deliver products on a consignment basis.

The proposed guidance is similar to existing US GAAP and IFRS. Current

revenue recognition, however, focuses primarily on the transfer of risks and rewards whereas the proposed standard focuses on control transfer. Although we expect many consignment arrangements will be unaffected by the proposed guidance, some arrangements might require different accounting under the proposed standard. Analysis of the facts and circumstances surrounding each consignment arrangement will be necessary.

Proposed standard	Current US GAAP	Current IFRS
Consignment sales Management will need to determine when control of the goods provided under a consignment arrangement is transferred. Inventory on consignment is typically owned by the consignor until the consignee sells the product to an end customer, consumes the good in production, or a specified period expires. Only then does the consignee have an unconditional obligation to pay for the products, and the consignor can no longer demand return or transfer the goods to another. Control does not therefore transfer until the consignee sells or consumes the product, or a specified period expires. There may be situations, however, in which the legal title of the goods has passed to the consignee but control has not. In these situations, a consignee might be acting as an agent, in which case control does not transfer until sale to a third party. Factors to consider in making this determination are whether the consignee: • Is obliged to pay for the goods only if sold • Can return the products • Obtains a return for selling the products that is in the form of a commission	Revenue in consignment arrangements can be recognized only when substantial risk of loss, rewards of ownership, and control of the asset have transferred to the consignee (assuming all other criteria for revenue recognition have been satisfied). Other situations may exist where legal title to delivered goods passes to a buyer, but the substance of the transaction is that of a consignment. Current revenue guidance includes several indicators that are considered to determine whether substantial risk of loss, rewards of ownership, and control of the asset have transferred.	Revenue is recognized by the shipper (consignor) in consignment arrangements when the goods are sold by the recipient (consignee) to a third party, as this is when the risks and rewards of ownership have generally passed.

Example 7—Accounting for consignment sales

Facts: A company recently developed a new type of cold-rolled steel sheet that is significantly stronger than existing products, providing for increased durability. This product is newly developed and therefore not yet widely used. Management and a manufacturer of high security steel doors agree to enter into an arrangement whereby the company will provide 50 rolled coils of the sheet on a consignment basis. The manufacturer is required to pay a deposit upon receipt of the coils. Title transfers to the manufacturer and payment is due only upon consumption of the coils in the manufacturing process. Each month, both parties agree on the amount consumed by the manufacturer. The manufacturer can return, and the company can demand back, unused products at any time. How does the entity account for revenue?

Discussion: Evidence suggests that control transfers and therefore revenue should be recognized upon consumption of the coils in the manufacturing process, as title transfers and payment is due only at that point. If the company did not retain the right to demand return of the inventory, that might suggest that control transferred to the customer upon receiving the shipment.

Bill and hold arrangements

Under bill and hold arrangements, the customer agrees to purchase and pay for goods prior to their shipment and the seller retains possession of the goods for some period of time prior to delivery to the customer. Bill and hold transactions are common in certain industries (e.g., oil and gas) where the nature of the customer's operations require this type of arrangement.

Current US GAAP and IFRS are similar to the proposed standard. However, the proposed standard is not as prescriptive as existing literature and it focuses on when control of the goods transfer to the customer in determining the point of revenue recognition. The exclusion of a fixed delivery schedule often precludes revenue recognition currently; however, such a requirement is not included in the

proposed standard. Entities will need to consider the facts and circumstances of its arrangements to determine whether control of the product has transferred to the customer prior to the delivery. Revenue recognition may occur earlier than under current practice in certain circumstances, however, we expect the timing of revenue recognition for many bill and hold arrangements to be unchanged.

Proposed standard	Current US GAAP	Current IFRS
Bill and hold arrangements Management will need to determine when control of the goods provided in a bill and hold arrangement is transferred. For a customer to have obtained control of a product in a bill and hold arrangement, the following criteria should be satisfied: • The customer must have requested the contract be on a bill and hold basis; • The product must be identified separately as the customer's; • The product must be ready for delivery at the time and location specified by the customer; and • The entity cannot have the ability to sell the product to another customer. Some of the transaction price is allocated to the custodial services if they are a material separate performance obligation.	Revenue is recognized once the following criteria have been met: • Persuasive evidence of an arrangement exists; • Delivery has occurred; • The price is fixed or determinable; and • Collectability is reasonably assured. If delivery has not occurred, revenue recognition may precede delivery in certain circumstances. In order to recognize revenue in a bill and hold arrangement prior to the delivery of the goods, the following criteria must be satisfied: • The risk of ownership must have passed to the buyer; • The customer must have made a fixed commitment to purchase the goods, preferably in writing; • The buyer, not the seller, must request that the transaction be on a bill and hold basis and have a substantial business purpose for ordering the goods on a bill and hold basis; • There must be a fixed schedule for delivery of the goods; • The seller must not have retained any specific performance obligations such that the earnings process is not complete;	Revenue recognition generally occurs when the following criteria have been met: • The entity has transferred to the buyer the significant risks and rewards of ownership; • The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control; • The revenue is reliably measurable; • It is probable that the economic benefits of the transaction will flow to the entity; and • The costs incurred or to be incurred can be measured reliably. These criteria are usually satisfied when the goods are delivered. The following conditions should be considered in determining whether revenue is recognized prior to delivery in a bill and hold arrangement: • The delivery is delayed at the buyer's request; • The buyer must have taken title to the goods and accepted billing; • It must be probable that delivery will take place;

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>	• The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders; and • The goods must be complete and ready for shipment. The following factors should also be considered in determining whether revenue recognition should precede the delivery of the goods to the customer: • The date by which the seller expects payment, and whether the seller has modified its normal billing and credit terms for the buyer; • The seller's past experiences with and pattern of bill and hold transactions; • Whether the buyer has the expected risk of loss in the event of a decline in the market value of goods; • Whether the seller's custodial risks are insurable and insured; and • Whether extended procedures are necessary in order to assure that there are no exceptions to the buyer's commitment to accept and pay for the goods. If the criteria noted above are not satisfied, revenue recognition is typically deferred until delivery of the goods.	• The goods must be on hand, identified and ready for delivery to the buyer at the time the sale is recognized; • The buyer must specifically acknowledge the deferred delivery instructions; and • The usual payment terms must apply.

Example 8—Accounting for bill and hold arrangements

Facts: A gas company placed an order for a drilling pipe with a tubular steel producer. The gas company requested the transaction to be on a bill and hold basis because of the frequent changes to the timeline for developing remote gas fields and the long lead times needed for the delivery of drilling equipment and supplies. The steel manufacturer has a long history of bill and hold transactions with this customer and has established standard terms for such arrangements. The pipe, which is separately warehoused by the steel manufacturer, is complete and ready for shipment. The standard terms of the arrangement require the gas company to remit payment within 30 days of the pipe being placed into the steel company's bill and hold yard. The gas company will request and take delivery of the pipe on an as needed basis. How does the steel manufacturer recognize revenue?

Discussion: It appears that control of the pipe transfers to the gas company once the pipe arrives at the steel manufacturer's bill and hold yard, at which time the steel manufacturer should recognize the related revenue. Although all facts and circumstances need to be evaluated, this conclusion is based primarily on the fact that the gas company requested the transaction to be on a bill and hold basis, the steel manufacturer cannot use the pipe to fill orders for other customers, and the pipe is ready for immediate shipment at the request of the gas company. Note that a fixed delivery schedule is not necessary to achieve revenue recognition in this fact pattern. If the custodial services are determined to be a material separate performance obligation, some of the transaction price may need to be allocated to such services.

***To have a deeper conversation
about how this subject may affect
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US GAAP Convergence & IFRS

Revenue recognition: Pharmaceutical and life sciences industry supplement

March 2011

Revenue recognition . . . full speed ahead

Pharmaceutical and life sciences industry supplement

What's inside:

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Reprinted from:

Dataline 2010–28 (Supplement)
September 24, 2010

Overview

The pharmaceutical and life sciences industry has diverse products and services, as the industry comprises subsectors including pharmaceutical, biotech, and medical technology entities. Revenue recognition issues are common to the industry as a result of the variety of products and services and the complexity of many arrangements. The proposed revenue recognition standard may significantly affect certain aspects of revenue recognition by entities in the industry, while having a lesser affect in other areas. Entities will also continue to face some of the same challenges under the proposed standard that they face under the current guidance.

One of the more significant aspects of the proposed standard is the change in the recognition and measurement of royalties and milestone payments under licensing and collaboration arrangements. Revenue is recognized when payment is reasonably assured (i.e., no longer contingent) today, which usually is close to when cash is received. Revenue is recognized under the proposed standard when the related performance obligation has been satisfied and the consideration can be reasonably estimated. Royalties and milestone payments are included in the transaction price when a reasonable estimate can be made and recognized when the related performance obligations are satisfied. The fact that receipt of the consideration may be contingent upon a future event (e.g., achievement of milestones, or specified sales levels) will not necessarily preclude recognition.

For example, a biotech entity that has sold or licensed its intellectual property and is entitled to receive a royalty upon commercialization of a product will need to consider whether it has any performance obligations remaining with respect to that royalty stream. The biotech entity will record royalty revenue when it is able to reasonably estimate the stream of royalty revenue if no performance obligations remain. When an entity can reasonably estimate the stream of royalty revenue will require judgment; however, in many cases revenue may be recognized earlier than under current guidance.

Overview (continued)

The proposed standard also distinguishes between licenses that constitute an in substance sale and those that are a license (either exclusive or non-exclusive) for a specified period of time. This guidance will affect pharmaceutical, life science, and medical technology entities that enter into licensing arrangements or collaborations. Revenue for a license that is in substance a sale of technology or intellectual property or is a non-exclusive license is recognized when the license is delivered to the customer under the proposed standard. Revenue for exclusive licenses that are for less than the entire economic life of the underlying asset is recognized over the period of the license. When a license has been granted with research services, entities will need to assess whether the license is a separate performance obligation distinct from other goods or services and, thus, accounted for separately, or whether the license and research services together are a single performance obligation and accounted for as a single unit of accounting.

The proposed guidance for product warranties that cover latent defects may affect medical technology manufacturers that sell products with standard warranties for repair or replacement of product. An entity will defer a portion of revenue based on estimated product replacements and/or repairs rather than recognize an expense and a liability for estimated warranty costs.

We discuss these and other issues in this paper. The paper, and the examples and related assessments contained herein, are based on the exposure draft, *Revenue from Contracts with Customers*, issued on June 24, 2010. The proposal is subject to change until a final standard is issued. Comments on the exposure draft are due by October 22, 2010. In light of the significant impact that the proposed standard may have on certain areas of revenue recognition for the industry, we encourage management to engage in the comment letter process and respond to the questions included in the exposure draft. For a more comprehensive description of the proposed standard refer to PwC's Dataline 2010–28 or visit www.fasb.org.

Variable consideration

Variable consideration is recognized under the proposed standard when the related performance obligation is satisfied and consideration can be reasonably estimated. Common examples of variable consideration recorded by entities in the industry include strategic collaborations and licensing arrangements that include milestone payments and royalties. Milestone payments might be contingent on the achievement of certain development or sales targets. Royalties are typically based on product sales.

Entities also provide discounts, contractual allowances, and rebates on sales to their direct customers (e.g., wholesalers, distributors, etc.) and indirect customers (e.g., government, managed care organizations, group purchasing organizations (GPO), etc.). Examples of discounts and rebates are prompt pay discounts, Medicaid and state supplemental rebates, managed care rebates, GPO volume discounts, and pay-for-performance rebates.

Proposed standard	Current US GAAP	Current IFRS
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. Variable consideration is included in the transaction price based on a probability-weighted estimate of consideration to be received if the variable consideration can be reasonably estimated. An estimate is reasonable, and is recorded, only if an entity: • Has experience with identical or similar types of contracts. An entity can refer to the experience of other entities if it has no experience of its own. • Does not expect circumstances surrounding those types of contracts to change significantly. In assessing whether circumstances may change significantly, management considers the impact of external factors, time until the uncertainty is expected to be resolved, the extent of experience, and the variability in the range of possible outcomes.	Milestone payments A substantive milestone is defined in <i>Revenue Recognition—Milestone Method</i> and includes milestone payments received upon achievement of certain events, such as the submission of a new drug application (NDA) to the FDA or approval of a drug by the FDA. An entity that uses the milestone method under current guidance recognizes revenue on substantive milestone payments in the period the milestone is achieved. Non-substantive milestone payments that might be paid to the licensor based on the passage of time or as a result of the licensee's performance are allocated to the units of accounting within the arrangement and recognized as revenue in a manner similar to those units of accounting. An entity that does not use the milestone method may use another revenue recognition model for recognizing milestone payments (e.g., analogy to the <i>Revenue Recognition of Long-Term Power Sales Contracts</i> model or the contingency adjusted performance model).	Milestone payments Milestone payments received for a license with no further performance obligations on the part of the licensor are recognized as income when they are receivable under the terms of the contract and receipt is probable. When development services are provided (with or without an associated license), the vendor/licensor accounts for the milestone payments using the percentage of completion method. The “milestone payment method” is often an appropriate method of accounting if it approximates the percentage of completion of the services under the arrangement.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>	Royalties Royalties are recognized as they are earned and when collection is reasonably assured. Royalty revenue is generally recorded in the same period as the sales that generate the royalty payment. Sales discounts, contractual allowances and rebates and pay-for-performance arrangements One of the criteria for revenue recognition in current guidance is that the selling price is fixed or determinable. The net selling price is determinable if management can reliably estimate discounts, contractual allowances, rebates, and performance outcomes for pay-for-performance arrangements upon sale of the product. An entity's ability to estimate selling price adjustments generally requires some historical experience as a basis for the estimates. Revenue (net of adjustments) is recognized upon delivery of the product when the adjustments can be reliably estimated.	Management should consider the following factors to determine when milestone payments are recognized as revenue: (1) the reasonableness of the milestone payments compared to the effort, time and cost to achieve the milestones; (2) whether a component of the milestone payments relates to other agreements or deliverables, such as a license and royalty; (3) the existence of cancellation clauses requiring the repayment of milestone amounts received under the contract; (4) the risks associated with achievement of milestones; and (5) obligations under the contract, including obligations that must be completed to receive payment or penalty clauses for failure to deliver. The milestone events must have substance, and they must represent achievement of specific defined goals. Royalties Revenue from royalties accrues in accordance with the terms of the relevant agreement and is usually recognized on that basis, unless it is more appropriate to recognize revenue on some other systematic basis. Sales discounts, contractual allowances and rebates and pay-for-performance arrangements Revenue is recognized when it can be measured reliably. Experience is needed for arrangements with discounts, contractual allowances, rebates, or pay-for-performance criteria in order to have a reasonable basis for estimating revenue and the required adjustments. Revenue (net of adjustments) is recognized upon delivery of the product if the adjustments can be reliably estimated.

Proposed standard	Current US GAAP	Current IFRS

Impact:

The proposal will fundamentally change the way many pharmaceutical, life sciences, and medical technology entities account for variable consideration. Revenue is recognized today only once a certain trigger (i.e., meeting a probability threshold or upon the achievement of a certain event) has been met. Revenue is recognized when variable consideration can be reasonably estimated under the proposed standard. The variable consideration is measured at the probability weighted expected outcome of the contingency, with the estimate updated at each reporting date. This may increase income statement volatility.

There are two main issues for pharmaceutical, life sciences, and medical technology entities:

- What is (are) the performance obligation(s) related to the milestone payments and royalties?
- Can the amount of revenue be reasonably estimated?

Milestone payments

Performance obligation

Entities will need to identify at inception the performance obligations under the arrangement and allocate the transaction price, which includes milestone payments (refer to the discussion of reliable measurement below), to the performance obligations based on their relative stand-alone selling prices. Entities will need to consider any contingent milestone events and whether there are separate performance obligations associated with them.

For example, a biotech entity grants a license to technology to a pharmaceutical entity and agrees to perform research services on the technology. The biotech entity also receives a milestone payment upon submission of an application for approval to the regulatory authority. It will need to determine whether both the performance of research services leading up to the submission and the submission are performance obligations to which the transaction price is allocated. In this case, the transaction price includes consideration received for research services and the contingent milestone payments once such payments could be reasonably estimated (see discussion of reliable measurement below). The transaction price allocated to the research services performance obligation is recognized as revenue when the research services are performed. If the submission of an application for approval is a performance obligation, the transaction price allocated to that performance obligation is recognized when the application is submitted.

Reliable measurement

Variable consideration is measured on a probability-weighted basis. Reliable measurement does not imply that the entity knows the outcome of the contingency. Management uses its experience with similar contracts, where relevant, to estimate the probabilities of different outcomes.

Entities in the industry must determine whether arrangements involving milestones are considered sufficiently “similar” to determine a reasonable estimate of outcomes. Research and development (R&D) services have highly uncertain outcomes and other R&D contracts may not be a guide to the potential outcomes of the contract in question, in which case no revenue is recognized until one or more potential outcomes can be estimated. However, an entity might be able to estimate potential outcomes prior to the milestone event and therefore recognize revenue before the milestone event is achieved.

An entity might be able to more easily estimate a sales-based milestone for a currently marketed product. In this case, milestone revenue is recognized when the related performance obligation is satisfied (e.g., when a license is granted) rather than when the milestone is achieved.

Revenue might be recognized prior to the removal of a contingency under the proposed standard if a reasonable estimate can be made. Outcomes are re-estimated at each period-end and revenue adjusted as necessary. Revenue is not limited to the amount of cash payments received or due and payable at the reporting date, as with current US GAAP. This might result in income statement volatility, including negative revenue in certain reporting periods, compared to current practice.

continued

Proposed standard	Current US GAAP	Current IFRS

continued from previous page

Royalties

Performance obligation

Entities will need to determine the performance obligation associated with a contractual royalty stream. Royalty revenue is recognized as the performance obligation is satisfied, as long as the revenue can be reasonably estimated. When the royalty is the consideration under a licensing arrangement, the performance obligation may be the transfer of the license. Royalty revenue is therefore recognized when the license is transferred (refer to discussion of licenses below) and the stream of royalty revenue can be reasonably estimated.

The proposed standard is a significant change from the current guidance and in many cases may result in earlier recognition of royalties. Royalties are currently recognized as the underlying sales are made, on an accrual basis, provided collectibility is reasonably assured.

Reliable estimate

Entities will need to consider when they have the ability to reasonably estimate future sales to determine a probability-weighted estimate of royalty revenue under the proposed standard. This could be at the inception of the arrangement, at some point prior to receipt of the royalty, or upon receipt of the royalty, depending on the licensor's ability to estimate future variable consideration.

An entity should consider the data used to determine the stand-alone selling price of performance obligations and whether that data can be used to make a reasonable estimate of the stream of royalty revenue. For example, an entity enters into a licensing arrangement under which it transfers the license to certain technology and receives an upfront payment and a royalty upon commercialization of a product. The entity will need to consider what data (e.g., projected cash flows) is available at the inception of the arrangement and at each reporting period to determine whether it can reasonably estimate the stream of royalty revenue. Whether available data is sufficient for an entity to conclude that it can reasonably estimate the contingent consideration is a matter of judgment.

Once an entity has recorded the probability-weighted estimate of royalty revenue, it should re-evaluate the estimate at each period-end and adjust revenue as necessary. This might result in income statement volatility compared to current practice, including negative revenue in certain reporting periods.

Contract asset

A contract asset is recorded when royalty revenue or milestone revenue is recognized prior to the receipt of the royalty or milestone payments.

The contract asset is discounted to reflect the time value of money, if the effect of discounting is material. The receivable is measured using a discount rate that reflects a separate financing transaction between the licensor and licensee and is adjusted each reporting period as circumstances change to reflect changes in estimates (with adjustments recorded in revenue). Any discount recorded on the receivable is amortized to interest income.

Sales discounts, contractual allowances and rebates

We believe that the proposed standard will not significantly change the accounting for sales discounts, contractual allowances, and rebates. An entity records a liability for estimated discounts, contractual allowances, and rebates with a corresponding reduction to revenue. The liability is assessed each reporting period and adjustments are recorded for changes in estimates or for actual payment data.

Pay-for-performance arrangements

Arrangements where an entity either receives additional amounts or pays rebates based on outcomes of its products in the patients who use the products are pay-for-performance arrangements. The performance obligation is the good or service provided, not the clinical outcome.

Entities will use a probability-weighted approach to determine the revenue to recognize as opposed to the "fixed or determinable selling price" requirement under US GAAP or the requirement for it to be "probable that the economic benefits associated with the transaction will flow to the entity" under IFRS. However, we do not expect the proposed standard to have a significant impact on pay-for-performance arrangements. The probability-weighted approach to determining a reasonable estimate of variable consideration may align well with the determination of the transaction price under arrangements in which the consideration received is dependent upon various outcomes.

Example 1—Royalties

Facts: A biotech entity enters into a licensing agreement in June 2010 that grants a license to certain intellectual property to a pharmaceutical entity. The biotech entity receives an upfront payment and is entitled to a 10% royalty on product sales. The biotech entity treats the transfer of the license to the pharmaceutical entity as a sale as the license is exclusive and covers the entire patent life of the underlying intellectual property (see discussion of licenses below). The biotech entity has no further performance obligations. How does the biotech entity recognize revenue?

Discussion: Upon transfer of the license to the pharmaceutical entity, the biotech entity recognizes revenue for the upfront payment. Once the biotech entity transfers the license, it has no further performance obligations to satisfy in order to receive the future royalty revenue. The biotech entity recognizes royalty revenue for the entire period under which the technology was licensed once it can form a reasonable estimate of the future royalty revenues to be received.

In cases where the biotech entity is unable to reasonably estimate royalty revenue at the inception of the agreement, it will need to re-assess each subsequent period whether it is able to reasonably estimate royalty revenue. The biotech entity will recognize the royalty revenue when it can be reasonably estimated.

The pharmaceutical entity receives approval in June 2014 for a commercialized product that was developed using the licensed technology. If the biotech entity has sufficient data to make a reasonable estimate of future royalties, it recognizes revenue for the total amount of royalties to be received over the term of the agreement. Assume the biotech entity expects the product to generate \$4 billion of gross revenue over the term of the agreement (based on a probability-weighted approach). The biotech entity records revenue and a contract asset of \$400 million (\$4 billion x 10% royalty rate) in June 2014. The contract asset is discounted if the time value of money is material.

Each subsequent period the biotech entity will re-assess the total royalty revenue expected to be recognized and record adjustments to revenue as appropriate for changes in its estimates.

Example 2—Milestone payment

Facts: A biotech entity enters into a licensing agreement with a pharmaceutical entity in June 2010. The biotech entity grants a license to certain intellectual property to the pharmaceutical entity and will perform research services on the intellectual property. The biotech entity receives an upfront payment of \$70 million, payments for research services performed, and a \$150 million milestone payment upon FDA approval of a commercialized product. The biotech entity treats the transfer of the license to the pharmaceutical entity as a sale as the license is exclusive and covers the entire patent life of the underlying intellectual property (see discussion of licenses below). How does the biotech entity recognize revenue?

Discussion: There are three performance obligations in this arrangement: (1) transfer of the license; (2) performance of research services; and (3) preparation and submission of information to the FDA to receive product approval.

The biotech entity allocates the contract consideration, which includes the upfront payment, the payments for research services, and the contingent milestone payment, to the performance obligations based upon their relative standalone selling prices.

At the inception of the agreement, the biotech entity cannot determine a reasonable estimate of the milestone payment (based on a probability weighted approach) due to the early stage of development of the technology. No revenue is therefore recognized for the milestone payment at inception even though the performance obligation for the license has been satisfied.

Following seven years of research and submission of an application for approval, in June 2017 the biotech entity can reasonably estimate the probability of receiving the milestone payment. Management estimates a 60% probability that the product will receive FDA approval. The biotech entity allocates the \$90 million ($(\$150 \text{ million} \times 60\%) + (\$0 \times 40\%)$) of transaction price to the performance obligations as follows:

Performance obligation	Fair value	Relative %	Milestone payment
License	\$75 million	75%	\$68 million
Research services	\$20 million	20%	\$18 million
Preparation and submission for FDA approval	\$5 million	5%	\$4 million
Total			\$90 million

The license was transferred at the inception of the agreement, so the biotech entity will recognize revenue of \$68 million in June 2017. The amounts allocated to research services and the preparation and submission of information to the FDA performance obligations are recognized to the extent these performance obligations have been completed. Refer to discussion of research services and continuous transfer in the collaborations section below.

Example 3—Sales rebates

Facts: A pharmaceutical entity sells its cholesterol drug to various distributors (direct customers) at list price. The distributors sell the drug to pharmacies, clinics, and others, which sell the product as prescribed by doctors. The entity has an agreement with a managed care organization (MCO) whereby the entity pays rebates to the MCO based on the relative share of the entity's drug prescribed to MCO members as compared to competitor drugs. The rebates are as follows:

Relative share of prescriptions as compared to competitor drugs	Rebate
+0–5%	10%
+5–10%	15%
+10%	20%

The rebates are calculated on gross sales in a calendar quarter and paid once the MCO submits a rebate claim and the entity has validated the claim amount. How does the pharmaceutical entity account for revenue?

Discussion: The entity has a history of indirect sales to the MCO (prescriptions to MCO members). It estimates that approximately 12% of its sales through distributors are sold to pharmacies and prescribed to MCO members.

The entity calculates a probability-weighted estimate of rebates to be paid to the MCO of 14.5% using the following data, which is based on the historical market share achieved by the MCO.

Rebate amount	Likelihood
0%	0%
10%	15%
15%	80%
20%	5%

The entity recognizes revenue when the product is delivered to the distributor. The entity expects 12% of its sales to the distributor to be sold through the MCO (i.e., prescribed to a member of the MCO), so it records variable consideration equal to the list price (price of the product sold to the distributor) less the rebate of 14.5% on the gross sales amount. The entity re-assesses its estimate of variable consideration on these MCO sales in each subsequent period and records adjustments to revenue as needed.

Example 4—Pay for performance arrangement

Facts: A pharmaceutical entity manufactures and sells an osteoporosis drug to a hospital, which administers the drug to its patients. The hospital is obliged to pay the entity for product purchased by the hospital under normal, 30-day payment terms. The hospital is eligible for a full refund if the patient’s test results do not meet pre-determined criteria after three months of treatment. The hospital has two months after the treatment period to request a refund (i.e., a total of five months after the initial treatment).

The pharmaceutical entity received regulatory approval for the osteoporosis drug two years ago, and began selling the drug immediately to the hospital. Over the past two years, the entity and the hospital have been tracking the number of patients whose post-treatment test results did not meet the pre-determined criteria, and it has consistently ranged from 6-7% on a monthly and annual basis. The entity

expects future refunds to be consistent with historical results based on the nature of this drug and the relatively consistent patient results over the past two years. On a probability-weighted basis, the entity determines the refund rate to be 6.25%. How does the pharmaceutical entity account for revenue?

Discussion: The pharmaceutical entity has sufficient historical data to calculate a reasonable estimate of consideration to be received for sales under the pay-for-performance arrangement. If the entity sells a unit of the osteoporosis drug to the hospital at a price of \$5,000, the entity recognizes revenue of \$4,700 ($\$5,000 \times (1 - 6.25\%)$) upon delivery of the drug to the hospital. The entity will re-assess its estimate of variable consideration on sales to the hospital each subsequent period and record adjustments to revenue as needed.

Licenses and rights to use

An entity that has developed a pre-regulatory approved technology may license that technology (intellectual property) to a pharmaceutical, life science, or medical technology entity. The license provides the licensee with rights to develop the technology and sell the resulting commercialized product. The licensor typically receives an upfront fee and a royalty stream for the license. Certain licensing arrangements may also include performance of research services on the licensed technology by the licensor.

Management will need to consider whether licenses granted qualify as a sale of technology or as exclusive or non-exclusive licenses. When a license is granted with a commitment to perform research services, management will also need to determine whether the license and research services are distinct performance obligations or are one combined performance obligation. This distinction will affect the timing of revenue recognition with respect to the license.

Proposed standard	Current US GAAP	Current IFRS
The transaction price allocated to the license is recognized when the performance obligation is satisfied. An entity will need to determine whether the license is in substance a sale or a license to determine when the performance obligation is satisfied. • Sale—The contract is a sale, rather than a license or lease of intellectual property, if the licensee obtains control of the entire licensed intellectual property. This is the case if the entity grants a licensee an exclusive right to use its intellectual property for its entire economic life. • Exclusive license—The licensor has a performance obligation that is satisfied over time as it permits the licensee to use its intellectual property if the licensee does not obtain control of substantially all of the rights to the licensed intellectual property and the licensor has promised to grant exclusive rights to the licensee. This is the case if the entity grants a licensee an exclusive right to use its intellectual property for a period less than its economic life.	Consideration is allocated to the license and revenue is recognized when earned, typically when the license is transferred if the license has standalone value. The license is combined with other deliverable(s), typically the research services, and revenue for the single unit of account is recognized when earned, typically as the research services are performed, if the license does not have standalone value.	Fees paid for the use of an entity's assets are normally recognized in accordance with the substance of the agreement. This may be on a straight-line basis over the life of the agreement, for example, when a licensee has the right to use certain technology for a specified period of time. An assignment of rights for a fixed fee or non-refundable guarantee under a non-cancellable contract that permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform is, in substance, a sale. Determining whether a license is in substance a sale requires the use of judgment. A license sold with services or other deliverables requires the vendor to exercise judgment to determine whether the different components of the arrangement should be accounted for separately.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i> • Non-exclusive license—A non-exclusive license is a single performance obligation. The entity satisfies that obligation when the licensee is able to use and benefit from the license, which is no sooner than the beginning of the license period.		

Impact:

Two main issues arise for pharmaceutical, life sciences and medical technology entities:

- When is the performance obligation satisfied?
- When license arrangements include a license and contract for performance of research services, is the provision of the license itself a distinct performance obligation?

Performance obligation

A license where the licensee gains control of the intellectual property for substantially all of its economic life (e.g., for the period to patent expiry) is a sale and may be relatively easy to identify. Most licenses in this sector will be for the entire patent life; however, there may be circumstances where determining whether a license is a sale of technology or an exclusive license requires further consideration.

For example, is there a sale if a biotech entity grants a perpetual, exclusive license to a compound to a pharmaceutical entity but places certain restrictions on its usage? Does a license that does not provide the pharmaceutical entity with the right to sublicense the compound indicate that the pharmaceutical entity does not have control? What if the pharmaceutical entity has the right to sell a commercialized product, but the biotech entity has retained the right to manufacture products? Is that an indication that the pharmaceutical entity does not have control? The proposed standard is not clear in this area.

It might be difficult for entities to determine whether a license is “exclusive.” Explicit non-exclusive licenses are rare in the industry. It is more likely that a license will be granted to develop and commercialize technology in particular territories or for particular indications. The proposed standard acknowledges that an entity may grant rights to use the same intellectual property to more than one customer, but the rights granted to one customer might differ substantially from the rights granted to another customer. For example, a licensor may grant rights to develop intellectual property in one territory to Entity A and grant the rights to develop the same intellectual property in a different territory to Entity B. These rights are likely to be substantially different for each customer and each will therefore represent an exclusive license. The timing of revenue recognition will depend on whether the license is for substantially all of the useful economic life of the asset (for example, the term of the patent to the underlying intellectual property). Revenue is recognized over the license term if the term is not for substantially all of the economic life of the asset.

Entities should consider the time period and distribution channel associated with the rights granted, as well as geography to determine whether licenses are exclusive.

License arrangements with research services

An entity will need to consider whether the provision of the license is a distinct performance obligation for which revenue is recognized when the obligation is satisfied. The license may be a separate performance obligation if the entity itself or another entity sells licenses separately or the license could be sold separately because it has a distinct function and a distinct profit margin.

Entities will need to consider what is meant in the proposed standard by “a similar good” to determine whether similar licenses are sold separately. For example, is a license considered a “similar good” if it is sold separately by a university, or if others sell licenses targeted at the same therapeutic area or if there are similar targeted technologies? Most biotech entities grant licenses to technology that will likely qualify as exclusive licenses. So, if an entity grants an exclusive license to technology A and an exclusive license to technology B, the question is whether these exclusive licenses are “similar goods” only if the technology is targeted in the same therapeutic area or whether they are similar even if targeted in different therapeutic areas.

If the license cannot be sold separately, management will need to consider whether the license has a distinct function and a distinct profit margin. This analysis may be challenging, similar to the challenges that US GAAP companies have in determining “standalone value.” Revenue may only be recognized on the satisfaction of “distinct” performance obligations.

continued

Proposed standard	Current US GAAP	Current IFRS

continued from previous page

When licenses are sold with research services, the stage of the research on the licensed technology may affect the determination of whether the license has a distinct function (apart from the research services). During the discovery stage, an entity may have specialized know-how and technology, making it the only entity able to provide the services for the specific licensed product. The provision of the license may not be a distinct performance obligation in this situation, and the license and the research services together are a single performance obligation. The consideration is allocated to the single performance obligation and revenue is recognized as the performance obligation is satisfied.

When a license has been granted with research services that comprise clinical trials, other entities might be able to perform the clinical trials. This might indicate that the license and research services can be separated. Consideration is allocated between the two performance obligations on a relative standalone selling price basis and revenue is recognized as the performance obligations are satisfied.

For example, a biotech entity licenses technology to a pharmaceutical entity and will perform research services on the technology. The license provides the pharmaceutical entity with control of the technology for its entire economic life and the transaction is therefore a sale. If the license is a distinct performance obligation, consideration is allocated to the license based on its relative selling price and revenue is recognized on the transfer of the license to the pharmaceutical entity. If the license is not a separate performance obligation, but the license and research services are together a single performance obligation, consideration is allocated to the license and research services and revenue is recognized as the research services are performed. Refer to discussion of research services below.

These issues will require careful consideration by management.

Example 5—License is a sale of technology

Facts: A biotech entity enters into a collaboration agreement with a pharmaceutical entity. The biotech entity grants an exclusive license to its early stage compound for the treatment of obesity to the pharmaceutical entity. The pharmaceutical entity has the right to develop, distribute, and market a commercialized product that is developed using the licensed technology and has the right to sublicense the technology. The term of the agreement is through the end of commercially reasonable development of the licensed product. For any marketed product, the term is twelve years from commercial launch or expiry of the licensed patents relevant to each licensed product.

The biotech entity will also perform research services on the compound. The biotech entity has determined that the license is a distinct performance obligation that should be accounted for separately from the research services performance obligation. How does the biotech company recognize revenue?

Discussion: The license is exclusive and the pharmaceutical entity has control of the license for the economic life of the technology, so transfer of the license to the pharmaceutical entity is a sale. The consideration that has been allocated to the license performance obligation is recognized when the license is transferred to the pharmaceutical entity and a reasonable estimate of the consideration can be made.

Example 6—License is an exclusive license

Facts: A biotech entity enters into a collaboration agreement with a pharmaceutical entity. The biotech entity grants an exclusive license to its early stage compound for the treatment of obesity to the pharmaceutical entity. The pharmaceutical entity has the right to develop, distribute, and market a commercialized product that is developed using the licensed technology for 10 years. The technology reverts to the biotech entity if a commercialized product has not been developed after 10 years. The biotech entity has determined that the

license period (10 years) does not represent the economic life of the technology.

The biotech entity will also perform research services on the compound. The biotech entity has determined that the license is a distinct performance obligation that should be accounted for separately from the research services performance obligation. How does the biotech company recognize revenue?

Discussion: The license is exclusive, but does not cover the entire economic life of the technology. The license to the pharmaceutical entity is therefore an exclusive license for less than the economic life of the technology. The consideration allocated to the license performance obligation is recognized over the 10 year license period.

Collaborations and licensing arrangements

Pharmaceutical, life science, and medical technology entities frequently enter into strategic collaborations and licensing arrangements. The parties to these arrangements gain access to emerging technologies and funding for development of technologies.

These arrangements typically include multiple elements that must be evaluated to determine the amount and timing of revenue recognition. A typical multiple element arrangement might include some or all of the following components: (1) license to use technology; (2) research services; (3) joint steering committee (JSC) participation; (4) performance based milestone payments (e.g., upon filing of an NDA, or approval by the FDA or another regulator); (5) royalties on sales of a commercialized product; and (6) a manufacturing agreement.

The multiple element arrangement guidance in the proposed standard is similar but not identical to the current standards. This will continue to be a complex area that involves judgment. The following are relevant considerations for management in reviewing collaborations and licensing agreements:

Identify the contract with the customer

Entities will need to consider whether the collaboration and licensing agreements should be segmented into two or more contracts based on specific facts and circumstances. For example, there could be separate contracts for the license, research services, and manufacturing of the compound. A contract should be segmented if the prices of the goods and services are independent of each other. If an entity sells a license with research services that have been independently priced, the entity will need to consider whether it regularly sells licenses and research services separately and if the contract should be segmented. This could affect how the transaction price (including variable consideration) is allocated amongst performance obligations and recognized when performance obligations are satisfied.

We expect that the license and research services will not typically be priced independently of one another and therefore will not be accounted for as separate contracts. Manufacturing services provided under the arrangement might qualify as a separate contract with revenue recognized as manufacturing is performed.

Identify and separate performance obligations in the contract

Entities will need to identify distinct performance obligations within a contract and determine when the performance obligations are satisfied in order to recognize revenue.

They will need to consider if the components in the contract, such as a license to use technology, research services, JSC participation, and milestones are each distinct performance obligations. An entity will need to consider whether the entity itself or another entity sells each individual component separately or if the different components could be sold separately because they have distinct functions and distinct profit margins.

- Whether *research and development services* performance obligations are distinct may depend on the stage of the project. For example, many biotech companies do not sell licenses separately without research services for early stage products. During the discovery stage, biotech companies have specialized know-how and technology for which only they can provide the related R&D services. Research services that comprise clinical trials may be performed by other companies, and this may indicate that research services can be separated and are a distinct performance obligation.

- *JSC participation* is often included in collaboration or licensing arrangements that include research services to be performed by an entity on licensed technology. The JSC, which is often comprised of representatives of the licensee and licensor, typically monitors and directs the research and development performed on the licensed technology. The key issue is whether participation on a JSC represents a performance obligation for the licensor. We would not expect this determination to be different under the proposed standard. Entities will continue to assess whether their participation on JSCs is required by the counterparty to determine whether their JSC participation is a performance obligation.

A licensor's JSC involvement that is participatory often represents an enforceable obligation of the licensor. In that case, it is a performance obligation whereas a licensor's JSC involvement that is protective may be a right rather than an obligation of the licensor.

When a licensor's JSC involvement is a performance obligation, the licensor will need to determine whether the JSC obligation has a distinct function by itself or should be combined with other performance obligations to determine whether revenue is separately allocated to the JSC involvement and when revenue is recognized.

Specific considerations with respect to licenses, milestones, and royalties provided under collaboration and licensing arrangements are discussed above.

Determine and allocate the transaction price

Entities will need to determine and allocate the transaction price to the performance obligations based on standalone selling prices.

Determination of the transaction price will be significantly affected by the proposed standard due to the proposed changes in recognition and measurement of milestone and royalty payments. Variable or contingent consideration is included in the transaction price based on a probability-weighted estimate of consideration to be received if the variable consideration can be reasonably estimated. Specific considerations with respect to licenses and variable consideration in the form of royalties and milestone payments are discussed above.

Once the transaction price is determined, consideration is allocated to separate performance obligations based on relative stand-alone selling prices. This might be difficult in practice because (a) observable transactions for individual elements may not be common and (b) pharmaceutical products and intellectual property are often unique and difficult to value. The relative stand-alone selling prices are determined at the inception of the arrangement and are not re-assessed in future periods. When there are changes to the transaction price, for example, when there is a change in the estimate of variable consideration, such changes are allocated to each of the performance obligations based on the relative stand-alone selling prices determined at the inception of the arrangement.

Recognize revenue when each performance obligation is satisfied

A performance obligation is satisfied when the customer obtains control of the good or service. Performance obligations can be satisfied at a point in time or continuously over time. The main area that pharmaceutical entities will need to consider within collaboration and licensing arrangements is determining when the performance obligations are satisfied in respect of licenses and research services.

Revenue is recognized when the license is delivered to the customer if the license is in substance a sale of technology or intellectual property or it is a sale of a non-exclusive license. Revenue for exclusive licenses is recognized over the period of the license. Licenses are discussed above.

Revenue for research services that are typically performed continuously over a period of time is recognized using a method that best reflects the transfer of services. It may be challenging to determine whether services are transferred continuously as they are performed or whether control of the results of the research activity is transferred only on completion or achievement of a successful milestone event. This will affect the point at which revenue is recognized.

Where control is transferred continuously, management will need to determine how revenue is calculated. The proposed standard provides examples of suitable methods, including output methods, input methods, and methods based on the passage of time. We would not expect a significant change under the proposed standard for entities that currently use these methods to recognize revenue for research services (e.g., proportional performance model, such as the contingency adjusted performance model).

Example 7—Collaboration arrangement

Facts: A biotech entity enters into a collaboration arrangement with a pharmaceutical entity in June 2010. The biotech entity grants a license to certain intellectual property to the pharmaceutical entity and will perform research services on the intellectual property. The biotech entity receives an upfront payment of \$40 million, payments for research services performed, a milestone payment upon FDA approval of a commercialized product of \$150 million, and a 10% royalty on sales of a commercial product. The biotech entity treats the transfer of the license to the pharmaceutical entity as a sale since the license is exclusive and covers the entire patent life of the underlying intellectual property (see discussion of licenses above). How does the biotech company account for the revenue for services?

Discussion: There are three performance obligations in this arrangement: (1) transfer of the license; (2) performance of research services; and (3) preparation and submission of information to the FDA to receive product approval.

The biotech entity allocates total contract consideration, which includes the upfront payment, the payments for research services, the contingent milestone payment, and royalties to the performance obligations based upon their relative standalone selling prices.

Management determines that it can reasonably estimate the payments to be received for research services at the inception of the arrangement based on expected effort (hours to be incurred) using its experience performing research services on other technologies. Management estimates that total payments to be received for research services will be \$25 million. However, at inception the entity cannot determine reasonable estimates of the milestone payment and royalties (based on a probability weighted approach) due to the early stage of development of the technology. No revenue is therefore recognized for the milestone payment and royalties at inception. Total arrangement consideration is allocated as follows:

Performance obligation	Fair value	Relative %	Upfront payment	Payments for research
License	\$75 million	75%	\$30 million	\$19 million
Research services	\$20 million	20%	\$8 million	\$5 million
FDA approval	\$5 million	5%	\$2 million	\$1 million
Totals			\$40 million	\$25 million

Performance obligation—transfer of the license

Management considers the license to be a sale of intellectual property. Therefore, \$49 million of consideration allocated to the license is recognized once control of the license has transferred. The biotech entity records revenue of \$49 million, comprised of the cash received of \$40 million and a contract asset established of \$9 million. The contract asset is adjusted as payments are received on the other performance obligations.

Performance obligation—research services

The biotech entity recognizes consideration allocated to research services over the estimated research period using an appropriate model. In this case an output model is used that considers estimates of the percentage of total research services that will be completed each period, as the performance obligation to perform these services is satisfied continuously over the research period.

Performance obligation—FDA submission process

The biotech entity recognizes consideration allocated to the FDA submission process once that performance obligation has been satisfied.

If the biotech entity determines after seven years of research and the submission of a new drug application to the FDA in June 2017 that it can reasonably estimate the milestone payment and royalties, the biotech entity will allocate the milestone payment and royalties to the performance obligations and recognize revenue for performance obligations satisfied to date.

The biotech entity estimates a 60% probability that the product will receive FDA approval. It therefore allocates \$90 million $((\$150 \text{ million} \times 60\%) + (\$0 \times 40\%))$ of consideration to the performance obligations. The entity estimates royalties will be \$400 million (calculated estimated sales of \$4 billion using a probability weighted approach $\times 10\%$) over the term of the arrangement. The milestone and royalty consideration is allocated as follows:

As the performance obligation to transfer the license has been satisfied, the entity recognizes revenue of \$368 million in June 2017. The entity recognizes a portion of the \$98 million allocated to research services based on the portion of the performance obligation that has been completed to date. The entity does not recognize the \$24 million of consideration allocated to the FDA submission process until the entity receives FDA approval.

Each subsequent period the biotech entity re-assesses the milestone payment revenue and total royalty revenue recognized and records adjustments to revenue for changes in its estimates.

Performance obligation	Fair value	Relative %	Milestone payment	Royalties
License	\$75 million	75%	\$68 million	\$300 million
Research services	\$20 million	20%	\$18 million	\$80 million
FDA approval	\$5 million	5%	\$4 million	\$20 million
Total			\$90 million	\$400 million

Sell-through approach and consignment stock

Pharmaceutical, life science, and medical technology entities may currently recognize revenue using a sell-through approach. Revenue is not recognized under this approach until the product is sold to the end customer, either because inventory is on consignment at

distributors, hospitals, or others or because the final selling price is not determinable until the product has been sold through to an indirect customer (e.g., government, managed care organizations, GPOs, etc.).

When the final selling price is not determinable until the product has been sold

through to an indirect customer, revenue recognition is deferred until the consideration can be reliably estimated. Refer to discussion of variable consideration above.

Entities will need to consider at what point control of consignment stock has passed to the distributor. The proposed standard may result in earlier revenue recognition under these arrangements.

Proposed standard	Current US GAAP	Current IFRS
Revenue is recognized on the satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. Factors to consider include, but are not limited to: • The customer has an unconditional obligation to pay • The customer has physical possession • The customer has legal title • The customer specifies the design or function of the good or service.	Revenue is recognized once the risks and rewards of ownership have transferred to the end customer.	Revenue is recognized once the risks and rewards of ownership have transferred to the end consumer.

Impact:

The proposed standard requires an entity that has entered into a consignment stock arrangement with a distributor, hospital or other customer under which the customer can return unsold product or rotate older stock to determine when transfer of control to the customer has occurred. If the customer has control of the product, including the right (but not the obligation) to return the product to the seller at its discretion, control transfers when the product is delivered to the customer. Management's estimate of expected returns, price concessions, etc., affects the amount of revenue recorded. The proposed standard might result in earlier revenue recognition than current standards, which focus on the transfer of risks and rewards.

If the entity has the ability to require the customer to return the product (i.e., a call right), the entity may control the goods and revenue is therefore only recognized when products are sold through to an end customer, similar to current accounting.

Example 8—Sale of products on consignment

Facts: A medical technology entity ships stents to hospitals on a consignment basis. A hospital places orders for stents based on its expected need and can return unused stents to the entity. Once the hospital uses a stent (surgically implanted into a patient), the hospital takes title to the

stent. The entity has no further obligations with respect to the stent once it has been used by the hospital. How does the entity account for revenue?

Discussion: The entity will need to consider whether the hospital has obtained control of the stents. For example, the entity will need to consider whether it has retained the right to demand the return

of the stents, which would indicate that control did not transfer to the hospital on receipt of the stents.

If control of the stents transfers upon delivery to the hospital and a reasonable estimate of stents to be returned by the hospital can be made, the entity recognizes revenue upon delivery of the stents.

Right of return

Pharmaceutical, life science, and certain medical technology entities sell products with a right of return. The right of return often permits customers to return product within a few months prior to and following product expiration.

Proposed standard	Current US GAAP	Current IFRS
Revenue is not recognized for product that is expected to be returned. An entity records a liability for expected refunds to customers using a probability-weighted approach. The liability is adjusted as an entity's estimate of expected returns changes. An asset and a corresponding adjustment to cost of sales are recognized for the right to recover goods from customers on settling the refund liability, with the asset initially measured at the original cost of the goods sold. An impairment might need to be recognized for product expected to be returned that cannot be resold, which is the case for pharmaceutical and many medical technology products. Entities that are unable to calculate a reasonable estimate of returns might not be able to assert that their performance obligation related to the return provision in their sales terms had been completed with respect to all sales.	Revenue is recognized on sales with a right of return when an entity meets the conditions in ASC 605-15-25 (<i>Revenue Recognition</i>). These conditions include that the amount of future returns can be reasonably estimated. If an entity cannot reasonably estimate sales returns, usually due to a lack of history, the entity is precluded from recognizing revenue and cost of sales until either the return privilege has substantially expired or the entity is able to estimate returns, whichever occurs first. Entities must therefore assess whether they have the return history to be able to reliably estimate returns on product sales in order to recognize revenue.	Revenue from the sale of goods is recognized when the amount of revenue and associated costs can be measured reliably. In the case of returns, this means that revenue is recognized when returns can be estimated reliably. Whether the level of returns is capable of being measured reliably is a matter of judgment and usually relies on having some historical basis from which to draw a meaningful comparison. A liability is recorded and revenue is not recognized for expected returns.

Impact:

We believe that the proposed standard will not affect the timing of revenue recognition when a right of return exists. Entities currently base their returns estimates on an expected return rate that considers return history and other factors (e.g., shelf lives, product in the channel, changes in product demand, launch of competitor product, etc.) to determine the probability that product will be returned within the return period. Management considers these factors in developing its estimate of returns and records a liability and a corresponding reduction to sales for estimated returns each period. If management cannot estimate sales returns, revenue is deferred until the return period expires or management is able to make a reasonable estimate of returns.

Pharmaceutical entities usually destroy returned inventory, but certain medical technology entities can re-sell returned product. Where this is the case, the entity would record an asset for the right to recover goods from customers and an offsetting refund obligation. The gross presentation of the refund obligation and the right to recover the inventory is a change from current practice where the obligation and right are typically recorded net, but it is unlikely to have a significant effect. If indicators of impairment exist, the right to recover the inventory should be assessed for impairment.

Bill-and-hold arrangements

Pharmaceutical, life science, and medical technology entities may have bill-and-hold arrangements with their customers whereby the entity bills a customer for product, but does not ship the product until a later date. Entities can currently recognize revenue when product is sold (rather than on delivery) under arrangements that meet certain criteria.

Proposed standard	Current US GAAP	Current IFRS
An entity will need to determine when control of the goods provided in a bill and hold arrangement is transferred. A customer will have obtained control of a product in a bill and hold arrangement when the following criteria are satisfied: • The customer has requested the contract to be on a bill and hold basis; • The product is identified separately as the customer's; • The product is ready for delivery at the time and location specified by the customer; and • The entity does not have the ability to sell the product to another customer. Some of the transaction price is allocated to the custodial services if they are a material separate performance obligation.	Revenue is recognized in a bill and hold arrangement prior to the delivery of the goods when the following criteria are met: • The risk of ownership has passed to the buyer; • The customer has made a fixed commitment to purchase the goods, preferably in writing; • The buyer, not the seller, requests that the transaction be on a bill and hold basis and has a substantial business purpose for ordering the goods on a bill and hold basis; • There is a fixed schedule for delivery of the goods; • The seller does not retain any specific performance obligations such that the earnings process is not complete; • The ordered goods have been segregated from the seller's inventory and not be subject to being used to fill other orders; and • The goods are complete and ready for shipment.	Revenue is recognized in a bill and hold arrangement prior to the delivery of the goods when the following criteria are met: • The buyer has taken title to the goods and accepted billing; • It is probable that delivery will take place; • The goods are on hand, identified and ready for delivery to the buyer at the time the sale is recognized; • The buyer specifically acknowledges the deferred delivery instructions; and • The usual payment terms apply.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>	The following factors should also be considered in determining whether revenue recognition should precede the delivery of goods to the customer: • The date by which the seller expects payment, and whether the seller has modified its normal billing and credit terms for the buyer; • The seller's past experiences with and pattern of bill and hold transactions; • Whether the buyer has the expected risk of loss in the event of a decline in the market value of goods; • Whether the seller's custodial risks are insurable and insured; and • Whether extended procedures are necessary in order to assure that there are no exceptions to the buyer's commitment to accept and pay for the goods. If the above criteria are not satisfied, revenue recognition is typically deferred until delivery of the goods.	

The proposed standard is not as proscriptive as existing US GAAP. It focuses on when control of the goods transfers to the customer to determine when revenue is recognized. The requirement to have a fixed delivery schedule often precludes revenue recognition under current US GAAP; however, this requirement is not included in the proposed standard. Entities will need to consider the facts and circumstances of their arrangements to determine whether control of the product has transferred to the customer prior to delivery. Some indicators that control has transferred include the product has been identified separately as the customer's, the product is ready for delivery in accordance with the terms of the arrangement, and the entity does not have the ability to sell the product to another customer. Generally, we expect the timing of revenue recognition for bill and hold arrangements to be unchanged.

Pharmaceutical entities that participate in vaccine stockpile programs should continue to apply the bill and hold

guidance in assessing when to recognize revenue. A vaccine stockpile program requires an entity to have a certain amount of vaccine inventory on hand for use by the government. The criteria in US GAAP for revenue recognition have not previously been met upon transfer of inventory to the stockpile because typically such arrangements do not include a fixed schedule for delivery and the vaccine stockpile inventory may not be segregated from the entity's inventory. The entity rotates the vaccine stockpile in many cases to ensure it is viable (does not expire). An exception has been provided by the SEC for entities that participate in US government vaccine stockpile programs, which permits them to recognize revenue at the time inventory is added to the stockpile, provided all other revenue recognition criteria have been met. This exception is very narrow in scope. For entities following US GAAP, the exception applies only to US government stockpiles and only to certain vaccines. It is not clear whether the SEC will carry forward the exception if the proposed

standard is adopted. For entities following IFRS, depending on the substance of the arrangements, revenue might be recognized when the inventory is added to the stockpile if the "bill and hold" requirements under IFRS are met.

Entities that participate in government vaccine stockpile programs will need to assess whether control of the product has transferred to the government prior to delivery. The proposed standard does not require a fixed delivery schedule, but the requirement for transfer of control of the inventory may not be met if the stockpile inventory has not been segregated from an entity's inventory and is subject to rotation. Entities will also need to consider their performance obligations under the arrangement. The storage of stockpile product, the maintenance and rotation of stockpile product, and delivery of product may be distinct performance obligations under the arrangement to which consideration is allocated and revenue recognized as performance obligations are satisfied.

Warranties

Many pharmaceutical, life science, and medical technology products are sold with implicit or explicit product warranties that the product sold to the customer meets an entity’s quality standards and other applicable regulatory requirements and that the product is usable and not defective. Some medical technology entities also offer extended warranties, which provide for coverage beyond the standard warranty period.

The proposed standard draws a distinction between warranties that protect against

latent defects (e.g., standard warranties) and warranties that provide protection for defects that arise after the product is transferred to the customer, such as normal wear and tear (e.g., extended warranties). The accounting for extended warranties under the proposed standard is similar to existing practice, but the accounting for standard warranties is likely to affect the timing of revenue recognition for certain medical technology products that are sold with a standard warranty and for which the entity has a history of replacing or repairing defective products. Such medical technology products may include capital equipment and instruments.

We do not expect the proposed standard to affect revenue recognition for products subject to stringent quality standards and applicable regulatory requirements, including pharmaceutical, life science, and other medical technology products, that do not have a history of being replaced or repaired under a standard warranty. These products may be sold with implicit or explicit standard warranties, but in practice, it is unlikely that they have any latent defects at the time of sale due to the stringent quality standards to which they are subject.

Proposed standard	Current US GAAP	Current IFRS
Warranties that protect against latent defects do not give rise to a separate performance obligation, but acknowledge the possibility that the vendor has not satisfied its performance obligation. At the reporting date, the vendor determines the likelihood and extent of defective products that it has sold to customers. If the vendor is required to replace defective products, it does not recognize any revenue for those defective products when it transfers them to customers. If the vendor is required to repair defective products, it does not recognize revenue for the portion of the transaction price attributed to the products’ components expected to be replaced in the repair process.	Warranties that protect against latent defects are accounted for as a loss contingency and do not generally constitute a deliverable. An entity records a liability for a warranty contingency and related expense when it is probable that a loss covered by the warranty had been incurred and the amount of the loss can be reasonably estimated. In determining whether the loss can be reasonably estimated, an entity normally takes into account its own experience or other available information. Warranties that provide protection for defects that arise after the product is transferred are considered separate deliverables for which revenue is deferred and recognized over the expected life of the contract.	When an entity sells a product subject to warranty, it first determines whether the warranty represents a separable component of the transaction. Products are often sold with a “standard warranty,” which protects the customer in the event that an item sold proves to have been defective at the time of sale (usually based on evidence coming to light within a standard period). This is not usually considered separable from the sale of goods. When the warranty is not a separate element and represents an insignificant part of the sale transaction, the full consideration received is recognized as revenue on the sale and a provision is recognized for the expected future cost to be incurred relating to the warranty.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i> Warranties that provide protection for defects that arise after the product is transferred give rise to a separate performance obligation. A portion of the transaction price should be allocated to the warranty. Once the warranty obligation has been satisfied, revenue is recognized.		If an entity sells a product with an extended warranty, it is treated as a multiple element arrangement and the revenue from the sale of the extended warranty is deferred and recognized over the warranty period. A provision is recognized for rectification and/or replacement only as defects arise through the warranty period. This differs from a standard warranty where provision is made at the time the goods are sold. Similar to other contracts, extended warranty contracts should be reviewed to ensure they are not onerous.

Impact:

Standard warranties

The proposed standard may affect the timing of revenue recognition for certain medical technology products that are sold with a standard warranty that provides for replacement or repair of defective products by an entity that has a history of defective product being replaced or repaired under the warranty. The entity defers revenue recognition under the proposed standard if the defective product is expected to be replaced. Delivery of a defective product does not result in satisfaction of the performance obligation and represents a failed sale. The result is similar to the accounting for expected product returns. If the defective product is repaired under the warranty, the entity defers revenue for the portion of the price attributed to the components expected to be replaced. This is different from the current guidance, which requires the entity to record a liability and expense for the estimated probable loss related to the warranty. This liability is generally measured at the cost to replace or repair the product rather than at its sales value.

Extended warranties

The proposed standard does not significantly change the current accounting models for extended warranties. However, the amount of deferred revenue could be different under the proposed standard depending on the distinct performance obligations identified and the consideration allocated to each performance obligation. An entity allocates a portion of the transaction price, which may include consideration for both the product and the extended warranty (if priced separately), to the extended warranty and defers the portion of the revenue related to the extended warranty until the performance obligation is satisfied or the warranty period has lapsed.

Product recalls and product liability claims

Pharmaceutical, life science, and medical technology entities experience both product liability claims and product recalls. Product liability claims are scoped out of the proposed standard and are instead subject to the loss contingencies guidance in *Contingencies* (US GAAP) or *Provisions, Contingent Liabilities and Contingent Assets* (IFRS).

Product recalls occur when a concern is raised regarding the safety of a product and may be either voluntary or involuntary. Recalls are generally not due to known manufacturing defects in a product at the time of sale. In fact, the recalled product was likely subject to stringent quality controls prior to sale. While not specifically addressed in the proposal, it is possible that a distinction may be drawn between defects that are known at the date of sale that require deferral of revenue and clinical safety issues that are not known or are not detected through manufacturing quality controls at the date of sale. If so, a product recall associated with clinical safety issues that are not known at the date of sale are not subject to the standard warranty guidance under the proposed standard. Recall related liabilities and product liabilities are not performance obligations under the proposed standard. Such recalls will continue to be subject to the loss contingencies guidance similar to a product liability

Example 9—Standard warranty

Facts: A medical technology entity sells diabetes monitoring devices that come with a standard product warranty that allows the customer to return the device within one year if the customer has any performance issues with the device. If

a device is returned under the standard warranty, the entity ships the customer a replacement device. Based on experience, the probability of a device having a performance failure is 5%. How does the medical technology entity recognize revenue?

Discussion: The entity will defer 5% of total sales when the devices are delivered. The entity re-assesses the probability of the device operating as intended and recognizes revenue as the warranty obligation is either satisfied or expires at each reporting date.

***To have a deeper conversation
about how this subject may affect
your business, please contact:***

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US GAAP Convergence & IFRS

Revenue recognition: Retail and consumer industry supplement

March 2011

Revenue recognition . . . full speed ahead

Retail and consumer industry supplement

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Overview

The accounting for revenue recognition in the retail and consumer (R&C) sector is covered by multiple pieces of literature under IFRS and US GAAP. The existing general revenue recognition model for product sales in the R&C sector is not expected to change broadly under the proposed standard, but where there is a change, it may have a significant impact. For example, certain aspects of product sales transactions in the R&C sector may be affected by the proposed standard such as return rights, “sell-through” versus “sell-to” revenue recognition, customer incentives including loyalty programs and gift cards, the licensing of intellectual property and warranties.

This paper, examples, and the related assessments contained herein are based on the Exposure Draft, *Revenue from Contracts with Customers*, which was issued on June 24, 2010. These proposals are subject to change at any time until a final standard is issued. The examples reflect the potential impacts of the proposed standard and any conclusions noted are subject to further interpretation and assessment based on the final standard. For a more comprehensive description of the proposed standard refer to PwC’s Dataline 2010–28 or visit www.fasb.org.

*This Dataline Supplement was revised on September 3, 2010 to reflect certain editorial revisions. None of the revisions resulted in substantive changes to the assessments of the proposed model contained herein.

Right of return

Return rights are commonly granted in the R&C sector and may take the form of price protection, product obsolescence protection, stock rotation, trade-in agreements, or the right to return all products upon termination of the agreement. Some of these rights may be articulated in contracts

with customers or distributors, while some are implied during the sales process. These rights take many forms and are driven generally by the buyer’s desire to mitigate risk related to the products purchased and the seller’s desire to promote goodwill with its customers and ensure customer satisfaction.

Proposed standard	Current US GAAP	Current IFRS
The sale of goods with a right of return is accounted for similarly to the current ‘failed sale’ model. That is, revenue is not recognized for goods expected to be returned, rather a liability is recognized for the expected amount of refunds to customers using a probability-weighted approach. The refund liability is periodically updated for changes in expected refunds. An asset and corresponding adjustment to cost of sales is recognized for the right to recover goods from customers on settling the refund liability, with the asset initially measured at the original cost of the goods (that is, the former carrying amount in inventory). The asset is subsequently adjusted for any impairment.	Currently, returns are estimated based on historical experience with an allowance recorded against sales. If an entity is unable to estimate the potential returns, revenue is not recognized until the return right lapses.	Revenue is typically recognized net of a provision for the expected level of returns, provided that the seller can reliably estimate the level of returns based on an established historical record and other relevant evidence.
Impact: The impact of product returns on earnings under the proposed standard will be largely unchanged from current US GAAP and IFRS accounting. However, the balance sheet will be grossed up to include the refund obligation and the asset for the right to the returned goods. If indicators of impairment exist, the asset is assessed for impairment. Management will use a probability-weighted approach to determine the likelihood of a sales return under the proposed standard.		

Example 1—Right of return as a separate performance obligation

Facts: A retailer sells 100 mobile phones for £100 each. The mobile phones cost £50 and include a return right for 180 days. The retailer determined that the probability of a sales return associated with this transaction is 10%, based on historical sales patterns. In establishing the 10% return rate, the retailer estimated a 32% probability that seven mobile phones will be returned, a 40% probability that nine mobile phones will be returned, and a 28% probability that 15 mobile phones will be returned.

Discussion: At the point of sale, £9,000 of revenue (£100 x 90 mobile phones) and cost of sales of £4,500 (£50 x 90 mobile phones) is recognized. An asset of £500 (10% of product cost, or £50 x 10 mobile phones) is recognized for the anticipated sales return, and a liability of £1,000 (10% of the sale price) would be established for the refund obligation. The probability of return is evaluated at each subsequent reporting date. Any changes in estimates are adjusted against the asset and liability, with adjustments to the liability recorded to revenue and adjustments to the asset recorded against cost of sales.

Sell-through approach

The sell-through approach is used for some arrangements with distributors where revenue is not recognized until the product is sold to the end customer (i.e., the consumer) because the distributor may have the ability to return the unsold product, rotate older stock or receive pricing concessions.

Proposed standard	Current US GAAP	Current IFRS
Revenue is recognized on the satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. Control can transfer at a point in time or continuously over the contract period. Factors to consider include, but are not limited to: • The customer has an unconditional obligation to pay • The customer has legal title • The customer has physical possession • The customer specifies the design or function of the good or service	The sell-through approach is common in arrangements that include dealers or distributors. Revenue is recognized once the risk and rewards of ownership have transferred to the end consumer under the sell-through approach.	A contract for the sale of goods normally gives rise to revenue recognition at the time of delivery, when the following conditions are satisfied: • the risk and rewards of ownership have transferred • the seller does not retain managerial involvement • the amount of revenue can be reliably measured • it is probable that the economic benefit will flow to the customer • the costs incurred can be measured reliably
	Impact: The impact of the proposed standard on current accounting under both US GAAP and IFRS will depend on the terms of the arrangement. The proposed standard requires the seller to determine when transfer of control to the customer has occurred. If the customer has control of the product, including the right (but not the obligation) to put the product back to the seller at its discretion, control transfers when the product is delivered to the dealer or distributor. Expected returns, price concessions, etc. affect the amount of revenue recorded. This will change the timing of revenue recognition compared to today's model, which focuses on the transfer of risks and rewards. If the seller is able to require the distributor or dealer to return the product (that is, a call right), the seller controls the goods, and revenue is only recognized when products are sold to a third party, similar to today's model.	

Example 2—Sale of products to a distributor using the sell-through approach

Facts: A consumer products company uses a distributor network to supply its product to the final customer. The distributor may return unsold product at the end of the contract term. Once the products are sold to the end customer, the consumer products company has no further obligations with respect to the product and the distributor has no further return rights. When does the consumer products entity recognize revenue?

Discussion: Revenue is recognized once control of the product has transferred to the customer. If the distributor controls whether the goods are returned or not, the distributor is considered the "customer", and transfer of control occurs when the goods are obtained by the distributor.

Example 3—Sale of products on consignment

Facts: A manufacturer provides household goods to a retailer on a consignment basis (e.g., scan based trading). The retailer does not take title to the products until they are scanned at the register. Any unsold products are returned to the manufacturer. Once the retailer sells the products to the consumer, the manufacturer has no further obligations with respect to the products, and the retailer has no further return rights. When does the manufacturer recognize revenue?

Discussion: The manufacturer will need to consider whether the retailer has obtained control of the products, including whether the retailer has an unconditional obligation to pay the manufacturer for the products, absent a sale to the consumer. Revenue recognition prior to the transfer of control of the product to the consumer (i.e., at the time of purchase by the consumer) might not be appropriate.

Customer incentives

R&C companies offer a wide array of customer incentives. Retailers commonly offer to their customers coupons, rebates issued at point of sale, free products (“buy-one-get-one-free”), price protection or price matching programs. Consumer product companies commonly provide vendor allowances including volume

rebates and cooperative advertising allowances, market development allowances and mark-down allowances (compensation for poor sales levels of vendor merchandise). Consumer product companies also offer product placement or slotting fees to retailers. There are various accounting standards that are applicable today and some diversity in practice in accounting for such incentives.

Proposed standard	Current US GAAP	Current IFRS
The proposed standard requires companies to identify the distinct performance obligations in an arrangement and allocate the transaction price to each performance obligation. The allocation should consider the impact of customer incentives and other discounts, which may be a separate performance obligation or may affect the total transaction price.	Sales incentives offered to customers are typically recorded as a reduction of revenue at the later of the date at which the related sale is recorded by the vendor or the date at which the sales incentive is offered. Volume rebates are recognized as each of the revenue transactions that results in progress by the customer toward earning the rebate occurs.	Sales incentives offered to customers are recorded as a reduction of revenue at the time of sale. Management uses their best estimate of expected incentives awarded to estimate the sales price. The potential impact of volume discounts is considered at the time of the original sale. For contracts that provide customers with volume discounts, revenue is measured by reference to the estimated volume of sales and the corresponding expected discounts. If estimates of the expected discounts cannot be reliably made, revenue recognized should not exceed the amount of consideration that would be received if the maximum discounts were taken.
	Impact: The proposed standard will affect some US GAAP reporting companies as it will require incentives to be accounted for similar to current IFRS standards. The proposed standard will require a company to assess the transaction price including the impact of the incentive program. If the incentive provides the customer with a material right (e.g., a discount on future purchases) that would not have been obtained without entering into the contract, the incentive is a separate performance obligation. The transaction price is allocated to the separate performance obligations and the amount allocated to the option (i.e., the future discount) would be deferred and recognized as revenue when the obligation is fulfilled or the right lapses. If the incentive creates variability in the pricing of the goods or services provided in the contract (as with volume discounts), management will need to determine the probability-weighted estimate of possible outcomes to determine the transaction price. Variable consideration is only included in the transaction price if management can reasonably estimate the amount of consideration to be received. Revenue may be recognized sooner than currently allowed if the consideration can be estimated reasonably.	

Example 4—Retailer issued coupons

Facts: A retailer sells a product and provides the customer with a coupon for 60% off the future purchase of a second, identical product. The retailer typically provides customers with 10% discounts on future purchases. The selling price of the product is \$10. How much revenue is recognized on the first sale?

Discussion: The retailer estimates the probability that the coupons will be redeemed. If the probability of redemption is 100%, the value of the option is \$5 ($\$10 \times 50\%$ discount [i.e., the incremental value to the customer of the discount considering a 10% discount is typically offered by the retailer] $\times 100\%$ expected redemption). The company allocates \$3.33 ($\$10 \times (\$5 / (\$5 + \$10))$) of the \$10 transaction price to the coupon. The retailer recognizes revenue of \$6.67 when the product is sold, assuming control transfers, and defers the coupon value of \$3.33 until the coupon is redeemed or expires unredeemed. If the coupon is redeemed in connection with a future sale, the \$3.33 allocated to the coupon is included with the transaction price associated with the subsequent sale.

Example 5—Manufacturer issued coupons

Facts: A manufacturer sells 1,000 boxes of laundry detergent to a retailer for €100 per box. The sale from the manufacturer to the retailer is final, and control of the product passes to the retailer. There are no return rights, price protection or stock rotation rights. The retailer sells the laundry detergent to consumers for €12 per box. The manufacturer issues coupons for a €1 discount directly to consumers via newspapers. The coupons are presented by the consumer to the retailer upon purchase of the detergent. The customer pays €12 if

it has no coupon or €11 if it has a coupon. The retailer submits coupons to the manufacturer and is compensated at the face value of the coupons (€1). It is estimated that 400 coupons will be redeemed. How much revenue should the manufacturer and retailer recognize?

Discussion: The manufacturer will recognize €9,600 of revenue (€10,000 less estimated coupon redemption of €400) for detergent sold to the retailer. The retailer will recognize revenue of €12 and cost of sales of €10 for each box upon sale to the customer. While not specifically addressed by the proposed standard, we believe the additional consideration paid by the manufacturer represents revenue to the retailer, as the fair value of total consideration received is €12. Cost of sales remains at the original amount paid by the retailer to the manufacturer.

Example 6—Free product rebate

Facts: A vendor is running a promotion whereby a customer who purchases three boxes of golf balls at ¥20 per box in a single transaction receives a mail-in rebate for one free box of golf balls. How is the consideration allocated to the various deliverables in the arrangement?

Discussion: The vendor is selling four boxes of golf balls for ¥60. Each performance obligation (i.e., each box) is allocated ¥15 based on the relative estimated selling price. Assuming the vendor is unable to determine if the mail-in rebate will be used on the date of sale, the transaction price allocated to the undelivered box is deferred until the earlier of redemption or expiration of the rebate.

Example 7—Slotting fees

Facts: A manufacturer sells \$8 million in

product to a retailer. The manufacturer also makes a \$1 million non-refundable up-front payment to the retailer for product placement services. The retailer's promise to display the manufacturer's products includes stocking and favorable placement of the products. The fair value of the product placement service is \$875,000, based on similar transactions. How does the manufacturer account for the upfront payment?

Discussion: Although the product placement services are not sold separately, under the proposed standard the service is distinct because it has a distinct function and distinct margin. The manufacturer recognizes an expense of \$875,000 (the estimated standalone selling price of the product placement services) when control of the goods transfers to the retailer. The remaining amount of consideration paid for the product placement services of \$125,000 is reflected as a reduction of the transaction price. The manufacturer recognizes \$7,875,000 in revenue when control of the products transfers to the retailer.

Example 8—Price protection if retailer subsequently lowers price

Facts: On January 1, a retailer sells a product to customer A for €100 and agrees to reimburse customer A for the difference between the purchase price and any lower price offered by the retailer over the next three months. How does the retailer account for the potential refund?

Discussion: The consideration expected to be paid to the customer is reflected as a liability at the time of the sale. The transaction price reflects the €100 sales price less the probability-weighted estimate of the consideration expected to be refunded to customer A.

Loyalty programs

Retailers often use customer loyalty programs to build brand loyalty and increase sales volume by providing

customers with incentives to buy their products. Each time a customer buys goods or services, or performs another qualifying act, the retailer grants the customer award credits. The customer can redeem

the credits for awards such as free or discounted goods or services. Credits that are not ultimately redeemed are forfeited. Forfeitures are often termed “breakage”.

Proposed standard	Current US GAAP	Current IFRS
An option to acquire additional goods or services gives rise to a separate performance obligation in the contract if the option provides a material right to the customer that the customer would not receive without entering into that contract. The proposed standard requires management to estimate the transaction price to be allocated to the separate performance obligations. The customer is paying for the future goods or services to be received when customer award credits are issued in conjunction with a current sale. Management recognizes revenue for the option when it expires or when these future goods or services are transferred to the customer.	There is divergence in practice in US GAAP in the accounting for loyalty programs. Two models commonly followed are a multiple-element revenue model and an incremental cost accrual model. Typically, revenue is recognized at the time of the initial sale and an accrual is made for the expected costs of satisfying the award credits under the incremental cost model. The incremental cost model is more prevalent in practice. Breakage related to award credits expected to be forfeited is accounted for either proportionally as the awards are redeemed or when the awards expire.	Loyalty programs are accounted for as multiple-element arrangements. The fair value of award credits is deferred and recognized when the awards are redeemed or expire. Revenue is allocated between the initial good or service sold and the award credits, taking into consideration the fair value of the award credits to the customer. The assessment of fair value includes consideration of discounts available to other buyers absent entering into the initial purchase transaction and expected forfeitures.
	Impact: The proposed standard is consistent with the multiple element model currently required under IFRS and thus it may have more impact on US GAAP reporters. The transaction price is allocated between the product and the loyalty reward performance obligations. The amount allocated to the loyalty rewards is deferred and revenue is recognized when the rewards expire or are redeemed. The accounting for breakage under the proposed standard may also impact the timing of revenue recognition. Management must consider the impact of breakage for loyalty rewards in determining the transaction price allocated to the performance obligations in the contract.	

Example 9—Loyalty points

Facts: A retailer has a loyalty program that rewards customers one point per £1 spent. Points are redeemable for £0.10 on future purchases (but not redeemable for cash). A customer purchases £1,000 of product at the normal selling price and earns 1,000 points redeemable for £100 of goods or services in the future. The retailer expects redemption of 950 points (i.e., 5%

breakage). The retailer therefore estimates a standalone selling price for the incentive of £0.095 per point based on the likelihood of redemption (£0.10 less 5%). How is the consideration allocated between the points and the product?

Discussion: The retailer would allocate the transaction price of £1,000 between the product and points based on the relative standalone selling prices of £1,000 for

the product and £95 for the loyalty reward as follows:

Product	£913 (£1,000 × £1,000/£1,095)
Points	£ 87 (£1,000 × £95/£1,095)

The £913 of revenue allocated to the product is recognized upon transfer of control of the product and the £87 allocated to the points is recognized upon the earlier of the redemption or expiration of the points.

Gift cards

The use of gift certificates and gift cards is common in the retail industry. The gift cards or certificates may be used by customers to obtain products or services in the future up to a specified monetary value.

Proposed standard	Current US GAAP	Current IFRS
Revenue is recognized on the satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. The transaction price (i.e., the amount of revenue recognized) is equal to the amount of consideration that a company receives, or expects to receive, from a customer in exchange for transferring goods or services.	A liability is recognized when the gift card is sold to the customer for the future obligation of the retailer to honor the gift card. The liability is relieved (and revenue recognized) when the gift card is redeemed. The portion of gift cards not redeemed is referred to as breakage. There are three accounting models that are generally accepted for the recognition of breakage, depending on the features of the program, legal requirements and the vendor's ability to reliably estimate breakage: • Proportional model (i.e., revenue for breakage is recognized ratably as redemptions occur) • Liability (or expiration) model (i.e., de-recognize an unredeemed incentive obligation and record revenue when the right expires) • Remote model (i.e., if the vendor can reliably estimate the pattern of redemption over time, recognize breakage revenue as the possibility of redemptions become remote) Where escheatment laws apply, the vendor cannot recognize breakage revenue from escheatable funds since it is required to remit the funds to a third party even if the customer never demands performance.	Payment received in advance of future performance is recognized as revenue only when the future performance to which it relates occurs. That is, revenue from the sale of a gift card or voucher is accounted for when the seller supplies the goods or services on exercise of the gift card. No specific models are provided for recognizing breakage. The models used under US GAAP are acceptable under IFRS.
Impact: Companies will continue to defer revenue for the future obligation to honor the gift card under the proposed standard. Revenue is recognized when the gift card is redeemed or when it expires. Breakage is considered in the allocation of revenue to the separate performance obligations when the gift card is sold as part of a bundled arrangement, thus the current diversity in practice is likely to be eliminated.		

Example 10—Gift cards

Facts: A customer buys a \$100 gift card from a retailer, which can be used for up to one year from the date of purchase. The retailer estimates that the customer will redeem \$90 of the gift card and \$10 will expire unused (10% breakage). Based on all applicable laws (i.e., unclaimed property laws), when the gift card expires the company has no requirement to remit any unused funds to the customer or any third party. The company's accounting policy for breakage is to apply the proportional model. Deferred revenue of \$100 is recorded upon sale of the gift card. How is revenue recognized when the gift card is redeemed?

Discussion: For every \$1 of gift card redemptions, the retailer recognizes \$1.11 ($\$1.00 \times \$100/\$90$) of revenue with \$0.11 of the revenue reflecting breakage. To illustrate, if the customer purchases a \$50 product using the gift card, the retailer recognizes \$55 of revenue, reflecting the product's selling price and the estimated breakage of \$5.

Licenses and royalties

Licenses are common in the retail and consumer sector—both from the licensor and licensee perspective. Many of the products that are sold today include a licensed image or name. The accounting for licenses under the proposed standard may be significantly affected.

Proposed standard	Current US GAAP	Current IFRS
The recognition of revenue for the license of intellectual property will depend on whether the customer obtains control of the underlying asset. The contract is considered a sale (rather than a license or a lease) of intellectual property if the customer obtains control of the entire licensed intellectual property (e.g., the exclusive right to use the property for its economic life). Revenue is recognized when control transfers if it is a sale. If the customer licenses intellectual property on an exclusive basis but does not obtain control for the entire economic life of the property, the performance obligation is satisfied over the term of the license. In this case, revenue is recognized over the term of the license. A contract that provides a nonexclusive license for intellectual property contains a single performance obligation. Revenue is recognized when the customer is able to use the license and benefit from it (i.e., when control transfers).	Revenue under license arrangements is recognized when earned and realized or realizable. Revenue is generally earned at either the beginning or throughout the license term, depending upon the nature of the license and any other obligations of the licensor. Royalty revenue is generally recognized when realized or realizable.	Revenue is not recognized under licensing agreements until performance occurs and the revenue is earned. The assignment of rights for a non-refundable amount under a non-cancelable contract permits the licensee to use those rights freely and where the licensor has no remaining obligations to perform is, in substance, a sale. A fixed license term is an indicator that the revenue should be recognized over the period because the fixed term suggests that the license's risk and rewards have not been transferred to the customer. However, the following indicators should be considered in determining whether a license fee should be recognized over the term or upfront: • Fixed fee or non-refundable guarantee • The contract is non-cancellable • Customer is able to exploit the rights freely • Vendor has no remaining performance obligations IFRS requires royalties to be recognized on an accrual basis in accordance with the relevant agreement's substance.

Proposed standard	Current US GAAP	Current IFRS
	Impact: The accounting for licenses and royalties may be significantly impacted under both US GAAP and IFRS. An estimate of royalties to be received is included in the transaction price at the probability-weighted amount if an entity can reasonably estimate the amount expected to be received, and recognized as revenue when control of the intellectual property is transferred. This may result in revenue being recognized earlier under the proposed standard than under current practice. Licensors may have to perform a much more in depth assessment of the legal terms of contracts to determine when control of the associated asset has been transferred. Licensors will need to focus on whether the asset is being licensed on an exclusive or non-exclusive basis as well as compare the term of the license to the underlying asset's economic life to determine whether the transaction is in substance a sale.	

Example 11—Exclusive licenses

Facts: A designer jeans company has a worldwide recognized brand. A global manufacturer of dolls often contracts with the designer jeans company for the rights to use its brand name on the clothes of the dolls. The terms of the agreement provide the doll manufacturer exclusive rights to use the brand name on the clothes of its dolls for a period of two years. During the contractual term, the jeans company will receive 12% of all sales of dolls that include garments branded by the jeans company. The manufacturer will provide updated sales estimates on a quarterly basis and actual sales data on a monthly basis. When does the designer jeans company recognize revenue?

Discussion: The designer jeans company has provided the manufacturer with an exclusive license. If the term of the license is for less than the economic life of the underlying brand name, revenue is recognized over the term of the license. The economic life of the brand name is longer than two years, therefore the transaction is not a sale. Revenue is recognized over the term of the license arrangement. The consideration to be received by the designer jeans company depends on the level of sales of dolls, so the transaction price is the probability-weighted estimate of consideration to be received from the manufacturer, presuming the consideration can be reasonably estimated. Assuming the doll maker expects doll sales of \$100 million during the term, the transaction price is \$12 million.

Warranties

Products are often sold with standard warranties that provide protection to the consumer that the product will work as intended for a fixed period of time. Many companies also offer extended warranties that cover defects that arise after the initial warranty period has expired. Standard warranties have historically been accounted for as a cost accrual while

extended warranties result in the deferral of the revenue. The model for accounting for warranties will be significantly affected by the proposals, as warranties for defects that arise subsequent to the original sale (both standard and extended warranties) will result in the deferral of revenue for the value of the related warranties. Management will need to closely consider the impact that accounting for warranties may have on its operations.

Proposed standard	Current US GAAP	Current IFRS
A warranty may provide a customer with coverage for latent defects (i.e., those that exist when the asset is transferred to the customer but that are not yet apparent). This warranty does not give rise to a separate performance obligation but acknowledges the possibility that the entity has not satisfied its performance obligation. No revenue is recognized at the time of sale for defective products that will be replaced in their entirety. However, warranties that require replacement or repair of components of an item result in revenue being deferred for only the portion of revenue attributable to the components that will be repaired or replaced. A warranty may provide a customer with coverage for faults that arise after the product is transferred to the customer (e.g., normal “wear and tear”). These warranties give rise to a separate performance obligation. A portion of the transaction price is allocated to that separate performance obligation at contract inception. Revenue is recognized over the warranty period.	Warranties are commonly included with product sales. Such warranties may be governed by third-party regulators depending on the nature of the product. For standard warranties, estimates of warranty claims are accrued at the time of sale for the estimated cost to repair or replace covered products. Extended warranties result in the deferral of revenue for the value of the separately priced extended warranty. The value deferred is amortized to revenue over the extended warranty period.	In contracts that include a warranty provision, management must determine if the warranty obligation is a separate element in the contract. When a warranty is not a separate element and represents an insignificant part of the transaction, the seller has completed substantially all of the required performance and can recognize the full consideration received as revenue on the sale. The expected future cost to be incurred relating to the warranty is not recorded as a reduction of revenue but rather as a cost of sale, as the warranty does not represent a return of a portion of the purchaser’s sales price. The costs of warranties are determined at the time of the sale, and a provision for warranty costs is recognized. If the cost of providing the warranty service cannot be measured reliably, no revenue is recognized prior to the expiration of the warranty obligation. The consideration for sale of extended warranties is deferred and recognized over the period covered by the warranty. In instances where the extended warranty is an integral component of the sale (i.e., bundled into a single transaction), management attributes a relative fair value to each component of the bundle.

Proposed standard	Current US GAAP	Current IFRS
	Impact: The proposed accounting for warranties is a significant change for both US GAAP and IFRS, as it will no longer be acceptable for an entity to fully recognize revenue upon sale and accrue the expected cost of the warranty. The warranty obligation is treated as a failed sale, for which revenue will be deferred, when the asset must be replaced or repaired. Management will need to carefully assess whether products are defective at the time control transfers to the customer. If defective products are delivered to the customer, management will need to defer the entire transaction price if the product must be replaced as the entity has not satisfied its performance obligation to provide a good that operates as intended at the time of transfer. A portion of the revenue equal to the standalone selling price of the component is deferred if only the defective component of a product must be replaced.	

Example 12—Warranties

Facts: A manufacturer sells a radio for £100, which comes with a warranty that ensures the quality of the product during its life cycle. Historically, the manufacturer has experienced a 5% warranty claim rate. How much revenue is deferred?

Discussion: The probability of a product failing to meet its specifications is 5%. The manufacturer defers £5 of revenue each time a product is sold. At each reporting date leading up to the expiration of the warranty, the manufacturer reassesses the probability of the product operating as intended and recognizes revenue as the warranty obligation expires.

***To have a deeper conversation
about how this subject may affect
your business, please contact:***

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US GAAP Convergence & IFRS

Revenue recognition: Technology industry supplement

March 2011

Revenue recognition . . . full speed ahead

Technology industry supplement

What's inside:

Overview

Product warranties

Elimination of software
specific guidance

Uncertain consideration

Multiple-element arrangements

Consulting service contracts

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Overview

The technology industry includes numerous subsectors, including but not limited to computer networking, semi-conductors, software, and clean technology. Each subsector has diverse product and service offerings and various revenue recognition issues common to the industry. Determining how to allocate consideration among elements of an arrangement and when to recognize revenue can be extremely complex and as a result, industry-specific revenue recognition models have developed. The proposed standard will contain a single recognition model, so we believe it will significantly affect a number of the technology subsectors.

The following are some of the areas within the technology industry that may be significantly affected by the proposed revenue recognition standard. This paper, examples, and the related assessments contained herein, are based on an interpretation of the Exposure Draft, “Revenue from Contracts with Customers,” issued on June 24, 2010. The examples reflect the potential impact based on the proposed standard and any conclusions noted are subject to further interpretation and assessment based on the final standard. For a more comprehensive description of the proposed standard, refer to PwC’s Dataline 2010–28 (www.cfodirect.pwc.com) or visit www.fasb.org.

Product warranties

The proposed standard draws a distinction between product warranties that provide coverage for latent defects and warranties that provide coverage for

faults arising after the product is transferred. Many of the warranties offered by technology companies are product warranties that provide coverage for latent defects, however, management will need to use significant judgment to determine

whether a defect is latent or has arisen subsequent to the sale. Practice could change significantly under the proposed standard, resulting in a greater deferral of revenue than under existing guidance in many situations.

Proposed standard	Current US GAAP	Current IFRS
Warranties A product warranty that provides coverage for latent defects does not give rise to a separate performance obligation but may indicate that the entity has not fully satisfied its initial performance obligation to transfer the product specified in the contract. Management will need to determine the likelihood and extent of defects in the products it has sold to customers at each reporting date to determine the extent of unsatisfied performance obligations. Revenue is not recognized at the time of sale for defective products that will be replaced in their entirety. Revenue is also not recognized for components of a product that will have to be replaced. A product warranty that provides coverage for faults arising after the product is transferred gives rise to a separate performance obligation. A portion of the transaction price is allocated to that separate performance obligation at contract inception. Revenue is recognized as the warranty services are provided.	Product warranties that provide coverage for latent defects are typically accounted for in accordance with existing loss contingency guidance, resulting in an expense and a warranty liability being recognized when the good is sold. Potential impact: Entities will defer revenue instead of recording an expense and warranty liability. Product warranties that provide coverage for faults arising after the product is transferred are similar to many extended warranty contracts that protect against defects arising through normal usage. Revenue is deferred for these warranties and recognized over the expected life of the contract. Potential impact: The amount of deferred revenue might vary under the proposed standard compared to current guidance, depending on whether the extended warranty is separately priced and substantive. Extended warranties give rise to a separate performance obligation under the proposed standard and therefore revenue is recognized over the warranty period. This may affect the accounting for extended warranties not separately priced because under current guidance, the warranty is recognized with other elements of the arrangements.	Product warranties that provide coverage for latent defects are typically accounted for in accordance with existing provisions guidance resulting in recognition of an expense and a warranty liability. Potential impact: Entities will defer revenue instead of recording an expense and warranty liability. Product warranties that provide coverage for faults arising after the product is transferred are similar to many extended warranty contracts that protect against defects arising through normal usage. Revenue is deferred for these warranties and recognized over the period covered by the warranty. Potential impact: We do not expect a significant impact, however the amount of deferred revenue might vary under the proposed standard compared to current guidance.

Example 1

Facts: A hardware vendor sells a hard drive, keyboard and monitor, and also provides a 60-day warranty that covers latent defects for certain components of the hard drive and monitor. Assume that the performance obligations (i.e., the hard drive, keyboard, monitor and warranty) qualify as distinct performance obligations under the proposed standard. How should the vendor account for the warranty?

Discussion: The proposed standard requires that the selling price of the hard drive and monitor components that will require repair or replacement would be estimated at contract inception. Revenue relating to those components is deferred until the customer receives those components without defects or when the warranty period expires.

Example 2

Facts: A vendor sells a hard drive, keyboard, monitor, and a 12-month warranty (i.e., not a coverage for latent defects but for future defects) to a customer. Assume that the performance obligations (i.e., the hard drive, keyboard, monitor and 12-month warranty) qualify as distinct performance obligations under the proposed standard. How should the vendor account for the warranty?

Discussion: The proposed standard requires that the vendor will recognize revenue as the performance obligations are satisfied. A portion of the transaction price is allocated to the warranty and recognized as revenue when the warranty obligation is satisfied since the insurance warranty represents a separate performance obligation. The vendor will need to assess the pattern of warranty satisfaction to determine when revenue is recognized (i.e., ratable or some other pattern).

Elimination of software specific guidance

The proposed standard will replace all industry specific guidance. Specific software revenue recognition guidance, which is applied to certain

transactions that include the sale of software under US GAAP, will be superseded. The elimination of the existing guidance will have a significant impact on the accounting for software and software-related transactions.

Proposed standard	Current US GAAP	Current IFRS
Software arrangements involving multiple elements The proposed standard requires separation of distinct performance obligations when they are satisfied at different times. Companies will no longer require VSOE of fair value for undelivered items in order to separate and allocate contract consideration. If an entity does not separately sell a good or service on a stand-alone basis, the entity should estimate the standalone selling price The residual method is not permitted.	Contract consideration is allocated to the various elements based on vendor-specific objective evidence (VSOE) of fair value, if such evidence exists for all elements in the arrangement. When VSOE of fair value does not exist for undelivered elements, revenue is deferred until the earlier of 1) when sufficient VSOE of fair value for the undelivered element does exist or 2) all elements of the arrangement have been delivered. Potential impact: Both the elimination of the residual method and the elimination of the VSOE requirement for software related transactions will significantly affect the consideration allocated to the various deliverables. The timing of revenue recognition will therefore be affected. These changes will also result in the need for significant modifications to the information systems currently used to record revenue.	Revenue is allocated to individual elements of a contract, but specific guidance is not provided on how the consideration should be allocated. Separating the components in a contract may be necessary in order to reflect the economic substance of a transaction. Separation is appropriate when the identifiable components have stand-alone value and their fair value can be measured reliably. The price regularly charged when an item is sold separately is the best evidence of the item's fair value. Other approaches to estimating fair value may also be appropriate, including cost plus margin, the residual method and, under rare circumstances the reverse residual method. Potential impact: The proposed separation and allocation methodology is similar to the current IFRS guidance, except for the elimination of the residual and reverse residual methods, which may have a broad impact in the industry. The differences in the separation of performance obligations and allocation of consideration will significantly affect revenue recognition and may create greater complexity. It will also result in the need for significant changes to the information systems used to record revenue.

Proposed standard	Current US GAAP	Current IFRS
Post-contract customer support (PCS) Post-contract customer support (or maintenance) generally has two elements: telephone support and the supply of new versions (bug fixes, updates and upgrades). The proposed standard requires the separation of distinct performance obligations when they are satisfied at different times using the estimated standalone selling price. If an entity does not separately sell a good or service on a standalone basis, management should estimate the stand-alone selling price in order to allocate the transaction price.	The fair value of PCS is evidenced by the selling price when this element is sold separately. This includes the renewal rate written into the contract provided it is substantive. Revenue for PCS is combined with the license revenue and recognized on a straight-line basis over the PCS term if the only undelivered element is PCS. Potential impact: Management will be required to estimate the standalone selling price of PCS when VSOE may not have previously been available. This might result in a different timing of revenue recognition for PCS and the contract consideration allocated to the delivered items (i.e., the license).	When the selling price of a product includes an identifiable amount of subsequent servicing, that amount is deferred and recognized as revenue over the period during which the service is performed. The amount deferred is that which will cover the expected costs of the services under the agreement, together with a reasonable profit on those services. Potential impact: The proposed standard is similar to the current IFRS guidance, however the residual method is permitted under current guidance and will no longer be permitted under the proposed standard. This may result in a different timing of revenue recognition for PCS and the contract consideration allocated to the delivered items (i.e., the license).

Example 3

Facts: Software Vendor sells Customer a perpetual software license (version 2.0) and post-contract customer support (PCS) services consisting of telephone support for a period of five years once the software is activated. None of the goods and services are sold on a stand-alone basis.

How should Software Vendor account for the transaction?

Discussion: If the license and the PCS are not sold separately, management will need to estimate the stand-alone selling prices under the proposed standard. An estimation method is not prescribed nor is any method precluded. Estimates can

be made using any reasonable and reliable method that maximizes observable inputs. Software Vendor will estimate the standalone selling prices for the software license, the PCS services and telephone support services. The need to estimate stand-alone selling prices may create practical challenges for some software companies.

Proposed standard	Current US GAAP	Current IFRS
Intellectual property licenses Revenue recognition for licenses of intellectual property will depend on whether the customer obtains control of the asset and whether the license is exclusive or non-exclusive. For outright sales of intangibles, perpetual licenses, and time-based licenses with a term greater than the useful life of the underlying asset; revenue should be recognized like a sale, once the license is delivered/enabled. For exclusive time-based licenses that are shorter than the useful life of the underlying asset; revenue should be recognized over the term of the license. For non-exclusive time-based licenses that are shorter than the useful life of the underlying asset; revenue should be recognized like a sale once the license is delivered/enabled.	Perpetual software license fees are recognized at the beginning of the license term (for software that does not require significant production, modification or customization) assuming: (a) persuasive evidence an arrangement exists, (b) delivery has occurred, (c) the fee is fixed or determinable, (d) collectability is probable, and (e) VSOE exists for the undelivered elements in the contract. For time-based licenses, the portion of revenue attributable to the license must be recognized on delivery to the client rather than over time in some circumstances. The treatment of revenue might vary depending on whether a substantive renewal rate for the PCS element allows it to be separated from the license based on the fair value of the PCS. In the absence of VSOE of fair value of the PCS element, all the revenue (license and PCS) must be deferred and recognized on a straight-line basis over the estimated PCS term.	Existing revenue guidance requires that fees and royalties paid for the use of an entity's assets are normally recognized in accordance with the substance of the agreement. This may be on a straight-line basis over the life of the agreement, for example, when a licensee has the right to use certain technology for a specified period of time. An assignment of rights for a fixed fee or non-refundable guarantee under a non-cancellable contract which permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform is, in substance, a sale. Judgment should be applied to determine the most appropriate treatment.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>	Extended payment terms in software licensing arrangements preclude revenue recognition unless the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions. Potential impact: The proposed standard distinguishes between exclusive and non-exclusive licenses. Entities that sell time-based non-exclusive licenses might be affected by recognizing revenue upfront for a non-exclusive license versus over time under current US GAAP when the PCS is not substantive. Extended payment terms will affect the amount of revenue being recognized when the performance obligation is satisfied (see below for further discussion on variable consideration). Time value of money might also be considered if the effect is material.	Potential impact: The proposed standard distinguishes between exclusive and non-exclusive licenses. Revenue recognition may change depending on the current accounting (over time or upfront) and whether the license is exclusive. For example, revenue for the sale of a non-exclusive time-based license with no future obligation other than a standard PCS package currently might be recognized over the life of the license versus upfront under the proposed standard.

Example 4

Facts: Software Vendor enters into a contract with a customer for an exclusive license to its software product for one year. The expected economic life of the software is two years. How should Software Vendor account for the transaction?

Discussion: Management will need to assess whether control of the underlying asset transfers to the customer or merely gives the customer the right to use the asset. This will dictate whether revenue should be recognized under a sale model (i.e., at a point in time) or continuously over the license term. As the license is exclusive and is for a period less than the economic life of software, under the proposed standard the performance obligation is satisfied over the term of the license. The economic life in this example is stated as being for a duration of two years, but we believe that determining the economic life of the software will require significant judgment and may depend on how the vendor intends to offer the intellectual property in the market.

Example 5

Facts: Software Vendor enters into a contract with a customer for a nonexclusive license to its software product (e.g., off-the-shelf software).

Discussion: The proposed standard states that the performance obligation is satisfied when control of the license transfers to the customer, which will generally be at the beginning of the license period for a nonexclusive license. The timing of revenue recognition under the proposed standard may be similar to current accounting, which allows revenue to be recognized at the time of delivery (assuming all other revenue recognition criteria are met).

Uncertain consideration

The transaction price is the consideration the vendor expects to receive in exchange for satisfying its contractual performance obligations. Determining the transaction price is straightforward when the contract price is fixed but it becomes more complex when it is not fixed. Royalties and discounts are common sources of

uncertain consideration for the technology industry. Management must determine if they can reasonably estimate the consideration to be received at contract inception and at each reporting date. This may result in earlier revenue recognition and more income statement volatility for royalty arrangements. Discounts will be estimated in the transaction price.

Proposed standard	Current US GAAP	Current IFRS
Uncertain consideration Variable consideration is included in contract revenue using a probability-weighted approach when such payments can be reasonably estimated. Variable consideration can be reasonably estimated when the entity can identify the potential outcomes of a contract. If management has experience with similar types of contracts and the entity does not expect significant changes in circumstances, variable consideration should be included in the transaction price. Management should consider several factors in assessing whether or not the circumstances may change significantly, including: the impact of external factors, the time until the uncertainty is expected to be resolved, the extent of experience, and the variability in the range of possible outcomes.	The seller's price must be fixed or determinable in order for revenue to be recognized. Revenue related to contingent consideration generally is not recognized until the contingency is resolved. It is not appropriate to recognize revenue based on the probability of a contingency being achieved. Potential impact: Variable consideration affects the measurement of consideration as opposed to timing of recognition under the proposed standard. Technology companies are consistently developing new or enhancing existing products and each company will need to consider at which point they are able to reasonably estimate any amount of variable consideration. Technology companies may recognize revenue earlier than they do currently in many circumstances.	Revenue is measured at the fair value of the consideration received or receivable. Fair value is "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." Trade discounts, volume rebates and other incentives, such as cash settlement discounts, are taken into account in measuring the fair value of the consideration to be received. Revenue relating to contingent consideration is recognized when it is probable that the economic benefits will flow to the entity and the amount is reliably measurable, assuming all other revenue recognition criteria are met. Potential impact: Variable consideration affects timing of revenue recognition. Revenue might be recognized earlier than currently as the probability of receipt of consideration affects the measurement of revenue not the timing of recognition.

Example 6

Facts: Vendor sells a license to use patented technology in a handheld device for no upfront fee and 1% of future product sales. The license term is equal to the patent term. Technology in this area is changing rapidly so the possible consideration ranges from \$0 to \$50,000,000 depending on whether new technology is developed. How should Vendor account for the transaction?

Discussion: Vendor will need to assess whether it can reasonably estimate the royalties to be received. Vendor will need to consider its experience and the experience of others in making this

determination. Royalty revenue is recognized when control of the license transfers if Vendor can reasonably estimate the consideration to be received. If Vendor cannot make a reasonable estimate of the royalties at contract inception, Vendor will need to reassess whether the consideration has become reasonably estimable at each reporting date. Once Vendor has better information and can make a reasonable estimate it will need to record the expected royalties.

Assume that, after three months, Vendor concludes it can reliably estimate the expected royalties. It will estimate the variable consideration based on a probability-weighted method. For example,

Possible royalties (1% of product sales)	Probability	Probability-weighted amount
\$0 million	1%	\$-
\$2 million	50%	\$1.0 million
\$10 million	25%	\$2.5 million
\$50 million	24%	\$12.0 million
		\$15.5 million

Based on the results of the probability-weighted assessment, management would record revenue of \$15.5 million when the license is transferred. Subsequent changes in the estimate of total consideration are adjusted against revenue.

Multiple-element arrangements

Many technology companies provide multiple products or services to their customers as part of a single arrangement. For example, hardware vendors

may sell extended maintenance contracts or other service elements along with the hardware. Elements included in a contract may either be combined as a single unit of accounting or separated into multiple units of accounting under the existing revenue recognition guidance.

Proposed standard	Current US GAAP	Current IFRS
Separation criteria for multiple-element arrangements The proposed standard requires separation of performance obligations when they are satisfied at different times provided such performance obligations are distinct. Management should estimate the standalone selling price if the entity does not separately sell the good or service in order to allocate the transaction price to all performance obligations. The residual method is not permitted under the proposed standard.	The following criteria are applied to transactions other than those involving software to determine if elements included in a multiple-element arrangement should be accounted for separately: • The delivered item has value to the customer on a standalone basis • Objective and reliable evidence of fair value of the undelivered item exists (either VSOE of fair value or relevant third-party evidence of fair value) • If a general return right exists for the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor. A vendor may use third-party evidence (TPE) of fair value to separate deliverables when VSOE of fair value is not available. Potential impact: Technology companies will need to assess whether technology contracts include multiple performance obligations. The separation criteria in the proposed standard is less restrictive than current guidance, which may result in more performance obligations being accounted for separately thereby impacting the timing of revenue recognition. This change in separation criteria may affect some entities more than others, depending on the guidance currently applied to the entity under US GAAP.	The revenue recognition criteria are usually applied separately to each transaction. In certain circumstances, however, it is necessary to separate a transaction into identifiable components in order to reflect the substance of the transaction. When identifiable components have stand-alone value and their fair value can be measured reliably, separation is appropriate. Two or more transactions may need to be grouped together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. The price that is regularly charged when an item is sold separately is the best evidence of the item's fair value. A cost-plus-reasonable-margin approach to estimating fair value is also acceptable under IFRS. The use of the residual method and, under rare circumstances, the reverse residual method, may be acceptable to allocate arrangement consideration. Potential impact: The new separation and allocation methodology is similar to the current IFRS guidance, although more performance obligations might be identified and the residual and reverse residual methods will no longer be acceptable.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>	Hierarchy under current guidance Entities must follow a hierarchy for estimating the selling price of a deliverable. This hierarchy requires the selling price to be based on VSOE if available, third-party evidence (TPE) if VSOE is not available, or estimated selling price if neither VSOE or TPE is available. The term “selling price” indicates that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant. Potential impact: The proposed standard is similar to current guidance for estimating selling prices. No hierarchy is prescribed but we expect this difference will have a limited affect as an entity will need to maximize the use of observable inputs in estimating selling prices.	

Example 7

Facts: Vendor sells a hard drive, keyboard, and monitor to a customer. The monitor is frequently sold on a standalone basis; the hard drive and keyboard are typically not sold on a standalone basis. Assume the performance obligations (i.e., the hard drive, keyboard, and monitor) are distinct and will be delivered at different times. How should Vendor account for the transaction?

Discussion: Vendor will need to consider the observable prices of goods or services, when available, to determine standalone selling prices and allocate the contract consideration. The standalone selling price of the monitor will be used in allocating the consideration to the monitor. The selling prices of the hard drive and the keyboard will need to be estimated since they are not sold separately. Vendor can use cost-plus-reasonable-margin or any other reasonable and reliable method that is consistent with standalone selling prices and that maximizes observable inputs. Once the selling prices are estimated, the transaction price should be allocated based on the relative stand alone selling price of each performance obligation. Revenue is recognized once control of each performance obligation transfers.

Consulting service contracts

Many technology companies provide a wide range of consulting services and arrangements, including business strategy services, supply-chain management, system implementation, outsourcing services and control and system reliance. Because technology service contracts are typically customer-specific, revenue

recognition is dependent on the facts and circumstances of each arrangement.

Accounting for service revenues may change significantly under the proposed standard as companies must determine whether the arrangement is more like the sale of a good or the provision of a service (i.e., whether the performance obligation is satisfied and control of the underlying asset transferred to the customer at a point in time or continuously over a period).

Many technology arrangements include customer acceptance provisions. For arrangements that only involve the delivery of services, the determination of when control of the services transfers may be affected by the presence of customer acceptance provisions.

Proposed standard	Current US GAAP	Current IFRS
Consulting service contracts Revenue is recognized upon the satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. Control can transfer at a point in time or continuously over the contract period. Determining when control transfers will require a significant amount of judgment. Factors to consider include, but are not limited to: • The customer has an unconditional obligation to pay • The customer has legal title • The customer has physical possession • The customer specifies the design or function of the good or service This list is not intended to be a checklist or all-inclusive; these are only factors and no one factor is determinative on a stand-alone basis.	US GAAP permits the proportional performance method for recognizing revenue for service arrangements not within the scope of guidance for construction or certain production-type contracts. Input measures with the exception of cost-to-cost measures, which approximate progression toward completion, may be used when output measures do not exist. Revenue is recognized based on a discernible pattern and if none exists, then a straight-line approach may be appropriate. Revenue is deferred where the outcome of a service transaction cannot be measured reliably. Potential impact: Entities will need to determine whether the performance obligation is the service provided to achieve an outcome or the service is the outcome itself (e.g., the issuance of a report with recommendations). The control indicators may be challenging to apply to consulting services arrangements. This may result in revenue being recognized in different periods than current practice.	IFRS requires that service transactions be accounted for by reference to the stage of completion of the transaction. This method is often referred to as the percentage-of-completion method. The stage of completion may be determined by a variety of methods (including the cost-to-cost method). Revenue may be recognized on a straight-line basis if the services are performed by an indeterminate number of acts over a specified period of time and no other method better represents the stage of completion. Revenue may be deferred in instances where a specific act is much more significant than any other acts. Potential impact: Entities will need to determine whether the performance obligation is the service provided to achieve an outcome or the service is the outcome itself (e.g., the issuance of a report with recommendations). The control indicators may be challenging to apply to services arrangements. This may result in revenue being recognized in different periods than current practice.

Example 8

Facts: Assume a computer consultant enters into a three month fixed-price contract to track a company's software usage in order to help the company decide which software packages it should upgrade in the future. The customer specifies and directs the services to be provided throughout the contract. The consultant will share his findings on a monthly basis, or more frequently if requested by the company. The consultant will provide a summary report of the findings at the end of three months. The company will pay the consultant \$2,000 per month, and the company can direct the consultant to focus on the usage of any systems it wishes to throughout the contract. How should the consultant account for the transaction?

Discussion: The customer has an unconditional obligation to pay throughout the contract as evidenced by the nonrefundable progress payments. The customer specifies the nature of services to be provided throughout the contract and hence, directs the nature of the services to be performed, which affects the entity's final report. The customer can also receive benefit from the services as they are performed. Consequently, control transfers continuously over time (i.e., the entity's performance obligation is to provide the customer with services continuously during the 3 month contract).

Example 9

Facts: Assume a vendor provides two customers (Customer A and Customer B) IT implementation services over a two-year period. Both arrangements include similar terms and the installation includes customization specific to each customer's network. The work is completed at the customer's site and the rights to all work in progress are transferred as the services are provided (i.e., continuous transfer of the outputs occur as the services are provided). However, one arrangement (Customer A) contains a customer acceptance provision while the other arrangement (Customer B) does not. How should vendor account for the transactions?

Discussion: Control transfers continuously as the services are provided because each customer has the right to work in progress. Substantive customer acceptance provisions may delay when control of the assets transfers to the customer.

Customer acceptance may be considered a formality that does not affect when the customer obtains control if the vendor can objectively determine that the good or service has been transferred to the customer in accordance with the contract specifications. If the vendor in the above example has a history of providing similar IT implementation services that met all of the customer-specified criteria noted in the contract, the vendor might determine that recognition of revenue as the services are provided is appropriate. This guidance may result in different accounting for Customers A and B although the transactions otherwise appear similar.

Rights of return

Return rights are common in sales involving hardware, software and various other technology products. Return rights may also take on various other forms

such as product obsolescence protection and trade-in agreements. These rights generally result from the buyer's desire to mitigate the risk related to the products purchased and the seller's desire to promote goodwill with its customers.

Proposed standard	Current US GAAP	Current IFRS
Right of return The sale of goods with a right of return should be accounted for similar to today's failed sale model. That is, revenue should not be recognized for goods expected to be returned and a liability recognized for the expected amount of refunds to customers using a probability-weighted approach. The refund liability should be updated for changes in expected refunds. An asset and corresponding adjustment to cost of sales should be recognized for the right to recover goods from customers on settling the refund liability, with the asset initially measured at the original cost of the goods (that is, the former carrying amount in inventory). The asset should be assessed for impairment if indicators of impairment exist.	Currently, returns are estimated based upon historical experience with an allowance recorded against sales. If an entity is unable to estimate the potential returns, revenue is not recognized until the return rights lapses. Potential impact: Technology companies that are deferring revenue because they do not meet the strict criteria to estimate the return rights under current guidance may be significantly affected by the proposed standard. The less restrictive criteria will result in revenue being recognized earlier. Technology companies that are currently estimating returns and recording a sale allowance may not be affected except for a gross up of the balance sheet for the refund obligation and the asset for the right to the returned goods.	Currently, returns are estimated based upon historical experience with an allowance recorded against sales. If an entity is unable to estimate the potential returns, revenue is not recognized until the return rights lapses. Potential impact: Technology companies that are deferring revenue because they cannot estimate the return rights under current guidance are unlikely to be affected. Technology companies that are currently estimating returns and recording a sale allowance may not be affected except for a gross up of the balance sheet for the refund obligation and the asset for the right to the returned goods.

Example 10

Facts: Vendor sells and ships 10,000 gaming systems to Customer, a reseller, on the same day. Customer may return the gaming systems to Vendor within 12 months of purchase. Historically, Vendor has experienced a 10 percent return rate from Customer. How should Vendor account for the transaction?

Discussion: Vendor should account for the gaming systems that are anticipated to be returned (i.e., 10 percent) as a failed sale. Vendor should record a contract liability for 1,000 gaming systems and derecognize the associated inventory. Vendor should record an asset (an intangible) for the right to the gaming system assets expected to be returned with a corresponding credit to cost of goods sold. The intangible asset should

be recorded at the original cost of the gaming systems. The refund liability and related asset should not be derecognized until the refund right lapses or until the actual refund occurs. The asset is assessed if there are indicators of impairment. The transaction price associated with the 9,000 gaming systems that are not expected to be returned are recorded as revenue once control transfers to the customer.

Onerous performance obligations

Many technology companies provide multiple products or services to their customers as part of a single arrangement

and may have anticipated losses on one performance obligation but an overall profitable contract. Anticipated losses on executory contracts are generally not recognized under current US GAAP and are accrued only if the overall contract is

onerous under current IFRS. Companies may be significantly affected under the proposed standard because they will need to recognize expected losses for each performance obligation.

Proposed standard	Current US GAAP	Current IFRS
Onerous performance obligations Performance obligations are not remeasured after contract inception unless those obligations become onerous. A performance obligation is onerous when the direct costs to satisfy a performance obligation exceed the consideration allocated to it. The excess should be recognized as a contract loss with a corresponding liability that is remeasured at each reporting period.	Anticipated losses on executory contracts (onerous contracts) generally should not be recognized, unless specific authoritative guidance provides for such recognition, because those anticipated losses have not yet been incurred. An accounting policy choice may exist in some situations when there is a loss on the first element of a multiple-element arrangement. When there is a loss on the first element but a profit on the second element of an arrangement (and the overall arrangement is profitable), an entity has an accounting policy choice if performance of the undelivered element is both probable and in the company's control. Specifically, there are two acceptable ways of treating the loss incurred in relation to the delivered unit of accounting. The company may: a) recognize costs in an amount equal to the revenue allocated to the delivered unit of accounting and defer the remaining costs until delivery of the second element, or b) recognize all costs associated with the delivered element (i.e., recognize the loss) upon delivery of that element.	Contracts in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under such contract are onerous. When there is an apparent loss on the first element of a multiple element arrangement, an accounting policy choice may exist as of the date the contract was entered into. When there is a loss on the first element, but a profit on the second element of an arrangement (and the overall arrangement is profitable), a company may elect an accounting policy to recognize a loss if performance of the undelivered element is both probable and in the company's control.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>	Potential impact: Onerous contracts are rarely recognized under existing US GAAP other than in relation to construction contract accounting. This may significantly affect entities not following construction contract accounting. The proposed standard may cause a significant change for other entities as the onerous contract assessment will be performed at the performance obligation level as opposed to the contract level.	Any expected losses on construction contracts are recognized immediately when it is probable that contract costs will exceed contract revenue. Potential impact: The current IFRS guidance requires an assessment of onerous provisions at the contract level, not the performance obligation level. The proposed guidance may lead to an increase in onerous contract provisions, resulting in losses being recorded even in situations in which the overall contract is profitable.

***To have a deeper conversation
about how this subject may affect
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US GAAP Convergence & IFRS

Revenue recognition: Telecommunications industry supplement

March 2011

Revenue recognition . . . full speed ahead

Telecommunications industry supplement

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Overview

The telecom industry comprises several subsectors, including wireless, fixed line, and yellow-page advertising. Wireless telecom entities provide voice and data products and wireless broadband. Fixed line telecom entities provide voice services (local and long-distance), internet access, broadband video, and data and network access together with outsourcing and networked IT services. Service revenues are primarily earned from providing access to, and usage of, the telecom entities' network and facilities. Access revenues are typically billed one month in advance and recognized when the services are provided. Usage revenues (services provided in excess of the customer's plan/tariff) are typically billed in arrears and recognized when services are rendered.

Telecom entities also provide enhanced services such as caller identification, call waiting, call forwarding, voicemail, text and multimedia messaging, as well as downloadable wireless data applications, including ringtones, music, games and other data content. These enhanced features and data applications generate additional service revenues through monthly subscription fees or increased usage through utilization of the features.

Some telecom entities also sell equipment such as handsets, modems, dongles (a wireless broadband service connector), customer premises equipment (CPE) and a variety of accessories.

Many telecom entities also publish yellow and white pages directories and sell directory and internet-based advertising.

This paper addresses how the exposure draft, "Revenue from contracts with customers," issued on June 24, 2010, could affect businesses operating in the telecom industry. The proposed guidance is subject to change until a final standard is issued. The examples included in this paper reflect potential effects based on the proposed guidance as set out in the exposure draft; any conclusions are subject to further interpretation and assessment based on the final standard.

For a more comprehensive description of the model refer to PwC's Dataline 2010–28 or visit www.fasb.org.

Accounting for multiple performance obligations

Performance obligations are defined as an enforceable promise to deliver goods or perform services. Determining when and how to separately account for performance obligations within a contract is important as performance obligations affect how the transaction price is allocated and the timing of revenue recognition.

Management will need to determine whether performance obligations within customer contracts should be accounted for separately from other performance obligations within the arrangement. The proposed separation criteria may result in

more performance obligations being identified (such as warranties, gifts, etc.) than under today’s standards. A performance obligation might be explicit in a contract, or implicit, arising from customary business practices. We expect that applying the proposed separation principle might be challenging in some circumstances due to the significant number of customers and multiple, various offerings included within bundled packages.

Telecom entities regularly enter into contracts with customers that bundle the sale of telecom services, activation/ connection services, and equipment (for example, handsets, modems, etc.). The sale of equipment is a separate earnings process from the sale of telecom services

under current US GAAP, as the equipment has stand-alone value. Activation/ connection services do not have standalone value and therefore are not considered a separate earnings process. The accounting under IFRS is currently based on a variety of different commercial models operating across the world (for example, telecom services only sold bundled with other products or services or telecom services sold separately).

Telecom entities will have to carefully assess their contracts with customers to identify and separate the performance obligations. Tracking these obligations (and the satisfaction of each obligation) could be a time-consuming process for some entities.

Proposed standard	Current US GAAP	Current IFRS
The proposed standard requires performance obligations that are “distinct” to be accounted for separately (assuming the performance obligations are delivered at different times). A good or service is distinct, and is accounted for separately: - if the entity, or another entity, sells an identical or similar good or service separately; or - if not sold separately, the good or service has a distinct function and the cost of delivering the performance obligation can be separately identified.	The following criteria are considered to determine whether elements included in a multiple-element arrangement are accounted for separately: - The delivered item has value to the customer on a stand-alone basis - If a general return right exists for the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor Third-party evidence (TPE) of fair value is used to separate deliverables when vendor specific objective evidence (VSOE) of fair value is not available. Best estimate of selling price is used if neither VSOE nor TPE exist.	For transactions that contain separately identifiable components, it is necessary to apply the revenue recognition criteria to each separately identifiable component of a single transaction in order to reflect the transaction’s substance. The customer’s perspective is important in determining whether the transaction has a single element or multiple elements. When elements in a single contract are accounted for separately, the transaction price should be allocated to the separate elements of the arrangement. Entities are not precluded from separating elements in a single contract if the elements are not sold separately. Telecom entities that have separated the equipment from service for revenue recognition purposes typically apply the residual method for allocating consideration to the various elements of the transaction.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>	Potential impact: Management will need to assess whether telecom contracts include multiple performance obligations. The separation criteria in the proposed standard are less restrictive than current guidance, which may result in more performance obligations being accounted for separately. This may accelerate the timing of revenue recognition. The proposed standard states that activation services are an example of nonrefundable upfront fees. Although activation service relates to activity that the entity is required to undertake at or near contract inception to fulfill the contract, the activity does not result in the transfer of a promised good or service to the customer. The payment for the activation service is an advance payment of future telecom services. The activation fee would therefore be recognized over the contract period consistent with today's accounting model for activation fees. Telecom entities will have to carefully consider outsourcing and network IT contracts, various types of activation/connection services and other upfront non-refundable fees (for example, connecting customers to their network or laying physical line to the customer's premises) charged to customers to determine if these services meet the definition of a separate performance obligation.	Potential impact: Management will need to assess whether telecom contracts include multiple performance obligations. The proposed standard states that activation services are an example of nonrefundable upfront fees. Although activation service relates to activity that the entity is required to undertake at or near contract inception to fulfill the contract, the activity does not result in the transfer of a promised good or service to the customer. The payment for the activation service is an advance payment of future telecom services. The activation fee would therefore be recognized over the contract period consistent with today's accounting model for activation fees. Telecom entities will have to carefully consider outsourcing and network IT contracts, various types of activation/connection services and other upfront non-refundable fees (for example, connecting customers to their network or laying physical line to the customer's premises) charged to customers to determine if these services meet the definition of a separate performance obligation.

Insight:

The exposure draft is expected to have significant impact in some markets where traditionally handsets and service have not been accounted for separately under current practice. Telecom entities also have complex product portfolios and typically manage millions of customer contracts. Estimating and then allocating the transaction price to each combination of performance obligations might require significant effort, and the capability of existing IT systems to capture relevant information might need to be addressed.

Telecom entities' current revenue systems are based on billing events for services rendered to customers (at prices that are linked to the contract). These events are not necessarily aligned to the obligations in the contract.

Entities will need financial processes that identify the different performance obligations in each contract and pinpoint when and how those obligations are fulfilled as telecom entities will account for revenue based on fulfillment of the contractual obligations they have with customers.

Example 1—Identifying performance obligations

Question: A telecom entity enters into a contract with a customer to provide wireless telecom services (voice, data, etc.) for \$50 per month, a handset for \$100 and an activation fee of \$30. How many distinct performance obligations are there in this contract?

Discussion: Two distinct performance obligations exist in this arrangement—wireless telecom services and the handset. Equipment provided with the sale of service is distinct, even if the telecom entity (or other entities) does not sell the service and the equipment separately, as the equipment has a distinct function and a distinct profit margin. Activation/connection fees are not distinct performance obligations but are advance payments for future communication services.

Example 2—Installation fees

Question: A telecom entity enters into a contract to provide telecom services (voice and data) on a monthly basis, with no contract end date. An upfront, non-refundable installation fee of \$50 is charged to recover the cost of laying physical line to the customer's premises. This line can be used by other telecom entities if the customer later changes service providers. Is the installation service a distinct performance obligation?

Discussion: Management will need to carefully assess customer arrangements that include upfront, non-refundable installation fees to determine whether the installation services are a separate performance obligation. In this example, management needs to determine whether laying the physical line is a distinct service. If the entity, or another entity, sells the laying of physical line without the sale of telecom services, it could be a distinct performance obligation. If the entity, or other telecom entities, only sell the laying of physical line with telecom services, it will need to determine whether the laying of the line has both a distinct profit margin and function (that is, has utility on its own or with other goods and services) to qualify as a separate performance obligation. In this example, other telecom entities can provide services on the same physical line, so the service has a distinct function; it is therefore a distinct performance obligation.

Uncertain or variable consideration/ determining the transaction price

The transaction price is the consideration the vendor expects to receive in exchange for satisfying its contractual performance obligations. Determining the transaction price is straightforward when the contract price is fixed; it becomes more complex

when it is not fixed. Discounts, rebates, refunds, credits and price concessions may cause the amount of consideration to be uncertain. Mail-in rebates and refunds on a portion of the sales price offered with the sale of equipment (for example, handsets and accessories) are common in the telecom industry. Entities that receive consideration from a customer and expect to refund some or all of that consideration will recognize a refund liability, reducing the transaction price.

The proposed standard is likely to have limited impact on the accounting for mail-in rebates, except as it relates to measuring the liability. However, management should assess all contractual arrangements that require all or a portion of the consideration received to be refunded to customers, as the refund amounts directly affect the revenue ultimately recognized.

Proposed standard	Current US GAAP	Current IFRS
Uncertain or variable consideration Variable consideration is included in contract revenue using a probability-weighted approach when such payments can be reasonably estimated. If an entity receives consideration from a customer and expects to refund some or all of that consideration to the customer, the entity recognizes a refund liability. The entity measures that liability at the probability-weighted amount of consideration that the entity expects to refund to the customer. The refund liability is updated at each reporting period for changes in circumstances. Management should consider several factors in assessing whether circumstances may change significantly, including: • the impact of external factors; • the time until the uncertainty is expected to be resolved; • the extent of experience; and • the variability in the range of possible outcomes.	The seller's price must be fixed or determinable in order for revenue to be recognized. Certain sales incentives entitle the customer to receive a reduction in the price charged for a product or service by submitting a form or claim for a refund or rebate of a specified amount. The vendor recognizes a liability for those sales incentives based on the estimated refunds or rebates that will be claimed by customers. If the future rebates or refunds cannot be reasonably and reliably estimated, a liability (or deferred revenue) is recognized for the maximum potential amount of the refund or rebate (that is, no reduction is made for expected breakage). Potential impact: Telecom entities will need to use a probability weighted average to determine the refund liability when they expect to refund all or a portion the consideration received. Using the probability weighted average will likely result in measurement differences from the deferred refund liability (or deferred revenue) calculated under today's practices. The refund liability reduces the total transaction price to be allocated among the performance obligations within a customer's contract.	Trade discounts, volume rebates and other incentives (such as cash settlement discounts) are taken into account in measuring the fair value of the consideration to be received. A liability is recognized based on the expected levels of rebates and other incentives that will be claimed. If no reliable estimate can be made, the liability should reflect the maximum potential amount. Potential impact: Telecom entities will need to use a probability weighted average to determine the refund liability when they expect to refund all or a portion the consideration received. Using the probability weighted average will likely result in measurement differences from the deferred refund liability (or deferred revenue) calculated under today's practices. The refund liability reduces the total transaction price to be allocated among the performance obligations within a customer's contract.

Example 3—Refund liability

Question: A telecom entity enters into a contract with a customer to provide telecom services (voice, data, etc.) for \$50 per month, equipment for \$200, and activation services for \$30. The customer receives a mail-in rebate of \$100 related to the purchase of the equipment. Mail-in rebates are funded by the entity. How should management account for this transaction?

Discussion: If the telecom entity expects to refund all or a portion of the consideration received from the customer, it will need to measure the refund liability based on the probability-weighted amount.

Assume, based on the telecom entity's most recent history for similar mail-in rebate programs (that is, similar products and refund amounts), it estimates the refund liability using the following probabilities:

Amount	Probability	Probability-weighted amount
\$ 0	25%	\$ 0
100	75%	75
		\$75

Management will record a refund liability of \$75 and reduce the total contract transaction price by \$75. Management will need to update the estimated liability at each reporting period, with any adjustments recorded to revenue.

Collectability

A key performance indicator in the telecom industry is average revenue per user (ARPU). The proposed standard might negatively impact this indicator, as collectability will affect the measurement

of the transaction price and therefore revenue. The exposure draft proposes that the transaction price be adjusted to reflect customers' credit risk. Only the consideration expected to be received, on a probability-weighted basis, will be recognized.

Proposed standard	Current US GAAP	Current IFRS
In determining the transaction price, an entity reduces the amount of promised consideration to reflect the customer's credit risk (the customer's ability to pay the amount of promised consideration). Entities only recognize revenue at the probability-weighted amount of consideration expected to be received. Once the receivable has been recorded, the effects of changes in the assessment of credit risk associated with that right to consideration are recognized as income or expense (that is, an adjustment to bad debt expense) rather than an adjustment to revenue.	Revenue is recognized when payment is reasonably assured (or probable). Credit risk is reflected as a reduction of accounts receivable, net, via an increase in the allowance for doubtful accounts and bad debt expense. Potential impact: Collectability is no longer a criterion for revenue recognition. Customers' credit risks will reduce the transaction price and therefore reduce the amount of revenue recognized. This will cause a decline in revenue per user or subscriber. Management will also need to determine a practical method to measure the probability-weighted amounts expected to be collected from customers to determine the transaction price. Consistent with today's practice, management will need to update its assessments to reflect subsequent changes to customers' credit risk, which will affect the amount of bad debt expense or other income recorded.	Entities must establish that it is probable that economic benefits will flow before revenue can be recognized. Provision for bad debts (incurred losses on financial assets including accounts receivable) is recognized in a two-step process: first, objective evidence of impairment must be present; then the amount of the impairment is measured based on the present value of expected cash flows. Potential impact: Collectability is no longer a recognition criterion. Revenue is reduced at the outset for any expected bad debt. Management will have to determine a practical method to measure the probability-weighted amounts expected to be collected from customers in determining the transaction price. Consistent with today's practice, management will need to update its assessments to reflect subsequent changes to customers' credit risk, which will affect the amount of bad debt expense or other income recorded.

Insight:

Significant effort will be required to assess customers' credit risk (that is, collectability). It may simplify the process to consider broad types of customers, but there will be added complexity in territories where, historically, there has been less vigorous enforcement of contracts or collection efforts.

Example 4—Collectability

Question: A telecom entity enters into a two-year contract with a customer to provide telecom services (voice, data, etc.) for \$40 per month, a wireless handset for \$200, and activation services for \$30. Payment for the handset and activation services is due at delivery (date of the sale); payment for the first month of service of \$40 is due one month after activation. The total promised consideration is \$1,190. How should the arrangement be accounted for?

Discussion: Assume, based on recent credit history of this customer and other similar customers (for example, consideration of credit history, geography and plans), management estimates the transaction price for the promised consideration using the probability-weighted method as follows:

Possible collections	Probability	Probability-weighted amount
\$ 0	0%	\$ 0.0
230	5%	11.5
710	50%	355.0
1,190	45%	535.5
		\$902.0

Based on the results of the probability-weighted assessment, the telecom entity would reduce the total transaction price to \$902. Management will also need to update this original assessment for any changes to the customer's credit risk, recognizing any changes as income or expense, and not as an adjustment to revenue.

Example 5—Collectability, subsequent measurement

Question: Continuing with the example above, the telecom entity later determines the customer's outstanding receivable balance of \$120 is impaired by an estimated \$40 due to further deterioration in the customer's credit risk. What is the accounting impact?

Discussion: At each reporting period, management will need to assess for any changes to the customer's credit risk. Receivable impairments are recognized by recording an allowance against the receivable and bad debt expense—not a decrease in revenue. The customer recognizes an allowance for doubtful accounts for \$40 with a charge for bad debt expense.

Example 6—Collectability, subsequent measurement

Question: The customer's financial condition improves and the telecom entity collects more than the estimated transaction price. What is the accounting impact?

Discussion: Amounts recognized in excess of the estimated transaction price are recognized in another component of income rather than as revenue.

Allocation of the transaction price and establishing stand-alone selling prices

Telecom entities often provide multiple products and services to their customers as part of a single arrangement. These arrangements usually consist of the sale of telecom services over a contracted period of time, the sale of equipment (wireless handset, modem, etc.) and activation services. These elements of the arrangement or contract might be combined into a single performance obligation or separated into multiple performance obligations under the existing revenue guidance. Various methods are used to allocate the transaction price to individual performance obligations. The proposed standard

requires the transaction price be allocated to each performance obligation in proportion to the stand-alone selling price of the good or service.

Determining the allocation may be straightforward for a single customer with one or two deliverables; it becomes more complex for millions of customers all with different deliverables and different price plans. In many markets, telecom entities do not sell the equipment (handset, dongle, CPE, etc.) on a stand-alone basis. The equipment is sold in conjunction with a service contract. Equipment sold on a stand-alone basis is typically a replacement provided under insurance contracts where the customer has lost or damaged its equipment and in some markets, telecom entities have limited evidence of the stand-alone selling price of the equipment.

The proposed standard will significantly change how telecom entities allocate the transaction price in arrangements that offer multiple products and services. The transaction price is allocated based on the relative stand-alone selling price of the performance obligation, so entities are likely to allocate more revenue to equipment and therefore, recognize more revenue upfront or at the delivery of the equipment, and attribute less revenue to service.

Management will need to estimate the stand-alone selling price where it does not have experience selling the goods and services on a stand alone basis. High-level estimation or a portfolio approach might be needed in determining telecom entities' reported revenues.

Proposed standard	Current US GAAP	Current IFRS
The transaction price is allocated to separate performance obligations in a contract based on relative stand-alone selling prices. The best evidence of stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately. Management estimates the selling price if a stand-alone selling price is not available. In doing so, the use of observable inputs is maximized. Possible estimation methods include: • Cost plus a reasonable margin • Standalone selling prices of the same or similar products or service, if available • Cash flow model or other valuation techniques	Arrangement consideration is allocated to each unit of accounting based on the unit's proportion of the fair value of all of the units in the arrangement. Entities must follow a hierarchy for estimating the selling price of a deliverable. This hierarchy requires the selling price to be based on VSOE if available, TPE if VSOE is not available, or estimated selling price if neither VSOE nor TPE is available. The term "selling price" indicates that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant. The residual or reverse residual methods are not allowed. However, consideration allocated to the delivered items is limited to the amount that is not contingent upon the delivery of additional items or meeting a specified performance condition (the non-contingent amount).	Revenue is measured at the fair value of the consideration received or receivable. Fair value is "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." IFRS does not mandate how consideration is allocated and permits the use of the residual method, where the consideration for the undelivered element of the arrangement (normally service or tariff) is deferred until the service is provided, when this reflects the economics of the transaction. Any revenue allocated to the delivered items is recognized at the point of sale.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>	Telecom entities typically account for the sale of the equipment and telecom services in a single arrangement as separate units of accounting. Telecom services are collectively accounted for as a single unit of account, as they are generally delivered at the same time. The arrangement consideration that can be allocated to the equipment is generally contingent on the entity providing telecom services. Therefore, the revenue that can be recognized on the delivery of the handset is limited to the cash received at the time of the equipment delivery. Handset revenue is recognized for the amount equal to the cash received for the handset and/or activation service, with the telecom service revenue and activation fee recognized as the service is provided, which is consistent with the monthly amounts subsequently billed, adjusted for accruals and/or deferrals. Potential impact: Management will need to exercise significant judgment to determine the stand-alone selling price for each of the performance obligations in a customer contract (that is, telecom services, equipment, etc.). Determining the estimated stand-alone selling prices of each performance obligation and the relative allocation of the transaction price might require assessments performed on a portfolio basis due to the variation in tariffs, the customer types, contract lengths, telecom plans and equipment purchased. A portfolio approach is still likely to be challenging due to the large volume of customer contracts and multiple contract variations. Management might need to make changes to processes, procedures and systems in order to estimate and then account for the allocation of the transaction price.	Potential impact: There are a significant number of different combinations of service plans and devices for many entities. The stand-alone selling price of the equipment and, in some cases, service might not be directly observable in the market. Management will need to exercise significant judgment to determine the stand-alone selling price for each of the performance obligations in a customer contract (that is, telecom services, equipment, etc.). Determining the estimated stand-alone selling prices of each performance obligation and the relative allocation of the transaction price might require assessments performed on a portfolio basis due to the variation in tariffs, customer types, contract lengths, telecom plans and equipment purchased. A portfolio approach is still likely to be challenging due to the large volume of customer contracts and multiple contract variations. Management might need to make changes to processes, procedures and systems in order to estimate and then account for the allocation of the transaction price.

Insight:

In some markets there is a good level of price transparency between telecom equipment and the associated service. But in many markets, telecom entities charge customers little, if anything, for the equipment. Significant judgment might be needed in estimating the stand-alone selling price of each of the performance obligations in that situation.

Systems and processes often are not set up to support this analysis or accounting. Changes to systems may be required to reflect the obligations arising from contracts. Entities should consider whether they need to modify existing systems or develop new systems to gather reliable information on customer contracts and understand the impact on the timing of revenue recognition.

Example 7—Allocation of transaction price

Question: A wireless entity enters into sales arrangements with two different customers—Customer A and Customer B. Each customer purchases or receives the same handset and selects the same telecom service plan. The stand-alone selling price for both phones is \$300 and the stand-alone selling price of the telecom service plan is \$40 per month.

Customer A purchases a handset for \$300 and enters into a cancellable contract to receive telecom services (voice and data) for \$40 per month. Customer A also pays an activation fee of \$30.

Customer B enters into a 24-month contract for \$50 per month and receives a free wireless handset. Customer B also pays an activation fee of \$30.

In summary:

Fair value of handset	\$300	
Fair value of services	\$960	(\$40 x 24 months)
Fair value of the contract	\$1,260	
Customer A transaction price	\$330	(\$300 handset + \$30 activation fee)
Customer B transaction price	\$1,230	(\$1,200 services + \$30 activation fee)

Discussion: Entities need to identify and separate performance obligations within customer contracts. The sales of telecom services and handsets are separate performance obligations and the activation services are not distinct. Revenue is recognized when a promised good or service is transferred to the customer. An entity transfers a promised good or service when the customer obtains control of that good or service.

Revenue is recognized on the sale of the handset at delivery, as the customer has gained control of the handset. Service revenue is recognized ratably over the contract service period, as control of the service transfers continuously to the customer over the contract period.

The tables on page 12 compares the affect of applying the allocation guidance in the proposed standard with that of the current guidance (example excludes time value of money).

Current guidance—existing US GAAP guidance

Customer	Day 1	Month 1	Month 2	Month 3
Customer A	\$300 *	\$41 **	\$41 **	\$41 **
Customer B	\$ 30 ***	\$50	\$50	\$50
Total	\$330	\$91	\$91	\$91

* Recognize revenue for the sale of the handset (\$300).

** Stand-alone selling price of the telecom services (\$40) and recognition of the activation fee (\$30) over the estimated customer relationship period.

*** Recognize revenue for the sale of the handset (delivered item) for the amount of consideration received that is not contingent upon the delivery of additional items or meeting a specified performance condition (the non-contingent amount).

Revenue recognition under IFRS is not restricted to the non-contingent cash received for the delivered items. IFRS allows the use of the residual method.

Proposed guidance—revenue recognized (without considering collectability)

Customer	Day 1	Month 1	Month 2	Month 3
Customer A	\$300	\$41 *	\$41 *	\$41 *
Customer B	\$293 **	\$39 ***	\$39 ***	\$39 ***
Total	\$593	\$80	\$80	\$80

* Includes the recognition of the activation fee over the estimated customer relationship period.

** Handset: $\$293 = (\$300/\$1,260) \times \$1,230$.

*** Monthly service revenue: $\$39 = (\$960/\$1,260) \times \$1,230 = \$937/24$.

**Proposed guidance—revenue
recognized for Customer B
considering collectability**

Based on recent credit history of this customer and other similar customers (for example, consideration of credit history, geography and plans), management estimates the transaction price for the promised consideration using the probability-weighted method as follows:

Possible collections	Probability	Probability-weighted amount
\$ 0	0%	\$ 0.0
30	5%	1.5
630	50%	315.0
1,230	45%	553.5
Total transaction price		\$870.0

Customer	Day 1	Month 1	Month 2	Month 3
Customer B	\$207 *	\$28 **	\$28 **	\$28 **

* Handset: \$207 = (\$300/\$1,260) x \$870.

** Monthly service revenue: \$28 = (\$960/\$1,260) x \$870 = \$663/24 months

Equipment installation revenues

Some telecom entities provide equipment installation services involving installing cable, phone systems, modems and routers. Revenues for these services are generally recognized, under US GAAP, using either the completed-contract method or the percentage-of-completion

method. Revenue will be recognized under the proposed standard on the satisfaction of performance obligations, which occurs when control of an asset (good or service) transfers to the customer. Control can transfer either at a point in time or continuously over the contract period. Telecom entities will have to carefully determine when control of the service is transferred to customers.

Proposed standard	Current US GAAP	Current IFRS
Equipment installation Revenue is recognized on the satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. Control can transfer at a point in time or continuously over the contract period. Determining when control transfers might require a significant amount of judgment. Factors to consider include, but are not limited to: • The customer has an unconditional obligation to pay. • The customer has legal title. • The customer has physical possession. • The customer specifies the design or function of the good or service. This list is not intended to be a checklist or all-inclusive; these are only factors, and no one factor is determinative on a stand-alone basis.	Revenue is recognized for installation contracts within the scope of construction contract accounting using the percentage-of-completion method when reliable estimates are available. For circumstances in which reliable estimates cannot be made, but there is an assurance that no loss will be incurred on a contract (for example, when the scope of the contract is ill-defined but the contractor is protected from an overall loss), the percentage-of-completion method based on a zero profit margin is used until more precise estimates can be made. Where reliable estimates cannot be made, the completed-contract method is required. Potential impact: The change to a control transfer model will require careful assessment as to when management can recognize revenue, specifically when control of the goods and services transfer. Management will have to carefully consider the contract terms, including the level of customization, payment terms and the customer's rights to the goods and services over the contract period.	Revenue is recognized for installation contracts using the percentage-of-completion method when reliable estimates are available. When reliable estimates cannot be made, but no loss is expected to be incurred on a contract (for example, when the scope of the contract is ill defined but the contractor is protected from an overall loss), the percentage-of-completion method based on a zero-profit margin is used until more precise estimates can be made. Potential impact: Demonstrating the transfer of control is expected to change the timing of recognition of revenue on contracts. IFRS reporters will need to carefully assess the terms of contracts and determine when the transfer of control has occurred.

Recognition of revenue—Impact on advertising and phone directory activities

Some telecom entities have publishing and advertising businesses that publish and distribute a range of periodicals and phone directories in paper (hard copy publication) and internet formats (online publication). Revenue, under US GAAP, is typically

recognized over the life of the directory (usually 12 months) for both hard copy and online publications. Under IFRS, revenue is recognized for hard copy publications when delivery has occurred. If there are multiple deliveries for a publication, revenue recognized is based on a percentage of completion methodology. Revenue recognition for online publications under IFRS is consistent with US GAAP. The proposed standard is likely to accelerate the timing of revenue recognition for US

entities to the delivery date or “publication date,” for hard copy publications—the date on which the performance obligation is satisfied. Revenue recognition associated with online publication is less likely to change, as the publisher has the obligation to continue to display the advertisement over the contractual period. Publishing entities will have to carefully assess the performance obligations in their advertising contracts and determine when these obligations are settled.

Proposed standard	Current US GAAP	Current IFRS
Revenue is recognized on the satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. Control can transfer at a point in time or continuously over the contract period. Determining when control transfers might require a significant amount of judgment. Factors to consider include, but are not limited to: • The customer has an unconditional obligation to pay. • The customer has legal title. • The customer has physical possession. • The customer specifies the design or function of the good or service. This list is not intended to be a checklist or all-inclusive; these are only factors, and no one factor is determinative on a stand-alone basis.	Revenue allocated to hard copy publications is recognized based on the entity's accounting policy choice, assuming certain conditions are met, using either of the two methods below. The majority of publishing entities apply the deferral method. • Delivery method—revenue is recognized based on the percentage of publications/books delivered (that is, a proportionate performance model). • Deferral method—revenue is recognized ratably over the contractual circulation period. Potential impact: The proposed standard is likely to eliminate the use of the deferral method and require publishing entities to apply the delivery method. This will accelerate revenue recognition. Management will have to apply judgment in estimating the total number of publications/books to be delivered, including the number of primary deliveries and secondary deliveries.	Revenue on advertising transactions is recognized as the service is performed. For advertisements included within hard copy publications, revenue is recognized when the advertisement appears publicly, which is typically when the directories are delivered. Potential impact: The timing of revenue recognition under the proposed standard is similar where an entity's performance obligation is to make the advertisement available to the public over a 12-month period, for example, on line. Where the obligation is to include the advertisement in the publication, revenue is recognized when the advertisement appears or upon delivery of the publications, which is similar to the proposed standard.

Example 8—recognizing revenue from advertising and phone directory activities

Question: An entity publishes and distributes a wide range of periodicals and phone directories in both paper (hard copy publication) and internet formats (online publication). The entity generates all of its fees from selling advertising in such publications to its customers. It is required to deliver these free publications or directories to specified locations. The advertisement is included in both the physical and online publications for a period equal to the circulation period of the hard copy publication, typically one year. The hard copy and online publication advertising are generally sold as a bundled package for one fee. The entity delivers the hard copy directories both through a primary broad distribution and a secondary delivery, for example, to new residents moving to an area. After delivery of the directories, the entity has completed its obligations for hard copy directories (that is, no other services are required). It has properly separated and allocated the fee between the two performance obligations (hard copy publication and online publication) based on the relative stand-alone selling price. How should the entity recognize revenue on each performance obligation?

Discussion: Revenue is recognized ratably or on a straight-line basis over the one-year contract period for the online publication services, as the entity is required to display the advertising on the website (that is, the transfer of services occurs continuously and evenly over time).

The entity satisfies the performance obligation upon delivery of the hard copy publication, rather than over the contract period. Management will, however, need to consider what additional services are required, if any, after primary deliveries to residents. Management should allocate a portion of the consideration to secondary deliveries and recognize revenue upon secondary delivery if the entity is required to provide secondary deliveries.

Contract costs

Telecom

Some telecom entities defer the cost of activating customer contracts (that is, labor and equipment cost), under US GAAP. These costs can be material and are typically deferred up to the amount of related activation revenue and amortized on a straight-line basis consistent with the related revenues. Some wireless entities—predominately wireless entities that report under IFRS—capitalize customer acquisition cost (for example, dealer commissions) as an intangible asset. These costs relate to commission amounts paid

to independent third-party distributors or dealers for connecting customers to the network. Entities with design-and-build arrangements sometimes defer set-up and transformational-type costs qualifying as assets under IFRS that are necessary investments to support the ongoing delivery of the contract.

The exposure draft includes guidance on accounting for contract costs. This may impact a number of different arrangements in the sector. The accounting for contract costs will change under the proposed standard. Costs incurred to obtain a customer contract are expensed, while costs to fulfill the contract are capitalized under the

scope of other standards or if they meet specific requirements under the proposed standard. Management will need to carefully review its cost capitalization and deferral methods in order to understand the potential effect of these changes.

Publishing

Entities involved in advertising and phone directory activities may no longer be able to defer and amortize directory cost over the contract period. The cost, consistent with the recognition of revenue described above, is likely to be expensed immediately upon delivery of the directories.

Proposed standard	Current US GAAP	Current IFRS
Telecom All costs of obtaining a contract, costs relating to satisfied performance obligations and costs related to inefficiencies are expensed as incurred. Other direct costs incurred in fulfilling a contract are expensed as incurred unless they are within the scope of other standards (for example, inventory, intangibles, fixed assets), in which case the entity accounts for such costs in accordance with those standards. If not, the entity recognizes an asset only if the costs: • relate directly to a contract; • generate or enhance resources that will be used in satisfying future performance obligations (that is, they relate to future performance); and • are expected to be recovered. These costs are then amortized, as control of the goods or services to which the asset relates is transferred to the customer.	Costs that are directly related to the acquisition of a contract and that would not have been incurred but for the acquisition of that contract (incremental direct acquisition costs) are typically deferred and charged to expense in proportion to the revenue recognized. All other costs—such as costs of services performed under the contract, general and administrative expenses, advertising expenses and costs associated with the negotiation of a contract that is not consummated—are charged to expense as incurred. Incremental direct costs incurred to install services relating to the acquisition or origination of a customer contract relating to, for example, non-refundable up-front fees, may be either expensed as incurred or deferred and charged to expense in proportion to the revenue recognized. Potential impact: Margins are likely to fall, as activation revenues will be recognized over the expected life of the customer's contract while the related activation costs would be expensed immediately.	Many of the costs of connecting customers form part of the operator's network and the costs are capitalized as property, plant and equipment. Costs of acquiring customer contacts have been capitalized by some telecom entities as intangible assets and amortized over the customer contract period. Potential impact: Costs of acquiring wireless customer contracts (for example, dealer commissions) might not qualify for capitalization. Other costs that are capitalized (for example, network infrastructure) and contract set-up costs that support the ongoing delivery of the contract may not be affected by the proposals if the criteria for capitalization are met.

Proposed standard	Current US GAAP	Current IFRS
Publishing Direct costs incurred in fulfilling a contract are expensed as incurred unless they are within the scope of other standards (for example, inventory costs) or meet the specific criteria described above.	Costs incurred to create directories (that is, graphics, printing, bindings and direct contract-acquisition costs) are capitalized as deferred publishing cost in inventory. Under the delivery method, the deferred costs would be recognized based on the proportional performance—in line with the corresponding percentage of total revenue recognized upon primary delivery. Under the deferred method, costs would be recognized ratably over the circulation period of the periodical/book. Potential impact: Publishing entities will recognize cost and revenue at delivery. Management will need to apply judgment in estimating the total number of publications/books to be delivered, including the number primary deliveries and secondary deliveries in order to determine cost to be recognized at each delivery.	Costs incurred to create directories (that is, graphics, printing, bindings and direct contract-acquisition costs) are capitalized as deferred publishing cost in inventory and recognized at delivery. Potential impact: Publishing entities will recognize cost and revenue at delivery. Management will need to apply judgment in estimating the total number of publications/books to be delivered, including the number primary deliveries and secondary deliveries.

Example 9—Customer acquisition cost

Question: A telecom entity enters into a contract with a customer to provide telecom services. The operator pays a third-party dealer to connect customers to its network. The customer signs an enforceable contract for a period of 18 months. Currently, the telecom entity capitalizes the dealer commission and amortizes the amount over the 18-month contract term. Will this accounting treatment be appropriate under the proposed standard?

Discussion: Costs of obtaining a contract, such as dealer commissions, might need to be expensed as incurred under the proposed standard. This could be a significant change for some telecom entities that are able to capitalize these costs as an intangible asset under existing guidance.

***To have a deeper conversation
about how this subject may affect
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US GAAP Convergence & IFRS

Revenue recognition: Transportation and logistics industry supplement

March 2011

Revenue recognition . . . full speed ahead

Transportation and logistics industry supplement

What's inside:

Overview

Transportation revenue and costs

Customer loyalty programs—
frequent flyer programs

Onerous performance obligations

Change fees

Variable consideration

Multiple-element arrangements

Reprinted from:

Dataline 2010–28 (Supplement)

November 16, 2010

Overview

The Transportation and Logistics sector includes entities associated with four primary modes of transportation: shipping, railways, airlines and trucking and logistics. Customers generally pay a fee for the movement of cargo or passengers between two or more specified points. Customer incentives are primarily in the form of volume discounts, or for airlines, customer loyalty programs where awards are earned based on mileage flown and can be redeemed for a variety of products or services.

The accounting for common items in the transportation industry may be significantly affected by the proposed revenue recognition standard. This paper, examples, and related assessments are based on the Exposure Draft, “Revenue from Contracts with Customers”, issued on June 24, 2010. The proposed standard is subject to change until a final standard is issued. The examples reflect the potential effects of the proposed standard, pending further interpretation and assessment based on the final standard. For a more comprehensive description of the model, refer to PwC’s Dataline 2010–28 or visit www.fasb.org.

Transportation revenue and costs

Transportation or freight services are generally provided over a period of time ranging from a day to several months. The proposed standard includes a control transfer model for recognizing revenue that will require careful consideration to determine when an entity can recognize revenue.

Proposed standard	Current US GAAP	Current IFRS
Transportation revenue Revenue is recognized upon satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. Control can transfer at a point in time or continuously over the service period. Factors to consider in assessing control transfer include, but are not limited to: • The customer has an unconditional obligation to pay • The customer has legal title • The customer has physical possession • The customer specifies the design or function of the good or service This list is not intended to be a checklist or all-inclusive. No one factor is determinative on a stand-alone basis.	There are two predominant methods for recognizing revenue and costs for freight services: (1) recognize both revenue and direct costs when the shipment is completed, and (2) allocate revenue between reporting periods based on relative transit time in each period with costs recognized as incurred (the proportionate performance method).	Revenue is recognized for service transactions, such as freight services, based on the stage of completion of the transaction. Costs are recognized as incurred.

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i>		
Transportation costs All costs of obtaining a contract, costs relating to satisfied performance obligations, and costs related to inefficiencies (i.e., abnormal costs of materials, labor, or other costs to fulfill) are expensed as incurred. Other direct costs incurred in fulfilling a contract are expensed as incurred unless they are within the scope of other standards (e.g., inventory, intangibles, fixed assets) or if other specified criteria are met. Costs that are in the scope of other standards are accounted for in accordance with those standards. An asset is recognized for costs outside the scope of other standards when the costs relate directly to a contract, relate to future performance, and are probable of recovery under a contract. These costs are then amortized as control of the goods or services to which the asset relates is transferred to the customer.	Impact: Management will need to determine whether the service being performed is transporting the goods-in which case the entity might conclude the service is provided (and control transferred) continuously-or the service is to transport goods to a specific destination-and thus control transfers and revenue is recognized upon delivery. Freight costs are expensed as incurred unless they can be capitalized under another standard or they relate directly to a contract, generate or enhance resources of the entity that the entity will use to satisfy performance obligations in the future, and are expected to be recovered. This might allow, in certain situations, direct costs of a contract to be capitalized until delivery if revenue is recognized upon delivery. Costs to obtain a contract (e.g., selling costs) as well as abnormal amounts of wasted contract fulfillment costs are expensed as incurred.	

Example 1

Facts: A freight railway entity enters into a contract with a customer to ship goods from point A to point B for \$1,000. The customer has an unconditional obligation to pay for the service when the service has been performed, which is when the goods reach point B. The transportation services are provided specifically for the customer. When should the entity recognize revenue from this contract?

Discussion: The performance obligation may not be satisfied until the goods reach point B. The indicators of control transfer are difficult to apply to certain service transactions and further clarification of the guidance may be needed to make the assessment of when control transfers. The expenses incurred need to be evaluated to determine if they are eligible for capitalization until the performance obligation is satisfied.

The proposed standard focuses on recognition of revenue when control transfers to the customer rather than on the entity's activities. Judgment will be required to determine when control transfers for service transactions typical in the transportation and logistics industry.

Customer loyalty programs—frequent flyer programs

Transportation and logistics entities, such as airlines, often grant award credits (often called “points” or “miles”) as part of sales transactions, including award credits that can be redeemed for goods and services not supplied by the entity. The most common customer loyalty programs in the industry are the frequent flyer programs offered by airlines.

Proposed standard	Current US GAAP	Current IFRS
Customer loyalty programs—frequent flyer programs <i>Performance obligations</i> Credits issued under customer loyalty programs are separate performance obligations if they provide the customer with a material right that the customer would not receive without entering into the transportation contract. The transaction price is allocated between the initial flight and the award credits based on the actual or estimated stand-alone selling price of each obligation. Revenue relating to the award credits is deferred until the obligation is satisfied (when the award credits are redeemed or expire). <i>Measurement (breakage)</i> The stand-alone selling price for a customer’s option to acquire additional goods or services (loyalty awards) is not usually directly observable and must typically be estimated. That estimate should reflect the discount the customer would obtain when exercising the option, adjusted for discounts readily available without the option and the likelihood that the option will be forfeited (breakage).	There is divergence in practice in the accounting for loyalty programs. Two models commonly followed are the incremental cost model and the multiple element model. Most entities use the incremental cost model and recognize revenue relating to the flight when the flight occurs. The cost of fulfilling award credits is treated as an expense and accrued. Other entities use the multiple-element model and allocate revenue to the award credits based on relative fair value. Revenue allocated to the award credits is deferred and recognized when the award credits are redeemed or expire. The fair value of the award credits is not reduced for expected forfeitures (breakage).	Customer loyalty programs are accounted for as multiple-element arrangements. Revenue allocated to the award credits is deferred and recognized when the award credits are redeemed or expire. The fair value of the award credits is adjusted for discounts available to other buyers absent entering into the initial purchase transaction and for expected forfeitures (breakage).

continued

Proposed standard	Current US GAAP	Current IFRS
<i>continued from previous page</i> Principal versus agent The airline recognizes revenue in the amount of consideration received (gross) when the airline redeems the award credit for goods or services that it provides. The airline recognizes revenue in the amount of any fee or commission received (net) when the airline arranges for another party to provide those goods or services.	An entity determines whether it is acting as a principal or an agent in the arrangement based on certain criteria.	An entity determines whether it is acting as a principal or an agent in the arrangement. An entity may be acting as an agent if it issues award credits that are transferred to and redeemed by other entities. Revenue is recognized net of payments made to others to redeem award credits if the entity is acting as an agent.
	Impact: Award credits issued under customer loyalty programs will likely be accounted for as separate performance obligations and the incremental cost model will no longer be acceptable. Adjustments for expected forfeitures (breakage) will affect the timing of revenue recognition. The stand-alone selling price of award credits will be reduced to reflect the award credits not expected to be redeemed. The accounting for breakage will result in earlier revenue recognition for entities that use the multiple-element model today. An entity will need to determine whether it is acting as a principal or an agent when delivering the underlying goods or services upon redemption of award credits. An entity might be acting as an agent if it issues award credits that are transferred to and redeemed by other entities. The entity will recognize revenue from the award credits net of payments made to other parties in these situations. These changes will align the accounting for customer loyalty programs under US GAAP with IFRS.	Impact: The proposed standard is consistent with the current IFRS guidance and the effect will therefore be limited.

Example 2

Facts: Airline A has a frequent flyer customer loyalty program rewarding customers with one award credit for each mile flown. A customer purchases a ticket for \$500 (the stand-alone selling price) and earns 2,500 award credits based on mileage flown. Award credits are redeemable at a rate of 25,000 award credits for one free travel award, which has an average value of \$500 (\$0.02 per credit). The award credits may only be redeemed for flights with Airline A. How is the consideration allocated between the award credits and the ticket (ignoring the time value of money and breakage)?

Discussion: The transaction price of \$500 is allocated between the ticket and award credits based on the relative stand-alone selling prices of \$500 for the ticket and \$50 for the award credits as follows:

Ticket:	\$455 (\$500 x \$500/\$550)
Award credits:	\$45 (\$500 x \$50/\$550)

Revenue of \$455 is recognized when the flight occurs. Revenue of \$45 is recognized upon the earlier of the redemption of the travel award or expiration of the award credits.

Example 3

Facts: Assume the same facts as in Example 2 above, except that the airline expects redemption of 80% of award credits earned (i.e. 20% breakage) based on the airline’s history. The airline estimates a stand-alone selling price for the credits of \$0.016 (\$0.02 x 80%) based on the likelihood of redemption. How is the consideration allocated between the award credits and the ticket (ignoring the time value of money)?

Discussion: The transaction price of \$500 is allocated between the ticket and award credits based on the relative stand-alone selling prices of \$500 for the ticket and \$40 for the award credits as follows:

Ticket:	\$463 (\$500 x \$500/\$540)
Award credits:	\$37 (\$500 x \$40/\$540)

Revenue of \$463 is recognized when the flight occurs. Revenue of \$37 is recognized upon the earlier of the redemption of the travel award or expiration of the award credits.

Example 4

Facts: Assume the same facts as in Example 3 above, except that the award credits can be redeemed for services not provided by the airline. The airline pays other participating entities the value of the award credits less a 10% commission when the award credits are redeemed for products or services not provided by the airline. How much revenue is recognized upon the redemption of the award credits assuming all credits are redeemed by other entities (ignoring the time value of money)?

Discussion: Revenue of \$3.70 (10% of \$37) is recognized upon the redemption of the award credits for products not provided by the airline. The entry when the award credits are redeemed is as follows:

Dr. Contract Liability	\$37
Cr. Revenue	\$3.70
Cr. Cash	\$33.30

Onerous performance obligations

The proposed standard requires that each performance obligation be assessed to determine whether a loss will be incurred relating to that obligation.

Proposed standard	Current US GAAP	Current IFRS
Onerous performance obligations Management will need to assess whether performance obligations are onerous. A performance obligation is onerous when the present value of the direct costs to satisfy a performance obligation exceeds the consideration allocated to it. The excess is recognized as a contract loss with a corresponding liability that is remeasured at each reporting period.	Anticipated losses on executory contracts (onerous contracts) generally should not be recognized.	Contracts in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under such contract are onerous; thus, an onerous provision is recognized.
	Impact: More provisions for onerous obligations are likely to be recognized under the proposed standard than currently recognized under both US GAAP and IFRS. Broader application will create more onerous provisions under US GAAP, and the need to perform the onerous loss assessment at the performance obligation level rather than the contract level will create more onerous provisions under both IFRS and US GAAP. The proposed standard may cause a significant change for entities, such as airlines, where excess capacity is sold at deeply discounted prices. Deeply discounted tickets may be onerous performance obligations at the time sold and require accrual of the expected loss. This would be the case if the selling price of a discounted ticket did not exceed total allocated costs of the flight, even though the ticket may be sufficient to cover the related incremental costs and contributes to the overall profitability of the flight.	

Change fees

Change fees are common in the airline industry. The predominant industry practice under US GAAP and IFRS is to account for change fees as a separate transaction independent of the original ticket sale and recognize revenue when the change occurs. Change fees are viewed as a separate transaction because the fees are charged subsequent to the initial sale, passengers are not required to pay the fee at the time of the original sale, and passengers who pay the fee receive an additional benefit.

An alternative view is that the change is not a separate transaction but the result of the customer paying the lowest cost to

obtain the new travel reservation (i.e., paying the change fee instead of the price of a new ticket). Under this view, the change fee is deferred and recognized when the travel occurs.

The proposed standard will require management to consider whether the change fee is a separate contract or one that should be combined with the original sales transaction. Contracts that are priced interdependently will need to be combined, while contracts priced independently are accounted for separately. It may be challenging to conclude that change fees are independently priced as the change fee is generally agreed at the time of the original ticket sale.

Variable consideration

Determining the transaction price is simple when the contract price is fixed and paid at the time services are provided. Determining the transaction price may be more complex if the consideration contains an element of variable

or contingent consideration. Common issues for the transportation and logistics industry include the accounting for volume discounts, performance bonuses, and time value of money. Many transportation and logistics entities offer discounts for shipping a specified cumulative volume or shipping to or from specific locations.

Discounts based on volume or other factors are variable consideration under the proposed standard. Management will need to determine the probability weighted estimate of consideration to be received and adjust the transaction price. The same accounting treatment applies to performance bonuses.

Proposed standard	Current US GAAP	Current IFRS
Volume discounts Volume discounts are generally receivable by the customer when specified cumulative levels of revenue are earned during a defined period. If an entity receives consideration from a customer and expects to refund some or all of that consideration, the entity recognizes a refund liability. That liability is measured at the probability-weighted amount of consideration that the entity expects to refund to the customer. Revenue is measured using a probability-weighted approach when payments can be reasonably estimated. The amounts can be reasonably estimated when the seller has experience with such volume rebates and the experience is relevant to the contract. Otherwise, revenue is limited to the amount of consideration that management can reasonably estimate.	Volume discounts are recognized as a reduction of revenue as the customer earns the rebate. The reduction is limited to the estimated amounts potentially due to the customer. If the discount cannot be reliably estimated, revenue is reduced by the maximum potential rebate.	Volume discount payments are systematically accrued based on discounts expected to be taken. The discount is then recognized as a reduction of revenue based on the best estimate of the amounts potentially due to the customer. If the discount cannot be reliably estimated, revenue is reduced by the maximum potential rebate.
	Impact: Revenue is measured based on the probability-weighted average estimated consideration to be received after adjusting for expected discounts. The probability-weighted approach in the proposed standard may change the timing of revenue recognition compared to the best estimate approach used today.	

Proposed standard	Current US GAAP	Current IFRS
Time value of money In determining the transaction price, an entity shall adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicitly or implicitly). Management uses a discount rate that reflects a separate financing transaction between the entity and its customer, and factors in credit risk.	The discounting of revenues is required only in limited situations, for example, receivables with payment terms greater than one year. When discounting is required, the interest component is calculated based on the stated rate of interest in the instrument or a market rate of interest if the stated rate is considered unreasonable.	Discounting of revenues to present value is required in instances where the effect of discounting is material. In such instances, an imputed interest rate is used to determine the amount of revenue to be recognized immediately, as well as the separate interest income component to be recorded over time.
	Impact: We do not expect a significant change to current practice for most transportation and logistics entities (excluding airlines) in connection with the time value of money, because payment terms often do not vary significantly from the timing of contract performance. Contracts with payment terms that vary significantly from the timing of contract performance, such as prepayments for flights and customer loyalty programs, might be affected (see Example 6).	

Example 5

Facts: A railway entity enters into a contract to ship goods from point A to point B for \$1,000. The customer earns a discount of \$100 per load if the customer ships at least 10,000 loads annually. How should the railway entity record revenue from this contract?

Discussion: Based on past experience, the railway entity believes there is a 70% probability that the customer will ship 10,000 loads and earn the discount of \$100 per load. The railway entity will record revenue of \$930 per load based on the probability-weighted amount of consideration it expects to receive $[(0.70 \times \$900) + (0.30 \times \$1,000)]$.

Example 6

Facts: An airline sells a non-refundable ticket to a customer with payment due at the time of booking, which is one year before the reserved flight. The ticket price is \$500. How should the airline record revenue from this contract?

Discussion: The airline will record a contract liability of \$500 when the customer pays. The airline determines that a 5% discount rate is appropriate based on the one year term and its credit characteristics. The airline recognizes interest expense of \$25 ($\$500 \times 0.05$) during the year before the flight with a corresponding increase to the contract liability. The airline records revenue of \$525 when the reserved flight is taken. This accounting treatment is a significant change from current practice.

Multiple-element arrangements

Many transportation entities provide multiple services to their customers as part of a single contract. Determining when to separately account for performance obligations under the proposed standard is a key determination and will require a significant amount of judgment.

Proposed standard	Current US GAAP	Current IFRS
Multiple-element arrangements The proposed standard states that a single contract may have numerous performance obligations. When these performance obligations are distinct they should be accounted for separately. A good or service is distinct, and should be accounted for separately, if the entity, or another entity, sells an identical or similar good or service separately. Performance obligations could be distinct if not sold separately if the good or service has a distinct profit margin and a distinct function. For performance obligations that require separate accounting, contract revenue is allocated to each performance obligation based on relative actual or estimated stand-alone selling prices.	Current guidance requires deliverables in contracts to be accounted for separately if each deliverable has stand-alone value and there is objective and reliable evidence of fair value of the undelivered element. When fair value does not exist for delivered elements, the residual method of allocation is permitted. The lack of objective and reliable evidence of fair value of the undelivered element often limits the separation of deliverables in a multiple-element arrangement. New multiple element guidance (required to be adopted for calendar year end companies effective January 1, 2011) requires deliverables in contracts to be accounted for separately if each deliverable has stand-alone value. At the inception of the arrangement, consideration is allocated to all deliverables based on the relative selling price. The residual method is no longer permitted.	The revenue recognition criteria are applied to each separately identifiable component of a single transaction to reflect the transaction's substance. Fair value is used to allocate the transaction price to the separate elements of a contract. The price that is regularly charged when an item is sold separately is the best evidence of the item's fair value. A cost-plus-reasonable-margin approach to estimating fair value is also acceptable. The use of the relative fair value method, residual method and, under rare circumstances, the reverse residual method, is acceptable to allocate arrangement consideration. Entities might separate elements in a single contract even if the elements are not sold separately.

Proposed standard	Current US GAAP	Current IFRS
	Impact: Management will need to determine whether transportation or logistics contracts include more than one performance obligation. The separation criteria in the proposed standard are less restrictive than current guidance. This might result in more performance obligations being accounted for separately, thereby changing the timing of revenue recognition. For example, entities that provide a complete solution including completion and filing of necessary transportation paperwork (e.g., customs forms) should consider whether the individual services are distinct performance obligations. The residual method of allocation is not permitted under the proposed standard.	Impact: The proposed separation and allocation methodology is similar to current guidance, although more performance obligations might be identified. The residual and reverse residual methods of allocation will no longer be acceptable.

Example 7

Facts: A trucking entity enters into a contract with a customer for maintenance services and emergency roadside assistance. The services are not typically sold on a stand-alone basis. Assume the performance obligations are each distinct and will be delivered at different times. How should the trucking entity allocate revenue to the performance obligations?

Discussion: The entity will need to consider observable prices of services, when available, in estimating the stand-alone selling price of each of the services. Stand-alone selling prices of the maintenance services and the emergency roadside assistance will be estimated because they are not sold separately by the entity. The entity might use a cost-plus-reasonable-margin approach or any other reasonable and reliable method to estimate stand-alone selling price as long as that method is consistent with stand-alone selling prices that maximize observable inputs. The arrangement consideration is allocated to each performance obligation on a relative basis. Revenue is recognized as the performance obligations are satisfied.

***To have a deeper conversation
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US GAAP Convergence & IFRS Leases

March 2011

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Leasing

FASB and IASB agree on changes that will reduce complexity of the proposed leasing standard

What's inside:

Overview

Status of redeliberations

The path forward

Reprinted from:

Dataline 2011–11
February 23, 2011

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- In August 2010, the FASB and IASB (the “boards”) jointly issued an exposure draft of a proposed accounting standard for leases (the “ED”). The proposals would change the accounting for lease transactions and have significant business implications.
- The comment period ended on December 15, 2010 and the boards have begun redeliberating the ED.
- The boards have considered the extensive feedback received that the ED was overly complex and, in some areas, inconsistent with the economics of the underlying transactions. The proposed changes address some of the specific concerns raised and should make implementation of the standard more operational and less costly and complex.
- Thus far, the boards have made tentative decisions to change the proposals in the ED with respect to the definition of lease term (threshold for inclusion of extension options) and inclusion of variable or uncertain cash flows (i.e., contingent rent), and have instructed the staff to conduct additional outreach with respect to their tentative decision concerning variable or uncertain cash flows.
- The boards are also considering changes in the definition of a lease, profit and loss recognition patterns and the lessor accounting model. However, no decisions in these areas have yet been reached and the staff will conduct additional outreach.

The main details

1. In January 2011, the boards issued a preliminary redeliberation plan that identified five key areas for discussion:
 - Definition of a lease (including “embedded leases”)
 - Lessor accounting
 - Definition of lease term (including extension options)
 - Variable/uncertain cash flows
 - Profit and loss recognition pattern
2. Decisions made during redeliberation of these items could significantly
3. The boards have discussed each of these items in their redeliberation meetings and have identified possible alternative approaches which may reduce complexity and address certain application issues. For several of these areas, the boards have directed their staff to conduct targeted outreach and prepare additional analysis.

change the scope and direction of the project. The staff also identified a more extensive list of other areas and application issues to be addressed once the boards address the main concerns listed above.

4. In the paragraphs that follow, we have summarized the decisions reached at the January and February 2011 joint meetings, as well as the status of discussions for each of the remaining key areas. We have also included PwC observations on the potential implications of these issues.
5. As the boards have not yet completed their redeliberations or issued a final standard, all FASB and IASB decisions noted in this Dataline are tentative and therefore subject to change. A complete summary of the boards' decisions on the leases project is available on the FASB's website at www.fasb.org or the IASB's website at www.ifrs.org.
6. For more information on key aspects of the ED and how it may impact you, refer to Dataline 2010–38, *A new approach to lease accounting—Proposed rules would have far reaching implications (which provides an overview and various insights into the ED)*, Dataline 2011–05, *Leasing—the responses are in...* (which summarizes comment letters received), and *10Minutes on the future of lessee accounting* (which provides insight into how companies will be impacted by the proposals in the ED and next steps to consider).

Status of redeliberations

Key decisions reached

Lease term

7. The boards have tentatively decided to raise the threshold for inclusion of extension options in the lease

term from the “more likely than not” threshold in the ED to those that provide “a significant economic incentive for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease.”

8. The boards decided to provide a list of indicators to help entities assess whether this threshold has been met. Indicators will likely include the existence of substantive bargain renewal options and economic penalties if the lease is not renewed (for example, direct penalty payments, tenant improvements with significant value that would be forfeited, or a lessee's guarantee of lessor debt related to the leased property). Under the revised approach, management intent and past business practice would not be included as part of the evaluation.
9. The boards also decided that reassessment of lease term should be performed when there is a significant change in one or more of the indicators such that the lessee would then either have, or no longer have, an economic incentive to exercise an option or terminate the lease.
10. The definition of lease term will be consistent for both lessees and lessors. The boards acknowledged that different conclusions could be reached related to the same lease as lessees and lessors may have different levels of information or make different judgments.

PwC observation: The higher threshold for including extension options would generally result in shorter lease terms and lower amounts recognized on the

balance sheet than would have resulted under the ED. The revised threshold is more consistent with today's treatment of including renewal periods in the lease term only when they are “reasonably certain” of being exercised, which is well understood in practice. It would also mitigate concerns about structuring opportunities, improve operability of the new standard, reduce volatility and more closely align the inclusion of these additional periods with the actual economic decisions to exercise extension options.

Variable or uncertain payments

11. Many respondents to the ED believed that certain types of contingencies should be included in the lessee's liability to make lease payments and the lessor's right to receive lease payments. However, they were concerned about the complexity of using a probability-weighted approach and the need to forecast certain types of contingencies such as performance-based contingencies tied to sales. Conversely, if all contingencies were to be excluded, the boards were concerned about potential structuring opportunities whereby leases could be structured such that lease payments appear entirely contingent, but where both parties expect significant payments to be made.
12. The boards tentatively decided that the following variable lease payments should be included in the measurement of lease obligations and assets:
 - All contingencies that are based on a rate or an index

- Any contingency that is a “disguised” minimum lease payment (i.e., an anti-abuse provision)
- Any portion of residual value guarantees that are expected to be paid
- Any other contingencies (i.e., usage or performance) that are “reasonably certain” (as that term is used in IFRS) or “probable” (as that term is used in US GAAP) of being paid

13. The boards tentatively decided that any contingent amounts would be included using a best estimate approach rather than the probability-weighted approach proposed in the ED. The boards also tentatively concluded that “term option penalties” should be included or excluded in a manner that is consistent with the thresholds for including extension options.

14. The boards have not yet discussed the reassessment of contingencies or how contingent rents included in the measurement would impact the profit and loss recognition pattern. The staff will be conducting additional targeted outreach on these topics.

PwC observation: The boards’ revised proposal strikes a balance between the complexity of including contingencies and the structuring concerns if all contingencies were excluded. The elimination of the requirement to use a probability-weighted approach will also improve operationality. When coupled with the revised threshold for inclusion of extension options, this approach will reduce complexity as compared to the ED, though not to the extent

that some constituents were looking for. Significant practical application issues remain in this area to be debated prior to the issuance of a final standard, including the profit and loss recognition pattern to be utilized for any contingent amounts recognized.

Status of discussions on other key areas

Profit and loss recognition pattern

15. The ED implicitly treats all leases as financing transactions with an accelerated profit and loss recognition pattern more commonly associated with financing transactions. Many respondents across a wide range of industries had significant concerns about this approach.

16. Many respondents did not believe the proposed recognition pattern was consistent with the economics of many types of lease transactions that are not priced like financing transactions, but rather in reference to other market transactions (e.g., by reference to market rent rates, not interest rates). They also observed that while many users of financial information (such as analysts and rating agencies) make adjustments to the balance sheet of lessees, they are not making adjustments to the income statement as they are generally satisfied with the current income statement recognition pattern and characterization of most leases. As a result, many were concerned about the continued usefulness of the income statement as a measure of performance under the ED with respect to leasing

transactions that were not financing transactions in nature.

17. In their redeliberations, the boards have been discussing whether there should be a fundamental distinction between those leases that are primarily financing transactions in nature and those that are “other than financing.” The boards may conclude that there is a fundamental difference and while all leases would be on balance sheet, the profit and loss recognition pattern may be different for different types of leases.

18. If the boards ultimately adopt this approach, those leases that are primarily financing transactions in nature would have a recognition pattern similar to a financed purchase. Those that are deemed to be “other than financing” would have a recognition pattern more closely aligned with today’s straight line rent under an operating lease. The boards tentatively agreed that distinguishing between these two types of leases would be based on two new sets of indicators and have instructed the staff to conduct additional targeted outreach in this area.

19. While some may argue that this approach for “other than financing” leases would represent a significant theoretical departure from the recognition patterns of other assets and liabilities, the boards have acknowledged that it may be necessary given the unique nature of leases, through which the asset and liability are inextricably linked.

PwC observation: If the boards ultimately conclude that a dual model by lessees for financing

and “other than financing” leases is appropriate, this may alleviate many of the concerns about the project. However, we believe that the boards have substantial work remaining in this area—in particular, describing the lease characteristics under each model and how each model would be applied.

Definition of a lease

- 20.** The ED predominantly carried forward the definition of a lease contained in existing leasing guidance. Perhaps most surprising to many is the level of concern raised regarding the fundamental question of whether an arrangement contains a lease, both in relation to the current accounting for leases and the proposed model.
- 21.** The boards have acknowledged that there may be many more multiple-element arrangements that contain an embedded lease than originally expected, which would substantially increase the complexity and costs of applying the proposed standard. Conversely, some respondents indicated that many transactions characterized as a lease within an agreement may not be a lease for accounting purposes under the proposed definition.
- 22.** Feedback received by the boards has also indicated that under current practice, whether an arrangement contains a lease often does not have a significant accounting impact if any lease identified would be an operating lease. However, under the ED, the difference in accounting could be very significant and, as a result, the judgments about whether or not a lease exists and the allocation between

lease (so called “embedded leases”) and non-lease elements would be much more important.

- 23.** The definition of a lease contained in the ED was “a contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration.” The boards have been discussing potential revisions to the definition that may help clarify when transactions are leases or service contracts or both. The boards have also discussed how to apply the definition to a number of practical examples (such as rail cars) where there may be questions as to whether there is a “specified asset” or whether control of the asset has been conveyed to the lessee. The boards have also begun exploring whether they should exclude embedded leases in arrangements that are “predominantly service contracts” or “where the embedded lessee asset is merely incidental to the delivery of a service” such as a cable TV set-top box. The boards also briefly discussed whether certain types of executory costs should be excluded from the measurement when the transactions are predominantly leases.
- 24.** The boards have instructed the staff to conduct additional targeted outreach in this area and to return to the boards with detailed proposals.

PwC observation: There remains a significant amount of discussion to be held in this area. We anticipate that the boards will make further progress on these discussions in the near term. We also observe that the changes in lease term described previously and the potential changes in profit and loss

recognition patterns may significantly reduce the concerns raised about embedded leases.

Lessor accounting

- 25.** Many respondents to the ED (including many in the user community) did not believe that the proposed lessor model in the ED represented sufficient improvement to warrant the substantial additional costs to implement and apply the new proposals.
- 26.** In response to this feedback, the boards have discussed the possibility of allowing the current lessor accounting guidance to continue (with the potential exception of eliminating leveraged lease accounting in the US). The boards have also discussed adjusting the existing lessor model to conform with changes in the definition of a lease, lease term and contingent rents to those that will be contained in the final standard.
- 27.** It is expected that the issue of lessor accounting will be revisited as soon as decisions in the other key areas have been finalized.
- 28.** The boards have also clearly indicated that they will be focused on making sure that the other current joint projects, most notably revenue recognition, are based on consistent core principles.

The path forward

- 29.** The boards will continue redeliberations in the coming months. A final standard remains targeted for issuance in mid-2011. We will continue to keep you informed of the significant redeliberation decisions.

10Minutes on the future of lessee accounting

What's inside:

Highlights

How new lessee accounting changes your company's financial picture

How changing financial metrics could impact ability to borrow

Where the proposals raised the most concern

Considerations for companies that use leases

What should your company be doing now?

Highlights

- Adding leased assets and obligations to balance sheets will affect measures of financial strength (e.g., debt-to-equity ratios), net income, and other performance metrics.
- Agreements tied to these measures may be affected, such as performance-based compensation plans and debt covenants.
- Accounting for contingent rents and renewal options will require significant judgment and estimates. Proposed continuous reassessment may increase earnings volatility.
- The proposed standard and its complexity will prompt some companies to reconsider how and why they use leases.
- Companies should begin to assess the impact of the changes and consider the adequacy of their systems and processes to address the new requirements.

Reprinted from:

10Minutes on the future of lessee accounting
February 2011

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

How new lessee accounting changes your company's financial picture

1. Leasing arrangements satisfy a wide variety of business needs, from short-term asset rentals to long-term asset financing. Leases allow companies to use assets—office and retail space, hotel rooms, equipment, cars, and aircraft—without having to make large initial cash outlays.
2. Leases can affect the amount, timing, and uncertainty of future cash flows. Yet about \$1.2 trillion in future cash obligations for lease arrangements aren't reported on the balance sheets of US public companies, according to a 2005 report by the SEC. Many analysts have had to make adjustments in their stock price models to factor in their estimates of these future cash flows.

3. But lessee accounting may be about to change. A proposed new global accounting standard would require companies to record the rights and obligations related to all leases on their balance sheets.
4. This 10Minutes provides a preview of the proposed changes and their implications, while the proposals are being re-deliberated in light of extensive comments received. The final rules are expected to be issued in mid-2011. But beware; substantial changes in the proposals could occur before the issuance of a final standard.

Companies should begin preparing

5. The proposed standard may change the scorecard by which investors, lenders, and rating agencies evaluate your company's indebtedness and creditworthiness. It may also change

your company's earnings picture. To limit surprises, you should understand the potential impact of the change.

6. Current systems, controls, and resources may be inadequate under the new standard. In fact, while your company tries to understand the impact of the new rules, you may have to consider the following:
 - new data and estimation methods and more skilled personnel may be needed to deal with new accounting rules about renewal options and contingent rents
 - new or upgraded systems may be needed to replace the current lease tracking systems in spreadsheets and accounts payable systems in companies with no formal asset management system
 - additional resources may be needed to apply the new accounting to what, for some, may be *thousands* of leases already in force, particularly in large companies

How changing financial metrics could impact ability to borrow

7. The new rules could re-calibrate your company's leverage and earnings, without any change in underlying cash flows or business activity. The changes could be significant.

New baselines for financial metrics

8. In a study of 3,000 companies, we found that recording lease rights and

At a glance

Under current lease accounting standards...

- leases are classified as either *capital leases* (effectively, financing arrangements), which are recognized on the balance sheet, or *operating leases*, which remain off the balance sheet.
- leases only include non-cancellable periods in the lease term, except where there is compelling economic reason to exercise an option (for example, a penalty provision).
- contingent rents are generally excluded from minimum lease payments and are reflected in earnings in the period they arise.
- companies recognize the expense for operating leases (excluding contingent rent) on a constant or "straight-line" basis.
- lease terms are generally not re-assessed, except when there is a change in the terms or a binding exercise of an extension option.

Changes lie ahead. Under the proposed rules:*

- substantially all leases would be recorded on the balance sheet as financings, with an asset and an obligation, based on the present value of payments over the term of the lease.
- the lease term would include non-cancellable periods and optional renewal periods that are "more likely than not" to be exercised.
- lease payments used to measure the initial value of the asset and liability would include estimated future "contingent" rent amounts.
- amortization and interest expense would replace rent expense, changing income statement "geography" and frontloading expense in the early years of the lease.
- companies would need to continually re-assess lease renewals and contingent rents, and adjust the related estimates as facts and circumstances change which would increase earnings volatility.

* Based on the proposals in the exposure draft published in August 2010. Certain provisions may change upon redeliberation.

obligations on balance sheets as assets and liabilities would result in about a 58% average increase in interest-bearing debt. Nearly a quarter of surveyed companies would experience an increase in debt of over 25%. In some cases, the added leverage

could be multiples of total assets. Moreover, the impact on leverage ratios could change often as a result of the required re-assessment of estimates, including both lease term and contingent rents.

Impacts on financial metrics vary by industry

PwC assessed the impact of the leasing proposals on the financial statements and key financial ratios of a sample of approximately 3,000 listed companies across a range of industries worldwide.

Industries	Average percentage** increase		
	Leverage**	Interest-bearing debt	EBITDA*
Retail and trade	64	213	55
Other services	34	51	25
Transportation and warehousing	31	95	44
Telecommunications	20	23	16
Professional services	19	158	27
Amusement	19	25	13
Accommodation	18	101	30
Wholesale trade	17	34	21
Manufacturing	9	50	13
Construction	8	68	14
Oil, gas, and mining	7	30	10
Financial services	6	27	15
Utilities	2	3	6
All companies	13	58	18

* Earnings Before Interest, Taxes, Depreciation and Amortization

** Increase in leverage (calculated as interest-bearing debt divided by equity) is the average increase in percentage points

9. On the other hand, operating earnings metrics such as EBITDA could increase because rents would no longer show up as a recurring operating expense. Instead, rent is effectively reported as principal and interest payments and the associated leased assets are amortized. Our study found that the average increase in EBITDA would be around 18%. In some cases, earnings could fall as a result of the acceleration of expense recognition in the new model. Stakeholders will need to adjust to the new information.
10. Investors focused on cash operating metrics may have to adjust reported earnings amounts. New metrics of a company's financial health may evolve to ensure earnings and indebtedness are understood by stakeholders.

baselines. A company's ability to borrow may be affected, as the new rules make existing operating leverage more transparent. Higher leverage ratios could also affect values of acquisitions or other deals.

12. Rating agencies and many stock analysts already reflect leasing activities in their credit and stock analyses. But the new standard may yield measures of leverage that exceed analysts' estimates. Any resulting changes in leverage ratios could impact a company's credit ratings, debt covenants, and regulatory compliance. Market reactions could occur.
13. Financial covenants are often based on the accounting principles in force at inception of the agreement. Those that are will require companies to keep track of both models—a complexity that may lead companies to want to renegotiate terms to simplify the accounting.

Likely impacts on financing

11. For some companies, it may be more than just getting used to new

Where the proposals raised the most concern

14. The complexity and the inherent subjectivity in applying the proposed rules raised many issues, ranging from the compliance burden to volatility in earnings and financial ratios.

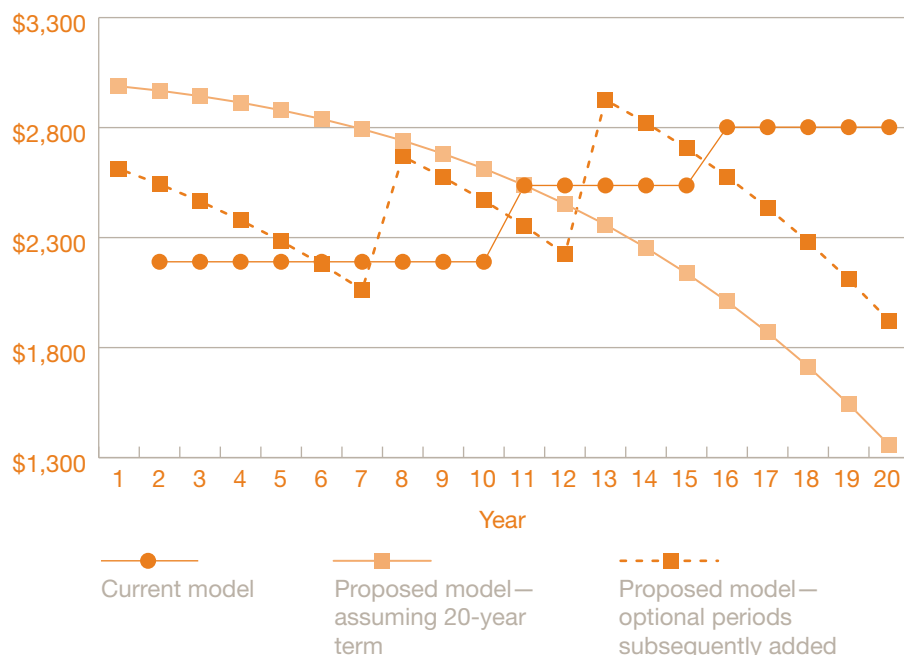
Operating leases become financing leases—

In general, even for basic leases, the proposed rules would treat leasing as a financing. The lease obligation would be treated like a mortgage, which would cause higher interest expense in the earlier years of the lease. The longer the term of the lease, the more expenses are front-loaded. For some businesses, such as new retail or restaurant outlets, the frontloading of expenses could come at a time when earnings may not be sufficient to cover the combined interest and amortization charges.

Renewal options—Including renewal options in the estimate of the lease obligation requires difficult judgments about the probability that options will be exercised as well as the related estimates of future rental payments.

Contingent rents—Including contingent rents means forecasting the likelihood of future events. Next year's restaurant sales, for example, are hard enough to predict accurately; estimates for the full 10- or 20-year term of a lease are even more difficult to predict and subject to a wide range of potential estimates.

The proposed rules result in frontloading of rent expense



This chart compares the expenses recorded under the current model and scenarios for the proposed model, using the example of a 10-year lease with two 5-year renewals, an initial rent of \$2,000, annual escalations of 2%, an incremental borrowing rate of 7%, and no contingent rent or residual value guarantees.

Continuous re-assessments—The proposed ongoing re-assessments in lease renewals and contingent rents not only impose compliance burdens, they also introduce volatility in earnings and financial ratios.

Alternative approaches may emerge

15. The proposals are still being debated and substantial changes could be incorporated into the final rules that will be issued in mid-2011.
16. The most significant concerns about the proposed rules are the high level of subjectivity involved in estimates and judgments, the frequency of changes in estimates, and the changed expense recognition pattern. But there are alternative approaches that could reduce subjectivity and the need for frequent re-assessments.
17. We've offered a number of suggestions that do this and also reduce complexity while addressing potential application challenges and costs. For

example, on extension options, we've recommended including only those options that are virtually certain to be exercised, that is, where the only reasonable economic choice for the lessee is to renew the lease. The cash flow implications of other kinds of options can be disclosed in footnotes and still meet investors' information needs.¹

Considerations for companies that use leases

18. Basic operating needs often drive leasing decisions. Through leasing, a restaurant chain, bank, or retail chain can quickly add new locations in response to increased demand. By leasing equipment, hospitals can take

advantage of the latest technologies without the risks of obsolescence. For a rapidly growing company, it might be faster and more efficient to execute a lease rather than to go through the approvals required for outright purchase. Leasing offers businesses the flexibility to ride out downturns or other disruptions. And in some cases, leasing is the only option because the property, such as retail space in malls, is not available for purchase.

Current economic conditions

19. The proposed standard would not change the fundamental decision process, nor would it change the basic economics of lease transactions. But its implementation will come at a time when the economic downturn has significantly changed property values and rents. Previously negotiated rents may be above the current market price. At the same time, assets may be available at favorable purchase prices.
20. Also, some companies may benefit by obtaining financing using their own credit rating versus the lessor's, which could be lower as a result of current market difficulties. Of course, the benefit will have to be weighed against the cost of renegotiating a prior lease arrangement.
21. These could become important factors in re-assessing existing contracts, potential re-negotiations, and new lease-versus-buy decisions.

¹ PwC, *Letter to the International Accounting Standards Board and Financial Accounting Standards Board*, 30 November 2010.

Regulatory and contracting factors

22. Regulators haven't yet indicated how risk-based capital requirements will be affected by the new standard. Also, there are implications for some cost plus contracts, which may reimburse an entity for the cost of rent, but not for capital-related items, such as interest and amortization. While the economics of lease transactions would not change, with rent expense re-classified as interest and amortization, the economics of cost plus and other contracts could change drastically.

Tax considerations

23. Federal and state tax considerations often play a significant role in strategic decisions about corporate real estate. Tax accounting will become more complex, particularly the tracking of temporary differences between the proposed model and the generally cash-based tax models. For state taxes, the proposed standard may affect the amount of business income apportioned to various states, which could cause an increase in state taxes.

Considering all factors together

24. As companies revisit past arrangements and consider future leasing decisions for specific locations, they should weigh the host of these economic, operating, regulatory, accounting, and tax factors together.²

² PwC, *The overhaul of lease accounting: catalyst for change incorporate real estate*, November 2010.

Fundamental lease-versus-buy questions:

- Why does your company lease or own in particular situations?
- What are the alternatives to leasing?
- How do current market opportunities (e.g., lease rates/ purchase prices) affect your strategies?
- How quickly are conditions changing in your industry?
- How important is flexibility in real estate and equipment procurement?
- How do federal, state, and local taxes factor into your lease-versus-buy decisions?

What should your company be doing now?

25. If leasing is significant to your business, ultimately, you may need to communicate with banks, rating agencies, and financial analysts about how your company's financial picture may be affected. The idea is to limit surprises.

Preparing for the change

- ☐ Educate key business leaders in the company about the leasing change
- ☐ Create a cross-functional steering committee to address the proposed standard and transition
- ☐ Inventory your leases; understand what assets are leased and where the data resides
- ☐ Identify contracts likely to include embedded leases
- ☐ Consider modeling the transition impact on certain significant leases (or sample from a variety of lease types)
- ☐ Summarize existing systems, control processes, and potential gaps
- ☐ Analyze potential income and other tax considerations (including federal, state, and foreign taxes)
- ☐ Identify contracts affected (e.g., financial covenants, compensation agreements, and earnout agreements), the potential implications, and how terms should be modified to maintain the original intent
- ☐ Identify regulatory issues such as implications for regulatory capital and cost plus government contracts
- ☐ Consider potential changes in leasing strategy; for example, lease/buy, shorter versus longer terms, options, contingent rents, etc.
- ☐ Consider if terms of existing leases should be renegotiated

Assess the potential impact early on

- 26.** Catalog existing leases and gather data about lease terms, renewal options, payments, and embedded leases. If your company has international operations, you may need to address leases written in different languages and any impact of local statutes in applying the proposed standards.
- 27.** Model the impact on certain significant leases or a sample from a variety of lease types. Consider the potential income tax and other tax effects and regulatory issues.
- 28.** Based on the information gathered, prepare a preliminary impact study and update it as needed. Monitor changes in the proposed standards.

Rally the people who need to act

- 29.** Educate key business leaders in the company about the issue and get the internal support needed for the transition from tax, operations, information technology, human resources, procurement, treasury, and investor relations.

Consider new systems and controls

- 30.** Critical to a smooth and orderly transition is the ability to gather the required information on existing leases, and to be able to capture data on new leases right at the outset, even before the accounting changes take effect. That might mean the need for new systems, which will take time to obtain, implement, and test.
- 31.** Initial recording on the balance sheet and annual re-assessment of lease terms and payments could also require significant and complex changes to existing processes and internal controls. And you might need more personnel resources.

Conduct strategic reviews

- 32.** In light of the proposed rules, review strategies and contract terms to make sure the company's operating and financial objectives are met. Where does it make sense to own rather than lease? Which leases warrant longer terms and exercise of renewal options? Where would it make sense to reduce contingency provisions?
- 33.** Review debt agreements with lenders and credit agreements with suppliers. Evaluate employment contracts to assure proper alignment of performance metrics with anticipated financial results.

Communicate in advance with your stakeholders

- 34.** Consider when to start the dialog to help your stakeholders understand the potential impact of the new standard, any resulting changes in leasing strategy, and other relevant information ahead of full implementation of the new standard.

Leasing

The responses
are in . . .

What's inside:

Overview

Background

Preliminary
redeliberation plan

Comment letters

Reprinted from:

Dataline 2011–05
January 27, 2011

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- The FASB and IASB (the “boards”) received over 770 comment letters in response to their August 17, 2010 Exposure Draft, Leases (the “ED”). The comment period closed on December 15, 2010. The boards have also performed direct outreach with users and preparers, and held public round-table discussions in London, Hong Kong, Chicago and Norwalk.
- We noted a number of recurring themes in the comment letters and round-table discussions, even across industries. While a majority of the respondents are supportive of the need for the project in general, especially as it relates to lessee accounting, most respondents have significant concerns about many aspects of the proposals contained in the ED, and strongly encourage the boards to take the time necessary to produce a standard that is both high quality and operational.
- In addition to comments about the technical application of the proposed standard, many respondents have also expressed concerns around the operability, cost/benefit and potential for unintended business implications.
- The boards are targeting to issue the final standard in the second quarter of 2011 but have acknowledged that substantial work remains. A final standard would likely have an effective date no earlier than 2014.

Summary of comments

1. The following table summarizes the comment letter themes by major topic.

Major area	Summary of comments
Scope exclusions	While there was general agreement that most arrangements accounted for as leases today should be governed by the standard, many have encouraged the boards to revisit the proposals on short-term leases and leases of intangibles.
Lessee accounting	Many respondents supported the right-of-use model for lessees, at least with respect to the balance sheet implications for simple leases. However, many disagreed with the measurement provisions for more complex leases. In addition, many expressed concern about the “deemed financing” premise and resultant accelerated expense recognition pattern in the ED.
Lessor accounting	Views on lessor accounting are more diverse. The ED proposes a “hybrid” model under which certain leases are accounted for under a performance obligation approach while others would be required to use a derecognition approach. Many believe that the case has not yet been made that the proposed hybrid model for lessor accounting represents a significant enough improvement from the current model to warrant a change. Some believe that a hybrid model is necessary to deal with different business models (e.g., financing models vs. contracts to use) while others believe a hybrid model is not consistent with concepts in the revenue recognition exposure draft and that only a derecognition approach is warranted.
Extension options	Almost all respondents disagreed with the definition of lease term as the longest possible term “more-likely-than-not” to occur. They believe this may result in recognition of amounts for extension periods that do not meet the definition of a liability. They also believe this approach would be highly subjective in application, result in significant volatility and be subject to manipulation in practice. While most respondents believe that some extension options should be included, there were differing views regarding the threshold at which respondents believe they should be recognized.
Contingent payments	The ED requires that contingent payments generally be included in the amounts recorded using a “probability-weighted” approach. Most respondents were critical of a probability-weighted approach and believe a “best estimate” approach is more appropriate. Some respondents also believe that certain types of contingencies (usage, performance, or index-based) should be treated differently—although there were differing views as to which types should be included and why.

Major area	Summary of comments
Profit and loss recognition pattern	The ED includes an inherent financing element in the right-of-use model. This model results in a recognition pattern for the lessee that changes the expense recognition pattern of operating leases from rental expense to a combination of amortization and interest expense. It will also typically result in the acceleration of expenses compared to today's operating lease accounting and the timing of cash payments. Many respondents questioned the usefulness of this model.
Purchase options	The ED proposes that purchase options should be accounted for only when exercised. Many respondents believe they should be considered as part of the lease model.
Multiple-element contracts, executory costs and service arrangements	The ED includes guidance for distinguishing a lease from an in-substance sale/purchase and from a service contract. It also includes guidance for identifying the service components of an arrangement that contains a lease. Many respondents (both lessee and lessor) had concerns about accounting for an embedded lease in a multiple-element arrangement in which the vendor can replace the underlying asset or there is no specific asset identified in the contract. Multiple-element contracts that include a lease and a service arrangement represent a significant concern to many, especially for real estate leases. Many respondents believe the standard should specifically exclude service and executory costs from lease payments rather than try to link to the definition of a distinct service under the revenue recognition exposure draft. Many respondents have also raised concerns about the potential volume of "embedded leases" which now could have a significant accounting impact on multiple-element arrangements.
Reassessment	The ED provides for reassessment of significant assumptions if facts and circumstances indicate there would be a significant change in the amounts from a previous reporting period. Many respondents raised concerns about the operationality and cost/benefit of this approach. These respondents indicated that an annual reassessment may be appropriate while others suggested a "trigger-based" reassessment.
Transition	The ED provides for a "simplified retrospective" approach and does not allow for early adoption. While many respondents supported this approach for cost/benefit reasons, others observed that it creates an artificial and nonrecurring expense pattern. Many respondents also asked for more guidance on transition issues in general (e.g., use of hindsight) and for specific issues (e.g., sale leasebacks, leveraged leases and build-to-suit leases).
Disclosure	Most respondents supported the overall disclosure objectives, but believe that preparers should be allowed to exercise judgment in determining the volume of disclosures and financial statement presentation.

Background

2. Leasing arrangements satisfy a wide variety of business needs, from short-term asset rentals to long-term asset financing. Leases allow companies to use assets—from office and retail space to hotel rooms, equipment, cars, and aircraft—without having to make large initial cash outlays. Sometimes, leasing is the only option to obtain the use of property when it isn't available for purchase.
3. Many observers have long believed that the current lessee accounting model is not consistent with the conceptual framework, which provides the underpinnings for accounting rules. They argue that current guidance allows lessees to structure lease transactions to achieve operating lease classification, resulting in off-balance sheet treatment. Critics also point out that the current guidance can result in something as seemingly illogical as a commercial airline company avoiding recognition of any airplanes on its balance sheet.
4. In June 2005, the Securities and Exchange Commission issued its *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Users*. One of the significant recommendations in this report was that existing lease standards needed to be revised, primarily to eliminate off-balance sheet accounting by lessees.

5. As part of their global convergence efforts, the boards added the joint project to their agendas in 2007 and have been working to create a single, global leasing standard. The project was intended to build on previous work contained in the 1999/2000 white paper titled *G4+1 Special Report, Leases: Implementation of a New Approach*. The boards issued similar discussion papers in March 2009 and the recent exposure drafts were issued in August 2010.
6. Refer to Dataline 2010–38 for a detailed discussion of the key aspects of the proposed standard, as well as PwC's response letter submitted to the boards on November 30, 2010.

Preliminary redeliberation plan

7. The IASB/FASB staffs are in the process of preparing a redeliberation plan and have preliminarily identified five main areas that will likely be the initial main areas of focus in upcoming redeliberations meetings. The five main areas are:
 - Definition of a lease
 - Lessor accounting
 - Lease term (i.e., extension option issues)
 - Variable lease payments
 - Profit and loss recognition pattern
8. Decisions made during redeliberation of these main areas could significantly change the scope and direction of the project. The staffs also identified a more extensive list of other areas and application issues to address once the boards address these main concerns.

Comment letters

9. The boards received over 770 comment letters from respondents in more than 30 countries. The large number of responses is reflective of the significance and prevalence of leasing as a fundamental business tool.
10. The respondents included preparers, industry trade organizations, professional organizations, local standard setters/regulators, individuals, auditors, consultants, academics and users. The respondents included both lessees and lessors in a wide range of industries including financial services, real estate, retail, automotive, aircraft, telecommunications, industrial products and utilities. At the public roundtables, concerns were raised about the relatively low volume of feedback from the user community and the need for more outreach by the boards/staffs to that group.
11. The respondents were disproportionately from North America and Europe as well as from international organizations (such as major multinational companies or international accounting firms). Some speculated at the roundtables that the disproportionate North American response may be the result of the fact that (i) US GAAP does not have the equivalent of Small and Medium-sized Entities accounting in IFRS and, therefore, the new standard would apply to a much broader group of entities (i.e., both public and private) and (ii) the US does not currently have an investment property standard thereby scoping in all real estate lessors.

12. Many of the respondents addressed only certain aspects of the proposed ED and did not respond to the detailed questions provided in the ED. Therefore, it is not possible to give precise percentages to measure how respondents reacted to particular issues. Accordingly, the discussion in this Dataline uses terms such as “majority,” “many,” “several,” or “some” to try and convey the perceived prevalence of a particular view on an issue expressed in comment letters or at the public roundtable discussions.

13. While the majority of respondents supported the project’s overall objectives, they had a number of concerns about some of the key provisions, including:

- Defining and identifying a lease
- Scope exclusions
- Lessee accounting
- Lessor accounting
- Extension options
- Contingent payments
- Profit and loss recognition pattern
- Purchase options
- Multiple-element contracts, executory costs and service arrangements
- Reassessment
- Additional guidance requested
- Transition
- Disclosure
- Operability and cost/benefit
- Tax/regulatory implications

14. In the paragraphs that follow we have summarized respondents’ comments on the above topics. We have also included in PwC observations the

comments we provided to the boards in our response letter.

Defining and identifying a lease

15. Perhaps most surprising to many who have been following this project is the level of concern raised regarding the fundamental question of whether an arrangement contains a lease, both in relation to the current accounting model and the proposed model. Some respondents indicated that many transactions legally identified as a lease may not be a lease for accounting purposes under the proposed definition. Others have indicated that certain other contracts, although called something else, may be fundamentally a lease such as power purchase contracts. Still others have raised significant concerns that there may be many more multiple-element contracts than originally expected that contain an “embedded lease,” which would substantially increase the complexity of applying the proposed standard.

16. The ED defines a lease as “A contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration.” Many respondents expressed concerns that this definition will be difficult to apply in practice. While this definition is consistent with the current accounting models, the existing accounting for an operating lease is not substantially different from the accounting for an executory contract in most cases. In contrast, the accounting for the lease element of an arrangement can

be substantially different under the proposed model. Accordingly, the evaluation of whether all or part of an arrangement is a lease and the appropriate allocation of consideration between the multiple elements becomes more significant.

17. Many respondents also requested guidance on how and at what level to evaluate whether an asset has been “specified” in applying the definition in situations where the lessor could replace the physical asset or where the lessee does not control the asset. Many observed that parties often enter into master-leases without knowing which physical asset, or even how many, will be leased. Respondents also cited a number of specific examples in various industries (e.g., computers, copiers and rail cars) with respect to the lessor’s ability to replace and control the asset.

18. Many respondents also raised concerns about some of the difficulty today in applying the current leasing guidance regarding whether an arrangement contains a lease (formerly EITF 01-8 and IFRIC 4). This guidance was essentially carried forward into the proposed standard.

PwC observation: We have urged the boards to take this opportunity to consider the scope holistically and also address many of the known issues with existing guidance (e.g., the former EITF 01-8 and IFRIC 4) in the final standard. The boards should also provide guidance on how to identify lease elements or so-called “embedded leases.” In addition, the boards should provide guidance on how to apply the concept of “specified”

asset in situations where the lessor can replace the asset or has control over the asset.

Scope exclusions

19. The scope of the project received only limited attention during the exposure draft and the discussion paper phases. To a large degree, this was based on the widely held expectation that the scope of the project should be consistent with the range of transactions for which the existing lease accounting standards are applied today. Under IFRS, IAS 17 applies to certain intangibles transactions, but under US GAAP, the current lease standards do not apply to leases of intangibles. Many respondents observed this inconsistency and requested that the boards address these issues either separately or by expanding the scope of the lease project.

20. Short-term leases: Most respondents support the proposed simplifications for short-term leases. While most respondents agree with the boards' proposed simplifications for short-term leases for lessors, many do not believe the proposals for lessees go far enough. These respondents believe the burden for a lessee is the cost of identifying and tracking a large number of short-term leases (e.g., identifying each employee using a hotel room or rental car at the end of each reporting period), which is not commensurate with the value to users of having this information.

21. Real estate: Many respondents supported the boards' proposed scope exclusion from lessor accounting for investment properties measured at

fair value in accordance with IAS 40 and urged the FASB to complete its investment property project, which would presumably result in a similar scope exemption under US GAAP. They urged the FASB to consider the timing of such a project to allow for simultaneous adoption of both standards. Many also encouraged the FASB to provide a scope exclusion for pension funds and certain real estate investment fund entities that currently account for investment real estate on a fair value basis.

22. Several respondents also suggested that the boards revisit the possibility of excluding leases of non-core assets (e.g., computers, copy machines) from the scope of a new standard.

PwC observation: We support the simplified accounting by lessors for short-term leases which does not require the recognition of lease assets and liabilities. We observe that the stated goal of the standard is to provide users with more information on the long-term obligations of a reporting entity. We believe that there is little incremental value provided by grossing up the lessee's balance sheet to include short-term lease assets and liabilities. While we agree with the boards that short-term leases may be significant in the aggregate, we do not believe that they are normally material to the economic decisions made by users.

We also support the scope exclusion for real estate carried at fair value (both internationally and in the US) and believe that convergence with IFRS for investment property should be a significant goal.

Lessee accounting

23. Most respondents supported the overall right-of-use model, at least with respect to the balance sheet implications for simple leases. However, most respondents raised concerns around how to account for extension options and contingent payments. Many also were concerned with the proposed expense characterization and profit and loss recognition pattern. These key areas of concern are discussed in more detail later in this Dataline.

PwC observation: We believe that the proposed right-of-use approach accomplishes the boards' aim to develop a model where assets and liabilities arising under a simple lease are recognized in a principled manner. We agree that a lessee should recognize an asset representing the right to use an underlying asset during the lease term (the right-of-use asset) and a liability to make lease payments. However, we disagree with the boards on the measurement of the right-of-use asset and liability to make lease payments for more complex leases that contain options and contingent payments. We also have concerns regarding the profit and loss recognition pattern's usefulness to users (see discussion later in this Dataline).

Lessor accounting

24. Many respondents indicated that they did *not* believe that the current lessor accounting model was fundamentally broken. Many also noted they needed

more time and/or more guidance on how certain provisions should be applied in order to coherently comment on the potential implications. For example, it was not clear to many respondents how to apply the criteria in making the choice of the appropriate approach (derecognition vs. performance obligation approach).

25. In addition, there were some respondents who raised concerns about the appropriateness of revenue recognition under the derecognition model if that model were selected in certain circumstances. Specifically, these respondents were concerned that inclusion of extension options in the “expected term” of the lease could lead to an inappropriate conclusion that the lessor is not exposed to significant risks of the underlying asset, which is not consistent with the true risk exposure.
26. Many respondents believe that a hybrid model as proposed in the ED is the only potential solution given the divergent views that are predicated on different business models. For example, many equipment manufacturer lessors shift substantially all the risks and rewards to the lessee except for credit risk and some relatively minor residual-value risk. As a result, these lessors fundamentally view the transaction as a sale and concurrent financing and believe the accounting should reflect that economic view. On the other hand, lessors leasing a portion of an asset (e.g., one floor in an office building) or an asset for only a portion of its life (e.g., a 10-year lease of a property with a 40-year life) do not believe they have sold the asset and, accordingly, do not believe they have financed a sale.

27. Many respondents indicated they do not believe the proposed hybrid model represents a significant enough improvement from today’s guidance and believe that lessor accounting should continue in its current form until the boards have had sufficient time to more fully vet lessor issues raised and potentially re-expose and/or field test the lessor model.

28. Respondents also differ on the path forward and questioned whether lease accounting by lessees should move forward separately from lease accounting by lessors. Many suggested that the timing of the entire project be extended to address both sides of the accounting in a consistent manner and with a consistent framework.

PwC observation: Although we agree with the boards’ aim to develop a consistent model for both lessees and lessors, we do not believe that the hybrid model to lessor accounting achieves this aim.

We believe that the performance obligation approach is not consistent conceptually with the proposals for lessee accounting. The derecognition approach is a better fit with the right-of-use approach, but applying it to all leases would be inconsistent with the boards’ proposed accounting for leases/licenses of intangible assets as set forth in their recent revenue recognition exposure draft. We are also aware of a number of practical issues in applying the derecognition approach for certain types of leases such as real estate leases (when measured at

something other than fair value) and time charter shipping.

We agree with the boards’ acknowledgement that lessee accounting is of greater concern to users than lessor accounting. Although we would prefer the boards look at lessor and lessee accounting at the same time, we do not believe the proposed hybrid model is a sufficiently significant improvement to current guidance to justify the substantial cost of change. Accordingly, we recommend that lessors continue to apply the existing lease guidance until the boards are able to develop a lessor approach that is consistent with both lessee accounting and accounting for leases/licenses of intangible assets. In the meantime, we are aware that there is currently diversity in accounting for licenses of intangible assets; we therefore accept that these be dealt with through the model proposed in the revenue recognition exposure draft as a pragmatic interim solution to accounting for leases/licenses of intangible assets.

Extension options

29. Fundamentally, the ED first measures the asset, including extension options that could represent assets under the current conceptual framework definition, and then the corresponding liability matches the computed asset. However, most respondents believe it is more appropriate to start with determining the amount of the liability. In these cases, most

extension options, purchase options and some forms of contingent payments would generally not meet the definition of a liability under the current conceptual framework.

- 30.** Looking at measurement from a liability perspective, most respondents therefore believe that the “more-likely-than-not” threshold (i.e., > 50% probability) contained in the ED for inclusion in the lease term of periods covered by extension options is too low. However, while the majority disagrees with the threshold contained in the ED, there are diverse views on what the appropriate threshold should be.
- 31.** In general, there was tension between raising the threshold to make the proposed standard easier to apply and a concern that raising the threshold too high invites significant structuring opportunities to achieve desired accounting results (e.g., converting a twenty-year lease into a lease for a day with a series of daily extension options aggregating twenty years). Many respondents indicated concerns about structuring were exaggerated. These respondents indicated natural market tensions between lessees and lessors and the need for lessors to recover their investments would inherently price in optionality costs that would make such abnormally short leases uneconomic. These respondents believe that the concerns about potential structuring abuses are better dealt with through anti-abuse provisions that would require the application of judgment around any exceptions, not through rules in the general standard adversely affecting normal market transactions.

- 32.** Several respondents also observed that including any assessment of probability of exercise adds an element of subjectivity and potential for accounting manipulation which is undesirable and will reduce comparability.

- 33.** The varying views of where the threshold should be are as follows, from highest threshold to lowest:
- **Exclude all options, non-cancelable term only.** Respondents with this view argue for a strict definition of a liability.
 - **Virtually assured/certain (e.g., >99% probability).** Respondents with this view argue for consistency with the definition of a liability but acknowledge that some extension options may be assured of exercise, effectively making the option non-substantive. Virtually assured extension options effectively provide for very little, if any, discretion to avoid. Respondents with this view observe that this threshold would be relatively easy to understand and apply.
 - **Reasonably assured/certain (e.g., >75% probability).** This threshold requires the preparer to consider economic factors (both direct and indirect) that would impact the exercise of the extension option. Respondents with this view observe that it is consistent with the current model and is generally understood and would, therefore, be easy to understand and apply. They note that changes in the probability around lease extension option exercise were likely to be more closely aligned

with actual business decisions (e.g., closer to end of lease term, or when a decision to make significant new improvements to a property such as in expectation of renewing).

- **More-likely-than not (>50% probability).** Many respondents were concerned about the inherent subjectivity of a threshold set at this level, the practical issues of applying this threshold and the potential for significant volatility resulting from reassessments.
 - **Include all extension options.** Few respondents have this view.
- 34.** Several respondents (especially those leasing real estate) also observed that in many cases extension options were in practice more of a “right to negotiate” which provides a level of control of the asset to the lessee. These respondents observed that, while a lessee may continue to use the asset after the initial term, the rents during renewal periods are frequently negotiated to be different from the rents specified for the extension period contained in the original contract. These respondents are concerned about recognizing assets and liabilities on the basis of contract provisions if historically they have not actually applied these provisions in practice.
- PwC observation:** Defining whether the lease term should include periods covered by some or all extension options or only the non-cancellable term has significant ramifications to the magnitude of the amounts recognized on the balance sheet and the recognition pattern in the income statement.

We agree that accounting for lease options should not be separated from the underlying lease contract. However, we believe that payments that would become due if an option were to be exercised should only be recognized if the definition of a liability is met in the case of lessees and the definition of an asset is met in the case of lessors. We believe an option is fundamentally different from an asset and liability. As with other options in financial accounting, we believe lease term extension options should not be accounted for as if they were already exercised.

We therefore believe that establishing the threshold at a “virtually certain” level is a better solution to this tension than either adopting the “more-likely-than-not” standard described in the exposure draft or retaining the current threshold of “reasonably certain/assured.” Establishing the threshold at this higher level also results in further benefits. Specifically, at the higher threshold, there will be less frequent need to remeasure and therefore, less associated volatility. It will also reduce the amount of estimates and judgments (e.g., for contingent rent and option periods) involved in determining the right-of-use asset and lease obligation for lessees and, as a result, reduce the preparer’s costs of implementing the new standard.

Contingent payments

35. The ED requires that all contingent payments be estimated and included in the amounts recorded using a

probability-weighted approach, excluding minimum lease payments for assumed option periods. Most respondents were critical of a probability-weighted approach which they believe would be unduly complex and impractical, especially for a large number of leases.

36. Many observed that determining the possible scenarios and estimating their probabilities would be highly subjective and arbitrary. Frequently, these assessments would likely be constructed to arrive at what one expects to pay. These respondents believe a “best estimate” approach is more appropriate for any contingent payments to be included in the recognized amounts.

37. Many respondents observed that the subjectivity in the estimation process was further magnified by the need to reassess estimates on an ongoing basis, and the inclusion of extension options in the lease term based on the proposed “more-likely-than-not” threshold.

38. Many respondents believe that most contingent amounts should be excluded on a basis consistent with the current lease model. They believe that the requirement to estimate these payments would be unduly complex and costly, while not adding substantial benefit to users of the financial statements. Some also believe contingent amounts do not meet the definition of a liability until the contingency is resolved (e.g., when specified sales levels are met).

39. On the other hand, some respondents expressed concern that exclusion of contingent payments would invite structuring opportunities to

create lease terms that on their face were contingent, but that were not consistent with the expected arrangement between the two parties. Taken to the extreme, this would result in leases with no base lease payments and all contingent rent. Excluding contingent rents in such a fact pattern would result in no current accounting for these leases. These respondents observed that for many of these leases there are clearly expectations of substantial payments that would be made by the lessee, which the lessee has little, if any, discretion to avoid. These respondents, therefore, believe the definition of a liability has been met in some cases.

40. Some respondents also believe that different types of contingencies (e.g., usage, performance, or index-based) should be treated differently, although there were differing views as to which ones should be excluded and why.

41. The varying views regarding certain types of contingent payments can be summarized as follows:

- **Usage-based contingencies (e.g., payments based on mileage).** Most respondents who commented on this type of contingency indicated that these types of provisions were more like extension options, whereby if they are reasonably within the lessee’s power to avoid they should be excluded.
- **Performance-based contingencies (e.g., payments based on lessee sales or profits).** There were conflicting views from respondents who commented on this type of contingency. Some believe that these types of provisions should be excluded because

they are “avoidable.” Other respondents believe that these should be included as this approach would be consistent with accounting for the operation as a going concern. These respondents also observed that other accounting guidance on financial liabilities (e.g., IAS 32) clearly states that contingencies such as turnover and net income are not within the control of the contracting party and therefore, these elements represent liabilities that should be recorded.

- **Index-based contingencies (e.g., payments based on changes in CPI or LIBOR).** Most respondents indicated that these types of provisions were outside of the control of the lessee and that amounts related to these provisions should be included in the lease asset and liability.
- **Residual value guarantees.** Most respondents who commented on this type of contingency indicated that such payments should be included if they were expected to be paid.

PwC observation: We believe that only those contingent payments that are not within the control of the lessee should be included in the calculation of the lease asset and liability. Contingent payments that are within the control of the lessee should not be included in the lease payments.

We believe contingent payments based on usage should be excluded but that performance-based, index-based and residual value guarantees should be included.

Profit and loss recognition pattern

42. Many respondents observed that the ED effectively views lease transactions fundamentally as the purchase of a right to use an asset with seller financing. These respondents were therefore accepting of the resultant accelerated expense recognition pattern caused by the financing element.
43. Others, however, believe that certain types of leases are not inherently financings, or they believe that leases are fundamentally different from other forms of financing because they are inextricably linked to the right to use the asset. As a result, these respondents were very concerned about the expense recognition pattern. Some respondents believe that it is more appropriate for lessees to apply an expense recognition approach for the combined earnings charge that more closely follows the economics (i.e., cash), while others support recognizing expense on some normalized basis (i.e., straight line). Some of these respondents suggest the utilization of a “linked approach” or sinking fund depreciation methods for the depreciation of the asset as a potential way to accomplish this goal.

44. Several respondents observed that certain types of leases (e.g., many equipment leases) were more like financing transactions while other types of leases (e.g., leases of real estate) were fundamentally different. These respondents either questioned the implicit assertion in the ED that leases include a significant financing element or suggested that a dual model approach was appropriate

(suggesting either the continuation of the operating lease accounting model or a model which reflects leases on balance sheet but has an expense recognition pattern consistent with current operating lease accounting).

45. Many respondents also observed that the acceleration of expense recognition was further magnified by lower thresholds for inclusion of extension options and inclusion of contingent rent.

PwC observation: We agree that if the “right-of-use” model is adopted, a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments.

However, the application of the proposal in the ED might reduce the income statement’s usefulness to many users. We understand that some users may therefore continue to make adjustments to reported amounts. We acknowledge that the proposals in the ED will result in front-loading of expenses and that some users may continue to adjust the reported numbers as a result.

Purchase options

46. The ED proposes that a contract be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised. Many respondents indicated that purchase options should be considered as part of the lease model. Some of these respondents believe that in essence purchase options represent a way for the lessee to “control” the underlying asset on a long-term basis

similar to how many utilize extension options as a “right to negotiate.” Some respondents indicated that to exclude purchase options would invite structuring opportunities.

PwC observation: We believe that purchase options should be accounted for in a similar fashion to extension options. If purchase options are considered prior to exercise, application guidance should be provided.

Multiple-element contracts, executory costs and service arrangements

47. Many respondents raised concerns that more guidance was needed with respect to how to evaluate whether there was an embedded lease and how to allocate amounts among multiple elements in an arrangement, when appropriate. These respondents have observed that, while some of these issues exist today, the accounting implications have not been substantial if the lease element was classified as an operating lease. This assertion is based on the observation that there are no balance sheet ramifications and the profit and loss recognition pattern for the lease element and the service element are often the same under the current guidance. In fact, because of the limited impact to the financial statements, if any lease identified would be an operating lease, many preparers today would ignore a potential embedded lease and not account for it as a separate element. Under the proposed model, the accounting implications of an embedded lease

would likely be greater and therefore, the identification and accounting for leases in a multiple-element arrangement would take on substantially greater significance.

48. Many respondents raised concerns about how service and executory costs should be evaluated in specific fact patterns, particularly in leases of real estate. It is unclear if common real estate service/executory costs would meet the “distinct service” definition contained in the ED (originally from the revenue recognition exposure draft). For example, it would be difficult to conclude that real estate tax reimbursement, or payments made by a tenant in a multi-tenant building for a pro rata portion of landscaping or snow removal meet the definition of a distinct service. In addition, items that might meet the definition of a distinct service might be combined with those that do not meet the definition. For example, rents may change based on increases or decreases in a pool of real estate costs; increases in the cost of some individual services may be offset by decreases in others. In this case, the costs related to services that are not distinct could be considered to make the whole pool of costs non-distinct.

49. Notwithstanding that these service and executory costs may not meet the definition contained in the exposure draft, most respondents believe that they should be excluded from the lease asset and obligation, because including these costs would not put leasing on parity with owning the asset. For example, when purchasing a real estate asset outright, an entity does not capitalize the present value of expected future operating costs

such as real estate taxes. Accordingly, these respondents believe these costs should also not be capitalized under lease accounting.

50. Respondents expressed similar views related to services provided in connection with equipment leases. Many respondents believe that a service that is provided over time should be separated from the use of the asset and not capitalized in the asset’s cost. They believe that the value of most services can be estimated, and they should be excluded from the measurement of the asset. They do not believe such services should have to meet the definition of distinct services included in the ED.

PwC observation: We believe that more discussion and guidance on how to separate service elements from the lease contract amounts should be provided in a final standard.

We also believe the boards should either change the model or clarify that executory/common operating costs are also considered distinct for purposes of applying the proposed standard. We believe this is consistent with the boards’ view that leasing is a form of financing.

Reassessment

51. Many respondents raised concerns regarding the reassessment requirements, not only with respect to the administrative burden and cost but also because of the volatility created when changes in estimates occur. Some lessors are also concerned with the feasibility of reassessing

individual leases and suggested lease assumptions only be reassessed if there is an expected significant change in the cash flows of a portfolio of leases.

PwC observation: We agree that there should be reassessment of estimates of both lease term and contingent payments. We agree with the boards' assessment in the basis of conclusion that users of financial statements receive more relevant information when entities reassess the lease term at each reporting date because reassessment reflects current market conditions and not reassessing could lead to misleading results. However, we observe that the lower the threshold ultimately selected by the boards for inclusion in the lease term of periods covered by renewal options, the greater the complexity of the reassessment, resulting in more frequent revisions and more volatility. We believe our proposal for including only those lease extension options that are virtually certain to be exercised still meets the aim of providing relevant and current information while minimizing the cost and complexity for preparers.

We do not believe the proposal to require reassessment where there has been a "significant change" in each leased asset is useful. Given the level of judgment involved in assessing what is significant, we propose, similar to impairment analysis, that the requirement should be supplemented by a

presumption that reassessment should occur based on certain triggering or reconsideration events and, at a minimum, on an annual basis. This will help reduce the risk that changes are recorded in an incorrect accounting period.

Additional guidance requested

52. Many respondents indicated that they believe additional guidance should be provided prior to issuance of a final standard in many areas which had either not been addressed at all or additional clarification was needed. These areas included:

- Discount rates/incremental borrowing rates to be used (100% financing option may not exist in the market nor be consistent with how a lessee would finance asset acquisitions)
- Fair market value cap on right-of-use asset
- Foreign currency/exchange accounting and whether the lease obligation should be treated as a monetary obligation under ASC 830
- Subleases guidance (especially if lessor accounting is deferred or modified)
- Change in obligation value due solely to the passage of time between lease inception and commencement
- Lease modifications/terminations
- Lease incentives (including "key money" and free rent periods)

- Sale leasebacks and other derecognition and leaseback transactions (e.g., lease-in-lease-out or "spin-off" leasebacks)
- Interaction with impairment guidance
- Interaction with leasehold improvements
- Treatment of asset retirement obligations pursuant to a lease
- Build-to-suit leases
- Intercompany leases and other lease transactions within a consolidated group

53. Many respondents asked that the final standard provide more examples and practical application guidance.

54. Many respondents raised concerns over the lack of exposure of required consequential amendments to other existing guidance, including guidance related to investment property and business combinations.

PwC observation: We observe that many of these issues were either not addressed or insufficiently addressed in the ED. We believe some of these issues are pervasive and significant and should be fully addressed in the final standard so that the new standard can be adopted in a consistent and objective manner across a wide range of affected industries.

Transition

55. Many respondents indicated a "simplified retrospective" approach

to transition was a cost-effective adoption approach for many affected parties. Many also believe that companies should be permitted to apply a full retrospective approach if desired.

56. Some respondents observed that some of the “front-end loaded” expense recognition pattern in the ED is mitigated over a portfolio of leases in different stages of their lease life. However, they also observed that for lessees that enter into a significant number of leases, the simplified retrospective approach effectively treats the lease portfolio at the initial date of application as if the entire portfolio were new leases at that date. Therefore, the entire portfolio of leases would have a higher level of expense as compared to the impact resulting from the long-term application of the standard. These respondents observe that for lease portfolios with a longer average lease life, the number of periods until “normalization” occurs may be extreme. These respondents believe that full retrospective transition should be allowed for those parties that are willing to undertake the additional cost and effort to do so.

57. Some respondents suggested that there be grandfathering of existing leases or only prospective application.

58. Many respondents agreed with the boards that a separate accounting model for leveraged leases should not be provided. These respondents observed that there is no similar model under IFRS today and that most other areas of accounting do not allow for netting of obligations and assets, or including tax characteristics

in the pre-tax lease accounting. Some respondents expressed the opposing view that the leveraged lease accounting model is a much more accurate depiction of the real economics of these transactions, which are fundamentally dependent on both the leverage and tax characteristics. These same respondents believe that even if leveraged lease accounting were to be eliminated, existing arrangements should be grandfathered.

59. The ED also precludes early adoption. Some respondents indicated early adoption should be permitted.

60. Many respondents requested additional transitional guidance prior to issuance of a final standard including:

- Adoption guidelines on how “hindsight” should be factored into making estimates of lease term and contingent payments
- Treatment of previously deferred gains on sale-leaseback transactions
- Application of additional rules on historical sale leasebacks
- Practical issues arising upon the elimination of leveraged lease accounting
- Potential elimination of US grandfathering by EITF 01-8 for transactions entered into before an entity’s next reporting period beginning after May 28, 2003 (the original transition date of EITF 01-8) and not subsequently modified¹

¹ The equivalent IFRS standard, IFRIC 4, did not permit grandfathering.

PwC observation: We agree that a simplified approach to transition is necessary. However, we do not believe the proposed simplified retrospective approach is as simplified as it should be, nor necessarily the best presentation in all cases.

While we believe that the simplified retrospective approach may be appropriate and cost effective for many, we do not believe that a full retrospective approach should be precluded, as it would represent a more faithful comparative presentation of the economics for those willing to undertake the exercise.

Because we believe that the new guidance would be an improvement in financial reporting by lessees, we believe that preparers should be allowed to adopt early if they wish.

Disclosure

61. The majority of respondents supported the overall disclosure objectives of requiring lessees and lessors to disclose quantitative and qualitative information that (i) identifies and explains the amounts recognized in the financial statements arising from leases and (ii) describes how leases may affect the amount, timing and uncertainty of future cash flows. Most respondents were also supportive of disclosures which explained key terms and assumptions used as well as a reconciliation of opening and closing amounts of lease assets and liabilities. However, many believe preparers should be allowed to exercise judgment in determining (i) the volume of disclosures considering

the significance of leasing transactions to the company and (ii) whether to separately present amounts related to leases on the face of the financial statements or within the footnotes.

62. Many respondents expressed a view that these disclosure requirements should be subject to judgment as to the appropriate level of disclosure, and that the new standard should not mandate burdensome disclosures that do not provide useful information.

63. Many respondents suggested that example disclosures would be useful.

PwC observation: We agree with the disclosure objectives outlined in the ED and believe that they could enhance the information provided to users compared to the current requirements. However, we observe that the list of qualitative and quantitative information required in the exposure draft is extensive and if it were made mandatory, without regard to the significance of the leases to a particular lessee or lessor, it could result in boilerplate disclosure of information that is not relevant or material to a user of the financial statements.

We believe it is important that the overarching requirement of disclosure be consistent with the boards' objective that an entity provides sufficient disclosure to allow a user to understand the amounts, timing and uncertainty of the cash flows arising from its lease portfolio.

Operationality and cost/benefit

64. Most respondents expressed concerns over both the operationality and cost/benefit relationship of the proposed new model for both lessees and lessors. Many of these concerns are driven by the significant judgments and estimates required by the proposed new lease standard with regard to both renewal options and contingent payments—both at inception and in subsequent reassessments. These respondents observe that for large portfolios of leases, these judgments and estimates can change significantly over time, resulting in significant adjustments, volatility, and reduced comparability.

65. Many respondents also observed that for lessees, both the operationality and the cost/benefit relationship would improve if certain suggested changes were made, most significantly raising the threshold for inclusion of option periods and the elimination of various types of contingent payments from the lease asset and obligation.

66. Many also observed that for lessors, the improvement of the new model over the current model (if any) does not warrant the extensive costs of implementing the new guidance likely to be incurred.

PwC observation: Many of our recommendations made to the boards (for example, how to treat extension options) would help to improve the operationality and cost/benefit relationship for lessee accounting.

We do not support the proposed hybrid model for lessors in the exposure draft, as it fails to meet users' needs and does not represent a significant enough improvement over the existing model to justify the costs of implementation.

Tax/regulatory implications

67. Many respondents requested that, given the potential implications of adopting the new model, outreach occur to various tax and regulatory authorities to mitigate unintended economic consequences. These include:

- Risk-based capital requirements for banks and other financial institutions
- Federal, state and international tax implications
- Government "cost-plus" contracts where rent expense may be recoverable, but amortization and interest expense may not
- Implications on independence rules for public accounting firms (these rules currently have certain exclusions for operating leases)

PwC observation: We believe all of these areas will need to be addressed in a timely fashion with appropriate parties as soon as practical and in any event prior to adoption of a final standard.

A new approach to lease accounting

Proposed rules would have far-reaching implications

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Appendix

Reprinted from:

Dataline 2010–38
September 16, 2010

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- On August 17, 2010, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly released exposure drafts of a proposed accounting model that would significantly change lease accounting.
- Under the proposed model, a lessee's rights and obligations under all leases—existing and new—would be recognized on its balance sheet. Lessors would report leases using either a performance-obligation approach or a derecognition approach.
- The proposal would require lessees and lessors to estimate the lease term and contingent payments at the beginning of the lease and subsequently re-assess the estimates throughout the lease term, entailing more effort than under existing standards.
- The proposed model would have significant business implications, including an impact on contract negotiations, key metrics, systems, and processes.
- The boards expect to issue final standards in 2011. The effective date, which has not yet been determined, could be as early as 2013.

The main details

1. As part of their global convergence process, the boards' objective of a new leasing standard is to ensure that assets and liabilities arising from lease contracts are recognized on the balance sheet.
2. This Dataline updates the discussion in Dataline 2010–09 to reflect the proposals in the FASB and IASB's exposure drafts, *Leases*, along with examples and our observations. The proposal will significantly change lease accounting. For lessees, the balance sheet will expand with the recognition of a right-of-use asset and lease obligation. In addition, straight-line rent expense will generally be replaced by amortization of the right-of-use asset and interest expense on the lease obligation. The interest expense will be front-end loaded, similar to mortgage amortization.
3. The proposal also would require both lessees and lessors to initially estimate and then reassess estimates of the lease term, contingent rent, and other cash flows as facts and circumstances change. As a result, significantly more effort will be required to account for leases both initially and on an on-going basis. Greater investment in (and reliance on) systems and processes would likely be needed to comply with the proposed model.
4. The exposure draft does not include any "grandfathering" of existing leases. Companies would need to assess and record all existing leases

under the proposed model, with the exception of certain “simple” capital leases, at the time of adoption and for comparable periods presented (see transition discussion). Because virtually all companies enter into lease arrangements, the impact of the proposed model will be pervasive. Therefore, companies should begin evaluating the impact the proposal will have on existing and proposed leases, continue to follow the project, and be prepared for implementation if the boards decide to adopt the proposal as a final standard.

5. The boards’ conclusions in the exposure draft are tentative and subject to change until a final standard is issued.

Scope

6. The boards have proposed that the scope of the leasing standard include leases of property, plant, and equipment and exclude leases of intangible assets. Similar to other standards, the proposed standard would not apply to immaterial items.

PwC observation: Although a single item might be immaterial, items of a similar nature might be material in the aggregate (i.e., one computer lease might be immaterial, but 10,000 computer leases might be material). For leases determined to be immaterial to the financial statements in the aggregate, companies may consider developing a policy similar to commonly used property and equipment capitalization policies.

7. The boards also propose to exclude from the scope (1) leases to explore for or use natural resources (such as minerals, oil, and natural gas); (2) leases of biological assets; and (3) leases of investment property measured at fair value under International Accounting Standard 40, *Investment Property* (IAS 40).

PwC observation: US GAAP does not currently have an investment property accounting model similar to IAS 40. However, at its July 14, 2010 meeting, the FASB tentatively decided to issue a proposed Accounting Standard Update (ASU) that would be similar to IAS 40. The FASB has indicated that the standard would *require* an investment property to be measured at fair value (fair value is currently optional under IAS 40). An “investment property” would be defined as real estate (including integral equipment) held by the owner, or held on a finance lease to earn rentals and/or capital appreciation. This would not include owner occupied property, property held for sale in the ordinary course of business (e.g., residential homes), or property constructed on behalf of third parties. An exposure draft on investment property could be issued as early as September 2010 with a comment period ending December 15, 2010. (This period would be concurrent with the comment period on the lease exposure draft). If a new investment property standard is completed, it is expected that the FASB would adopt it concurrently with adopting a final leasing standard.

Short-term leases and non-core assets

8. The boards considered excluding short-term leases and leases of non-core assets. Factors considered include the cost of applying the model, the difficulty in defining non-core assets, and the potential structuring opportunity that such an exclusion would create. They decided that excluding these leases would run counter to their objective of bringing the rights and obligations of all leases on the balance sheet.
9. Although the boards decided against a short-term lease exclusion, they did propose a simplified method for lessees to ease the burden of accounting for them. For leases with a maximum possible term (including all extension options) of twelve months or less, lessees could use a simplified lease accounting approach on a lease-by-lease basis. Under the simplified approach, the lessee would recognize a right-of-use asset and liability equal to the gross payments remaining on each lease. Payments for the lease would be recognized in the income statement over the lease term.

PwC observation: Because of the short duration of leases that would qualify for the simplified approach, the time value of money associated with those short-term leases would be ignored as a practical expedient. The exposure draft does not explicitly state how lease payments for short-term leases under the simplified approach would be reported in the income statement (e.g., as rent expense or amortization

expense). However, we expect that if the asset is being recorded and amortized, the amount included in the income statement would represent amortization expense. Any payments to the lessor would reduce the obligation.

10. Lessors may elect on a lease-by-lease basis not to recognize assets or liabilities arising from short-term leases. If this election is made, the lessor would continue to recognize the underlying asset in accordance with other existing guidance. Thus, if this option is elected, lessors with short-term leases would not need to recognize lease assets or liabilities or derecognize any portion of the underlying asset.

Arrangements containing both lease and service components

11. The scope also includes leases contained within other arrangements, such as service or supply contracts. Existing guidance on when such a contract conveys the right to control the use of the underlying asset is included in ASC 840-10-15 (which represents the codification of the guidance formerly included in EITF 01-8, *Determining Whether an Arrangement Contains a Lease*) and IFRIC 4, *Determining Whether an Arrangement Contains a Lease*. Similar guidance is included in the proposed standard. As a result, a right to control the use of an underlying asset would be considered an embedded lease and reflected on the lessee's balance sheet in accordance with the exposure draft. Unlike the limited grandfathering that

was provided in EITF 01-8, it appears that this requirement would apply to all existing embedded leases since the exposure draft does not provide for any grandfathering.

PwC observation: Under current guidance, the embedded leases within these arrangements are often classified as operating leases. Because the accounting for a service or supply arrangement and an operating lease is similar, separating the two components in practice has presented few issues. This will change when the embedded lease is brought onto the balance sheet under the right-of-use model. Accordingly, considerably more judgment in separating the components may be required than under current practice.

12. For lease contracts that contain both service and lease components, a determination of whether the service is considered distinct would be required. Total payments under the arrangement would be allocated between distinct service and lease components using the same principle proposed in the recently issued exposure draft, *Revenue from Contracts with Customers*. If services are not considered distinct or if total payments cannot be allocated among the service and lease component, the entire arrangement would be accounted for as a lease. The proposal reflects the FASB's tentative decisions in the revenue recognition project that a service would be distinct if either (a) the entity, or another entity, sells an identical or similar service separately or (b) the entity could sell the service

separately because it has a distinct function and a distinct profit margin.

PwC observation: The definition of distinct service components may present difficulties for lessees to separate executory costs/services from the lease component. If not considered distinct, certain components considered to be executory costs or service components (e.g., common area maintenance, common area utilities, security, insurance and property taxes) would be included in the amounts recorded on the balance sheet. This would differ from the accounting treatment if the asset were owned, making it a major issue for many lessees of real estate where the leases are significant to the company.

In-substance sales and purchases

13. The boards recognize that some contracts may be leases in legal form but are, in substance, sales contracts under which the lessor has ceded control of the underlying leased asset to the lessee. Contracts would be considered a purchase or sale if, at the end of the contract, an entity transfers control of the asset and no more than a trivial amount of the risks and benefits are retained. Indicators of a transfer of control include contracts that automatically transfer title at the end of the lease term and contracts that have a bargain purchase option that is reasonably certain to be exercised.

PwC observation: Agreements meeting these conditions would be

considered a sale and a purchase rather than a lease and therefore would not be in the scope of the proposed standard. The determination would be made at the inception of the contract and would not be revisited. For lessors, if the contract is considered a sale, the transaction would follow the revenue recognition guidance under the proposed revenue exposure draft. See Dataline 2010–28, *Revenue Recognition...Full Speed Ahead*.

Lessee accounting

The basic model

14. The boards have proposed a right-of-use model for lessee accounting. This model requires the lessee to recognize at the commencement of the lease an asset representing its right to use the leased item for the lease term and a corresponding liability for the obligation to pay rentals. Under this approach, all leases not considered to be purchases would be accounted for in a similar manner; the classifications of capital and operating leases used today would be eliminated.
15. The boards believe that the right-of-use model is consistent with their conceptual frameworks and increases the transparency of lease accounting. Because leases are commonly viewed as a form of financing, the obligations recognized on the balance sheet under the right-of-use model would be consistent with how businesses reflect other financing arrangements.

PwC observation: The right-of-use model might cause companies to

change how they negotiate leases. It may also affect lease-versus-buy decisions. However, we believe leasing will continue for a variety of business reasons. Leasing provides more operational flexibility than outright ownership; certain leasing structures are more tax efficient than direct ownership; and leasing often provides effective financing to companies whose financing options are otherwise limited. In addition, for large-ticket items, such as real estate, leasing is expected to continue as a viable option because many companies prefer not to own these types of assets in order to maintain operating flexibility or the specific asset may only be available through leasing (e.g., a specific retail location).

Initial measurement

16. Lessees would initially measure the obligation to pay rentals at “cost.” Cost is defined as the present value of the lease payments. The right-of-use asset would be measured at the amount of the lease obligation plus any initial direct costs incurred by the lessee. The boards have defined initial direct costs as incremental costs directly attributable to negotiating and arranging a lease. For example, initial direct costs may include commissions, legal fees, negotiating lease terms, preparing and processing lease documents, closing the transaction and other internal costs that are incremental and directly attributable to negotiating and arranging the lease.
17. Present values would be determined using the lessee’s incremental

borrowing rate as the discount rate at the date of inception of the lease. If the rate the lessor is charging in the lease is readily determinable, this rate can be used in lieu of the incremental borrowing rate.

PwC observation: Lessees would not be obligated to seek out the rate the lessor is charging in the lease and most often will not be able to identify that rate. The rate the lessor is charging is more likely to be identifiable in equipment leases, particularly when the equipment also may be purchased outright. For other types of leases, including real estate leases with rents based on cost per square foot, the lessee rarely knows the rate the lessor is charging because it is typically not relevant to negotiations. Nonetheless, the boards have proposed to grant lessees the option to use the rate the lessor is charging, if known. They did so because in certain circumstances it may be more cost effective for the lessee to use the rate the lessor is charging in the lease rather than determine its incremental borrowing rate.

The boards proposed that measurement of the lease occur at lease inception (i.e., the earlier of the date of the lease agreement or the date of commitment). However, the asset and corresponding liability are not recorded until the commencement date of the lease (the date on which the lessor makes the leased asset available). The exposure draft does not address the accounting for the change in present value

of the obligation when a significant amount of time passes between lease inception and lease commencement. We believe that the asset and liability should be adjusted at commencement to eliminate this differential.

Subsequent measurement

18. The boards proposed that the right-of-use asset should be subsequently measured at amortized cost. The expense recorded would be presented as amortization expense rather than rent expense. The lessee's obligation to pay rentals would be subsequently measured at amortized cost using the effective interest rate method under which payments would be allocated between principal and interest over the lease term. Interest expense determined under that method would be higher in the early years of a lease compared to the current straight-line treatment for rent expense under an operating lease. (See example in paragraph 27).

PwC observation: These changes will affect balance sheet ratios and income statement metrics. EBITDA (earnings before interest, taxes, depreciation, and amortization) would increase, perhaps dramatically, with the absence of rent expense. The changes in metrics may also affect loan covenants, credit ratings, and other external measures of financial strength. Internal measures used for budgeting, incentive and compensation plans, and other financial decisions may similarly be affected.

Lease term

19. Under existing standards, optional periods are considered part of the lease term if the lessee concludes at lease inception that it is "reasonably assured" (ASC 840, *Leases*) or "reasonably certain" (IAS 17, *Leases*) of exercising the option to renew the lease for the additional periods. Under the right-of-use model, lessees would be required to estimate the ultimate expected lease term and periodically reassess that estimate. A detailed examination of every lease at each reporting date would not be required. A lease's term would be re-examined if facts and circumstances indicate that there would be a significant change in the liability since the previous reporting period.
20. The lease term is defined as the longest possible term more likely than not to occur. In estimating the lease term, all relevant factors should be considered, including contractual, non-contractual, and business factors, as well as intentions and past practices. For example, consider a lease with a non-cancellable five-year term and two five-year renewal options. Clearly, the minimum contractual term of five years is more likely than not to occur. (The probability is 100 percent that the lease will cover at least the initial five-year period). The lessee would also need to consider whether the ten or fifteen-year terms available as a result of the renewal options are more likely than not to occur. Once the lessee has determined which lease terms are more likely than not to occur, the longest of those terms would be the lease term used to account for the lease.

Purchase options

21. The boards proposed that purchase options not be accounted for in the same manner as options to extend a lease. Instead, purchase options would be recognized only upon exercise. At that time, the exercise of a purchase option would result in the lessee recognizing the underlying asset.

PwC observation: This decision reflects the boards' view that a purchase option goes beyond conveying the right to use an asset for a specified period and, therefore, the purchase should be accounted for separately.

Contingent cash flows

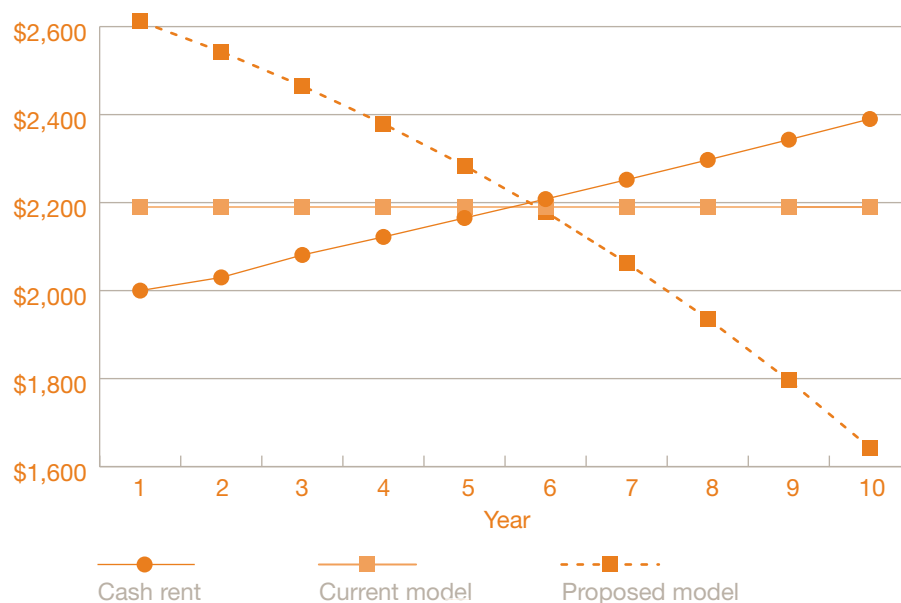
22. Under existing standards, contingent rentals generally are recognized as expenses in the period incurred. The right-of-use model would require that the initial measurement of the obligation to pay rentals include contingent cash flows, such as "percentage rents," increases in rents based on changes in an index (such as CPI), and residual value guarantees.
23. The boards proposed to use an expected outcome technique for measuring contingent cash flows with the clarification that a lessee does not have to consider every possible scenario. This technique requires the calculation of a probability-weighted average of the cash flows for a reasonable number of outcomes. Many respondents to the boards' March 2009 discussion paper on leases disagreed with the inclusion of lease renewal options and contingent

rentals in measuring the right-of-use asset and lease liability. They argued that options and contingent payments are not the same as a commitment and therefore do not meet the definition of a liability. In the Basis for Conclusions that accompanies the exposure draft, the boards set forth their belief that contingent rentals and renewal options meet the definition of a liability. The boards indicated that not reflecting contingent rentals and options in the measurement of the lease obligation would result in the non-recognition of payments due the lessor and could result in structuring opportunities to avoid recognizing an obligation.

Changes in estimates and remeasurements

24. The boards proposed that lessees would be required to reassess estimates of lease term and contingent cash flows as warranted by changes in facts and circumstances. Subsequent measurement of the lease obligation would reflect all such changes in estimate. Changes in the lessee's obligation due to a reassessment of the lease term would be recognized through an adjustment of the right-of-use asset.
25. The boards have proposed a mixed model to account for changes in estimated contingent cash flows. Where changes in amounts payable under contingent cash flow arrangements are based on current or prior period events or activities, those changes should be recognized in profit or loss. All other changes would be recognized as an adjustment to the lessee's right-of-use asset. For

Exhibit 1: Comparison of the proposed model, current model and cash payments



example, consider a lessee that enters into a ten-year lease agreement that includes rental payments based on a percentage of sales. During the second year of the lease, the lessee determines that the original estimated sales figures require updating. Adjustments in the obligation arising from modifying sales for years one and two would be recognized in profit and loss. Changes in the obligation from the updated forecast in sales in years three through ten would be recognized as an adjustment to the right-of-use asset.

26. The boards considered whether the discount rate should be updated when a remeasurement is required due to a change in estimated term or contingent cash flows, but decided the original discount rate should be used throughout the lease term. The only exception would be a lease with rentals contingent on variable reference interest rates; for all other leases, the accounting would be consistent with that of a fixed-rate borrowing.

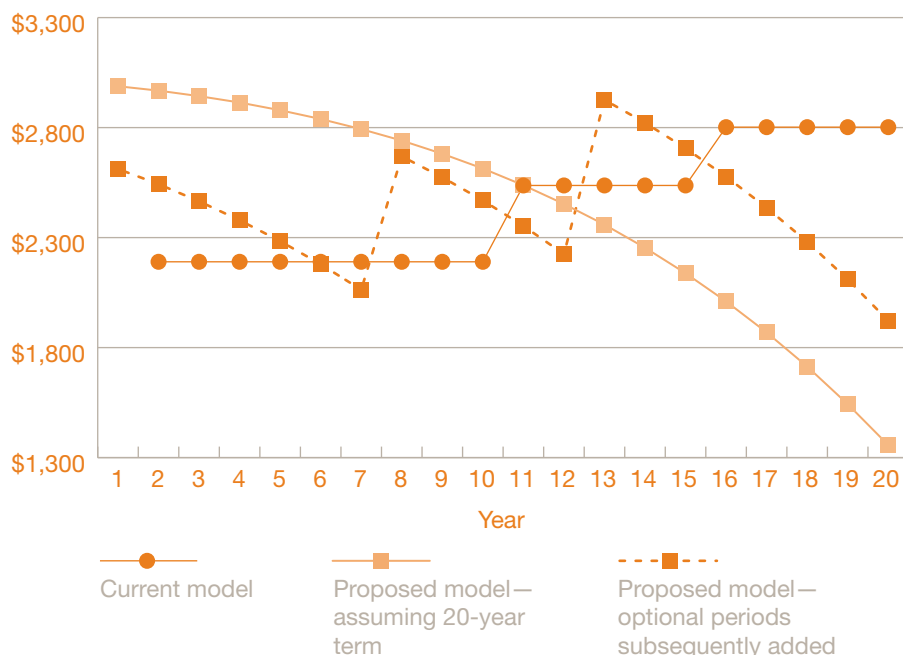
PwC observation: The requirement to reassess these estimates entails significant incremental effort compared to the current model,

under which lease accounting is set at inception and revisited only if there is a modification or extension of the lease. In addition, it may be necessary to invest in information systems that capture and catalog relevant information and support reassessing lease terms and payment estimates as facts and circumstances change.

Lessee example

27. Exhibit 1 illustrates the effect of the proposed standard on expense recognition for a fixed 10-year lease with rental payments that increase 2% per year (see also example 1 in the appendix). The current accounting model reflects rent expense for operating leases on a straight-line basis over the non-cancellable lease term. Historically, critics of today's model have observed that this was sufficiently divergent with the cash due under the contract and does not reflect economic reality. The new approach diverges even further from the cash due under the contract.
28. Under the proposed model, rent expense would be replaced with interest and amortization expense.

Exhibit 2: Comparison of timing recognition of optional renewal periods



The expense will be front-end loaded with more expense recognized in the beginning of the lease term and less at the end—similar to a mortgage. For a lease that includes escalating rents, the cash payments will be directionally the inverse of what the expense will be—lower in the earlier years and higher in the later years.

29. When a lease contains optional periods or contingent payments, additional volatility may be introduced into the income statement, as the lessee would be required to revisit the original estimates of lease term and contingent rentals as facts and circumstances change. Using the same lease example as paragraph 27, Exhibit 2 assumes there are two optional five-year renewal periods. The rents during the option periods continue the same pattern, escalating 2% per annum.

30. Exhibit 2 depicts the expense recognition pattern in the following scenarios:

- **The current leasing model** (assuming the exercise of the options was not reasonably assured at lease inception)—the current model has a “stair step” type recognition pattern for each non-cancellable term.

- **The proposed model**—assuming management determined at inception that the longest lease term more likely than not to occur was 20 years—results in increased expense at the front-end of the lease that declines over the lease term.

- **The proposed model**—assuming management initially estimated the longest lease term was 10 years. In year 7, management determined that a 15-year term was likely. Finally, in year 12, management concluded that the estimated lease term was 20 years—this results in a “saw tooth” recognition pattern, thereby adding increased volatility to the income statement.

31. The proposed model does not provide a discretionary choice regarding the pattern of expense recognition. The decision regarding inclusion of optional periods in the lease term will depend upon the likelihood of exercising the options throughout the lease term. Management should consider all relevant factors in initially determining the lease term and contingent payments and reassess these factors as facts and circumstances change.

Lessor accounting The basic models

- 32.** The boards proposed to use a dual model for lessor accounting. Depending on the economic characteristics of the lease, a lessor would apply either a performance obligation approach or a derecognition approach.
- 33.** The performance obligation approach would be used for leases in which the lessor retains exposure to significant risks or benefits associated with the leased asset either during the term or subsequent to the term of the contract. If significant exposure is not retained by the lessor, the derecognition approach would be followed.
- 34.** Retaining exposure to the risks or benefits of the leased asset at the end of the term could include either having the expectation or ability to generate significant returns by re-leasing the asset or by selling it. A determination of which approach to use would be made at lease inception and not revisited, absent a lease modification.
- 35.** To determine whether the risks and benefits associated with an underlying asset are retained during the term, lessors would consider (a) the significance of contingent rentals during the expected lease term based on performance or use of the underlying asset, (b) options to extend or terminate the lease, or (c) material non-distinct services provided in the lease contract. For this assessment, credit risk of the lessee during the expected lease term would not be considered.

36. Under the performance obligation approach, the underlying leased asset would continue to be accounted for as an economic resource of the lessor and remain on the lessor's balance sheet. The lessor recognizes a lease receivable, representing the right to receive rental payments from the lessee, with a corresponding performance obligation, representing the obligation to permit the lessee to use the leased asset. The performance obligation is satisfied (and revenue recognized) over the lease term. See example 2 in the appendix for an illustration of the accounting under the performance obligation approach.

37. The derecognition approach assumes that the lessor has performed by delivering the leased asset and providing an unconditional right to use it over the lease term. Consequently, the lessor recognizes a receivable representing the right to receive rental payments from the lessee and records revenue. In addition, a portion of the carrying value of the leased asset is viewed as having transferred to the lessee and is derecognized and recorded as cost of sales. See example 3 in the appendix for an illustration of the accounting under the derecognition approach.

PwC observation: The boards recognize that the dual model they are proposing is somewhat similar to existing lessor accounting. Originally, the boards desired a single lessor model, but they realized that this was the only principles-based alternative as

certain fact patterns could only be addressed through a dual model. For example, board members who expressed general support for the derecognition approach were concerned about applying the approach to short-term leases of long-lived assets or multi-tenant real estate leases. At the same time, some board members who expressed general support for the performance obligation approach were concerned about the balance sheet gross-up in that approach. Others supported up-front recognition of manufacturer and dealer profit.

Symmetrical treatment

38. Where possible, the boards aim to have symmetrical accounting for the lessee and the lessor in a lease arrangement. This section describes areas where the boards proposed asymmetrical provisions.

Initial measurement

39. The lessor's lease receivable would be measured similarly to the lessee's obligation, except that the lessor would be required to use the rate the lessor is charging in the lease as the discount rate.

PwC observation: In certain operating lease transactions today, the lessor does not calculate an implicit rate for the lease. For example, in leases of real estate the rent is based largely upon the market rental rates at inception of

the lease rather than the return on investment or lessee credit risk. The proposal would require lessors to calculate a rate of interest, which will entail incremental effort over the current model.

40. Under the performance obligation approach, the lease receivable and a performance obligation are recognized. Under the derecognition approach, entries would be made to recognize revenue and the lease receivable and partially derecognize an allocated amount of the leased asset and record cost of sales for the portion of the asset considered to be sold. The amount derecognized would be based on the relationship between the fair value of the receivable from the lessee and the fair value of the underlying asset. The exposure draft provides guidance on determining the derecognized portion of the underlying asset and the amount retained as the initial carrying value of the residual asset. The amount derecognized by the lessor is calculated as the carrying amount of the underlying asset, multiplied by the fair value of the right to receive lease payments, and divided by the fair value of the underlying asset. The derecognized amount is determined at inception of the lease.

Subsequent measurement

41. Subsequent measurement of the lessor's receivable would be at amortized cost using the effective interest method, resulting in interest income.

42. The performance obligation would decrease as the lessor permits the lessee to use the leased item over the lease term. The performance obligation is satisfied and revenue is recognized in a systematic and rational manner based on the pattern of use of the underlying asset (i.e., over time, usage, or output).

43. Under the derecognition approach, the lessor would not remeasure the residual asset retained, except for impairment. The value of the residual asset would not be accreted over time.

PwC observation: Similar to the lessee impact, the right-of-use model would affect the timing of income statement recognition for lessors. For the performance obligation approach to lessor accounting, interest income under the effective interest method would be higher in a lease's early years compared to the current straight-line recognition of an operating lease's rental income. For lessors using the derecognition approach, the cost of goods sold would likely be different than under current sales type leases, thereby affecting the margin recorded at lease commencement. Further, lessors who have sales type leases under current standards may not qualify for the derecognition approach under the proposal, which would result in lease income recognized over the term of the lease rather than at commencement of the lease. In addition, some sales-type leases may meet the definition of a sale rather than a lease and would

be excluded from the scope of the lease standard.

Lessor consideration of lease term

44. The boards proposed that accounting by lessors for optional renewal periods would generally be symmetrical with the accounting by lessees for those options. However, the boards acknowledged that, in the same lease transaction, the objective of symmetry might not result in the lessee and lessor determining the same lease term since there could be different judgments made based on different perspectives and different information. The lessee normally has sole control over the decision to extend and more information about the factors that go into that decision. A lessor might not have insight into the business plans and intentions of the lessee and, therefore, may have less insight into whether the lessee will exercise renewal options. Nonetheless, a lessor is required to estimate the renewal options that the lessee will exercise and revisit the estimate if facts or circumstances indicate that there would be a significant change in the right to receive lease payments.

Contingent cash flows

45. Similar to lessees, lessors would be required to recognize a receivable for contingent rentals and residual value guarantees, but only if the receivable could be reliably measured. This is consistent with the boards' current

view in their exposure draft on revenue wherein contingent revenue would be recognized only if the amount can be measured reliably.

Changes in estimate and remeasurement

46. Under the performance obligation approach, changes in the lessor's lease receivable resulting from a reassessment of the lease term would be recognized as an adjustment to the performance obligation. In the case of contingent cash flows, changes would be recognized in revenue if the performance obligation has already been satisfied. When the performance obligation has yet to be satisfied, changes would be recognized as an adjustment to the performance obligation.

47. The derecognition approach differs from the performance obligation approach for changes in estimates. When a reassessment results in a change in term, the change in the lease receivable is allocated to the rights derecognized and the residual asset. For changes in contingent cash flows, changes in the lease receivable are adjusted through revenues.

Other topics

Sale and leaseback transactions

48. Some linked sale and leaseback transactions would be accounted for using sale-leaseback accounting while others would be accounted for as financings. The different accounting would

be based on whether the transaction meets the proposed leasing standard's criteria for an in-substance sale/purchase. As discussed previously, when the seller/lessee retains no more than a *trivial* amount of risks and benefits and control is transferred to the buyer/lessor at the end of the lease, the asset would be considered sold.

49. If the transaction qualifies as a sale, gains or losses would be recognized immediately. The boards have also proposed that, if the sale or leaseback is not established at fair value, then the asset, liability, and gain or loss would be adjusted to reflect current market rentals.
50. If the transaction does not qualify as a sale, it would be accounted for as a financing. The transferred asset would not be derecognized and any amounts received would be recognized as a liability.

PwC observation: This would be a significant change under US GAAP, which currently provides guidance for determining whether transactions involving real estate qualify for sale accounting (ASC 360-20) or sale-leaseback accounting (ASC 840-40). (The Exposure Draft is expected to replace ASC 840, *Leases*, including the guidance relating to ASC 840-40-55, *Criteria for Determining Whether the Lessee Should be Considered the Owner of the Asset Under Construction*.) Under the proposal, the determination of whether a sale and linked leaseback qualifies for sale treatment would be less cumbersome. However, for sales

and leasebacks of non-real estate assets, some transactions may qualify as a sale under current standards but not under the proposed model. If the transaction qualifies as a sale, any gain or loss would not need to be deferred under the proposal.

On the other hand, IAS 17 currently requires any gain in a sale-leaseback transaction to be deferred if the transaction results in a finance lease. If the sale was at fair value, any gain would be taken up front in a sale-leaseback transaction resulting in classification as an operating lease. The determination of operating versus finance lease is based upon whether the seller/lessee transfers substantially all of the risks and rewards incidental to ownership of the underlying asset. Under the proposal, more transactions likely will be treated as financings rather than sales due to the higher hurdle of retaining no more than trivial risks and benefits.

Subleases

51. As expected, the accounting for subleases builds on the lessee and lessor accounting models that the boards have proposed. When a leased asset is subleased, the sublessor would account for the head lease (i.e., the lease agreement between the original lessor and lessee) in accordance with the proposed right-of-use lessee model and, likewise, would account for the sublease under the appropriate proposed approach for lessor accounting.

52. Presentation of the assets and liabilities will differ depending on which of the two lessor models is followed. To avoid the “double gross-up” in the balance sheet that would otherwise result under the performance obligation model, the boards proposed that all assets and liabilities arising from both the head lease and sublease, except for the obligation to pay rentals to the head lessor, would be presented together at gross amounts in the balance sheet with a net subtotal. The obligation to the head lessor would be presented separately in liabilities. When the lessor approach is derecognition, however, all assets and liabilities arising under a sublease would be presented gross in the balance sheet.

Presentation and disclosure

53. For lessee accounting, the boards proposed that assets, liabilities, amortization, and interest related to leases would be presented in the financial statements based on the nature of the item. The boards also proposed that the amounts be broken out on the face of the financial statements. However, they asked respondents to comment on whether break-out in the footnotes may suffice. Cash payments on leases and interest expense arising from lease contracts will be presented as financing activities in the statement of cash flows, separately from other financing cash flows.
54. Under the performance obligation approach, lessors would present the

leased asset, the lease receivable, and the performance obligation gross in the balance sheet, totaling to a net lease asset or net lease liability. For lessors using the derecognition approach, the residual asset would be separately reported in the balance sheet within property, plant, and equipment.

55. The boards differed in their views about the presentation of income under the performance obligation approach. The FASB proposed that interest income, lease income, and depreciation expense be presented separately in the income statement, totaling to net lease income or expense. The IASB proposed that the amounts be presented separately, but does not believe that netting the amounts in the income statement is necessary.
56. Lessors would classify collection of the lease receivable and interest income arising from that receivable as operating activities in the statement of cash flows.
57. Due to the significantly expanded use of estimates and judgments in the proposed lease standard, disclosure requirements will go well beyond those required under current leasing standards. Quantitative and qualitative financial information that identifies and explains the amounts recognized in financial statements arising from lease contracts and a description of how leases may affect the amount, timing, and uncertainty of the entity's future cash flows would be required.
58. Specific disclosures required would include a description of the nature of an entity's leasing arrangements,

the existence and terms of optional renewal periods and contingent rentals, and information about assumptions and judgments. In addition, any restrictions imposed by lease arrangements, such as dividends, additional debt, and further leasing should also be disclosed.

59. The following disclosures would also be required:
 - Information about the principal terms of any lease that has not yet commenced if the lease creates significant rights and obligations
 - A reconciliation between the opening and closing balances of right-of-use assets and obligations to pay rentals, disaggregated by class of underlying asset
 - A narrative disclosure of significant assumptions and judgments relating to renewal options, contingent cash flows, and the discount rate used
 - A maturity analysis of the gross obligation to pay rentals showing (a) undiscounted cash flows on an annual basis for the first five years and a total of the amounts for the remaining years and (b) amounts attributable to the minimum amounts specified in the lease and the amounts recognized in the balance sheet
 - Additional disclosures would apply if (a) the simplified option for short-term leases is elected, (b) significant subleases exist, or (c) there is a sale-leaseback transaction

Transition and effective date

60. The proposed standard would be applied by lessees and lessors by recognizing assets and liabilities for all outstanding leases at the transition date.

PwC observation: The boards proposed that the new model be applied as of the date of initial application (the beginning of the earliest period presented). For example, if a company were to adopt the standard on January 1, 2014, and present two comparative years, it would be required to apply the provisions of the standard beginning January 1, 2012. All outstanding leases would be required to be recognized and measured on the date of initial application. As proposed, leases that expired before the adoption date but existed in the earlier periods would also be recast.

61. Lessees would measure the lease obligation at transition at the present value of the lease payments discounted using the lessee's incremental borrowing rate on the transition date. When lease payments are uneven over the term, the accrued or prepaid rent account (used under current standards to provide for straight-line rent expense) would be recharacterized to the right-of-use asset. Uneven lease payments could result from lease incentives, rent-free or reduced rental periods, or rent escalation clauses. Additionally, the right-of-use asset would be reviewed for impairment.

62. Under the performance obligation approach, lessors would measure the lease receivable and performance obligation using the rate the lessor is charging the lessee, determined at inception, as the discount rate. A lessor would reinstate previously derecognized leased assets at depreciated cost, adjusted as necessary for any impairment considerations.

63. Under the derecognition approach, lessors would measure the lease receivable at transition using the rate the lessor is charging the lessee, determined at inception of the lease. This is consistent with measurement under the performance obligation approach. The residual asset would be measured at fair value as of the transition date.

64. The boards have proposed an exception for “simple capital leases,” or leases currently classified by lessees as capital leases but do not include options, contingent rents, termination penalties, or residual value guarantees. Capital leases entered into prior to the transition date that meet this exception would continue to follow existing capital lease accounting standards.

65. This simplified transition approach reflects the reality that, for many long-term leases, the information needed to adopt the proposed standard retrospectively may no longer be available. The boards considered providing an option to adopt retrospectively, recognizing that the asset and obligation are equal only at inception, but rejected it in favor of a single transition approach.

PwC observation: The lack of grandfathering for existing leases will mean that extensive

data-gathering will be required to inventory all contracts and then, for each lease, a process to capture information about lease term, renewal options, and fixed and contingent payments. The information required under the proposed standard will typically exceed that needed under current GAAP. Depending on the number of leases, the inception dates, and the records available, gathering and analyzing the information could take considerable time and effort. Beginning the process early will ensure that implementation of the final standard is orderly and well controlled. Companies should also be cognizant of the proposed model when negotiating lease contracts between now and the effective date of a final standard.

66. The boards expect to issue a final standard in mid-2011. They have not discussed the effective date of the standard. Presumably, it would be no earlier 2013, with 2014 more likely. Given the potential impact of the proposed changes on accounting and operations, and the express purpose of the boards to ensure that assets and liabilities arising from lease contracts are recognized on the balance sheet, management should begin assessing the implications of the proposal on existing contracts and current business practices.

Timing for comments

67. Comments on the exposure draft are due by December 15, 2010. We encourage management to engage

in the comment letter process and suggest that entities respond formally to the questions included in the exposure draft.

Specific insights

68. Due to the broad range of assets currently being leased, the proposed standard may affect the leasing of certain assets differently than others. Supplements related to corporate real estate and equipment leases will be provided discussing some of the more significant implications to help readers of this Dataline identify and consider the implications of the proposed standard. Additional supplements may follow.

69. The supplements, examples, and related assessments will be based on the Exposure Draft, *Leasing*, which was issued on August 17, 2010. The provisions of the proposed standard are subject to change at any time until a final standard is issued. The examples included in the supplements reflect the potential affect of the proposed standard and any conclusions noted are subject to further interpretation and assessment based on the final standard.

70. We encourage management to read the topics discussed in the supplements and consider the potential effects that the proposed standard could have on their existing leasing practices and operations. The issues discussed in the supplements are intended to assist companies in formulating feedback to the boards that can help in the development of a high-quality final standard.

Appendix

Examples of revised financial statement format

71. The Appendix to this Dataline includes examples of the lessee and lessor balance sheet and income statement implications under the proposed model. The Appendix includes the following:

- Lessee simple example
- Lessor simple example—performance obligation approach
- Lessor simple example—derecognition approach

This Appendix includes the following examples:

- Example 1: Lessee simple example
- Example 2: Lessor simple example—performance obligation approach
- Example 3: Lessor simple example—derecognition approach

The following example of a real estate lease is provided to demonstrate how the lessee model would be applied in practice.

Example 1: Lessee simple example

The lease is for a 100,000 square foot building with a 10-year fixed term, an initial annual rent of \$20 per square foot (paid in equal monthly payments) with rent escalating by 2% per year. The lessee's incremental borrowing rate is 7%. The lease has no extension options, residual value guarantees, or contingent rent.

Balance sheet implications (in thousands)	Initial recognition	Year 1	Year 2
	Balance at end of year		
Right to use asset	\$15,540	\$13,986	\$12,432
Lease obligation	(15,540)	(14,598)	(13,547)

Income statement implications (in thousands)		Year 1	Year 2
Proposed model			
Amortization of right to use asset		\$1,554	\$1,554
Interest expense on lease obligation		1,058	989
Total expenses related to the lease	A	\$2,612	\$2,543
Current accounting model (straight line):	B	\$2,190	\$2,190
Difference—current period	A-B	\$422	\$353
Difference—cumulative		422	775
Cash (paid in monthly installments)		\$2,000	\$2,040
Cumulative cash		2,000	4,040

The present value of the cash flows of \$15.5M (calculated at a discount rate of 7%) would be recorded as the lease obligation and the right-to-use asset. The asset would then be amortized, most likely on a straight-line basis, while the obligation is decreased using the effective interest rate method. This results in a total expense of \$2.6M in the first year. This is \$612K higher than the cash rent and \$422K (approximately 20%) higher than expense under the straight-line method used today.

This example illustrates that over the lease term, the total amount of expense recognized would be the same under the proposed model as it is under the current operating lease model (straight-line expense recognition) and would be equal to the aggregate cash payments at the end of the lease term.

Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	
Balance at end of year								
\$10,878	\$9,324	\$7,770	\$6,216	\$4,662	\$3,108	\$1,554	\$-	
(12,377)	(11,079)	(9,644)	(8,061)	(6,318)	(4,403)	(2,302)	-	
Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
\$1,554	\$1,554	\$1,554	\$1,554	\$1,554	\$1,554	\$1,554	\$1,554	\$15,540
911	825	730	625	509	382	242	89	6,360
\$2,465	\$2,379	\$2,284	\$2,179	\$2,063	\$1,936	\$1,796	\$1,643	\$21,900
\$2,190	\$2,190	\$2,190	\$2,190	\$2,190	\$2,190	\$2,190	\$2,190	\$21,900
\$275	\$189	\$94	(\$11)	(\$127)	(\$254)	(\$394)	(\$547)	
1,050	1,239	1,333	1,322	1,195	941	547	-	
\$2,081	\$2,123	\$2,165	\$2,208	\$2,252	\$2,297	\$2,343	\$2,391	
6,121	8,244	10,409	12,617	14,869	17,166	19,509	21,900	

The following example of a real estate lease demonstrates how the performance obligation under lessor accounting would be applied in practice.

Example 2: Lessor simple example—performance obligation approach

The lease is for a 100,000 square foot building with a 10-year fixed term, an initial annual rent of \$25 per square foot (paid in equal monthly payments) with

rent escalating by 2% per year. The rate the lessor is charging the lessee is 7%. Of the initial \$25 per square foot amount, \$5 per square foot is estimated to cover common area maintenance charges, which is also expected to escalate at a rate of 2% per year. The lease has no residual value guarantees or contingent rent. The

Balance sheet implications (in thousands)	Initial recognition	Year 1	Year 2
	Balance at end of year		
Lease receivable	\$15,540	\$14,598	\$13,547
Underlying asset	20,000	19,500	19,000
Performance obligation	(\$15,540)	(\$13,986)	(\$12,432)

Income statement implications (in thousands)		Year 1	Year 2
Proposed model:			
Interest income on lease receivable		\$1,058	\$989
Lease income on performance obligation		1,554	1,554
Subtotal of lease revenue		2,612	2,543
Depreciation of underlying asset		(500)	(500)
Total net lease income	A	\$2,112	\$2,043
Current accounting model			
Lease income (straight line)		\$2,190	\$2,190
Depreciation of asset		(500)	(500)
Total net lease income	B	\$1,690	\$1,690
Difference—current period	A-B	\$422	\$353
Difference—cumulative		422	775
Cash (paid in monthly installments)		\$2,000	\$2,040
Cumulative cash		2,000	4,040

carrying value of the underlying asset at lease commencement is \$20M. The building has a remaining useful life of 40 years.

The present value of the cash flows of \$15.5M (calculated at a discount rate of

7%) would be recorded as the lease receivable and the performance obligation. The lease asset would then be decreased using the interest method, the performance obligation is decreased based on the pattern of use of the underlying asset, most likely on a straight-line basis, and the underlying

asset is depreciated on a straight-line basis using the remaining life of 40 years. This results in net lease income of \$2,112K in the first year. This is \$422K (20%) higher than lease income under the straight-line method used today.

Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Balance at end of year							
\$12,377	\$11,079	\$9,644	\$8,061	\$6,318	\$4,403	\$2,302	\$0
18,500	18,000	17,500	17,000	16,500	16,000	15,500	15,000
(\$10,878)	(\$9,324)	(\$7,770)	(\$6,216)	(\$4,662)	(\$3,108)	(\$1,554)	\$0

Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
\$911	\$825	\$730	\$625	\$509	\$382	\$242	\$89	\$6,360
1,554	1,554	1,554	1,554	1,554	1,554	1,554	1,554	15,540
2,465	2,379	2,284	2,179	2,063	1,936	1,796	1,643	21,900
(500)	(500)	(500)	(500)	(500)	(500)	(500)	(500)	(5,000)
\$1,965	\$1,879	\$1,784	\$1,679	\$1,563	\$1,436	\$1,296	\$1,143	\$16,900
\$2,190	\$2,190	\$2,190	\$2,190	\$2,190	\$2,190	\$2,190	\$2,190	\$21,900
(500)	(500)	(500)	(500)	(500)	(500)	(500)	(500)	(5,000)
\$1,690	\$1,690	\$1,690	\$1,690	\$1,690	\$1,690	\$1,690	\$1,690	\$16,900
\$275	\$189	\$94	(\$11)	(\$127)	(\$254)	(\$394)	(\$547)	
1,050	1,239	1,333	1,322	1,195	941	547	-	
\$2,081	\$2,123	\$2,165	\$2,208	\$2,252	\$2,297	\$2,343	\$2,391	
6,121	8,244	10,409	12,617	14,869	17,166	19,509	21,900	

The following example of an equipment lease demonstrates how the journal entries under the derecognition approach would be calculated for both equipment in inventory (carrying value is not equal to the fair value) and equipment whose carrying value is equal to the fair value.

Example 3: Lessor simple example—derecognition approach

The lease is for a piece of equipment with the following contract terms and assumptions:

Lease terms and assumptions		
	Carrying value not equal to fair value	Carrying value equals fair value
Fair value of asset	\$100,000	\$100,000
Cost of asset	\$60,000	\$100,000
Monthly lease payments	\$2,763	\$2,763
Lease term	3 Years	3 Years
Rate charged in the lease	6.00%	6.00%
Estimated residual value at lease end	\$11,000	\$11,000
No extension options, residual value guarantees, or contingent rent		

Based on the terms and assumptions, the lease receivable and corresponding lease revenue of \$90,823 is calculated by taking the present value of monthly cash payments of \$2,763 discounted at a 6% rate. The amount of the asset derecognized, and corresponding cost of goods sold, of \$54,494, and \$90,823

is calculated by taking the carrying value of the asset multiplied by the present value of lease payments and then divided by the fair value of the asset ($\$60,000 \times \$90,823 / \$100,000$) and ($\$100,000 \times \$90,823 / \$100,000$). Subsequently, the lease receivable would be decreased using the interest method.

The portion of the inventory balance not derecognized represents the residual asset. It would not be remeasured during the lease term, unless an impairment adjustment is necessary.

	Carrying value not equal to fair value		Carrying value equals fair value	
Journal entries at lease commencement:	Debit	Credit	Debit	Credit
Lease receivable	\$90,823		\$90,823	
Lease revenue/income		\$90,823		\$90,823
Lease expense	\$54,494		\$90,823	
Residual asset	\$5,506		\$9,177	
Underlying asset		\$60,000		\$100,000

The overhaul of lease accounting

Catalyst for change in corporate real estate

What's inside:

Overview

Executive summary

Preparing for the change

Appendix—Summary of the exposure draft

Reprinted from:

The overhaul of lease accounting:
Catalyst for change in corporate real estate
November 2010

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates, publication along with subsequent updates.

Overview

At a glance

- The International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) recently issued Exposure Drafts of a proposed accounting model that would significantly transform lease accounting.
- The model, if adopted as proposed, would affect almost every company, but is especially relevant to those that are significant users of real estate. Under the proposed model, a lessee's rights and obligations under all leases—existing and new—would be recognized on its balance sheet.
- The Boards expect to issue final standards in mid-2011. The effective date, which has not been determined, could be as early as 2013; however, it is more likely to be 2014 or 2015. Upon adoption of the new standard, prior comparative periods will be restated.

Executive summary

Proposed standard

1. An overview of the proposed lease accounting standard is as follows:
 - The proposal would eliminate off-balance sheet accounting for leases; essentially all assets currently leased under operating leases would be brought on balance sheet.
 - Income statement "geography" and timing of recognition would *significantly* change because straight-line rent expense would be replaced by interest expense (which would be greater in earlier years, like a mortgage) plus straight-line amortization of the leased asset, such that total expense would be front-end loaded.
 - Financial performance ratios may no longer be useful for their historical purposes, and other operating metrics may evolve as a result of adoption of the new standard.
- The new lease assets and liabilities would be recognized based on the present value of payments to be made over the term of the lease and would be carried at amortized cost.
- The lease term would include optional renewal periods that are "more likely than not" to be exercised; this is substantially different than today's model. Lease payments used to drive the initial value of the asset and liability would include "contingent" amounts, such as rent based on a percentage of a retailer's sales and rent increases linked to the Consumer Price Index (CPI), for example.
- Lease renewal periods and contingent rents would need to be continually reassessed and the related estimates trued up as facts and circumstances change—again, substantially different than today's model, which is largely "set it and forget it."

- The proposed lease accounting model would require significant systems and process changes at adoption date and maintenance on an ongoing basis.
 - Preexisting leases are not expected to be grandfathered.
2. At a minimum, compliance with the proposed standard may drive companies to consider significant upgrades, replacements, or overhauls of their legacy accounting systems, processes, and controls. Importantly, the proposed standard would also have a significant impact on a company's operating results, financial ratios, and potentially its debt covenants. The scale of adoption extends well beyond accounting, and many companies are already starting to plan for the coming changes.
 3. For most companies, real estate represents one of their most significant costs. Yet the existing corporate real estate function may have been designed to support a very different operational structure from what exists today or that was originally motivated by financing or tax considerations that no longer apply.
 4. For some companies, the proposed lease accounting standard represents just another compliance exercise, but it's one likely to entail significant cost and complexity that will need to be managed. Expected costs are likely to include education of all key stakeholders, robust systems upgrades, and implementation of new controls.
 5. For others, the compliance exercise will serve as a much-needed catalyst for change in their overall corporate real estate strategies. Because the

model if adopted will eliminate the off-balance sheet accounting for operating leases, it will also eliminate the perceived accounting advantages of leasing. Thus, the proposed standard, coupled with change from other current economic, tax, and business issues, may be an impetus to overhaul their real estate strategies. Changes to strategy may include lease-versus-buy decisions and structuring of lease terms and common provisions (e.g., fixed rent steps rather than contingent rent based on sales or CPI changes).

6. For many significant users of real estate (e.g., retail companies), managing investor and other user relations during the transition will be critical. The issuance of the Exposure Draft has created a significant buzz, and analysts and shareholders are likely to start raising questions about the potential impact. Traditional operating metrics such as EBITDA used as proxies for free cash flow may no longer be relevant and will likely need to be replaced. Longer term, the inherent volatility in the income statement and balance sheet will require thoughtful communication, in addition to significant changes in presentation and metrics.
7. Because no existing leases will be grandfathered at the time of adoption, companies entering into leases of any significant duration today should consider the implications of the new standard for these transactions in the future and potentially change their negotiation strategies. Many leasing strategies employed today inherently consider accounting biases around lease term, extension options, and

contingent rents that may no longer be beneficial under the new model.

8. A detailed summary of the key provisions of the proposed leasing standard, as well as a practical example, have been provided in the Appendix.

Significant impacts

9. The new model will have pervasive business and accounting impacts if adopted. For example:
 - **Expense recognition patterns will change.** Cash payments versus expense recognition will further diverge. Management judgments concerning renewal options and contingent rents may produce significant income statement volatility.
 - **All leases will generate a liability.** Analysts and credit agencies are underestimating the significance of the liability when adding back "debt-like" items for operating leases.
 - **Decision points and data needs will change.** Operating leases are dead. Structuring consideration will change to focus on liability and volatility reduction as opposed to obtaining operating lease treatment. Data needs for ongoing reporting will change significantly.
 - **Lease-versus-buy decisions should be revisited.** Possible complacency in lease-versus-buy decisions, based upon reliance on operating-lease treatment, should be addressed.
 - **Transition could be as early as 2013; however, it is more likely to be 2014 or 2015.** Industrywide

neglect of leasing software and systems may necessitate upgrades and enhancements, which will require a significant runway to adequately prepare for transition.

- **Asset recognition may change state tax liability.** Income apportionment among states may change, potentially attracting additional income to higher-tax jurisdictions. State capital and net worth taxes will increase as a result of an increasing balance sheet. Timing of sales and use tax payments may accelerate, and state property taxes may increase.

Opportunity

10. The last five years have seen a host of changes for corporate real estate organizations. From cost management to outsourcing, from systems changes to designing the workplace of the future, the role of the corporate real estate department has never been more complex. Nevertheless, the department's role as a strategic function within the enterprise has been overlooked. Simply put, many senior executives and boards of directors have not viewed their corporate real estate department as a material element in driving the success of the organization.
11. At best, corporate real estate departments are viewed as a necessary, but largely administrative, function or cost center that has little bearing on the overall success or failure of the company. However, if effectively addressed, corporate real estate can be a key or contributing driver in the success of many operations.

12. By some estimates, real estate leasing accounts for nearly two-thirds of all leasing activity (estimated at more than \$2 trillion) of US companies. As part of our discussions with client and industry representatives on the changes that may be coming with the new lease accounting standard, we are beginning to see senior executives at many companies target their corporate real estate strategy and operations for a major renovation and update. Their reasons for doing so are to prepare for the new GAAP requirements and to be more nimble in the current economic climate.

Preparing for the change

Some fundamental questions

13. As you assess your current corporate real estate strategy, a number of fundamental questions should be asked, such as:
 - Why does your company lease or own in particular situations?
 - What are the alternatives to leasing?
 - What are current market opportunities (e.g., lease rates/purchase prices), and how would they affect your real estate strategy?
 - How do federal, state, and local taxes factor into your corporate real estate decisions?
 - How does your company manage occupancy costs today?
 - What is the potential impact of the proposed lease model on your company?

- What changes will your company need to make to manage the process?
- Do your company's existing systems have the capabilities necessary to apply the proposed lease standard?

The 'stakeholders'

14. Corporate real estate activity affects a number of key functional areas. Any reconsideration of your approach should include, at a minimum, members of each of the following key constituencies:
 - Accounting/reporting
 - Treasury
 - Legal/regulatory
 - Operations
 - Tax planning and reporting
 - Information/systems
 - Human resources (e.g., impact on compensation agreements)
15. Each of these stakeholders will be impacted by the accounting standard if it is adopted. Accordingly, many companies that are significant users of real estate are creating a steering committee composed of individuals from each of these constituencies to help them consider the implications. A joint approach in the planning stages is vital to ensure unexpected implementation issues are identified early in the process.
16. Many companies quickly identify some of the more significant transition impacts, such as the change in financial reporting or the impact on debt covenants. However, other less obvious impacts also exist for

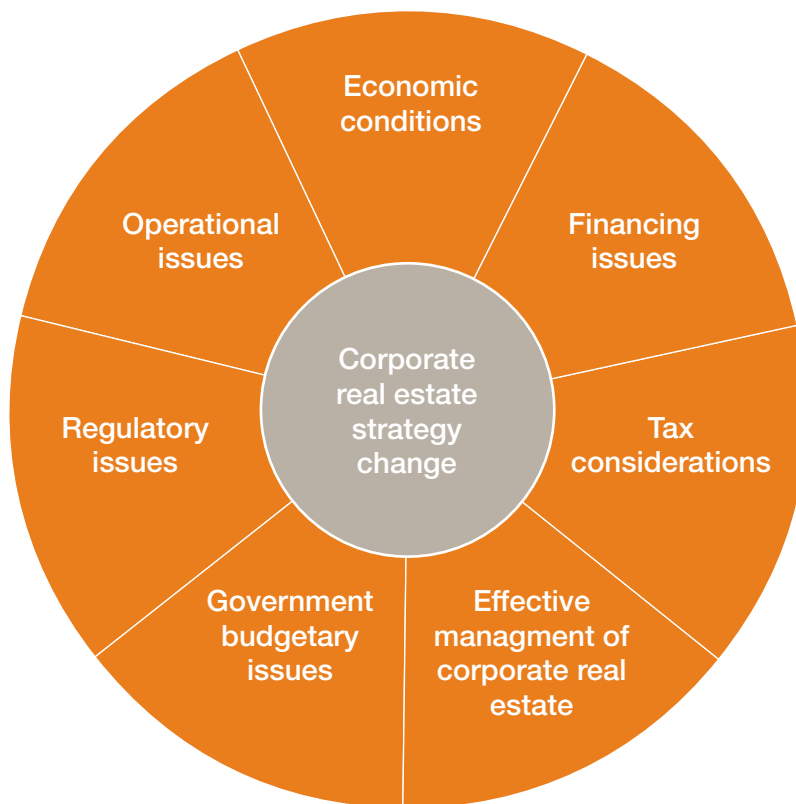
particular companies or industries. For example, recording significant additional assets may affect state tax payments, while changes to key metrics may alter incentive compensation payments or earnouts and perhaps even impact legal or regulatory capital. Additionally, the time and effort associated with executing leases will increase as both sides of the transaction negotiate to achieve the most desirable accounting impact. Accordingly, it is essential for companies to seek broad participation in the process of identifying and addressing the potential impacts of the proposed lease accounting standard.

Factors that impact corporate real estate strategy

17. The proposed standard will be the catalyst for companies to take a fresh look at factors that influence corporate real estate strategy. Many of these factors drive the decision to lease a particular asset versus buying it.

New considerations for corporate real estate strategy

- Reassess “lease-buy” decision criteria where buying is feasible
- Consider negotiation strategy around lease term—controlling space/economics versus accounting effect
- Consider pricing implications of option periods versus longer terms
- Consider common terms, and modify where appropriate—what is the “new normal”?



(e.g., eliminate certain contingent rent provisions)

- Evaluate regulatory impact including regulatory capital, cost plus contracts, etc.
- Evaluate tax impact including federal, state, local, and foreign taxes

18. Many companies are looking for a simple answer to the question “how should we change our real estate strategy?” Unfortunately, the answer is, “It depends.” As we will discuss further, the decisions around when and how to lease are affected by a large number of factors including need to control particular assets, operational flexibility, availability of alternatives, common industry practices, tax and regulatory impacts, and expectations of management. Careful consideration of the impacts and the company’s specific circumstances will be required. It is not a “one size fits all” evaluation for all companies or for different types of transactions. Rather, management should be armed with an understanding of the impacts of

the new model so it can create various strategies for major classes of transactions and then be able to apply those to specific situations as they arise.

Operational issues

19. A company’s need for corporate real estate is driven in large part by both its current and planned physical requirements. Space needs can change dramatically over time with such changes driven by a variety of factors including growth/contraction plans, potential acquisitions, productivity improvements, and physical obsolescence of space. Further, local demographics may change needs for particular locations. These issues vary significantly from company to company and by property type. The following examples help illustrate the diversity of potential issues based on a company’s operations:

Example 1—Retail company

A retail company typically requires several types of property for its

operations including (i) store locations, (ii) warehouse locations, and (iii) key corporate offices in central business districts.

Example 2—Bank

Banks normally maintain a variety of property locations for their operations including (i) bank branches, (ii) processing operations (often in fungible office space in suburban markets), and (iii) key corporate offices in central business districts.

- 20.** Generally, a company is more likely to lease real estate when its long-term property needs are unclear, operational flexibility is highly desirable, and expected access to acceptable alternatives is good. Leasing has also historically carried the added advantage of providing companies with a form of off-balance sheet financing.
- 21.** Conversely, a company is more likely to buy when the company's long-term property needs are clear, the need for specific properties is expected to be stable and long-term, specific assets are needed, and/or there are concerns with respect to the availability of acceptable alternatives.
- 22.** There are also many operational reasons why companies rent rather than own that may be unrelated to the accounting or even to the economics. One such reason frequently cited is that leasing allows tenants to avail themselves of professional property management. Does a bank, for example, want to maintain a staff of engineers, maintenance, or other personnel necessary to address the day-to-day issues surrounding management of real estate? In these circumstances, we may begin to see an expansion of service options that may allow incentivized property management to be done on a contract basis.
- 23.** Overriding operational considerations are often the impact of market practice or practical availability of property for purchase. Certain types of properties (e.g., retail store locations) may be unique and not generally available for purchase, whereas commercial office space may be more fungible and, in some cases, also more available for purchase.
- 24.** With the loss of off-balance sheet accounting, companies that presently lease may instead opt to own. Companies with low leverage and high credit ratings may have a substantially lower cost of capital that may create a capital arbitrage benefit.
- 25.** We have already begun to hear of increasing potential purchase transactions involving single-tenant office buildings. It is possible that the conversion of certain property types as condominiums may also increase as a result of the proposed lease model. However, this trend will be affected by “why” the companies are leasing, as discussed previously. It is also likely to vary significantly by property type. For example, this is more likely to occur in more physically static situations such as individual floors or blocks of floors in large office buildings or with single-tenant retail sites, both of which may be functionally independent. It is less likely to occur with partial floors or in malls/strip centers, which are not functionally independent and may frequently require reconfiguration of space to accommodate a different tenant mix.
- 26.** Today, in many cases, companies “outsource” their corporate real estate lease administration because commercial real estate service providers offer this service relatively inexpensively (to gain access to more lucrative transaction activity such as leasing commissions). Outsourcing may be more cost effective than doing such administration in-house. However, the additional information needed to account for leases under the proposed lease model (such as the expectation of exercising renewal options or projections of retail store sales and the impact of same on percentage rents to be paid) may be sensitive to the company's lease negotiating position. Companies may be hesitant to allow such interested parties to have the necessary access to the information to prepare the required accounting documentation.

Economic conditions

- 27.** Recent economic turmoil has significantly affected property values, and in many cases, market rents have declined dramatically. Vacancy rates in some property types and markets are rising—sometimes significantly, but not uniformly across markets. Further, many property owners are struggling with declining cash flow from operations, liquidity issues, and near-term debt maturities. As a consequence, landlords may be more willing to discuss asset sales and lease modifications—sometimes trading a lower rent in exchange for a longer lease (i.e., so-called “blend and extend” transactions).
- 28.** Accordingly, the current environment presents both potential challenges and

opportunities for users of corporate real estate. Current rents being paid pursuant to existing leases may be significantly above current “market” asking rents, and property owners will likely be resistant to changing current terms. In certain cases, opportunities to buy assets at favorable prices may exist, while in other cases, negotiating rent concessions currently or through “blend and extend” transactions may yield lower “all-in” occupancy costs. Although these market issues exist irrespective of the potential impact of the new lease accounting model, the impacts of the new lease accounting project are acting to focus a spotlight on these issues as companies consider the implications of the accounting proposals.

Financing issues

29. For many industries or individual companies, alternative financing options to leasing may be limited or too expensive. As a result, leasing, historically, may have been the only option available, or it may have been cheaper than other sources of financing available to the company. In many cases, this will not change irrespective of the accounting ramifications.
30. However, depending on the credit quality of the company, corporate real estate departments may now want to reconsider purchasing assets that were previously subject to a lease. When underwriting the amount and terms of a commercial mortgage to a property owner, lenders will consider factors such as debt yields, coverage ratios, loan-to-value, the length of lease terms, likelihood of renewal,

and credit quality of the tenant or tenants occupying the property. In some cases, the property owner cannot effectively fund property improvements necessary for the current operation of the property. A corporate real estate user may have a better credit profile and lower cost of capital compared with a particular property owner or the “average” credit in a pool of tenants at a site. If the user is committed to a longer-term use of the property, such user may benefit from obtaining financing using its own credit rating versus the landlord’s, which may be lower as a result of current market difficulties.

Tax considerations

31. The proposed standard would reduce the difference in the accounting effects of leasing versus owning an asset, and companies may be more inclined to purchase assets than lease them. As companies take a fresh look at future real estate investment decisions and model the proposed accounting standard for existing leases, they may reevaluate previous decisions or identify assets that no longer meet their needs. The proposed accounting standard is unlikely in and of itself to cause significant disposition of assets; however, a reexamination of the portfolio may result in asset disposition.
32. Federal and state tax considerations often played a significant role in many corporate real estate strategic decisions. A clear understanding of the tax motivations and implications for both counterparties in a transaction is critical as these factors may significantly affect the pricing as well as the range of transactions the parties may be willing to consider. In addition, the economic issues affecting either side of a transaction may have radically changed since the time when the decisions were made. A company with net operating loss carryovers may be more willing to undertake substantial restructuring to accelerate benefits or utilize the carryovers before they expire. One with expiring capital loss carryovers may be seeking opportunities to generate gains. Tax-sensitive or tax-oriented transactions by entities with significant owned real estate are generating more interest once again—including sale-leasebacks, joint ventures, spin-offs, and real estate investment trust (REIT) conversion transactions.
33. In most cases, federal taxes will remain unchanged. However, significant federal deferred tax adjustments may need to be tracked as the related book amounts change.
34. For state income tax purposes, business income of a company is apportioned among the states by means of an apportionment formula. For states that utilize a property factor in the apportionment formula, the proposed lease standard may affect the amount of business income apportioned to a state. In general, a property factor includes all real and tangible personal property owned or leased by the company and used during the tax period in the regular course of business. In most states, property owned by a taxpayer is valued at its original cost, and property leased by the taxpayer is valued typically at eight times its net annual rental rate. Certain states’ tax codes

provide that federal income tax rules apply when determining the property factor. Others, such as New Jersey, do not follow the federal income tax treatment and determine property factor values based on book value. Companies doing business in these states may have historically used financial statement rent expense when calculating the annual rental rate. In such instances, the proposed change in lease accounting may affect the calculation of the property factor.

35. Depending on the facts and circumstances of the company's specific portfolio, the impact could be an increase in state taxes if the relative allocation moves from lower-tax jurisdictions to higher ones. Of course, the reverse could also be true if the relative allocation moves from higher-tax jurisdictions to lower ones. Unfortunately, however, the states with higher rental rates (and therefore higher rental assets under the new model) also generally happen to be the states with higher taxes—thereby creating an expectation that in many cases a state tax increase will be the result of the change in apportionment. Accordingly, a detailed analysis to consider these state tax impacts using the company's fact pattern may be necessary to devise a plan to minimize their implications.
36. State franchise/net worth taxes may also be impacted by a change in the leasing standard. Certain states, such as Illinois, determine the value of a company for franchise tax purposes using generally accepted accounting principles (GAAP). In addition, this value may be apportioned to the state by use of a property factor, which is

also calculated under GAAP principles. As a result, net worth taxes in certain states may increase because of the increased value of property as reflected on the balance sheet.

37. There also may be other types of state and local tax issues associated with the proposed lease standard, such as sales tax or property tax consequences. Companies may need to evaluate the unique tax provisions found in each state and locality to determine the various consequences for their particular case under the proposed leasing standard.
38. Internationally, the proposed lease accounting model may have other impacts on the tax treatment of leasing transactions. In many jurisdictions outside the United States, tax accounting for leasing is often based on accounting used for book purposes. Given that there is no uniform leasing concept for tax purposes, the effect of the proposed lease accounting model will vary significantly, depending on the jurisdiction.
39. Items that may be impacted include the applicable depreciation rules, specific rules limiting the tax deductibility of interest (for example, thin capitalization rules and percentage of earnings before interest, taxes, depreciation, and amortization [EBITDA] rules), existing transfer pricing agreements, sales/indirect taxes, and existing leasing tax structures (in territory and cross-border). A reassessment of existing and proposed leasing structures should be performed to ensure continued tax benefits and management of tax risks.

40. Even where tax does not follow the proposed lease accounting model (as in the United States), management may see an increase in the challenges of managing and accounting for newly originated temporary differences impacting deferred taxes in the financial statements.
41. Timely assessment and management of the potential tax impact will help optimize the tax position by enabling entities to seek possible opportunities and/or reduce tax exposures.

Regulatory issues

42. In some cases, the decision to lease was driven by regulatory issues particular to certain industries. For example, reimbursement rates paid on some government contracts are based on GAAP reporting. Today, for some contracts, the government will reimburse 100% of the cost of rent but does not reimburse for capital-related items such as interest and amortization/depreciation of owned real estate. With the proposed elimination of the operating lease model (where "rent" is replaced by amortization and interest), government contracts and/or reimbursement rules may need to be modified to ensure that the intended economics of the arrangement continue.
43. Since the standard is still in a proposal phase, additional regulatory effects may emerge when the standard is final and its effects are better understood. What is uncertain at this point is how regulatory agencies will react to the impacts this change will have on risk-based capital requirements and other key regulatory metrics.

The change could be very significant to banks/broker-dealers and other regulated entities whose capital ratios and/or other metrics are closely monitored and which would be adversely affected in many cases if computed under the proposed model. Historically, banking regulators have not provided much relief for the impacts of such accounting changes.

44. While the lessor operations of many banks will not be significantly affected, those with large leveraged lease portfolios and significant lessee activity (e.g., bank branches, headquarters buildings, processing centers, and ATM locations) may be.

Intercompany issues

45. Many heavy corporate real estate users utilize a central real estate “holding entity” for owned and “leased in” property and then provide for intercompany charges to the consolidated subsidiaries. In some cases, the structures have been created (1) to take advantage of beneficial pricing (allowing companies to aggregate subsidiary needs to take bigger spaces), (2) to obtain operating synergies and negotiate better terms, and (3) for operational ease (allowing corporations with multiple subsidiaries to be flexible in allocating space between these units). It also may be driven by tax considerations (e.g., private REITs with beneficial state tax impacts). In some cases, companies executed intercompany leases, but in others, no formal arrangement existed and costs were allocated through an intercompany expense charge.

46. Under the proposed lease standards, these intercompany transactions will need to be reflected on each consolidated subsidiary’s books and thereby affect them from a regulatory standpoint (e.g., subsidiary broker-dealers may be inadequately capitalized). The documentation of the arrangement is likely to be much more important since it will drive the value of assets and associated liabilities for entities reporting on a stand-alone basis.

Governance, budgetary issues, and investment alternative issues

47. Some historical decisions to lease versus buy may have been driven by approval protocols and budgetary factors. For example, where a company is growing rapidly, it might have been faster and more efficient to execute a lease of real estate or equipment rather than going through the process to approve the purchase of a capital asset. In addition, internal budgeting may have led to a leasing bias since the upfront cash outlay is much lower than with a purchase. If the approval rules follow the new lease model, an operating lease may now need the same level of approval as an outright purchase.
48. In addition, some decisions to lease may have been driven by a company’s prior alternative investment options for available cash. Today, many companies are holding significant cash balances that are earning only nominal returns. In the near term, using some of this cash to buy certain types of assets—especially ones that

they expect to utilize for a substantial portion of their lives—instead of paying much higher implicit rates in leases would be accretive to earnings long term. However, because existing leasing activity under today’s operating leases may not be visible to corporate treasury departments, this alternative use of cash may not be in focus, and these opportunities may be missed.

Managing corporate real estate

49. In many organizations, the corporate real estate department is viewed as more of an administrative function or “cost center” than a part of a strategic function or a competitive advantage. Further, corporate real estate departments are frequently understaffed and often do not have the infrastructure or systems to effectively track and manage the real estate for which they are responsible. Additionally, in many cases the information necessary to make various decisions, estimates, and periodic remeasurements has not previously been reported to the corporate real estate department on a timely basis (such as changing expectations of renewals or changing expectations of future contingent rents).
50. Further, many companies that operate as a group of decentralized subsidiaries (either domestically or internationally) or ones that have grown larger through acquisition with significant legacy systems used in many places are often “balkanized,” thus limiting management’s ability to understand and manage real estate

on a companywide or even country-wide basis. Such systems are neither optimal for a company's current operations nor fully integrated into the larger enterprisewide systems, including accounting and reporting. In addition, because of the length of a typical real estate lease, current management may not be aware of the original rationale for specific decisions, some of which may have changed with the circumstances. Moving this environment to a more centralized one may require significant cultural changes that may not be easy to accomplish.

51. In some cases, corporate real estate departments may have the responsibility for tracking the real estate but not enough resources and focus to (1) identify and manage excess capacity, (2) identify and seek reimbursement for overcharges for lease operating costs (e.g., CAM and bill back overcharges), and/or (3) minimize other cash real estate occupancy costs. Finally, for many companies, existing tracking systems are informal, incomplete, or inaccurate. These "tracking systems" might be nothing more than a drawer for storing copies of leases, a notebook containing lease abstracts, spreadsheets, or nonintegrated or out-of-date software applications.
52. With respect to asset management systems, many companies are still accounting for their leases of corporate real estate using spreadsheets and accounts payable systems with no formal corporate real estate asset management system. Even for the more sophisticated corporate real estate groups that have asset management systems, these systems

are often freestanding and utilized more for management purposes, with no integration with the company's accounting systems.

53. Management of the changes may be possible for some companies without significant upgrades or integration, but to do so may miss an excellent opportunity to automate a previously labor-intensive activity and free up employees for other more productive uses. Few companies track property, plant, and equipment in an automated fashion, and the lack of ongoing reevaluation and measurement, as well as the need to split and track nonlease items, makes leasing a prime target for systems support.
54. The new lease accounting model would require many judgments in its application and significant changes in the calculations prospectively (including new amortization schedules). From a long-term sustainability perspective (for companies with substantial leasing activities), spreadsheet-based accounting will not be practical because of the significant maintenance required and resultant susceptibility to error. High-volume corporate real estate users will likely need new systems/processes to create a documentation trail of the judgments and changes in estimates made. The system will also need to be largely automated to make the necessary computational adjustments resulting from changes in estimates. Full integration into the company's control structure and accounting systems will be necessary, as will the ability to create extensive quantitative disclosures that are mandated in the new accounting model.

55. Given all of the above, these changes will necessitate potentially significant cultural changes as well as significant operational ones.

Internal controls and processes

56. Many entities in the past have not needed robust processes and controls for leases, other than those surrounding their initial classification. In addition, the existing lease accounting model (absent a modification or exercise of an extension) does not require leases to be periodically revisited. The new standard would require that leases be remeasured for changes in estimates (for example, for changes in expected lease term or expected contingent rent payments) and would require entities to design or redesign processes and controls to ensure proper management and accounting of all lease agreements.
57. Initial recording on balance sheet and annual reassessment of lease terms and payment estimates may require significant and complex changes to existing processes and internal controls, including support for significant management assumptions. Monitoring and evaluating the estimates and updating the balances may also require more personnel resources than required by the current accounting.
58. Timely assessment and management of the impact on processes, controls, and resource requirements will help reduce reporting risks. This approach includes the related areas of tenant improvements, impairment valuation, and tax accounting.

IT and lease accounting systems

- 59.** Information technology and lease accounting systems in the marketplace are based on the existing risks and rewards concept. They will need to be modified to the proposed right-of-use concept. Systems designed to meet the needs of this potential standard do not exist. Development and implementation of suitable new modules or systems are likely to have a significant lead time. Lessees will have to account for and manage lease agreements differently (including existing operating lease agreements). They may need to implement contract management systems for lease agreements and integrate these with existing accounting systems. Lessees will need to identify and implement IT and accounting solutions that meet their future needs. In addition, if a company also has significant subleases, additional complexities will arise, as the company will be applying both lessor and lessee accounting.
- 60.** Lessees may expect lessors to provide them with the necessary information to comply with the proposed standard. However, lessors may not have, or may be unwilling to provide, data required by lessees. Consequently, lessees will need to capture such information themselves and may need to modify their systems accordingly.
- 61.** Timely assessment and management of the impact on IT and lease accounting systems will help reduce business and reporting risks. We understand that some of the Enterprise Resource Planning (ERP) systems providers are in the process of evaluating upgrades and solutions that will allow for an

integration of the accounting for the new lease standard and potential controls thereon. However, such discussions are only at their conceptual and planning phases.

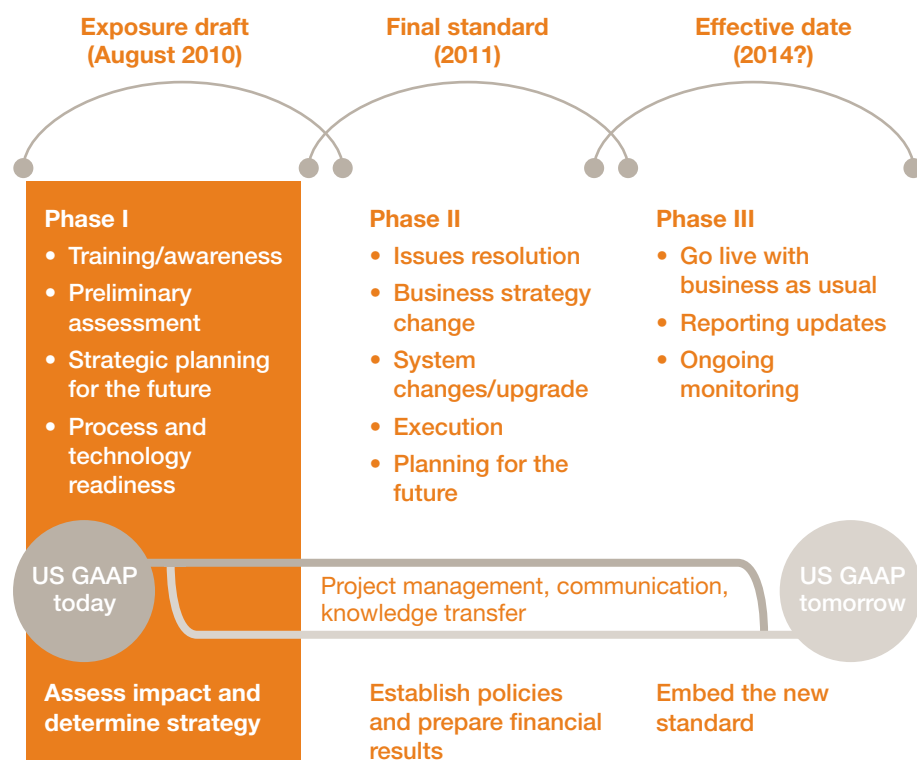
Financial reporting and impact on ratios

- 62.** The financial statements will require restatement for the effect of the changes. The effects of the proposed lease accounting model should be clearly communicated to analysts and other stakeholders in advance.
- 63.** Ongoing accounting for leases may require incremental effort and resources as a result of an increase in the volume of leases recognized on balance sheet. There is also likely to be a need for regular reassessment of the lease term, contingent rentals, residual value guarantees, or the impact of purchase options.
- 64.** The impact of the change will not be restricted to external reporting. Internal reporting information, including financial budgets and forecasts, will also be affected.
- 65.** The proposed lease model will change both balance sheet and income statement presentation. Leverage and capital ratios may suffer from the gross-up of balance sheets. Rent expense will be replaced by depreciation and interest expense. In addition, the expense recognition pattern will change significantly. This will negatively influence some performance measures, such as interest cover, but perversely improve others, such as EBIT/EBITDA and cash flow from operations, all with no change in
- the underlying cash flows or business activity. In addition, continuous remeasurement will increase volatility in these key ratios. These ratios may no longer be useful for their historical purposes, and other operating metrics may evolve as a result of adoption of the new standard.
- 66.** Timely assessment of the proposal's impact on covenants and financing agreements will enable management to start discussions with banks, rating agencies, financial analysts, and other users of the entity's financial data. Entities anticipating capital market transactions should consider the effects on their leverage ratios. There is speculation that new metrics will be created for debt service coverage ratios that neutralize these effects, although it will likely take some time for these changes to take effect. Other agreements based on (entity-specific) key performance indicators will require reassessment and, potentially, adjustment (for example, compensation agreements). Companies in the process of negotiating new or existing agreements should seek provisions in the agreements that specify how changes in GAAP impact financial covenants (i.e., whether covenant calculations are always based on then-current GAAP or on GAAP that was in effect when the agreements were signed).

Next steps

- 67.** The proposed lease standard is not expected to allow for grandfathering of existing leases, with the exception of certain capital leases. Accordingly, prior to adoption, management will need to catalogue existing leases and gather data about lease term, renewal

Proposed timeline



options, and payments to measure the amounts to be included on balance sheet. Gathering and analyzing the information could take considerable time and effort, depending on the number of leases, the inception dates, and the availability of records. In many cases, original records may be difficult to find or may not be available. Other factors such as embedded leases that had not been a focus before will need to be identified and recorded.

- 68.** In addition, companies with international operations may need to deal with leases written in different languages and with the potential impact of local statutes in applying the standard. For example, in France, certain local statutes provide the lessee with an automatic rent-controlled renewal option irrespective of whether one is contained in the lease agreement itself.
- 69.** Though the adoption of the new standard remains at least three years away, organizations are well advised to begin considering the impact of these changes now—and to put into motion

the steps needed to prepare the organization for the change.

- 70.** The chart that follows depicts a potential transition plan with respect to evaluating the effects of the proposed lease model. Incremental corporate real estate strategy and systems changes would be performed concurrently with this plan.
- 71.** In addition to changes in the technical accounts, operations, and systems outlined in this document, we predict that changes to your corporate real estate role will also be needed, and the lease accounting changes being proposed should provide the “catalyst for change in corporate real estate.” Beginning the process early can ensure that implementation of a future standard is orderly and well controlled and that data on new leases written before implementation of the changes is captured from the outset. In addition, timely action may allow entities to consider potential adoption and negotiation strategy changes for new leases and the potential renegotiation of existing agreements to reduce the impact at adoption.

How can PwC help?

PwC has multidisciplinary teams of specialists who can assist you with the aspects of your corporate real estate journey.

Real estate strategy and accounting advisory

- Training, planning and implementation assistance with regard to the new lease standard
- Analysis of needs and market trends
- Analysis of, or assistance with, evaluating financial and strategic impact of the new lease standard

Tax and transaction support

- Analysis of tax implications and structuring opportunities with respect to the new lease standard
- Sale-leaseback transactions
- REIT spin-offs of corporate real estate to unlock shareholder value
- Federal and state tax planning transactions

Systems and processes

- Process/control change consulting/implementation planning with respect to impact of the new lease standard
- Strategic information systems planning
- Gap analysis and system selection
- Technology integration and implementation

Operational effectiveness and cost containment

- Lease expense “audits” for potential recovery
- Process redesign and leading practices in corporate real estate
- Benchmarking and performance monitoring
- Spend analysis, strategic sourcing, and outsourcing effectiveness
- Operational and organizational effectiveness

Valuation/market analysis

- Real estate and lease portfolio valuation
- Market studies
- Valuation analyses in conjunction with accounting requirements (i.e., FAS 141)

Where to find additional information

If you would like further information on the proposed lease accounting model or assistance in determining how it might affect your business, please speak to your regular PwC contact. A list of PwC contacts has also been provided on the back cover of this publication.

Preparing for the change

- ☐ Educate key business leaders about the issue
- ☐ Create a cross-functional steering committee to address the standard and transition
- ☐ Perform an inventory of your lease portfolio; understand what types of assets are leased and where the data resides
- ☐ Identify contracts likely to include embedded leases
- ☐ Consider modeling the transition impact on certain significant leases (or sample from a variety of lease types)
- ☐ Summarize existing systems and potential gaps
- ☐ Summarize existing control processes and potential gaps
- ☐ Analyze potential income and other tax considerations (including federal, state, and foreign taxes)
- ☐ Identify contracts affected by the change in accounting (e.g., financial covenants, compensation agreements, and earnouts), the potential implications, and how terms should be modified in the future
- ☐ Identify regulatory issues affected by the change in accounting (e.g., regulatory capital implications and cost plus government contracts), the potential implications, and how terms should be modified in the future
- ☐ Consider potential changes in real estate leasing strategy (e.g., lease/buy, shorter versus longer leases, modify common terms, etc.)

Key takeaways on transition

- **Be strategic:** Planning your transition will go much more smoothly if you have concrete data to work with. Modeling selected leases will give you relevant data to share with internal constituents. It will also help you understand what data you have, what data you need, and how your leasing strategy may need to change to minimize the adverse accounting impact of the standard.
- **Manage market reaction:** For many significant users of real estate (e.g., retail companies), managing investor and other user relations during the transition will be critical. The issuance of the Exposure Draft has created a significant buzz, and analysts and shareholders are likely to start raising questions about the potential impact. Traditional operating metrics such as EBITDA used as proxies for free cash flow may no longer be relevant and will likely need to be replaced. Longer term, the inherent volatility in the income statement and balance sheet, in addition to significant changes in presentation and metrics, will require thoughtful communication.
- **Don't wait:** In our discussions with clients, many expect adoption to take from 12 to 24 months. While the adoption timetable will vary by company, most believe adoption will be complex and time consuming. Targeted steps today will help you understand the complexity and duration of the transition effort and, more importantly, what steps you can take today to modify existing or planned leases to minimize the effort of complying with the new rules.

The table on the following pages describes common terms in lease agreements and the current and proposed accounting for these items.

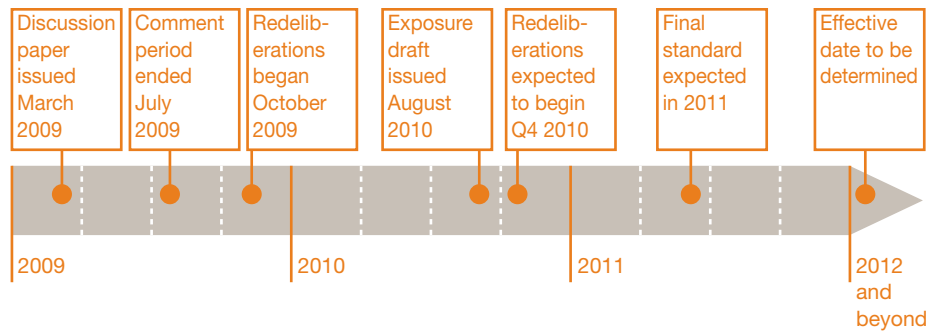
Impact on common real estate lease provisions

Terms	Example	Existing accounting	New accounting	Potential strategy impact
Co-tenancy clauses	There are various types of co-tenancy clauses. One example is for “key tenants” whom other tenants believe are critical to the successful operation of the location. If a key tenant departs, the property owner has time to cure the issue but until cured, rent may be reduced.	Reflect any reductions in period they occur but do not project them in considering minimum lease payments.	Reflect any reductions in period they occur but do not project them in considering minimum lease payments.	Likely no changes in strategy.

Terms	Example	Existing accounting	New accounting	Potential strategy impact
CPI escalations	Office tenant has a rent escalation each anniversary date based on the change in the published Consumer Price Index.	Treated as contingent rent which is not included in “minimum lease payments” used for straight line rent purpose but rather the expense is recognized in each annual period based on actual increase in that period.	The new standard would require the office tenant to use a probability weighted approach to estimate its future payments under these provisions for whatever lease term is utilized (including potential extension options) and include them in the calculations.	CPI escalation provision features will no longer have an advantageous accounting for lessees and we expect that the use of such provisions may be reduced in practice if for no other reason than to reduce complexity. Further, from a risk standpoint, if a tenant that expects 3% inflation can get similar accounting for a fixed rent step of 3%, all other things being equal, they would lower their risks and complexity by moving to a fixed rent strategy.
Free rent periods	Retail tenant given six-month free rent period in connection with 10-year lease.	Current lease model would apply a “straight line rent” method whereby expense is reflected based on a mathematical average of the aggregate minimum lease payments over the period from commencement of the lease through end of lease term. This model does not compensate for the economic impacts of the timing of payment.	The new model would have no cash out-flows in the present value calculation for first six months. As a result, initially the right of use asset and lease obligation would be lower. The obligation would increase over the free rent period as the obligation is remeasured using a constant effective yield with interest being added to the balance during the free rent period (i.e., like a negative amortizing loan).	Largely economic—business practices in this area likely not to change.
Lease allowance	Property owner pays tenant \$1.0 million for part or all of the improvements to the leased property.	If the tenant allowance is for improvements considered tenant assets, the accounting is the same as described under “lease inducement” below. If the tenant allowance is for improvements considered to be property owner assets, the payment is treated as a reimbursement for the cost of a lessor asset with no additional accounting over the lease term.	The accounting for a tenant allowance for improvements considered tenant assets is the same as described under “lease inducement” below. There is no change from existing accounting for a tenant allowance for improvements considered to be property owner assets.	Likely no changes in strategy.

Terms	Example	Existing accounting	New accounting	Potential strategy impact
Lease inducement	Property owner pays tenant \$1.0 million to enter into a lease that may be used for any purpose.	Treated as negative rent payment and reduction in minimum lease payments to be reflected using straight-line method over lease term.	Treated as reduction in lease obligation and, therefore, the asset at inception. As a result, the amortization (generally straight-line method) over the lease term (including potential extension options) would be lower.	Accounting impact is the same if lease term is the same—\$1 million amortized on a straight-line basis to the income statement. If extension options included, amortization period may be different. Likely no changes in strategy.
Percentage rent	Retail tenant pays additional rent of 4% of annual sales at the location in excess of \$10.0 million.	Treated as contingent rent which is not included in “minimum lease payments” used for straight line rent purpose but rather the expense is recognized based on actual sales when it becomes probable annual sales will exceed \$10.0 million.	The new standard would require the retailer to use a probability-weighted approach to estimate its future payments under additional rent terms for whatever lease term is utilized (including potential extension options) and include them in the calculations.	It depends. For more predictable operations, percentage rent features will no longer have an advantageous accounting for lessees and we expect that the use of such provisions may be reduced in practice if for no other reason than to reduce complexity. For less predictable operations, for example a new concept store or one in an uncertain market location, we expect that such provisions will continue in use.
Perpetual leases	In some jurisdictions, by statute the tenant may have the right to renew the lease indefinitely. For example, in France, many retail leases are automatically renewable by the tenant in three-year increments.	Today these are straight-lined for each three-year period.	If tenants have the unilateral right to renew by contract or statute, the lease term may be longer than the current term. This evaluation would be based on the probability of renewal. If renewals are assumed, in many cases the rent would need to be estimated, which may be complex.	Likely no changes in strategy.
Prepaid rent or uneven rent	Lessee prepays a significant amount of rent at the inception of the lease.	Rent recognized over the term of the lease on a straight-line basis.	New model would recognize an asset and a liability for the payments. Since the prepayment is made at inception, it would not have a present value discount. The right-of-use asset would amortize on a straight-line basis. Interest on the obligation would be reduced or eliminated (depending on whether partially prepaid or fully prepaid).	Likely no changes in strategy.

Terms	Example	Existing accounting	New accounting	Potential strategy impact
Security deposit	At the beginning of the lease term, tenant pays property owner \$1 million, which is approximately two months of rent due under the lease agreement. The amount protects the property owner from a default by the tenant or damage to the leased property caused by the tenant and is refundable if neither occurs.	Treated as a liability by the property owner and as an asset by the tenant until returned to the tenant or used by the property owner in the event of default or damage to the leased property.	Same as existing accounting.	Likely no changes in strategy.
Tenant improvements	At the beginning of the lease term, tenant pays to improve the space.	Treated as separate asset amortized over the lesser of the life of the improvement or the assumed term of the lease.	Treated as separate asset amortized over the lesser of the life of the improvement or the assumed term of the lease. However, under the proposed model, the lease term may now be longer if option periods are included. There should be consistent assumptions between amortization period and lease term.	Likely no changes in strategy.
Termination rights	A retail tenant is uncertain about the potential viability of a location. They sign a 10-year lease with the right to terminate the lease after two years.	Frequently, these are considered 10-year leases because of the penalties—either direct penalties or economic ones from having to walk away from the tenant improvements.	Lease term probably similar to that of today. A similar lease could be structured as a two-year lease with a right to extend for 8 years. The new model will evaluate the expected term as either two years or 10 years based on the probability of the lease running for those periods.	Likely no changes in strategy.



Appendix—Summary of the exposure draft

Detailed discussion of proposed leasing standard from lessee's perspective

Status of the new leasing standard

72. This Appendix summarizes the FASB and IASB's Exposure Draft, Leasing, issued on August 17, 2010. The comment letter period ends on December 15, 2010, whereupon the Boards will redeliberate with a target date for issuance of a final standard in 2011. The provisions of the proposed standard are subject to change until a final standard is issued. Adoption date has not been discussed but could be as early as 2013; however, it is more likely to be 2014 or 2015.

Background

73. Leasing is an important and widely used source of financing. It enables entities, from start-ups to multinationals, to acquire the right to use property, plant, and equipment without making large initial cash outlays.

74. Lessees currently account for leases as operating leases or capital leases. Lease classification is based on complex rules. Though many operating leases provide nearly the same risks and rewards as outright ownership, neither the leased asset nor the obligation to pay for it is recorded on the balance sheet. Rather, rent expense is recorded on the income statement on a straight-line basis

throughout the lease term under current GAAP.

75. Many observers have long believed that the current lease accounting model is not consistent with the conceptual framework, which provides the underpinnings for accounting rules. They also argue that current guidance allows lessees to structure lease transactions to result in operating lease classification, resulting in off-balance sheet treatment. Critics also point out that the current standards permit something as illogical, for example, as a commercial airline company reporting no airplanes on its balance sheet.

76. In June 2005, the Securities and Exchange Commission (SEC) issued its *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Users*. One of the significant recommendations in this report was that existing lease standards need to be rewritten.

77. As part of their global convergence efforts, the Boards have been working to create a single, comparable, worldwide leasing standard. The project was intended to build on previous work contained in the 1999/2000 white paper titled *G4+1 Special Report, Leases: Implementation of a New Approach*. The Boards issued a joint discussion paper in March 2009 that included possible changes to lease accounting, followed by the Exposure Drafts of the proposed model in August 2010. They expect to issue final standards in 2011. The effective date, which has not been

determined, could be as early as 2013; however, it is more likely to be 2014 or 2015.

The timeline

78. The project timeline and reasonable reaction periods for tenants and property owners to evaluate potential impacts are shown above.

Key provisions

79. We will discuss the following expected key provisions of the standard and provide examples of the impact on a real estate user (lessee) in a hypothetical lease scenario.

Scope

80. The Boards have proposed that the scope of the leasing standard include leases of property, plant, and equipment and exclude leases of intangible assets. Similar to other standards, the proposed standard would not apply to immaterial items.

PwC observation: Although a single item might be immaterial, items of a similar nature might be material in the aggregate (i.e., one computer lease might be immaterial, but 10,000 computer leases might be material). Accordingly, those items, in the aggregate, would be subject to the proposed accounting. For leases determined to be immaterial to the financial statements in the aggregate, companies may consider developing a policy similar to commonly used property and equipment capitalization policies.

81. The Boards also propose to exclude from the scope (1) leases to explore

for or use natural resources (such as minerals, oil, and natural gas); (2) leases of biological assets; and (3) lessor accounting for leases of investment property measured at fair value under International Accounting Standard (IAS) 40, Investment Property.

PwC observation: US GAAP does not currently have an investment property accounting model similar to IAS 40. However, at its July 24, 2010, meeting, the FASB tentatively decided to issue a proposed Accounting Standard Update (ASU) that would be similar to IAS 40. The FASB has indicated that the standard would require an investment property to be measured at fair value (fair value is currently optional under IAS 40). The Board's current efforts are focused on defining which entities would be included in the scope of the investment property guidance to determine whether those entities' investment properties would be required to be carried at fair value and excluded from the proposed leases guidance. One alternative that the Board discussed at an Education Session on November 3, 2010, was to include only entities whose primary business is investing in real estate (real estate investment companies). The Board will be discussing this alternative, as well as the specific characteristics of such entities, at a later meeting. An Exposure Draft on investment property could be issued in the first quarter of 2011. If a new investment property standard is completed, it is expected that the FASB would adopt it concurrently with adopting a final

leasing standard. This would result in the exclusion of investment property owned by lessors from the lease standard. This does not affect how the lessee would account for the lease of such property for its own operations.

Short-term leases and non-core assets

82. The Boards considered excluding short-term leases and leases of non-core assets from the scope of the proposed leasing standard. Factors considered included the cost of applying the model, the difficulty in defining non-core assets, and the potential structuring opportunity that such an exclusion would create. They decided that excluding these leases would run counter to their objective of bringing the rights and obligations of all leases onto the balance sheet.
83. Although the Boards decided against short-term lease exclusion, they did propose a simplified method for lessees to ease the burden of accounting for such leases. For leases with a *maximum* possible term (including all extension options) of 12 months or less, a simplified lease accounting approach could be used on a lease-by-lease basis. Under the simplified approach, the lessee would recognize a right-of-use asset and liability equal to the gross payments remaining on each lease. Payments for the lease would be recognized in the income statement over the lease term, presumably as amortization.

PwC observation: Because of the short duration of leases that would qualify for the simplified approach,

the time value of money associated with those short-term leases would be ignored as a practical expedient. The Exposure Draft does not explicitly state how lease payments for short-term leases under the simplified approach would be reported in the income statement (e.g., as rent expense or amortization expense). However, we expect that if the asset is being recorded and amortized, the amount included in the income statement would represent amortization expense. Payments to the lessor would reduce the obligation.

Lessee accounting The basic model

84. The Boards have proposed a right-of-use model for lessee accounting. This model would require the lessee to recognize at the commencement of the lease (usually upon, for example, the tenant taking possession of the property) an asset representing its right to use the leased item for the lease term and a corresponding liability for the obligation to pay rentals. Under this approach, all leases not considered purchases would be accounted for in a similar manner; the classifications of capital and operating leases used today would be eliminated.
85. The Boards believe that the right-of-use model is consistent with their conceptual frameworks and increases the transparency of lease accounting. Because leases are commonly viewed as a form of financing, the obligations recognized on the balance sheet under the right-of-use model would be

consistent with how businesses reflect other financing arrangements.

PwC observation: The right-of-use model might cause companies to change how they negotiate leases. It may also affect lease-versus-buy decisions. However, we believe leasing will continue for a variety of business reasons. For example, leasing provides more operational flexibility than outright ownership; certain leasing structures are more tax efficient than direct ownership; and leasing often provides effective financing to companies whose financing options are otherwise limited.

With respect to large-ticket items, such as real estate, leasing is expected to continue as a viable option because many companies prefer not to own these types of assets to maintain operating flexibility, or the specific asset may be available only through leasing (e.g., a specific retail location). Leasing may also be more appropriate for space users that occupy only a small portion of a larger facility (e.g., tenant in a regional mall) or for a period that is substantially shorter than the useful life of the asset (e.g., five years for an office building with a useful life of 40 years or more).

Initial measurement

86. Lessees would initially measure the obligation to pay rentals at “cost” computed at the inception of the lease, which would generally be the date the lease is signed. Cost is defined as the present value of the

lease payments. The right-of-use asset would be measured at the amount of the lease obligation plus any initial direct costs incurred by the lessee.

87. The Boards have defined initial direct costs as incremental costs directly attributable to negotiating and arranging a lease. For example, initial direct costs may include commissions, legal fees, and costs incurred in negotiating lease terms, preparing and processing lease documents, closing the transaction, and other internal costs that are incremental and directly attributable to negotiating and arranging the lease.

88. Present values would be determined using the lessee’s incremental borrowing rate as the discount rate at the date of inception of the lease. If the rate the lessor is charging in the lease is readily determinable, this rate can be used in lieu of the incremental borrowing rate.

PwC observation: Lessees would not be obligated to seek out the rate the lessor is charging in the lease and most often will not be able to identify that rate. The rate the lessor is charging is more likely to be identifiable in equipment leases, particularly when the equipment may also be purchased outright. For other types of leases, including real estate leases with rents based on cost per square foot, the lessee rarely knows the rate the lessor is charging because it is typically not relevant to negotiations. Nonetheless, the Boards have proposed to grant lessees the option to use the rate the lessor is charging, if known. They did so because, in certain circumstances, it may be more cost effective for the lessee to

use the rate the lessor is charging in the lease rather than determine its incremental borrowing rate.

As indicated above, for real estate leases, the implicit rate would rarely be known or useful. The lessee would then use a discount rate commensurate to a secured borrowing that the lessee could obtain to finance the purchase of the specific asset over a borrowing term consistent with the initial expected term of the lease (including any assumed extension options considered more likely than not to be exercised). For example, if a company were entering into a lease of a property in Chicago with an assumed term of 10 years, it would use a rate consistent with a 10-year fixed-rate secured borrowing for property in Chicago. This rate would not subsequently change even if the expected term changes because of changes in judgments of the likelihood of exercise of extension options.

Service costs/executory costs

89. The Exposure Draft indicates that where lease payments also contain service costs, the combined payments would need to be allocated between “distinct services” and lease rentals associated with the lease of the asset. If allocation is not possible, the entire arrangement would be accounted for as a lease.

90. For this purpose, the Exposure Draft utilizes the distinct service definition being considered in the revenue

recognition project. Under this definition, a service component is considered distinct if either:

- The entity, or another entity, sells an identical or similar service separately
- The entity could sell the service separately because the service has both a distinct function and a distinct profit margin.

91. While this definition would likely work for services provided by the landlord for the space (e.g., cleaning services for the office space being rented), it is not clear how it would be applied to many other common real estate terms.

92. The concept of excluding executory/common costs was not carried over from the existing lease accounting model into the proposed model. Executory costs in today's accounting include insurance, maintenance, and taxes. In practice, this term is often also applied to other common cost allocations, including common area maintenance, utilities, snowplowing, security, landscaping, etc. These costs are frequently included in the quoted lease terms (especially for real estate). There are several different types of leases that are common with respect to real estate, and each may have some unique issues. Some of these are described below:

Net lease

These types of leases are common for retail/industrial property and single-tenant property where either the tenant is billed by the lessor for executory costs incurred (on a pro rata basis for multitenant properties)

or such costs are paid directly by the tenant. In such leases, the tenant bears the risk and rewards of all of the downside and upside changes in executory costs.

“Modified gross” or “base year” lease

These leases are common for office property where the tenant's rent is set during the first year of the lease (i.e., the “base year”), which includes executory costs (on a pro rata basis for multitenant leases). In subsequent years, the tenant pays additional amounts for executory costs to the extent they exceed the tenant's pro rata share of the aggregate of those expenses in the “base year.” In these leases, tenants bear all the aggregate downside in the case of rising prices, and the lessor gets any benefits of aggregate efficiencies that reduce overall costs.

Gross lease

Gross leases have historically been very simple. The quoted base rent includes all executory costs. In such leases, the lessor bears the risk of all the upside/downside associated with cost changes. In many cases, especially for real estate, a tenant neither knows nor cares what these executory costs are—its focus is solely on the all-in cost of occupancy.

93. The Exposure Draft indicates that costs for services meeting the definition of distinct services would need to be removed from the lease payments used to measure the initial right-of-use asset and liability. The costs associated with “distinct” services are operating period costs and should be reflected in the period incurred.

PwC observation: Many believe that executory costs should be excluded from the payments the lessee uses in measuring the lease obligation when applying the proposed standard. However, it is not clear that these costs would meet the “distinct service” definition. For example, it would be very difficult to say that real estate tax reimbursement or the pro rata portion of landscaping or snow removal in multitenant buildings meets the “distinct” service definition.

Further, in many cases, items that might meet the definition of a distinct service are intertwined with those that do not meet the definition. For example, the cost reimbursement for an increase in a base year lease is not for each individual expense but rather for the entire pool of expenses, and increase in some may be offset by decreases in others. Assuming the final standard indicates that these service/executory costs should be excluded, companies would then need to segregate out the portion of these included in the rent amounts under base year and gross leases. Stripping out executory costs is not significant in many cases under the current lease accounting model but will become significant under the proposed leasing model. Therefore, management may need to obtain information with respect to service/executory costs from property owners or find ways of estimating them.

Subsequent measurement

94. The Boards proposed that the right-of-use asset be subsequently measured at amortized cost. Amortization for real estate assets would generally be recognized on a straight-line basis. The expense recorded would be presented as amortization expense rather than rent expense.
95. The lessee's obligation to pay rentals would be subsequently measured at amortized cost using the effective interest method, under which payments would be allocated between principal and interest over the lease term. Interest expense determined under this method would be higher in the early years of a lease compared with the current straight-line treatment for rent expense under an operating lease.

PwC observation: The Boards proposed that measurement of the lease occur at lease inception (i.e., the earlier of the date of the lease agreement or the date of commitment). However, the asset and corresponding liability are not recorded until the commencement date of the lease (the date on which the lessor makes the leased asset available to the lessee). It is not uncommon for there to be six months or even several years between the signing of a real estate lease (lease inception) and the tenant's taking possession of the space (lease commencement). This can occur for a number of reasons including asset construction, the space not being available until a later date (e.g., existing tenant term has not yet expired), or the tenant

does not need the space immediately and, accordingly, negotiates for a forward start date.

The Exposure Draft does not address the accounting for the change in present value of the obligation when significant time passes between lease inception and lease commencement. The remeasurement of the obligation at commencement date will be higher than the amount at lease inception date. A question arises in applying the guidance in the proposal as to whether this increase results in an immediate interest charge or an adjustment to the asset. We believe that the asset and liability should be adjusted at commencement to eliminate this differential at lease commencement.

Lease term

96. Under existing standards, optional extension periods are considered part of the lease term if the lessee concludes at lease inception that exercise of such options is "reasonably assured" (ASC 840, Leases) or "reasonably certain" (IAS 17, Leases) for the additional periods.
97. Under the right-of-use model, lessees would be required to estimate the ultimate expected lease term and periodically reassess that estimate. A detailed examination of every lease at each reporting date would not be required. The term would be reexamined if facts and circumstances indicate that there would be a significant change in the liability to make lease payments since the previous reporting period.

98. Under the proposed model, the lease term is defined as the longest possible term that is more likely than not to occur. In estimating the lease term, the party should consider all relevant factors, including contractual, noncontractual, and business factors, as well as intentions and past practices. For example, consider a lease with a non-cancellable five-year term and two five-year renewal options. Clearly, the minimum contractual term of five years is more likely than not to occur since the probability is 100% that the lease will cover at least the initial five-year period. The lessee would also need to consider whether the 10- or 15-year terms available because of the renewal options are more likely than not to occur. Once the lessee has determined which lease terms are more likely than not to occur, the longest of those terms would be the lease term used to account for the lease.

Purchase options

99. The Boards have proposed that purchase options not be accounted for in the same manner as options to extend a lease. Instead, purchase options would be recognized only upon exercise. At that time, the exercise of a purchase option would result in the lessee recognizing the underlying asset.

PwC observation: This decision reflects the Boards' view that a purchase option goes beyond conveying the right to use an asset for a specified period and, therefore, the purchase should be accounted for separately.

Contingent cash flows

100. Under existing standards, contingent rentals generally are recognized as expenses in the period incurred. The right-of-use model would require that the initial measurement of the obligation to pay rentals include contingent cash flows, such as “percentage rents,” increases in rents based on changes in an index (such as CPI), and residual value guarantees.

101. The Boards have proposed using an expected outcome technique for measuring contingent cash flows with the clarification that a lessee does not have to consider every possible scenario. This technique requires the calculation of a probability-weighted average of the cash flows for a reasonable number of outcomes. Many respondents to the Boards’ March 2009 discussion paper on leases disagreed with the inclusion of lease renewal options and contingent rentals in measuring the right-of-use asset and lease liability. They argued that options and contingent payments are not the same as a commitment and therefore do not meet the definition of a liability. In the “basis for conclusions” that accompanies the Exposure Draft, the Boards have set forth their belief that contingent rentals and renewal options meet the definition of a liability. The Boards indicated that not reflecting contingent rentals and options in the measurement of the lease obligation would result in the nonrecognition of payments due the lessor and could result in structuring opportunities to avoid recognizing an obligation.

102. The Boards indicated that lessees should use a probability-weighted

approach for most contingent rents and a forward curve for contingent rents based on an index.

PwC observation: Rather than a best estimate of what a lessee expects to pay, the Boards’ approach may be difficult if not impossible to apply. Multiple scenarios for percentage rent calculations may be arbitrary, and there is no published source of some of the more common index-based contingency clauses, such as CPI. We believe a best estimate approach would be better and still meet the Boards’ goals.

Changes in estimates and remeasurements

103. The Boards proposed that lessees be required to reassess estimates of lease term and contingent cash flows as warranted by changes in facts and circumstances. Subsequent measurement of the lease obligation would reflect all such changes in estimate. Changes in the lessee’s obligation because of a reassessment of the lease term would be recognized through an adjustment of the right-of-use asset.

104. The Boards have proposed a mixed model to account for changes in estimated contingent cash flows. Where changes in amounts payable under contingent cash flow arrangements are based on current or prior period events or activities, those changes should be recognized in determining net income. All other changes would be recognized as an adjustment to the lessee’s right-of-use asset.

105. For example, consider a lessee that enters into a 10-year lease agreement that includes rental payments based on a percentage of sales. During the second year of the lease, the lessee determines that the original estimated sales figures require updating. Adjustments in the obligation arising from modifying sales for years one and two would be recognized in determining net income. Changes in the obligation from the updated forecast in sales for years three through ten would be recognized as an adjustment to the right-of-use asset.

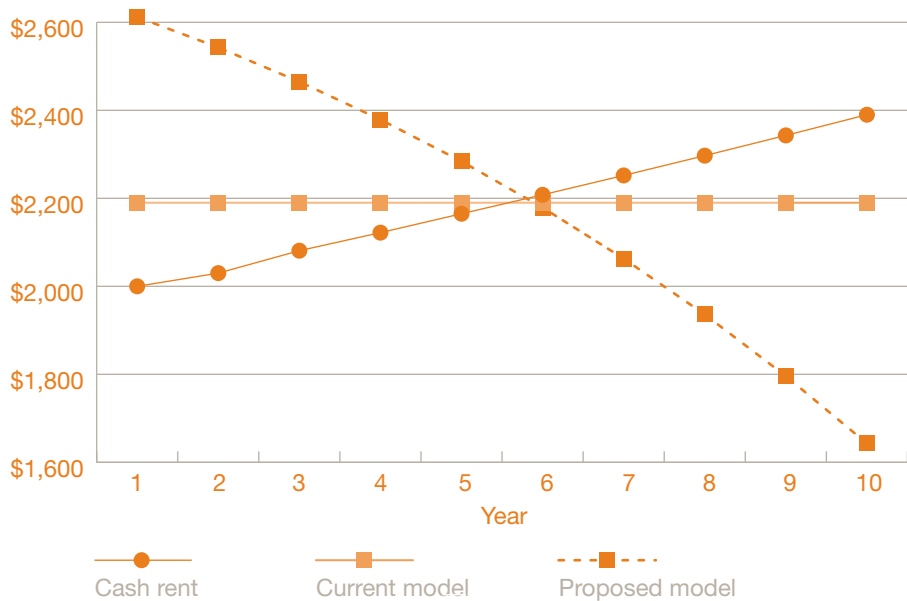
106. The Boards also considered whether the discount rate should be updated when a remeasurement is required because of a change in estimated term or contingent cash flows, but decided the original discount rate should be used throughout the lease term. The only exception would be a lease with rentals contingent on variable reference interest rates; for all other leases, the accounting would be consistent with that of a fixed-rate borrowing.

PwC observation: The requirement to reassess these estimates entails significant incremental effort compared with the current model, under which lease accounting is set at inception and revisited only if there is a modification or extension of the lease. In addition, it may be necessary to invest in information systems that capture and catalog relevant information and support reassessing lease terms and payment estimates as facts and circumstances change.

Lessee example

Exhibit 1 graphically illustrates the

Exhibit 1: Comparison of the proposed model, current model and cash payments



effect of the proposed standard on expense recognition for a fixed 10-year lease with rental payments that increase 2% per year (see detailed calculations at the end of the Appendix). The current accounting model reflects rent expense for operating leases on a straight-line basis over the noncancellable lease term. Historically, critics of today's model have observed that this model does not consider the time value of money and is sufficiently divergent with the cash due under the contract such that it does not reflect economic reality. Though the proposed model clearly factors in the time value of money, the new approach diverges even further from the cash due under the contract.

Under the proposed model, rent expense would be replaced with interest and amortization expense. The expense would be front-end loaded, with more expense recognized in the beginning of the lease term and less at the end—similar to a mortgage. For a lease that includes escalating rents, the cash payments will directionally be the inverse of what the expense will be—lower in the earlier years and higher in the later years.

When a lease contains optional periods or contingent payments, additional volatility may be introduced into the income statement because the lessee would be required to revisit the original estimates of lease term and contingent rentals as facts and circumstances change.

Exhibit 2, "Comparison of timing recognition of optional renewal periods," takes the lease depicted in Exhibit 1 and assumes there are two

optional five-year renewal periods. The rents during the option periods continue the same pattern, escalating 2% per annum.

Exhibit 2 on the next page depicts the expense recognition pattern in the following scenarios:

- **The current leasing model—** Assuming the exercise of the options was not reasonably assured at lease inception. The current model has a "stair step"-type recognition pattern for each noncancellable term.
- **The proposed model—** Assuming management determined at inception that the longest lease term more likely than not to occur was 20 years. Results in increased expense at the front end of the lease that declines over the lease term.
- **The proposed model—** Assuming management initially estimated the longest lease term was 10 years. In year 7, management determined that a 15-year term was likely. Finally, in year 12, management concluded that the estimated lease term was 20 years. This results in a "saw tooth" recognition pattern,

thereby adding increased volatility to the income statement.

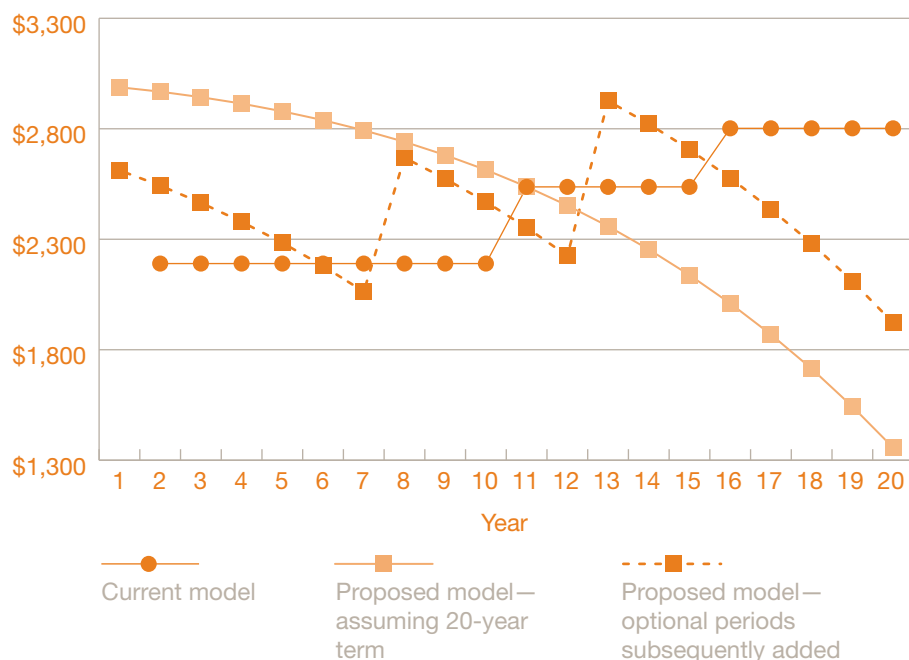
The proposed model does not provide a discretionary choice regarding the pattern of expense recognition. The decision regarding inclusion of optional periods in the lease term will depend on an assessment of the likelihood of exercising the options throughout the lease term. Management should consider all relevant factors in initially determining the lease term and contingent payments and reassess these factors as facts and circumstances change.

Other areas of difficulty

Sale and leaseback transactions

107. Some sale and leaseback transactions would be accounted for using sale-leaseback accounting, while others would be accounted for as financings. The different accounting would be based on whether the transaction meets the proposed leasing standard's criteria for an in-substance sale. When the seller/lessee retains no more than a trivial amount of risks and benefits and control is transferred to the buyer/lessor at the end of the lease, the asset would be considered sold.

Exhibit 2: Comparison of timing recognition of optional renewal periods



108. If the transaction qualifies as a sale, a gain or loss would be recognized immediately. The Boards have also proposed that if the sale or leaseback is not established at fair value, then the asset, liability, and gain or loss would be adjusted to reflect current market rentals.

PwC observation: This would be a significant change under US GAAP, which currently provides guidance for determining whether transactions involving real estate qualify for sale accounting (ASC 360-20) or sale-leaseback accounting (ASC 840-40). (The Exposure Draft is expected to replace ASC 840, “Leases,” including the guidance relating to so-called “build to suit” transactions under ASC 840-40-55, “Criteria for Determining Whether the Lessee Should be Considered the Owner of the Asset Under Construction.”) Under the proposal, the determination of whether a sale and linked leaseback qualify for sale treatment would be less cumbersome. However, for sale and leasebacks of non-real estate assets, some transactions may qualify as a sale under current standards but not under the proposed model. If the transaction qualifies

as a sale, any gain or loss would not need to be deferred under the proposal.

Fundamentally, for long-term leasebacks, there is a concern that recognition of this gain may not be appropriate since most of the gain relates to the period of continued use rather than to what is fundamentally the sale of the residual interest.

Subleases

109. As expected, the accounting for subleases builds on both the lessee and lessor accounting models that the Boards have proposed. When a leased asset is subleased, the sublessor would account for the head lease (i.e., the lease agreement between the original lessor and lessee) in accordance with the proposed right-of-use lessee model and, likewise, would account for the sublease under the appropriate proposed approach for lessor accounting.

110. Presentation of the assets and liabilities will differ depending on which of the two lessor models is followed. In most cases, there will be sufficient continuing involvement that the

performance obligation approach would likely be required for the lessor. To avoid the “double gross-up” in the balance sheet that would otherwise result under the performance obligation model, the Boards proposed that all assets and liabilities arising from both the head lease and sublease, except for the obligation to pay rentals to the head lessor, be presented together on the asset side of the balance sheet at gross amounts with a net subtotal. The obligation to the head lessor would be presented separately in liabilities.

Presentation and disclosure

111. For lessee accounting, the Boards proposed that assets, liabilities, amortization, and interest related to leases be presented in the financial statements based on the nature of the leased item. The Boards also proposed that the amounts be broken out on the face of the financial statements. However, they asked respondents to comment on whether breakout of the amounts in the footnotes may suffice. Cash payments on leases and interest expense arising from lease contracts will be presented as financing activities in the statement of cash flows, separately from other financing cash flows.

112. Specific disclosures required would include a description of the nature of an entity’s leasing arrangements, the existence and terms of optional renewal periods, contingent rentals, and information about assumptions and judgments. In addition, any restrictions imposed by lease

arrangements, such as dividends and additional debt, should also be disclosed.

113. The following disclosures would also be required:

- Information about the principal terms of any lease that has not yet commenced if the lease creates significant rights and obligations.
- A reconciliation between the opening and closing balances of right-of-use assets and obligations to pay rentals, disaggregated by class of underlying asset.
- A narrative disclosure of significant assumptions and judgments relating to renewal options, contingent cash flows, and the discount rate used.
- A maturity analysis of the gross obligation to pay rentals showing (a) undiscounted cash flows on an annual basis for the first five years and a total of the amounts for the remaining years and (b) amounts attributable to the minimum amounts specified in the lease and the amounts recognized in the balance sheet.

114. Additional disclosures would apply if (a) the simplified option for short-term leases is elected, (b) significant subleases exist, or (c) there is a sale-leaseback transaction.

PwC observation: Because of the significantly expanded use of estimates and judgments in the proposed lease standard, disclosure requirements will go well beyond those required under current leasing standards.

Transition and effective date

115. Lessees would apply the proposed standard by recognizing assets and liabilities for all outstanding leases at the initial application date.

116. The Boards expect to issue a final standard in 2011. They have not discussed the effective date of the standard. Presumably, it would be no earlier than 2013; however, it is more likely to be 2014 or 2015. Given the potential impact of the proposed changes on accounting and operations, as well as the express purpose of the Boards to ensure that assets and liabilities arising from lease contracts are recognized on the balance sheet, management should begin assessing the implications of the proposal on existing contracts and current business practices.

PwC observation: The Boards proposed that the new model be applied as of the date of initial application (the beginning of the earliest period presented). For example, if a company were to adopt the standard on January 1, 2014, and present two comparative years, it would be required to apply the provisions of the standard beginning January 1, 2012 to all leases that exist at that date (even if they had expired or were terminated prior to the 2014 adoption period). Fundamentally, this exacerbates the front-end loading issue because it treats all leases that exist at the initial application date as if they were new leases. Over time, a portfolio of leases in

different phases of life will smooth out some of the front-end loading.

117. Lessees would measure the lease obligation at transition at the present value of the lease payments discounted using the lessee's incremental borrowing rate on the transition date. When lease payments are uneven over the term, the accrued or prepaid rent account (used under current standards to provide for straight-line rent expense) would be recharacterized to the right-of-use asset. Uneven lease payments could result from lease incentives, rent-free or reduced rental periods, or rent escalation clauses. Additionally, the right-of-use asset would be reviewed for impairment.

118. The Boards have proposed an exception for "simple capital leases," those leases currently classified by lessees as capital leases that do not include options, contingent rents, termination penalties, or residual value guarantees. Capital leases entered into prior to the transition date that meet this exception would continue to follow existing capital lease accounting standards.

119. This simplified transition approach reflects the reality that, for many long-term leases, the information needed to adopt the proposed standard retrospectively may no longer be available. The Boards considered providing an option to adopt retrospectively, recognizing that the asset and obligation are equal only at inception, but rejected it in favor of a single transition approach.

PwC observation: While the new standard provides that a lessee would adjust the asset at inception for prepaid or accrued rent, it is unclear if this is on a contractual accrual basis only or whether this adjustment would also include the accumulated deferred rent asset/liability resulting from the pre-adoption application of the straight-line accounting for an operating lease under current accounting. We believe the asset should also be adjusted for these amounts; otherwise, the aggregate pre- and post-adoption recognized costs would be different than the total amount of cash paid under the contract.

The lack of grandfathering for existing leases will mean that extensive data-gathering will be required to inventory all contracts and then, for each lease, a process will be needed to capture information about lease term, renewal options, and fixed and contingent

payments. The information required under the proposed standard will typically exceed that needed under current GAAP. Depending on the number of leases, the inception dates, and the records available, gathering and analyzing the information could take considerable time and effort. Beginning the process early can ensure that implementation of the final standard is orderly and well controlled. Companies should also be cognizant of the proposed model when negotiating lease contracts between now and the effective date of a final standard.

The Exposure Draft does not contain any discussion of transition implications for existing sale-leasebacks. For example, there is no discussion as to what happens with prior deferred gains from transactions that occurred before the initial application date or between the initial application date and adoption date (i.e., in the restated periods).

Timing for comments

120. Comments on the Exposure Draft are due by December 15, 2010. We encourage management to engage in the comment letter process and suggest that entities respond formally to the questions included in the Exposure Draft.

Example

121. The example on the following page is provided to demonstrate how the lessee model would be applied in practice.

Example: Lessee simple example

The lease is for a 100,000-square-foot building with a 10-year fixed term; initial annual rent is \$20 per square foot (paid in equal monthly payments) with rent escalating by 2% per year. The lessee's incremental borrowing rate is 7%. The lease has no extension options, residual value guarantees, or contingent rent.

The present value of the cash flows of \$15.5 million (calculated at a discount rate of 7%) would be recorded as the lease obligation and the right-to-use asset. The asset would then be amortized, most likely on a straight-line basis, while the obligation is decreased using the effective interest method. This results in a total expense of \$2.6 million in the first year, which is \$612,000 higher than the cash rent and \$422,000 (approximately 20%)

higher than expense under the straight-line method used today.

This example illustrates that over the lease term, the total amount of expense recognized would be the same under the proposed model as it is under the current operating lease model (straight-line expense recognition) and would be equal to the aggregate cash payments at the end of the lease term.

Balance sheet implications (in thousands)	Initial recognition	Year 1	Year 2
Right to use asset	\$15,540	\$13,986	\$12,432
Lease obligation	(\$15,540)	(\$14,598)	(\$13,547)
Cash (paid in monthly installments)		\$2,000	\$2,040
Cumulative cash		\$2,000	\$4,040
Income statement implications (in thousands)		Year 1	Year 2
Proposed accounting model			
Amortization of right to use asset (straight-line method)		\$1,554	\$1,554
Interest expense on lease obligation (effective interest method)		\$1,058	\$989
Combined expense related to the lease	A	\$2,612	\$2,543
Current accounting model			
Rent expense (straight-line method)	B	\$2,190	\$2,190
Difference—current period	A-B	\$422	\$353
Difference—cumulative		\$422	\$775

Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
\$10,878	\$9,324	\$7,770	\$6,216	\$4,662	\$3,108	\$1,554	\$0	
(\$12,377)	(\$11,079)	(\$9,644)	(\$8,061)	(\$6,318)	(\$4,403)	(\$2,302)	\$0	
\$2,081	\$2,123	\$2,165	\$2,208	\$2,252	\$2,297	\$2,343	\$2,391	\$21,900
\$6,121	\$8,244	\$10,409	\$12,617	\$14,869	\$17,166	\$19,509	\$21,900	
Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
\$1,554	\$1,554	\$1,554	\$1,554	\$1,554	\$1,554	\$1,554	\$1,554	\$15,540
\$911	\$825	\$730	\$625	\$509	\$382	\$242	\$89	\$6,360
\$2,465	\$2,379	\$2,284	\$2,179	\$2,063	\$1,936	\$1,796	\$1,643	\$21,900
\$2,190	\$2,190	\$2,190	\$2,190	\$2,190	\$2,190	\$2,190	\$2,190	\$21,900
\$275	\$189	\$94	(\$11)	(\$127)	(\$254)	(\$394)	(\$547)	\$0
\$1,050	\$1,239	\$1,333	\$1,322	\$1,195	\$941	\$547	\$0	

***To have a deeper conversation
about how this subject may affect
your business, please contact:***

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US GAAP Convergence & IFRS

Leases: Updated through March 31, 2011

March 2011

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IASB/FASB leasing redeliberations— March 2011 (third March meeting)

What's inside:

What is the issue?

Sale and leaseback—tentative decision

Contracts that contain a lease—tentative decision

Initial recognition and measurement—tentative decision

Determination of the discount rate—tentative decision

Initial direct costs—tentative decision

What is the issue?

The boards met this week with yet another long list of secondary re-deliberation issues, namely:

- sale and leaseback;
- contracts that contain a lease;
- initial recognition and measurement;
- determination of the discount rate; and
- initial direct costs.

Tentative decisions were made on each of these issues (summarised below). The next step is for the staff to bring back the remaining key redeliberation issues to the board for decisions in April, following the completion of the consultation efforts.

Reprinted from:

Straight away
March 25, 2011

Sale and leaseback— tentative decision

In a change from the exposure draft proposals, the boards have tentatively decided that a transaction should be accounted for as a sale and leaseback transaction when a sale occurs, using the control criteria in the proposed revenue recognition standard. They also confirmed that the seller/lessee can record a sale upon sale of the whole asset. Where the sale criteria are not met, the transaction would be accounted for as a financing lease. The additional risk and rewards assessment proposed in the exposure draft has been removed.

The boards confirmed their original proposal that, when consideration for the underlying asset is at fair value, any gains or losses arising from the transaction should not be deferred. Where the consideration is not at fair value, the assets and liabilities and gains or losses recognised should be adjusted to reflect current market rentals.

Contracts that contain a lease—tentative decision

The boards discussed the issue of multiple element contracts and which components should be separated when a lease contract also includes non-lease components. The boards have tentatively decided that all non-lease components, including services and other executory costs, should be separated and accounted for in accordance with applicable guidance.

For lessors, it was tentatively agreed that they should be required to allocate all payments required by the contract between the lease and non-lease components, consistent with an allocation method in the revenue recognition project.

For lessees, it was tentatively decided that they should be required to allocate between lease and non-lease components based on their relative stand-alone purchase price. However, where the purchase price of only one component is

observable, a lessee is permitted to use the residual method to allocate the price to the component for which there is no observable price. It was also clarified that a lessee does not have to 'hunt' for observable prices. Where there are no observable prices for any of the components, the entire contract should be treated as a lease.

Initial recognition and measurement—tentative decision

It was tentatively decided that a lessee and lessor should recognise and initially measure lease assets and liabilities at the date of commencement of the lease. This is a change from the exposure draft, where it was proposed that measurement would be at the date of inception of the lease and recognised on the date of commencement.

It was also tentatively decided that a lessee should use its incremental borrowing rate calculated at the date of commencement when using that rate to measure the liability to make lease payments. Any costs incurred by the lessee before the date of commencement relating to the construction of the underlying asset would be outside the scope of the lease standard (common with build-to-suit leases). The lessee will apply other relevant standards when accounting for such construction costs.

The boards also tentatively decided that lease payments made prior to the lease commencement date should be recognised as a pre-payment. This pre-payment balance would be transferred to the right-to-use asset on the date of commencement.

Determination of the discount rate—tentative decision

The boards tentatively decided that a lessee should use the incremental borrowing rate or the rate the lessor charges the lessee if readily determinable, as proposed in the exposure draft. The boards have clarified that if both rates are available, the lessee should use the rate the lessor charges the lessee; however, a lessee would not be expected to use extreme measures to determine the rate the lessor charges the lessee. The boards also tentatively decided that a lessor should use the rate charged in the lease.

Additional guidance will be provided in the standard on how to apply the discount rate to specific circumstances—or example, for property leases, determining the yield on property.

Initial direct costs—tentative decision

The boards confirmed that the definition of initial direct costs will be 'costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made'. This is consistent with the proposed definition in the exposure draft, except for the removal of the notion of 'recoverable'; it was felt that this was implicit in the definition. Initial direct costs should be included in the amount recognised for the lessee's right-to-use asset and the amount recognised for the lessor's lease receivable.

FASB and IASB propose additional changes to the leases exposure draft

What's inside:

What's new?

What are the key decisions?

Is convergence achieved?

Who's affected?

What's the effective date?

What's next?

Reprinted from:

In brief 2011–10

March 18, 2011

What's new?

The FASB and IASB (the “boards”) have met twice in March to discuss their joint project on leasing and have additional meetings planned throughout the remainder of March. The focus of the most recent meetings was to discuss and reach tentative decisions on several items in a long list of secondary redeliberation issues including: (1) short-term lease accounting, (2) guidance for distinguishing a lease from a purchase or sale, (3) accounting for purchase options, and (4) scope.

It is important to note that the boards' decisions are tentative and subject to change, as the boards have not yet concluded their redeliberations or issued a final standard. A complete summary of the boards' decisions on the leases project is available on the FASB's website at www.fasb.org or the IASB's website at www.ifrs.org.

What are the key decisions?

The tentative decisions made this month thus far are summarized as follows:

Area	Summary of decisions
Short-term lease accounting	The boards have responded to constituent concerns regarding the simplification guidance for short-term leases for lessees. They tentatively agreed that a lessee will be permitted to account for short-term leases in a manner consistent with the current requirements for operating leases. This decision will make the accounting for short-term leases by the lessee symmetrical to the proposed accounting for short-term leases by the lessor in the exposure draft. The boards re-confirmed that a short-term lease is defined as a lease that, at the date of commencement of the lease, has a maximum possible lease term—including any options to renew or extend—of 12 months or less. The short-term lease guidance will be an accounting policy choice made on an asset class basis. The boards also confirmed that the lease payments for short-term leases should be recognized by a lessee and a lessor on a straight-line basis in the income statement unless another systematic and rational basis better represents the time pattern in which use is derived from the underlying asset. This is similar to existing guidance for operating leases.

Area	Summary of decisions
Guidance for distinguishing a lease from a purchase and sale	The boards tentatively decided that the final lease accounting standard will not include guidance for distinguishing a lease of an underlying asset from an in-substance purchase or sale of the asset. They have agreed that a contract should be accounted for in accordance with the lease standard where the definition of a lease is met. Where the definition of a lease is not met, the contract should be accounted for in accordance with other applicable standards, such as revenue recognition by lessors and PP&E by lessees, where there is a sale or purchase of the underlying asset.
Accounting for purchase options	The boards have tentatively agreed that lessees and lessors should account for purchase options consistent with their tentative decision on renewal options – that is, purchase options should be included in the measurement of lease payments where there is significant economic incentive to exercise the option, such as a bargain purchase option. The staff has been instructed to conduct targeted outreach to determine whether reassessment of such options would be very common in practice and to obtain more information on the costs and benefits of reassessment.
Scope	The boards confirmed that the scope of the leasing standard would be the same as the scope described in the exposure draft.

Is convergence achieved?

The boards jointly issued the exposure draft on Leases, with no major areas of divergence between the boards. They are jointly redeliberating the exposure draft, and convergence is expected to be achieved.

Who's affected?

All companies that enter into leasing arrangements will be affected by these decisions. Some companies will be impacted more than others depending on the number and type of leases. Existing leases will not be grandfathered.

What's the effective date?

The boards have yet to decide on an effective date, but it likely will not be before 2014.

What's next?

The boards will continue redeliberations throughout the remainder of March and over the coming months. The FASB staff and IASB staff are performing targeted outreach. A final standard remains targeted for mid-2011. We will continue to keep you informed of the significant redeliberation decisions.

***To have a deeper conversation
about how this subject may affect
your business, please contact:***

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US GAAP Convergence & IFRS

Fair value measurement

March 2011

Fair value measurement

FASB and IASB joint project near completion

What's inside:

Overview

Key provisions

Differences between US GAAP and IFRS

Next steps

Reprinted from:

Dataline 2011–12
February 23, 2011

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- The FASB and IASB are close to completing their joint project on fair value measurement. Except for effective dates and transition, the boards have completed their redeliberations and plan to finalize their new, respective standards in March 2011.
- The joint project is part of the Memorandum of Understanding between the FASB and IASB. The objective of the project is to bring together as closely as possible the fair value measurement and disclosure guidance of the two boards. On June 29, 2010, both boards issued exposure drafts of proposed changes to their standards to achieve this goal. The IASB's exposure draft reflects significant changes to the proposed disclosures set out in its May 2009 exposure draft.
- In response to feedback on its ED, the FASB decided to make certain changes and clarifications to its proposal. Similar changes are also expected in the IASB's final standard. Although many of the changes to existing US GAAP will not have a significant effect on practice, some will.

This Dataline is based on the information in Dataline 2010-33, *FASB and IASB propose changes to fair value measurements and disclosures*. It summarizes key aspects of the ED and decisions reached by the FASB and IASB during redeliberations conducted subsequent to the issuance of their exposure drafts. Although all decisions are tentative until a final standard is issued, there is currently no indication that any of the boards' key tentative decisions on this project will be revisited.

The main details

1. Since 2008, entities that report under US generally accepted accounting principles (US GAAP) have been required to apply the guidance in the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures*, when accounting for fair value measurements. In May 2009, the International Accounting Standards Board (IASB) issued an exposure draft on fair value measurement and disclosure, which proposed guidance similar to that found in US GAAP. Facing potential divergence between International Financial Reporting Standards (IFRS) and US GAAP as a result of the comments received by the IASB, the FASB and the IASB (the boards) in October 2009 agreed to work together to reconcile differences with a goal of reaching a converged standard. This joint project is part of the Memorandum of Understanding between the boards.
2. The boards have agreed on many aspects of the project, including principles (such as the definition of

fair value and the market participant concept), other specified guidance (such as an exception for the measurement of financial instruments held in a portfolio with offsetting risks), and disclosures. Certain of the proposed changes will result in significant changes in practice. Such changes include how and when the valuation premise of highest and best use applies, the application of premiums and discounts, as well as new required disclosures. Despite the boards' alignment on most aspects of the project, certain differences will not be resolved through this project. Those differences include the recognition of gains and losses at the inception of a transaction that result from differences between fair value and transaction price ("day one" gains and losses) and the valuation of certain investments that report a net asset value ("NAV").

3. This Dataline describes the key proposed changes, as well as other notable clarifying guidance included in the FASB's proposals, updated to reflect the results of the boards' redeliberations. It also highlights certain similarities and differences between the proposed changes to US GAAP and to IFRS. The comment periods for the boards' proposals ended on September 7, 2010 and the boards are currently expected to finalize their respective standards in March 2011. Except for effective dates and transition, the boards have finalized their redeliberations. Those remaining discussions are expected to occur in March 2011.

PwC observation: Key issues raised during the comment process focused on the need for

clarification or reconsideration of the measurement uncertainty disclosure, the elimination of the highest and best use concept, which establishes the valuation premise, for all fair value measurements other than for nonfinancial assets, and the proposals regarding blockage factors and other premiums and discounts. The boards have decided to make certain clarifications and deal with the proposed measurement uncertainty analysis disclosure in a separate phase of the project. However, those changes may not fully address the concerns raised by many constituents. For example, we expect that the final standard issued by the FASB will continue to require certain quantitative disclosures about unobservable inputs as well as qualitative disclosures about the sensitivity inherent in Level 3 fair value measurements. These disclosures may, similar to the requirement proposed in the ED, be time consuming and costly to prepare with limited benefit.

Key provisions

4. The following FASB key provisions are consistent with what the IASB currently plans to issue.

Primary changes

Valuation premise and highest and best use

5. One of the most significant areas of proposed change involves the

valuation premise and the concept of highest and best use which establishes that premise. Under existing US GAAP, the valuation premise incorporates two approaches for determining the highest and best use of an asset: "in-use" and "in-exchange." In-use refers to a valuation premise for an asset that provides maximum value to market participants principally through its use with other assets as a group. In-exchange refers to a valuation premise for an asset that provides maximum value to market participants principally on a stand-alone basis.

6. The FASB proposed to eliminate the terms in-use and in-exchange. Instead, the objectives of the valuation premise would be described such that an asset or a liability would be used either in combination with a group of assets, with a group of liabilities, or with a group of assets and liabilities (formerly in-use), or on a standalone basis (formerly in-exchange).
7. Of greater consequence however, is the FASB's (and IASB's) proposal that the concepts of the valuation premise and highest and best use are only relevant when measuring the fair value of nonfinancial assets (and therefore would not apply to financial assets or any liabilities). During redeliberations, the boards reaffirmed this principle as proposed. This will result in a significant change to ASC 820, which provides general guidance on the application of the valuation premise and highest and best use for assets but provides for its application to all assets, as appropriate in the circumstances. The proposal therefore prohibits the grouping of financial

instruments for purposes of determining their fair values and requires that their fair values be measured at the level of the unit of account as specified in other guidance.

8. The boards reached this conclusion based on the view that financial assets do not have alternative uses, that disposing of financial assets in different ways (such as in a group) represents an entity-specific decision, and that the concept of highest and best use was originally developed for valuing non-financial assets, such as land. Therefore, the fair value of financial assets would need to be measured based on the unit of account of the underlying item. For example, aggregating individual financial assets (such as a block position of a particular equity security) into a pool of securities or block position would no longer be permitted in arriving at a valuation, but rather measurement would have to be based on the value of the individual security consistent with the unit of account defined by other guidance. This would apply even though the disposition of the financial assets may be most efficiently and economically achieved by grouping them, and such groupings may be consistent with prior business practices and with management's intent.

PwC observation: The current in-use methodology is commonly applied to financial items that trade in pools of relatively homogeneous assets, such as blocks of equity securities or insurance policy risks. Eliminating it for financial instruments has the potential to significantly affect the way that

entities such as private equity firms value their financial asset holdings, resulting in values that may be inconsistent with expectations based on business and market practices.

Measuring portfolios of financial instruments

9. The boards proposed an exception to the valuation premise when an entity manages its market risks and/or counterparty credit risk exposure within a group (portfolio) of financial instruments on a net basis. This exception would also apply to portfolios of derivatives that are managed on a net basis and recorded at fair value on a recurring basis. In these circumstances, this exception would allow for the fair value of those financial assets and financial liabilities to be measured based on the net positions of the portfolios (i.e., the price that would be received to sell a net long position or transfer a net short position for a particular market or credit risk exposure), rather than the individual values of financial instruments within the portfolio. This represents an exception to how financial assets and financial liabilities would be measured under the proposed guidance, which would require measurement of each security within the portfolio on its own (that is, on a gross basis).
10. This exception to the valuation premise was proposed based on the results of outreach performed by staff of the FASB and IASB. The results indicate that many financial institutions or similar entities that

hold financial instruments manage financial assets and financial liabilities in this manner (that is, based on the net long or net short position for a particular market risk or counterparty credit risk). The ED articulates that the net risk exposure of a group of financial assets and financial liabilities is a function of the instruments the entity decides to hold and its tolerance for risk relative to a position (that is, entity-specific decisions that would not normally form part of a fair value measurement). The boards recognized that market participants holding the same group of financial instruments would likely price them in the same way. Therefore, this exception is intended to result in financial reporting that provides more information about the relationship between a reporting entity's business strategy and the fair value of the financial instruments that are in a portfolio with offsetting risks, while addressing a practical issue for entities that manage their portfolios in this manner.

11. In order to qualify for either the exception related to market risks or credit risk, the ED proposed four overall criteria that the reporting entity must meet as follows:
 - It manages the group of financial assets and financial liabilities on the basis of its net exposure to a particular market risk (or risks) or to the credit risk of the counterparty, in accordance with the reporting entity's documented risk management or investment strategy. Market risks refer to interest rate risk, currency risk, or other price risk (for

example, commodity price risk for commodity derivatives).

- It provides information on that basis about the group of financial assets and financial liabilities to management (for example, the reporting entity's board of directors or chief executive officer).
- It manages the net exposure (to a market risk or counterparty credit risk) in a consistent manner from period to period.
- It is required to or has elected to measure the financial assets and financial liabilities at fair value in the balance sheet at each reporting date.

- 12.** As a result of feedback from constituents, the boards decided to remove the requirement contained in the third bullet above, recognizing that portfolios are not static. Since the composition of a portfolio changes continually due to rebalancing and as an entity changes its risk exposure preferences over time, this requirement would have limited an entity's ability to use the exception. Therefore the boards decided to clarify that the reporting entity must make an accounting policy decision to use the exception and must meet the remaining listed criteria. The boards also decided to provide some guidance about how an entity may consider allocating its bid-ask and credit portfolio adjustments among the positions within the portfolio.

Offsetting market risks

- 13.** In addition to meeting the criteria outlined in paragraphs 11 and 12 above, the proposal requires that

market risks that are being offset be substantially the same in order for the entity to use the exception to measuring fair value at the level of the unit of account (paragraph 9 above). Further, entities should apply the bid-ask spread guidance in ASC 820 to the net position (that is, an entity should apply the price within the bid-ask spread that is most representative of the fair value of the entity's net exposure to those market risks). The adjustments applied to the net position would then need to be allocated among the positions in the portfolio to arrive at their individual fair values.

PwC observation: It is important to note that the exception relating to the offsetting of market risks is limited to those risks that are substantially the same. During board redeliberations, discussions were held about what is meant by "substantially the same." These discussions seemed to suggest the availability of the exception may be narrow as compared to the current practice of offsetting risks in the marketplace.

Offsetting credit risk

- 14.** In addition to meeting the criteria outlined in paragraphs 11 and 12 above, to apply the exception related to credit risk, the entity must have a legally enforceable right to set off with the counterparty in the event of default (for example, through a master netting agreement). In a portfolio of financial assets and liabilities (including derivatives) within a master netting agreement,

the adjustment for credit risk could be applied to the net exposure to the counterparty, rather than to each of the financial assets and liabilities separately. The adjustment would be applied to the net position based on the counterparty's credit risk in the case of a net asset position or the reporting entity's own credit risk in the case of a liability position.

Blockage factors and other premiums and discounts

- 15.** A blockage factor is a discount applied in measuring the value of a security to reflect the impact on its value of selling a large block of the security at one time. ASC 820 currently prohibits application of a blockage factor in measuring the fair value of financial instruments that have quoted prices in active markets (that is, Level 1 fair value measurements). However, blockage factors are not prohibited for Level 2 and Level 3 fair value measurements under ASC 820.
- 16.** The ED proposed to continue to prohibit the application of blockage factors for Level 1 fair value measurements but also to eliminate the application of blockage factors for all levels in the fair value hierarchy, on the basis that the incurrence of a blockage factor is an entity-specific decision (which does not form part of a fair value measurement). The boards have since decided to clarify that a fair value measurement that is not a Level 1 measurement may include premiums or discounts when market participants would do so when pricing the asset or liability given the unit of account specified in other guidance. In the absence of the unit of account

being defined within US GAAP, an entity would apply premiums or discounts if market participants would do so to maximize the fair value of an asset or minimize the fair value of a liability, on the basis of how market participants would enter into a transaction for the asset or liability. Adjustments to the inputs for assets or liabilities deemed to be within Level 1 of the fair value hierarchy would continue to be precluded (that is, if a fair value measurement is a Level 1 fair value measurement, additional premiums or discounts could not be applied to the Level 1 input(s)).

17. The boards also decided to clarify that the concept of value maximization is fundamental to the fair value measurement of financial instruments because market participants would enter into transactions that maximize fair value. The concept of value maximization would therefore apply as follows:

- If the unit of account is specified in other guidance, the concept of value maximization would apply when determining fair value at the level of the unit of account.
- If the unit of account is not specified in other guidance, fair value would be determined including the use of premiums and discounts as appropriate, applying the concept of value maximization.

18. The unit of account of the asset or liability being measured determines the premiums or discounts that can be applied. For example, control premiums are applied in the context of a controlling interest and not in the context of a holding of securities where the unit of account is the

individual instrument. As a result, control premiums will not be applicable when the unit of account is the individual instrument. Instead, application of control premiums would be permitted only in the case of a unit of account that is specified in US GAAP and provides a greater level of aggregation than the individual security or when the unit of account is not specified in US GAAP and aggregation would be consistent with market participant assumptions. This may be the case with a reporting unit for which fair value is applied in connection with a business combination or goodwill impairment testing.

PwC observation: The guidance regarding premiums and discounts may require changes to current practice for investments held in blocks owned by private equity or investment companies. In such cases, if a block of securities was purchased at a premium, this change may result in the immediate recognition of losses because fair value could no longer be determined using a control premium. Conversely, immediate gain recognition may occur if a block of securities was purchased at a discount.

Disclosures

19. The ED includes some new and revised disclosure requirements. During redeliberations, the boards decided to retain most of the proposed disclosures with some clarifications. However, the proposed measurement uncertainty disclosure was deferred pending further outreach and field testing. Certain additional disclosures

regarding Level 3 fair value measurements will be required. The new disclosures that the boards agreed to are described below.

20. For Level 3 fair value measurements, quantitative information about unobservable inputs and assumptions used, a description of the valuation control processes in place, and a qualitative discussion about the sensitivity of recurring Level 3 fair value measurements will be required. These disclosures will replace the originally-proposed measurement uncertainty analysis that would have required entities to disclose the effect on a Level 3 fair value measurement when changes from unobservable inputs to other inputs that could reasonably have been substituted result in significant differences in measurement. In response to cost/benefit concerns raised by constituents regarding the proposed measurement uncertainty analysis disclosure, the boards determined that additional outreach and field testing would be performed as a separate phase of the overall fair value measurement project.

PwC observation: Although the boards agreed to perform additional work before requiring the proposed measurement uncertainty analysis disclosure, it is unclear whether the alternative disclosures that will be required will be any more or less complex and costly to prepare. While the specific requirement for Level 3 fair value measurements will not be known until the final standards are released, the requirement to include quantitative information as well as qualitative information about sensitivity and

inter-relationships between unobservable inputs may continue to draw similar cost/benefit concerns from constituents.

- 21.** The FASB has also proposed a subtle, yet potentially significant, change to existing disclosure requirements for transfers of fair value measurements among levels in the fair value hierarchy. Currently, US GAAP requires disclosure of any significant transfers between Level 1 and Level 2, including the reasons for those transfers. The FASB will now require that public companies disclose *any* such transfers, whether significant or not, including the reasons for those transfers. While this proposed change has not been highlighted by the FASB as a key change, the requirement to disclose *any* such transfers is broader than the current requirement, which focuses on *significant* transfers, and may be more operationally difficult to apply in practice.
- 22.** Also included in the proposals is a new requirement regarding the disclosure about the highest and best use of a nonfinancial asset. If the highest and best use of a nonfinancial asset differs from its current use by the entity, it would be required to disclose the reason(s) why the asset is being used differently. This would be required in the case where the nonfinancial asset is being recorded at fair value on the balance sheet (as well as those only disclosed at fair value, for public companies). For example, if a nonfinancial asset is acquired in a business combination and is recorded at fair value based on its highest and best use

under the market participant principles in ASC 820, but the entity is using the asset differently in its business, it will be required to disclose that fact and the reason(s) why.

- 23.** The ED also contains a requirement that all fair value measurements (whether they represent fair value measurements recognized on the balance sheet or, for public companies, are disclosure-only in accordance with ASC 825) be categorized in the fair value hierarchy with disclosure of that categorization. As a result, public companies will be required to determine the level in the fair value hierarchy of assets and liabilities that are not recorded at fair value (such as the disclosure of the fair value of long-term debt that is recorded at amortized cost on the balance sheet).

Disclosure exceptions for nonpublic entities

- 24.** No exceptions to the principles of fair value measurement will be provided to nonpublic entities. However, the FASB decided that nonpublic entities will not be required to disclose:
- Any of the disclosures above pertaining to fair value measurements if fair values are not reported as the measurement basis on the balance sheet, but are only disclosed.
 - Transfers of fair value measurements between Level 1 and Level 2 of the fair value hierarchy.
 - The qualitative discussion about the sensitivity of recurring Level 3 fair value measurements.

Other new or clarifying guidance

Instruments classified within shareholders' equity

- 25.** While ASC 820 currently does not include guidance on how to measure the fair value of instruments classified within shareholders' equity, the principles in ASC 820 must be applied when measuring their fair values. An example where this may apply is when equity interests are issued as consideration in a business combination. The proposed guidance specifies that an entity should measure the fair value of its own equity instruments from the perspective of a market participant who holds the instrument as an asset. The boards decided during redeliberations that an entity may apply the guidance on measuring the fair value of liabilities when measuring instruments classified within shareholders' equity at fair value. This proposed guidance is not expected to result in a change in practice under US GAAP for the valuation of instruments classified in shareholders' equity. However, some entities could experience a difference if they have historically used another method to value these instruments.

Principal (or most advantageous) market

- 26.** The IASB received comments indicating a lack of clarity about the concept of principal market in its original fair value measurements exposure draft. Therefore, the boards jointly deliberated and concluded that a clarification on how the principal

market is determined should be provided. The ED includes a clarification that the principal market is the market with the greatest volume and level of activity *for the asset or liability*. This represents a change from existing US GAAP, since currently ASC 820 indicates that the principal market is the market where the *reporting entity transacts* with the greatest volume and level of activity for the asset or liability. However, the ED also clarifies that the principal market is presumed to be the market in which the reporting entity normally transacts, unless there is evidence to the contrary. Reporting entities do not have to do exhaustive searches for other markets where the asset or liability may have more activity. The boards decided to retain the guidance proposed in the ED. Practice is not expected to change except where it is evident there is another active market with greater activity for the asset or liability than the one in which the reporting entity transacts.

27. In addition to the clarification of the principal market, the ED specifies that in the absence of a principal market for an asset or liability, a reporting entity should determine the most advantageous market and, in doing so, take into account both transaction costs and transportation costs. Further, the measurement of fair value would continue to incorporate transportation costs but would exclude transaction costs unless specifically required by other U.S. GAAP. This does not represent a difference from how US GAAP is applied today.

Application to liabilities

28. Two clarifications proposed to the guidance for measuring the fair value of liabilities were reaffirmed by the boards during their redeliberations. The first requires that transfer restrictions on liabilities should be ignored in the valuation because the fair value of the liability is a function of the requirement to fulfill the obligation. This is different from an asset, whereby a restriction on the transfer of the asset affects its marketability. The boards determined that nearly all liabilities include a restriction preventing their transfer. Consequently, the effect of any restrictions preventing the transfer of a liability would be consistent for all liabilities; thus, such restrictions are effectively inherent in other inputs to the valuation. This is consistent with current practice for valuing liabilities based on a hypothetical transfer.
29. The second clarification pertains to the income approach for liabilities. When measuring the fair value of a liability using a present value technique, US GAAP currently requires that a reporting entity include the compensation that a market participant would require for taking on that obligation. The boards have agreed that compensation that a market participant would require for taking on the obligation includes the return that the market participant would require for (1) undertaking the activity and (2) assuming the risk associated with the obligation. The return for *undertaking the activity* represents the value of fulfilling the

obligation, for example, by using resources that could be used for another purpose. The return for *assuming the risk* represents the value associated with the risk that cash flows may ultimately differ from expectations. Because existing US GAAP requires that reporting entities include market participant assumptions in the fair value measurement (including considering compensation for taking on a liability) this clarification, while providing clearer guidance, is not expected to result in a significant change in practice.

Effective date and transition

30. The FASB has yet to determine the effective date. Within its overall request for feedback on effective dates and transition methods as part of the joint project by that name, the IASB specifically requested feedback from constituents about the fair value measurement project (whereas the FASB did not). The FASB has determined that it will consider the responses that the IASB receives specific to the fair value measurement project for purposes of finalizing the effective date for that project.
31. The FASB is expected to finalize transition guidance concurrently with the effective date. The ED proposed that the new guidance would be effective as of the beginning of the period of adoption, with a cumulative effect adjustment to beginning retained earnings in the period of adoption. That cumulative effect

adjustment would reflect differences in fair value measurements resulting from applying the new guidance. New disclosures would be required prospectively upon adoption.

Differences between US GAAP and IFRS

32. The impetus for this joint project was convergence of the fair value measurement and disclosure guidance between US GAAP and IFRS. Based on the proposals and board redeliberations, a high degree of convergence should be achieved for the measurement and disclosure of the fair value of assets and liabilities, when fair value is required or permitted to be used. However, two key differences between the fair value measurement and disclosure guidance under US GAAP and IFRS would continue to exist, as described below.

Day one gains and losses

33. The issuance of ASC 820 resulted in a difference between US GAAP and IFRS in the accounting for day one gains and losses. Under ASC 820, the immediate recognition of gains and losses is required even when inputs are unobservable. ASC 820 had the effect of nullifying prior guidance that prohibited immediate recognition of unrealized gains and losses for the difference between transaction price and fair value, when the fair value determination relied significantly on inputs that were not based on observable market data. Furthermore, the ED confirmed that guidance by adding

the following in newly proposed ASC 820-10-30-6:

If another Topic requires or permits a reporting entity to measure an asset or a liability initially at fair value and the transaction price differs from fair value, the reporting entity shall recognize the resulting gain or loss in earnings unless that Topic specifies otherwise.

34. In contrast, certain standards within IFRS contain guidance restricting day one gains and losses when the fair value measurement is based on inputs that are not observable. This guidance will remain in place, for example, within IAS 39, *Financial Instruments: Recognition and Measurement*, as carried forward by IFRS 9, *Financial Instruments*. The IASB has not addressed whether it will change that guidance.

35. While this difference pertains to the recognition of gains and losses (rather than to how the fair value of an asset or liability should be measured or disclosed), it is an important difference that arises in the fair value measurement of assets and liabilities.

Measuring the fair value of alternative investments

36. In October 2009, the FASB issued ASU 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, which amended ASC 820. This guidance provides a practical expedient to reporting entities, allowing them to measure the fair value of investments

within the scope of the ASU at NAV, under certain conditions. The scope of the guidance includes investments in entities that are substantially similar to investment companies, as specified in ASC 946, *Financial Services—Investment Companies*. The guidance was issued due to certain practical difficulties of adjusting NAV to estimate the fair value of certain alternative investments.

37. The FASB retained this guidance in its proposal. However, under IFRS, there currently is no definition of or guidance on investment companies. As a result, and because NAV is not defined or calculated in a consistent manner in different parts of the world, the IASB has decided against issuing similar guidance on measuring alternative investments at this time.

Next steps

38. The FASB and IASB expect to finalize their standards in March 2011, after completing their redeliberations on transition and effective dates.

PwC observation: While many of the proposed changes to US GAAP are clarifications to existing guidance, some (such as the change in the valuation premise, the application of premiums and discounts to fair value measurements, and new required disclosures) could have a significant impact on current practice. Reporting entities should familiarize themselves with the proposals and the boards' decisions coming out of redeliberations, and consider the potential impact on their financial reporting.

***To have a deeper conversation
about how this subject may affect
your business, please contact:***

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US GAAP Convergence & IFRS

Statement of comprehensive income

March 2011

Statement of comprehensive income

The FASB is expected to allow one continuous statement, or separate consecutive statements of net income and other comprehensive income

What's inside:

Overview

Key provisions of the FASB's requirements

Comparison with the IASB's requirement

Effective date and transition

Reprinted from:

Dataline 2011-08

February 15, 2011

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- The FASB and IASB (the "Boards") issued proposals, in May 2010, to require companies to issue a single continuous statement of comprehensive income. Together the FASB and IASB received over 200 comment letters on the proposed new primary financial statement.
- Based on their re-deliberations, the Boards are expected to amend their proposals. They have tentatively decided to require entities to present net income and other comprehensive income in either a single continuous statement or in two separate, but consecutive, statements of net income and other comprehensive income. The option to present items of other comprehensive income in the statement of changes in equity would be eliminated.
- Both Boards are expected to issue final standards incorporating the tentative conclusions by the end of the first quarter of 2011. The new requirements would generally be effective in fiscal years beginning after the end of calendar-2011. Early adoption would be permitted.

The main details

1. In May 2010, the FASB issued a proposal to require most entities to provide a new primary financial statement, referred to as the statement of comprehensive income. Under the May proposal, all components of net income and other comprehensive income would be reflected in one continuous statement of comprehensive income. The Boards worked jointly on this project, and the IASB concurrently issued a similar proposed amendment to IAS 1, *Presentation of Financial Statements*.

PwC observation: The proposals were consistent with the Boards' 2008 discussion paper titled *Preliminary Views on Financial Statement Presentation*. Although the Boards had intended to propose this new statement as part of their financial statement

presentation projects, they decided to accelerate this change because of the increased use of other comprehensive income that both Boards are considering under other proposals. For example, under the FASB's proposal to revise the accounting for financial instruments (also issued in May 2010), entities would be permitted to recognize in other comprehensive income changes in the fair values of certain financial assets and liabilities that are held for the collection or payment of contractual cash flows. (See Dataline 2010-25 for more information.) Similarly, the IASB issued IFRS 9, *Financial Instruments*, which permits an entity to make an irrevocable election to present in other comprehensive income changes in the fair value of any investment in equity instruments that are not held for

trading. And, in April 2010, the IASB issued an Exposure Draft titled *Defined Benefit Plans* proposing that actuarial gains and losses be recognized in the balance sheet in full through a charge or credit to other comprehensive income in the periods in which the gains and losses occur. Those amounts would not be subject to subsequent amortization into net income, as is currently required under US GAAP. (See Dataline 2010–23 for more information.)

2. The FASB and IASB received over 70 and 150 comment letters, respectively, on their May 2010 proposals.

PwC observation: The majority of preparers who responded opposed the proposal to require one continuous statement of comprehensive income. They believe that the new statement would de-emphasize the importance of net income, the presentation of two measures of income in the same statement could confuse financial statement users, and there is no compelling reason for the proposed changes. Some significant investor groups, however, supported the proposed change on the basis that it appropriately raises the profile of comprehensive income.

Furthermore, many constituents called for the Boards to address the conceptual basis for items to be included in other comprehensive income and what items should be subsequently recycled to net income. While the Boards generally agreed with the longer term need to address those questions, they

preferred not to delay finalizing this project until they had developed a conceptual basis for other comprehensive income. The Boards are expected to consider later this year whether to add a project to address those questions.

3. The Boards have considered constituents' feedback on their proposals and have tentatively decided not to require a single continuous statement of comprehensive income. Instead, they will allow entities to present items of net income and other comprehensive income either in one continuous statement or in two separate, but consecutive, statements. Most other aspects of their May 2010 proposals were reaffirmed. This Dataline reflects the decisions that we anticipate will be formalized in a soon to be issued FASB accounting standards update.
4. The new requirements would not change, under either accounting framework, which components of comprehensive income are recognized in net income or other comprehensive income, or when an item of other comprehensive income must be reclassified to net income. Also, the earnings-per-share computation would not change; it would continue to be based on net income. Nevertheless, the Boards felt that these presentation changes were needed because of the potential for more items to be reflected in other comprehensive income under other proposals. The requirements are intended to enable easier comparability of entities' reporting between the two sets of standards and to provide a more consistent method of presenting

non-owner transactions that affect an entity's equity.

5. The Boards are expected to issue their respective final standards before the end of the first quarter 2011. It is anticipated that the new requirements would become effective in 2012 with full retrospective application required. Early adoption would be permitted.

Key provisions of the FASB's requirements

Scope

6. The new presentation requirements would apply to all entities that provide a full set of financial statements to report financial position, results of operations, and cash flows. The requirements would also apply to investment companies, defined benefit pension plans, and other employee benefit plans that are exempt from reporting a statement of cash flows under ASC 230, *Statement of Cash Flows*. An entity that is deemed a not-for-profit entity under ASC 958, *Not for Profit Entities*, would be outside the scope of the requirements. In addition, an entity would continue to report only net income in the performance statement if it does not have items of other comprehensive income for any of the periods presented.

PwC observation: Although the requirements would also apply to investment companies, defined benefit pension plans and other employee benefit plans, those entities typically do not have items of other comprehensive income and therefore this requirement would not impact most of them.

The alternatives

7. An entity would be able to elect to present items of net income and other comprehensive income in one continuous statement or in two separate, but consecutive, statements. An entity would be required to display each component of net income and each component of other comprehensive income under either alternative. In addition, totals would need to be displayed under either alternative for comprehensive income and each of its two parts—net income and other comprehensive income.
8. Under either alternative, the statement(s) would be required to be presented with equal prominence as the other primary financial statements. The current alternative option to report other comprehensive income and its components in the statement of changes in equity would be eliminated.

PwC observation: It is unclear whether the elimination of the option to present other comprehensive income within the statement of changes in equity will lead some financial statement users to place greater emphasis or importance on other comprehensive income and/or comprehensive income. However, the increased prominence of other comprehensive income and comprehensive income could lead to an increase in questions from financial statement users. Consequently, entities should be prepared to proactively address or respond to these questions.

9. Reclassification adjustments between net income and other comprehensive income would have to be shown on the face of the statement(s). The current option to disclose reclassification adjustments in the footnotes would be eliminated.
10. An entity would, if applicable, continue to separately disclose items of net income and comprehensive income attributable to its parent and any non-controlling interest. In addition, the requirement would not change:
 - The items that constitute net income and other comprehensive income
 - When an item of other comprehensive income must be reclassified to net income
 - The earnings-per-share calculation

Tax effects

11. The option to present components of other comprehensive income net of the related tax effects or before the related tax effects with one amount reported for the tax effects of all other comprehensive income items would continue to be available. Entities would still be required to present parenthetically on the face of the statement or disclose in the footnotes the tax allocated to each component of other comprehensive income, including for reclassification adjustments.

Accumulated balances

12. The components of accumulated other comprehensive income would need to be displayed separately from retained earnings on the statement of changes in equity or in the footnotes. Currently, entities have the option to present these accumulated balances on the statement of financial position, the statement of changes in equity, or in the footnotes.

Statement of changes in equity

13. Entities would continue to be able to present accumulated other comprehensive income components either gross or net of the related tax effects on the statement of changes in equity.

Example presentation

14. The examples on pages 4 and 5 illustrate some of the alternative presentation requirements:

Example 1: Single statement

Statement of comprehensive income	For years ended Dec. 31	
	2012	2011
Revenues	\$ 3,550,000	\$ 3,300,000
Expenses	(2,100,000)	(1,950,000)
Gains (losses) on sales of available-for-sale securities	600,000	(250,000)
Income from operations before tax	2,050,000	1,100,000
Income tax expense	(600,000)	(250,000)
Income before extraordinary item	1,450,000	850,000
Extraordinary item, net of tax	(50,000)	-
Net income	1,400,000	850,000
Other comprehensive income, net of tax:		
Foreign currency translation adjustments	5,000	(20,000)
Unrealized gains (losses) for the period	450,000	60,000
Less: reclassification adjustment for (gains) losses included in net income	(150,000)	(50,000)
Unrealized gains on available-for-sale securities	300,000	10,000
Prior service cost of the period	10,000	5,000
Net loss for the period	(70,000)	(120,000)
Less: amortization of prior service cost included in net periodic pension cost	(5,000)	(5,000)
Defined benefit pension plan	(65,000)	(120,000)
Other comprehensive income	240,000	(130,000)
Comprehensive income	\$ 1,640,000	\$ 720,000

Example 2: Two separate, but consecutive, statements

Income statement	For years ended Dec. 31	
	2012	2011
Revenues	\$ 3,550,000	\$ 3,300,000
Expenses	(2,100,000)	(1,950,000)
Gains (losses) on sales of available-for-sale securities	600,000	(250,000)
Income from operations before tax	2,050,000	1,100,000
Income tax expense	(600,000)	(250,000)
Income before extraordinary item	1,450,000	850,000
Extraordinary item, net of tax	(50,000)	-
Net income	\$ 1,400,000	\$ 850,000

After page break:

Statement of comprehensive income	For years ended Dec. 31	
	2012	2011
Net income	\$ 1,400,000	\$ 850,000
Other comprehensive income, net of tax:		
Foreign currency translation adjustments	5,000	(20,000)
Unrealized gains (losses) for the period	450,000	60,000
Less: reclassification adjustment for (gains) losses included in net income	(150,000)	(50,000)
Unrealized gains on available-for-sale securities	300,000	10,000
Prior service cost of the period	10,000	5,000
Net loss for the period	(70,000)	(120,000)
Less: amortization of prior service cost included in net periodic pension cost	(5,000)	(5,000)
Defined benefit pension plan	(65,000)	(120,000)
	240,000	(130,000)
Comprehensive income	\$ 1,640,000	\$ 720,000

Comparison with the IASB's requirement

- 15.** The IASB's amendment to IAS 1, Presentation of financial statements, is expected to be similar to the FASB's final standard. However, some terminology and other differences are anticipated between the two final standards. The one continuous performance statement alternative is referred to by the IASB as the statement of profit or loss and other comprehensive income. Both the FASB and the IASB, however, would continue to allow entities to use other titles for the primary financial statements.
- 16.** IFRS currently allows comprehensive income to be presented in two statements: a statement displaying components of profit or loss and a second statement beginning with profit or loss and displaying components of other comprehensive income. Therefore, the final standard will have a limited impact on current IFRS. The IASB had eliminated the option to present other comprehensive income within the statement of changes in equity in 2007.
- 17.** Consistent with the FASB, the IASB decided not to change the items that constitute net profit or loss or other comprehensive income. Earnings-per-share will continue to be based on net profit or loss. Also, entities would continue to have the option to present items of other comprehensive income either gross or net of tax.
- 18.** The IASB will require that items included in other comprehensive income that may be recycled into profit or loss in future periods (for example, cash flow hedges and the cumulative translation adjustment) be presented separately from those that will not be recycled (for example, revaluations of property, plant and equipment, and actuarial gains and losses). This distinction does not exist under US GAAP, where all items included in other comprehensive income are subject to recycling.
- 19.** An entity that elects to show items in other comprehensive income before tax would be required to allocate the tax between the tax on items that might be reclassified subsequently to profit or loss and tax on items that will not be reclassified subsequently.
- 20.** The IASB is not expected to eliminate the option to present the components of accumulated other comprehensive income on the face of the statement of financial position. In addition, the IASB is expected to retain the option to disclose reclassification adjustments in the notes to the financial statements. As noted above, the FASB would eliminate those options.

Effective date and transition

- 21.** The new requirements would be effective as of the beginning of a fiscal year that begins after December 15, 2011 for US GAAP and for fiscal years that begin on or after January 1, 2012 for IFRS. Early adoption would be permitted.
- 22.** Full retrospective application will be required under both sets of accounting standards.

***To have a deeper conversation
about how this subject may affect
your business, please contact:***

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US GAAP Convergence & IFRS

Balance sheet offsetting

March 2011

Balance sheet offsetting

The FASB and IASB proposal

What's inside:

Overview

The main details

Reprinted from:

Dataline 2011–10
February 22, 2011

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- On January 28, 2011, the FASB and the IASB (the “Boards”) jointly issued an exposure draft, *Offsetting Financial Assets and Financial Liabilities*.
- Entities that historically elected to present derivatives assets and liabilities subject to master netting arrangements on a net basis will be required to report them gross in their statement of financial position. This could significantly impact the balance sheet of many reporting entities that currently apply an accounting policy election to net these amounts.
- Entities will have to evaluate the method of settlement for any transactions processed through an exchange or clearinghouse in order to ascertain whether a financial asset and financial liability are to be “simultaneously settled.”
- The exposure draft proposes new disclosure requirements for financial assets and liabilities subject to offset.

The main details

1. Under the proposed guidance, an entity will be *required* to offset a recognized financial asset and recognized financial liability if (and only if) it has an unconditional and legally enforceable right of offset and intends to either settle the asset and liability on a net basis or realize the asset and settle the liability simultaneously.

Unconditional and legally enforceable right of setoff

2. The proposed guidance defines an unconditional right of offset as a right of offset that is enforceable in *all* circumstances, including, but not limited to, default or bankruptcy of the counterparty. Conversely, a conditional right of offset is defined as a right of offset that is *only* enforceable upon the occurrence of a future event, such as the default or bankruptcy

of one of the counterparties to a contract.

3. Under current US GAAP, an entity has the ability to elect gross or net presentation for derivatives and related collateral postings subject to master netting agreements. The ability to elect net presentation under US GAAP is an “exception” to the existing offsetting criteria. These master netting agreements generally include only a conditional right of offset and as a result, net presentation would not be permitted under the proposed guidance. The elimination of this exception could significantly impact the balance sheet of many reporting entities that currently apply an accounting policy election to net these amounts. Under IFRS, derivative assets and liabilities are not presented on a net basis as there is no “exception” to the existing offsetting criteria.

PwC observation: The Boards’ discussion about conditional

and unconditional right of offset, although drafted more broadly, was focused on the standard provisions of the International Swap Dealers Association (ISDA) master agreement. ISDA's master agreement is the industry standard utilized for derivative instruments. These agreements provide for netting of amounts owed against amounts due in the event of bankruptcy or default of one of the counterparties to the arrangement. Under the proposed guidance, these terms would represent a conditional right of offset.

The Boards reasoned that requiring offsetting on the basis of what might or might not happen in the future would not be appropriate. The FASB's historic position on permitting derivative asset and liabilities (and related collateral amounts) to be reported on a net basis was driven by a view that this most accurately portrayed the credit risk the reporting entity was exposed to. In their deliberations, the Boards specifically noted that the statement of financial position is not intended to represent the aggregation of credit risk of an entity.

4. The proposed standard also eliminates certain industry-specific offsetting guidance, including:
 - **Contractors:** Advances on cost plus contracts
 - **Broker and dealers:** Trade date receivables and payables
 - **Depository and lending:** Reciprocal account balances

Under the proposed standard, these amounts can only be offset if the criteria described above are met.

Intention to settle net or settle simultaneously

5. In order to offset a financial asset and financial liability, an entity must have the intention to settle net or settle simultaneously the asset and liability. The entity's intentions may be demonstrated through past practice, usual operating practices, or by reference to documented risk management practices.
6. In order for settlement to be considered simultaneous, the realization of the asset and settlement of the liability must occur at the same moment (i.e., there is exposure only for the net amount). As a result, if settlement takes place over a period of time, it is not simultaneous settlement.

PwC observation: Many constituents are evaluating what impact this provision will have on an entity's current ability under US GAAP to elect to net repurchase and reverse repurchase agreements settled on the same day and transacted through a securities transfer system. The current US GAAP model is based on a conclusion that certain securities transfer systems that meet specified requirements (focused on their design, operations, and ability to perform) achieved effective net settlement even though their processes required gross settlement of individual transactions.

However, the analyses previously performed under US GAAP are not necessarily sufficient to conclude that the agreements are "simultaneously settled."

Entities will need to obtain a detailed understanding of the method of settlement for each of the exchanges or clearinghouses that their transactions are settled or processed on in order to determine whether they are "simultaneously settled." Some of the factors to consider include:

- How is the settlement of transactions processed? Do they process them all simultaneously or are they processed in batches?
- Is there a continuous net settlement (CNS) process?
- How long does the processing of daily settlements take?
- How does the securities transfer system interact and process entries with the related securities repository?

Multilateral setoff arrangements

7. The proposed standard allows an entity to offset an amount owed to one party against an amount due from a second party if the contractual right exists and that right is enforceable in all circumstances. These circumstances are infrequent in practice, but the Boards did not see any reason to exclude these arrangements if they otherwise meet all of the criteria for offsetting.

Disclosures

8. The Boards concluded that information about rights of setoff and related arrangements (such as collateral agreements) are necessary to enable users of financial statements to understand the effect of those rights and arrangements on the entity's financial position. As a result, the Boards decided an entity shall disclose, at a minimum, the following information about rights of setoff and related arrangements associated with derivatives and financial assets and financial liabilities:

a. The gross amounts

b. Shown separately:

1. Amounts offset in accordance with the established criteria to determine the net amounts presented in the statement of financial position
2. Portfolio-level adjustments made in the fair value measurement to reflect the entity's net credit exposure (or the impact of the entity's own credit risk)
3. The net amount presented in the statement of financial position

c. Amounts that the entity has an unconditional and legally enforceable right to set-off, but does not intend to settle net

d. Amount that the entity has a conditional right to set-off, identified separately by each type of conditional right

e. Net amount of eligible assets and eligible liabilities after taking into account above items

f. For cash or other collateral obtained or pledged:

1. The amount of cash collateral (excluding the amount in excess of the net amount presented in the statement of financial position)
2. The fair value of other financial instruments (excluding the amount in excess of the net amount presented in the statement of financial position)

g. The net amount after taking into account the previous items

9. The Boards decided that the proposed disclosures should be provided in tabular format, unless another format is deemed to be more appropriate. The Boards also concluded that to the extent offsetting information is provided in other notes to the financial statements, the information described above should be cross-referenced to that information.

PwC observation: The proposed disclosures are extensive and require the disclosure of a considerable amount of information that is not disclosed under current US GAAP. Preparers will likely have to implement new procedures to capture this information so that it can be reported.

The gross amounts used as the starting point in this disclosure are amounts before taking into account

amounts offset in the statement of financial position and portfolio-level adjustments for credit risk of the counterparties. Portfolio-level adjustments made to incorporate the credit risk of the counterparties are typical in derivative valuation processes and have not historically been disclosed separately, as they have been considered a component of valuation as opposed to an offsetting adjustment.

Effective date and transition

10. The Boards decided to require retrospective application to all periods presented at transition. The Boards believe that prospective application could be misleading to investors. The Boards are seeking feedback regarding the time and effort that would be involved in implementing the proposed requirements. In addition, they will be considering the feedback associated with the effective dates and transition of other planned new standards. They will use that information to determine an appropriate effective date.

What's next?

11. The comment period on the exposure draft ends April 28, 2011. A roundtable discussion is being planned for the first quarter of 2011 and a final Accounting Standards Update is expected to be issued during the second quarter of 2011.

***To have a deeper conversation
about how this subject may affect
your business, please contact:***

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US GAAP Convergence & IFRS

Pensions and postemployment benefits

March 2011

Pension/OPEB accounting

Understanding changes expected from the IASB

What's inside:

Overview

Key provisions

Reprinted from:

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February 28, 2011

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- The IASB is nearing completion of various amendments to its standard on accounting for defined benefit pensions and other postretirement benefits (OPEB). The amendments are not the result of joint deliberations with the FASB. However, the objective of the IASB and FASB is to adopt a converged standard on this topic and both boards have stated their intent to make further changes to their respective standards to achieve this. Thus, the changes the IASB is expected to adopt shortly will be considered by the FASB for purposes of achieving convergence.
- The IASB has concluded that fluctuations in the value of the benefit obligations and plan assets (i.e., gains and losses) should be recognized in the balance sheet in full. This would be accomplished through a charge or credit to other comprehensive income (OCI) in the periods in which the gain or loss occurs. Those amounts would not be subject to subsequent amortization into net income, as currently required under US GAAP.
- We expect the final amendments to be issued in April 2011, with an effective date no earlier than January 1, 2013. Adoption will be retrospective with early adoption allowed.

The summary in this Dataline is based on our understanding of the decisions made by the IASB to date and may change based on our review of the final amendments.

Background

1. For many years, the accounting for pensions and OPEB has been criticized by preparers, auditors, and financial statement users. Preparers and auditors have found the strict rules-based guidance on this subject difficult to understand and apply. Investors and other financial statement users have found the information disclosed about retirement benefits difficult to interpret and correlate to the economics of the benefit arrangements.
2. One of the primary causes of complexity in the accounting has

been the deferred recognition techniques that enabled changes in the value of the benefit obligation and plan assets to be recognized on a delayed basis under both IFRS¹ and US GAAP.² Under that approach, and prior to 2006, the amount reported on the employer's balance sheet did not represent the full amount of the benefit obligation less plan assets. For income statement purposes, deferred recognition results in benefit expense

1 International Accounting Standard 19, *Employee Benefits*.

2 FASB Statements No. 87, 88, 106, and 132(R) (codified in ASC 715).

that is significantly less volatile from period to period, since the impact of changes in the value of obligations and plan assets is typically recognized over several subsequent periods.

3. In 2006, the FASB began requiring the funded status of a plan (i.e., the current value of benefit obligations less plan assets) to be reported on the balance sheet.³ However, deferred recognition of changes in those amounts continued for income statement purposes. Since 2005, the IASB has allowed an alternative approach under which actuarial gains and losses can be recognized immediately on the balance sheet through OCI with no income statement effect.

Key provisions

The elimination of deferred recognition

4. As the IASB debated this project, board members agreed that deferred recognition should be eliminated. That is, any changes in the value of the benefit obligation and plan assets should be immediately recognized in the period in which they occur. The IASB published a discussion paper sharing its preliminary thinking in late 2008. In subsequent deliberations, the board reached a preliminary view that all changes in the obligations and assets, including the effects of plan amendments (i.e., changes to the plan

that grant additional benefits attributable to employees' prior service) and gains and losses, should be recognized currently in determining an employer's net income.

5. As the debate continued into 2009, the IASB received feedback from preparers and various stakeholders opposing this treatment. The IASB was told that the deferral mechanisms are needed to reduce the impact of gains and losses on current period earnings. Those who advocated the continued use of deferral mechanisms were troubled by the volatility of net income and earnings per share that could result if the full amount of changes in the obligation and plan assets were recognized in the income statement each period. There was also concern about the understandability of the impact of benefit expense on net income and earnings per share if gains and losses were included in determining those amounts, because gains and losses have less predictive value than other components of benefit expense.

6. The IASB's April 2010 exposure draft (ED) proposed a compromise. Instead of recognizing gains and losses in net income in the period in which they occur, the IASB proposed that they be recognized through a charge or credit to a category called "remeasurement costs" in OCI. This approach is equivalent to the current US GAAP treatment of such amounts. However, unlike US GAAP, where such amounts are subsequently amortized from accumulated other comprehensive income (AOCI) into benefit expense, the IASB proposed no such "recycling" of these amounts.

7. The majority of comment letters received by the IASB expressed support for the 2010 proposal. However, a number of respondents expressed concern that where assets held to satisfy pension obligations did not meet the definition of plan assets, gain and loss recognition in OCI could lead to an accounting mismatch (i.e., the gains and losses on the assets may be reflected in net income while the gains and losses on the obligation will be reflected in OCI). Other comment letters also pointed out that the IASB (and FASB) had not set out clearly the purpose of OCI and why items recognized in OCI should, or should not, be recycled through net income. Those respondents argued that it is premature to reach a conclusion on the use of OCI in pension accounting before establishing general guidance related to OCI.

PwC observation: In a separate joint project, the FASB and IASB had proposed that a continuous statement of comprehensive income be required, with subtotals for net income and OCI. However, in subsequent redeliberations the boards decided not to adopt this approach. Instead, they decided to maintain the current IFRS position, which gives entities two presentation choices: (1) a continuous statement of comprehensive income or (2) two separate statements—a statement of net income (profit or loss) and a statement of comprehensive income that immediately follows the statement of net income. The third alternative currently used by most US GAAP entities but not permitted under IFRS—presenting OCI within the

3 Under Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)* (now ASC 715).

statement of changes in stockholders' equity—would no longer be permitted under US GAAP. Pension/OPEB gains and losses may receive greater attention when they are presented as part of a comprehensive income statement rather than within the statement of changes in stockholders' equity.

8. These comments were debated at great length and several Board members preferred to allow at least some choice between recognition in net income or OCI. However, the IASB concluded that it would be better to require recognition of actuarial gains and losses only in OCI with no recycling to net income. Currently, IAS 19 permits employers to make an accounting policy election, applied consistently to all of its plans, to reflect gains and losses in either OCI or net income. Under the planned amendments, the alternative of recognizing gains and losses in net income will be removed.
9. The IASB has also decided to eliminate deferred recognition of prior service costs. Prior service costs related to benefits that have not yet vested will no longer be amortized (prior service costs related to vested benefits are immediately expensed under existing IAS 19 requirements). Instead, at the date a plan amendment is adopted, the benefit obligation will be remeasured to reflect the new plan provision, and any increase or decrease in the obligation will be immediately recognized in determining net income.

PwC observation: Under IAS 19 today, operating income increases or decreases as a result of the

requirement to immediately recognize prior service costs arising from plan amendments that relate to vested benefits. Prior service costs arising from plan amendments involving benefits that have not yet vested are currently recognized over the average period until the benefits become vested. Whether requiring all prior service costs to be recognized immediately, regardless of whether the related benefits are vested, will be a significant change will depend on the significance of the unvested benefits and the length of the period over which the costs would have been recognized under the current guidance. The IASB requirement will continue to be significantly different from US GAAP, which requires prior service costs to be initially recognized in OCI and then amortized through net income.

10. Thus, under the IASB's planned amendments, employers will recognize all changes in the benefit obligation and the fair value of plan assets in the period that the changes occur in both the balance sheet and either a single statement of total comprehensive income, or split between two statements—a statement of income and a statement of comprehensive income. All deferred recognition approaches for actuarial gains and losses (e.g., the “corridor approach,” under which amortization is required only if the net gain or loss is outside a prescribed range) will be eliminated.

11. The IASB's rationale for eliminating deferred recognition is based on the following:
 - Immediately recognizing the effect

of remeasurements of benefit obligations and plan assets is conceptually appropriate and will more faithfully present the employer's financial position and comprehensive income.

- Deferred recognition is inconsistent with accounting principles for changes in estimates applied to other financial transactions, and fails to present obligations and asset values in a transparent manner in the financial statements.
- Prior service costs associated with a plan amendment arise from the employee's past service, and therefore should be recognized in full when the plan is amended.

PwC observation: Total comprehensive income will be subject to volatility from period to period under the IASB's planned amendments. For many companies, a majority of the volatility would come from remeasurements of plan assets, which typically include significant amounts of equity securities, private equity, and other alternative investments, whose values fluctuate. Because the IASB is not expected to amend its interim reporting requirements, if a company reports earnings on an interim basis, the immediate recognition of gains and losses and prior service costs will likely require remeasurement of obligations and plan assets at each interim reporting period. Accordingly, companies will need to ensure that necessary information is obtained on a timely basis in order to meet interim reporting deadlines. Unlike US GAAP, IFRS does not restrict

remeasurements during a year to specific circumstances, such as curtailments, settlements and significant plan amendments.

- 12.** The IASB has rejected any approach that would include recycling gains and losses reflected in OCI and recognizing those amounts in determining net income. This differs from US GAAP, where recycling of OCI amounts into net income is required. The IASB believes that once a transaction is recognized in comprehensive income, there is no conceptual basis to shift that amount from AOCI into net income. Instead, those amounts are immediately reflected in equity.

PwC observation: The FASB also has a project on its agenda to comprehensively reconsider employers' accounting for pensions and OPEB. That project will reconsider the deferred recognition techniques allowed under US GAAP. The FASB has acknowledged that its ultimate goal is convergence with the IASB's standard and appears to be waiting for the outcome of the IASB's project. Accordingly, US employers and other US stakeholders may wish to consider what impact the IASB's planned amendments could have if they are incorporated into US GAAP.

Presentation

- 13.** The ED proposed requiring employers to display separately the components of pension and OPEB cost (service cost, finance cost, and

remeasurement) in the statement of comprehensive income. However, some respondents expressed a view that separate display could distort performance metrics for companies in some industries. The IASB therefore concluded that it would only require disaggregation in the footnotes. In the statement of comprehensive income, the IASB will give the employer flexibility to either (1) present all components recognized in determining net income (i.e., service and finance costs but not actuarial gains and losses) as a single net amount (similar to US GAAP) or (2) separately display those components.

Service cost component

- 14.** The IASB concluded that both current and prior service costs directly relate to employment costs and thus both should be included in employee costs. The IASB decided that the effects of curtailments and "non-routine" settlements should also be included in employee costs.

Finance cost component

- 15.** The ED proposed that interest cost be based on the net defined benefit liability or asset reported on the balance sheet multiplied by the discount rate. Interest cost would be recognized as a finance cost in the statement of comprehensive income. This reflects the IASB's view that since the net defined benefit liability or asset is a present value amount, interest should be accreted on that net amount based on the passage of time. During redeliberations, the IASB reaffirmed its decision to move to a net interest cost model. The IASB's

planned amendments will require separate disclosure of that interest cost in the footnotes. However, as noted above, separate or aggregate presentation of service plus finance cost components will be permitted in the financial statements.

- 16.** The net interest cost model replaces the "expected return on plan assets" method currently used in IAS 19 (as well as US GAAP). In essence, the expected long-term rate of return assumption will be replaced by the discount rate assumption for purposes of determining a return on plan assets, and the expected return on plan assets will be effectively treated as interest income when measuring the net interest cost presented in the financing cost component. For many employers, that amount will be less than the expected return on plan assets that is currently calculated under US GAAP and IFRS, as many employers use an expected rate of return that is higher than the discount rate.

PwC observation: Under current IAS 19, a company can present the expected return on plan assets and interest cost amounts before or after operating income, based on a policy election. Companies will have the same choice for the new measure of finance cost under the IASB's planned amendments. Accordingly, for companies that report under IFRS, reporting interest income calculated using the discount rate versus a larger expected rate of return on plan assets could affect operating income, or only net income, depending on their policy.

Remeasurement component

- 17.** Under the IASB's planned amendments, the remeasurement component will consist of actuarial gains and losses on the defined benefit obligation, and actual return on plan assets (excluding interest income on plan assets included in the finance cost component). The remeasurement component will be presented on a net-of-tax basis in OCI.
- 18.** Adjustments under IAS 19 relating to the asset ceiling (i.e., the limit on any balance sheet asset for an overfunded plan) will also be included in the remeasurement component since the effect of the limit arises from a remeasurement.

Disclosure

- 19.** The ED proposed several new required disclosures, which were generally consistent with disclosures already required under US GAAP. Many of the comment letters expressed the view that the IASB had proposed too many required disclosures. In considering the comments received, the IASB moved to an approach that specifies objectives that the disclosures should achieve rather than a checklist of required disclosures. Although that change should make the disclosure requirements more manageable, the proposed disclosures still represent a significant increase over current IAS 19 disclosure requirements. In particular, the IASB's planned amendments are expected to require significantly more disclosures about plan assets.

- 20.** The following are some of the expected disclosures:

- **Characteristics of the defined benefit plan**—the nature of the benefits to be provided by the plan, any minimum funding requirements, a narrative description of unusual risks or concentration of risks that are specific to the plan or the entity, and any plan amendments, curtailments, or non-routine settlements
- **Explanation of amounts in the financial statements**—disaggregation of the fair values of plan assets and the defined benefit obligation into categories that separate the risk and liquidity characteristics of those assets and obligations (e.g., types of investments included in plan assets)
- **Amount, timing, and uncertainty of future cash flows**—a sensitivity analysis of the significant actuarial assumptions used to determine the benefit obligation, as well as the methods and assumptions used in creating the sensitivity analysis, details of any asset-liability matching strategies to manage risk, a narrative description of any funding arrangements and policy, and details regarding the maturity profile of the benefit obligation

Multi-employer plans

- 21.** The IASB's planned amendments will not change the accounting requirements for employers that participate in a multi-employer benefit plan.

However, there will be new disclosure requirements for those employers, such as:

- A description of the funding arrangements, including how the funding requirements are determined
- The extent to which the employer can be liable for other employers' obligations
- The employer's level of participation in the plan by disclosing its proportion of total plan members or total contributions
- If the employer accounts for its proportionate share of the plan, all information required for a traditional single-employer plan
- If the employer accounts for the plan as if it were a defined contribution plan, the fact that the plan is a defined benefit plan, the reason sufficient information is not available to account for it as a defined benefit plan, expected contributions for the next year, how those contributions are determined, and any deficit/surplus in the plan that may affect those contributions
- Qualitative disclosures of any withdrawal obligation, unless it is probable that the withdrawal obligation will be triggered (in which case the amount would be reported in the balance sheet along with sufficient disclosure in the footnotes to explain the relevant facts and circumstances)

Other amendments

- 22.** The IASB is also making other changes to IAS 19. For instance, the definition of termination benefits will be narrowed so that, for example, stay bonuses will be classified as post-employment benefits and not termination benefits. Additionally, the difference between a short-term employee benefit and a long-term employee benefit will be clarified. A long-term benefit will be a benefit the employer does not expect to settle within twelve months of the reporting date, while a short-term benefit will be a benefit expected to wholly settle in less than twelve months. In addition, the IASB changed the timing of recognition of certain plan amendments, curtailments, and termination benefits to require recognition of the gain or loss related to such events that occur in connection with a restructuring when the related restructuring cost is recognized.
- 23.** The ED also addressed the accounting for administration costs. IAS 19 currently permits administration costs to be included in the return on plan assets or considered in developing actuarial assumptions used to estimate the defined benefit obligation. The ED would have required these costs to be included in the defined benefit obligation unless they relate to the management of plan assets and the benefit promise does not depend on the return on those assets.
- 24.** Comments received by the IASB indicated a widespread concern that

requiring administration costs to be included in the benefit obligation would mean allocating costs, such as costs related to actuarial valuations and plan recordkeeping, between past and future service, and that such an allocation would be arbitrary. Based on these comments, the planned amendments will require that expenses related to investment management, including taxes payable on the investments, be reflected in the actual return on plan assets. Other taxes payable by the plan would be reflected in the measurement of the defined benefit obligation, and all other expenses would be recognized as incurred.

Items not addressed

- 25.** Other aspects of accounting for pensions and OPEB will not be addressed by the planned amendments. For example, contribution-based promises, which were a significant focus in the IASB's 2008 discussion paper, are not addressed. IFRIC 14, the interpretation regarding application of the asset ceiling test in IAS 19, has not been incorporated into the standard because of the wide variation in its application. Some of the areas that are expected to be addressed in future phases of the IASB's (and FASB's) project include:
- **Measurement**—how the measurement of the retirement benefit obligation should be performed (which likely would resolve key questions related to contribution-based

promises, including cash balance plans)

- **Assumptions**—how key assumptions, such as the discount rate, should be determined
- **Multi-employer plans**—how to account for participation in multi-employer plans

Transition and effective date

- 26.** The amendments are not expected to be accompanied by any special transition rules, other than a practical exception for the potential affect on past capitalized costs. Therefore, employers will apply the general IFRS transition requirements to the amendments. These requirements call for accounting changes to be applied retrospectively to all years presented. The IASB believes that retrospective adoption is consistent with its general requirements for adoption of changes in accounting principles and that the information necessary to apply the new requirements should generally be available.

PwC observation: While the information may be available, companies should consider the effort required for compliance, particularly if they have (1) numerous plans, (2) special events, such as curtailments and settlements, and (3) complicated tax allocations.

- 27.** The effective date for the amendments will not be before January 1, 2013 with early application allowed.

***To have a deeper conversation
about how this subject may affect
your business, please contact:***

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US GAAP Convergence & IFRS

Insurance contracts

March 2011

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Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- Several key issues surfaced from the comment letters, three public roundtable discussions, and other outreach efforts regarding the IASB's July 2010 exposure draft (ED) and the FASB's related September 2010 discussion paper (DP) setting out proposed changes to insurance accounting.
- The proposals would fundamentally change the accounting by insurers and other entities that issue contracts with insurance risk, and cover recognition, measurement, presentation, and disclosure for insurance contracts.
- The Boards have been redeliberating the issues, and the IASB seems intent on continuing at a rapid pace to meet its targeted June 2011 date for issuance of a final standard. No official timetable has been published by the FASB on its next steps, but comments have been made at recent FASB meetings about the potential for an exposure draft to be released around the same time as the IASB final standard.
- Respondents' preferences on the overall measurement model were mixed, with US constituents tending to support the FASB approach (in the event of a converged standard), and a clear majority of non-US constituents supporting the IASB approach.
- Given the potential impact of the changes being considered, management should keep abreast of this rapidly developing project and consider assessing the implications of the possible changes on existing contracts and its current business practices.

The main details

1. Several key issues surfaced from the comment letters, three public roundtable discussions, and other outreach efforts regarding the IASB's July 2010 exposure draft (ED) titled *Insurance Contracts* and the FASB's related September 2010 discussion paper (DP) entitled *Preliminary Views on Insurance Contracts*. The issues involve the discount rate, cash flows, acquisition costs, the risk adjustment and margins, unbundling, the modified approach for short-duration contracts, financial statement presentation, and transition.
2. The Boards began redeliberating some of these issues in January and plan further discussions in March through May. The IASB seems intent

*The At a glance (third bullet), Building block approach (paragraphs 26 and 27 and PwC observation), Discount rate (paragraphs 42 and 43), and Simplified method for short duration contracts (paragraph 47 and PwC Observation) sections were revised to reflect the Boards' decisions at their March 1–2 joint meeting.

on continuing at a rapid pace to meet its targeted June 2011 date for issuance of a final standard. This is likely because comprehensive guidance on insurance accounting does not currently exist under IFRS, and thus there is greater urgency for the IASB to adopt some version of its exposure draft as a final standard.

3. At a February Board meeting, the FASB announced its decision to continue deliberating the issues in this project jointly with the IASB. Although US GAAP has an existing comprehensive accounting model for insurance accounting, the FASB's ultimate objective is to improve upon existing US GAAP for insurance contracts. It also has an objective to converge US GAAP with IFRS.
4. Despite the urgency for the IASB, many respondents commented that both boards should take the time to field test their proposals, given the fundamental changes being proposed and the extensive process and systems changes that will likely be required for entities to properly apply the proposed standards.
5. Respondents' preferences on the overall measurement model were mixed, with US constituents tending to support the FASB composite margin approach (in the event of a converged standard), and a clear majority of non-US constituents supporting the IASB explicit risk adjustment approach. In general, respondents in Europe and other non-US territories tended to support the provisions in the IASB proposal that are consistent with their existing or proposed

regulatory requirements (such as the explicit risk adjustment and discount rate approaches).

6. Conversely, some in the United States (particularly property and casualty companies) questioned whether the proposed models would be an improvement to existing US GAAP, particularly if convergence is not achieved. Many US respondents, both preparers and some users, believe that the current short-duration accounting model used by property and casualty companies is well understood and appropriately reflects their business model, and therefore do not believe a change from current GAAP is needed.
7. From a life insurer perspective, the item causing the most controversy among US preparers is the requirement that cash flows be discounted at a risk free rate plus an illiquidity adjustment, updated each period. There are several criticisms with the discount rate: that the prescribed rate does not fully reflect the characteristics of the liability and how insurers price their product, that updating of the discount rate each period is inconsistent with the long-term hold strategy for the liabilities, and that the lack of an established methodology for determining the required illiquidity adjustment to the risk free rate makes it questionable whether reliable, comparable estimates can be achieved.
8. Amongst the feedback received by the Boards there is a common theme on one key issue—presentation. There is limited support for a summarized margin approach as proposed, with most preparers wanting to display,

and users wanting to see, gross revenue and expense information for both life and non-life contracts on the face of the financial statements. Users note that new business written is a key metric and a driver in predicting future profitability, and other gross information is needed to derive key metrics, such as loss ratios. Many expressed concern over the number and degree of disclosures including detailed account roll-forwards and sensitivity analyses.

9. Other areas where there is some alignment across territories include acquisition costs, unbundling, and transition. Many respondents believe that allowing only acquisition costs that are incremental at the individual contract level to be included in contract cash flows and thus effectively deferred is not reflective of the insurer's business model. They believe both incremental and certain directly allocable costs should be included, such as salaried sales force and underwriting—said another way, costs that are incremental at the portfolio level.
10. With respect to unbundling, there is wide agreement that the proposed guidance is unclear and in parts inconsistent. Many Europeans prefer the non-unbundled approach, while views are somewhat mixed in the US. Some in the US view the insurance contract as an integrated set of components. Others seem to prefer unbundling of certain account balances and embedded derivatives if measurement outside the insurance model could lead to a significantly different result.

11. There was overwhelming objection to the transition provisions suggested in the IASB ED. Those provisions would effectively eliminate any residual margin and related subsequent income amortization on all in-force business at transition. This would distort future periods' income recognition for years to come for longer duration contracts.

Comment letter themes and redeliberations by topic

12. The following provides a brief summary of the FASB DP and IASB ED, followed by a detailed analysis of the comments received on both the DP and ED for major issues, as well as the steps the Boards have taken through February to address constituent observations and concerns. For a detailed discussion of the FASB DP and IASB ED provisions, refer to PwC Dataline 2010–39, *Insurance contracts—Fundamental accounting changes proposed*.

Background

13. Both the IASB's positions in its ED and the FASB's preliminary views in its DP (the "proposals") would apply to all entities that issue insurance contracts, not just insurers. The Boards would utilize a broad definition of insurance contracts that could result in contracts issued by non-insurers being subject to the guidance, such as certain financial guarantee contracts, loans with waivers upon death, certain types of warranty contracts, and, under the FASB proposal, health

insurance provided by employers. The accounting by policyholders (other than reinsurance) entering into insurance contracts is not addressed.

14. Both proposals would require an insurer to measure its insurance contracts using a current measurement model, where estimates of the present value of cash flows are remeasured each reporting period. The estimated cash flows would be discounted at risk-free interest rates, adjusted for differences between the liquidity characteristic of the insurance contracts and corresponding risk-free instruments.

15. The IASB approach would include an explicit risk adjustment for the uncertainty about the amount and timing of future cash flows that would be separately estimated and remeasured each period. The FASB approach would not.

16. At contract inception, both proposals would defer and amortize any excess of expected cash inflows over outflows to eliminate any initial profit recognition, but would recognize any losses immediately. This amount is referred to as the composite margin under the FASB approach and as the residual margin under the IASB approach.

17. Cash flows under both proposals would be measured from the issuer's perspective (rather than a market participant perspective), although any market-related variables would be consistent with observable market prices.

18. Incremental contract acquisition costs (such as commissions) would be included in the net cash flows, effectively deferring and amortizing them over future periods, although not as

an explicit asset. All other acquisition costs would be expensed as incurred.

19. Under both proposals, account balance, embedded derivative, and certain service components would be required to be unbundled and accounted for separately if they are not closely related to the insurance coverage.

20. The IASB's proposal requires short-duration contracts of approximately 12 months or less to be measured using a simplified approach. The FASB did not include a specific proposal on this.

21. Under both proposals, the income statement presentation would be driven by the measurement model. Issuers would not recognize premiums as revenue (except where the short-duration simplified approach is used) but would separately show an underwriting margin and changes in cash flow estimates and experience variances. Supplemental disclosures would provide premium and claim information.

22. The IASB proposed a modified retrospective approach to transition under which the opening balance for in-force contracts at the transition date would be limited to the present value of cash flows plus the risk adjustment, with no residual margin. This transition approach could significantly reduce future profits on long-duration contracts, particularly for life insurers.

Building block approach

23. There is general support for the building block approach, and constituents see the fulfillment value

objective as an improvement over the IASB's former current exit value approach. However, three main issues commented on by constituents include:

- the requirement to use probability-weighted cash flows;
- the types of costs to be included in expected cash flows; and
- the types of acquisition costs that should be included in expected cash flows.

24. While most constituents support the objective of expected value of future cash flows rather than a single, most likely outcome, many believe that the Boards should clarify that the objective is to arrive at the mean value. Given that the ED and DP focused on “probability-weighted cash flows,” some constituents are concerned that the proposal is mandating a full stochastic approach and consideration of every remote scenario.

25. During February redeliberations, the Boards agreed with a staff recommendation that the measurement objective of expected value is the mean value, and that there is no need for all possible scenarios to be quantified in all circumstances. Some Board members believe an education session on the different actuarial methodologies for arriving at a mean is necessary, as it is not clear whether some methodologies may give rise to issues in calculating a risk margin.

26. Some constituents commented that overhead costs should be included in expected cash flows, as they are costs that are included in pricing and would be more accurately reflected as expected cash flows rather than

being implicitly included in the residual margin. In their February redeliberations, the Boards decided that costs to be included in the cash flows should be those that “relate directly” to the fulfillment of the contracts in the portfolio (such as payments to policyholders and claim handling costs) as well as those costs that the staff describes as “directly attributable” and allocable to fulfilling that portfolio of contracts. Some understood the latter type of costs to include rent for space occupied by the claims handling department and IT technology costs associated with that function, and to exclude indirect costs such as the CEO's salary and corporate headquarters. Some Board members continue to be concerned that too wide a definition would allow general overhead to be included in the liability measurement. The staff reiterated that the types of direct and indirect costs to be included are intended to be consistent with those in IAS 2, *Inventories*, and they will draft implementation guidance consistent with that standard and present it to the Board.

27. Many constituents commented that the definition of acquisition costs is too narrow and opposed its restriction to costs incremental at the contract level rather than the portfolio level. The IASB and FASB redeliberated this issue in February and early March, with both Boards agreeing by a narrow margin that acquisition costs that are direct and incremental at the portfolio level (rather than the contract level) for sales force contract selling, underwriting, medical, inspection, policy issuance, and processing functions

should be included as contractual cash flows of the insurance contract. The FASB would limit costs to successful efforts (similar to the guidance on accounting for deferred acquisition costs in ASU 2010–26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*), while the IASB believes that costs for unsuccessful efforts should also be included. The two Boards have also not reached agreement on which categories of allocable acquisition costs, other than sales force and underwriter salaries, should be included in the contract measurement. For example, the IASB appears more open to including certain other indirect costs, such as rent and software associated with the selling function, which they believe is consistent with their general position on cash flows noted in paragraph 26 above.

PwC observation: Items requiring further follow-up in this area include a potential education session on the alternative actuarial methods used in practice as a proxy for the mean. In addition, clarification is needed on the types of overhead that would be included in contract cash flows. It is uncertain how the Boards' disagreement on the components of acquisition costs to be included in cash flows will be resolved. The FASB position is consistent with its recently updated guidance on insurance acquisition costs, which is effective for 2012. On the other hand, the IASB position to include both unsuccessful efforts and certain indirect costs is more in line with US GAAP in effect for 2010.

Risk adjustment

- 28.** The most significant difference between the FASB and IASB proposed models relates to the use of an explicit risk margin. Only the IASB's model includes an explicit risk adjustment for uncertainty about the amount and timing of future cash flows. This amount would be separately estimated and remeasured, along with the present value of cash flows each period.
- 29.** Most respondents are predominantly in favor of the explicit risk adjustment approach rather than the composite margin approach, with notable exceptions being most US insurers and US users. Non-US supporters note that an explicit risk adjustment allows for a current measure of the insurer's risk and therefore is more transparent and useful, is consistent with proposed Solvency II requirements in Europe, and is already being measured in several territories, including Australia and Canada.
- 30.** There are disagreements with some of the detailed provisions of the explicit risk adjustment, with respondents arguing that it should not be limited to 3 prescribed methods, and that disclosure of the confidence level equivalent is not useful and does not result in cost efficient information.
- 31.** Opponents of the explicit risk adjustment believe that it would involve substantial set up costs, is prone to subjectivity, manipulation, and non-comparability, is not observable and therefore not verifiable, and is inconsistent with a fulfillment value approach.
- 32.** In February redeliberations, many Board members agreed that at a conceptual level an explicit risk margin provides useful information to users and would be understandable. Whether a risk adjustment can be determined in a verifiable way, would be comparable across companies, and pass a cost-benefit analysis, will be the subject of a future meeting.
- 33.** With regard to remeasurement of the residual or composite margin, suggestions were made by respondents that the margin either be recalibrated when building block estimates are subsequently revised, or that the margin be used as a shock absorber against current period losses due to non-financial and possibly financial input changes. Locking in the margin seemed to many to be inconsistent with the rest of the "current value" model. Constituents noted that using the residual or composite margin as a shock absorber, at least for non-financial estimate changes, would avoid current period losses followed by profits in the future as the margin is unwound.
- 34.** In February redeliberations, the Boards indicated that they are willing to explore a "floating" residual/composite margin approach that remeasures the margin for favorable and unfavorable changes in non-financial estimates, but need to consider whether the residual margin could be negative (essentially reducing the risk adjustment).
- 35.** Constituents expressed their dissatisfaction with the amortization methods for both margins, with some noting that amortization of the residual margin based on the expected timing of incurred claims and benefits, or based on the premiums/claims paid formula in the FASB composite margin, was not consistent with the economics of the contracts. Under the model, much of the composite margin recognition would be delayed until claim/benefit payments were made.
- 36.** Alternatives offered by respondents included prescribing a principles-based approach rather than a single method for amortization. Some suggested that the composite margin should be amortized over the coverage period only for those types of coverages where there was minimal risk and claim settlement efforts later in the contract.
- 37.** Decisions on remeasurement and amortization methods for residual margins (ED model) and composite margins (FASB DP model) are expected at future meetings.
- PwC observation:** The Boards are in the "exploratory" phase of redeliberations on the risk adjustment. It is the key difference between the IASB and FASB models, and has been the subject of much debate. Within each of the Boards, there have been split views on this issue. From a constituent perspective, all but US respondents seem to generally embrace the explicit risk adjustment.
- Discount rate**
- 38.** Most US life insurer respondents disagreed with the IASB ED and FASB

DP requirement to utilize a risk-free rate plus a premium for illiquidity to present value the cash flows of an insurance contract for several reasons. They noted an inconsistency between the proposal and the implicit rate credited to policyholders under the contract, particularly for many long-duration life insurance contracts, which could result in non-economic day one losses. In addition, US as well as non-US life insurers commented that short-term fluctuations in insurance liabilities due to changes in market discount rates are not reflective of their business models. As a result, they would support either a discount rate locked-in at the inception of the contract or recognition of interest rate changes in other comprehensive income rather than income.

39. Most agreed with excluding an insurer's non-performance risk, but some suggested using a rate that includes the market price of credit (but not the price of credit for the specific liability), such as a high quality corporate bond rate. Others suggested an asset-based rate, adjusted for the risk of defaults (a "top down" approach that starts with an asset portfolio rate, rather than the ED "bottom up" approach that starts with the risk free rate). Many, including users, raised concerns regarding the feasibility, objectivity, and comparability of an illiquidity adjustment that is not observable in the market.
40. In February, after having heard proposals from several constituents on "top down" approaches, Board members seemed to support this methodology as an acceptable alternative to the ED's proposed "bottom

up" approach. This assumed that both expected defaults and the reward for default risk, as well as any other components in the asset rate but not relevant to the liability rate, would be subtracted to arrive at a rate that is consistent with the bottom up risk free rate plus illiquidity adjustment.

41. The Boards agreed in February that the standard should not prescribe a rate or method for determining the discount rate but instead should explain that the objective is to adjust future cash flows for the time value of money and reflect the characteristic of the insurance contract liability. The rate should be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, excluding the effect of the insurer's own non-performance risk. The rate should exclude the effect of risks and uncertainties included in the cash flows or the risk adjustment, and should exclude any factors that influence the observed rates but are not relevant to the insurance liability (such as investment risk not passed along to the policyholder).
42. Despite concerns expressed by various Board members with obtaining deep and liquid corporate bond market rates and making an adjustment for credit risk, the Boards also agreed to explore further the possibility of whether and under what circumstances a practical expedient (such as a high quality bond rate) would be allowable, at least for smaller insurers.
43. While some constituents believe that the discount rate for at least certain types of contracts should be locked in

at inception, the Boards rejected this view during early March redeliberations. The staff provided a comparison of insurance liabilities to other measurements, such as financial liabilities, financial assets, and leases. The staff view, supported by the Boards, is that due to the higher variability in cash flows of insurance contracts versus the other instruments, they are not analogous. The staff believes that in the "current value" model proposed in the insurance ED and DP, which reestimates cash flows each period, it would be inconsistent to lock in the discount rate.

PwC observation: On balance, while the Boards' recent decisions focus on stating a principle rather than prescribing a method, and thus seem to address constituents' concerns regarding estimating the illiquidity adjustment, concerns expressed about day one losses and accounting mismatches remain.

Simplified method for short duration contracts

44. The proposals call for a simplified approach for contracts with terms no longer than a year. Many respondents, including most users, supported the proposal to develop a modified approach for short-duration contracts. However, most objected to the strict one-year cut-off. Many noted that the modified approach in the IASB ED is over-engineered in its requirement to discount premiums, accrete interest in the pre-claim period, include a risk adjustment in the onerous contract

test, and perform the test at a lower level than is currently done in practice under existing GAAP.

45. Many, if not most, US property/casualty insurers as well as health insurers favored maintaining the current US GAAP accounting model for short-duration contracts as they believe it better depicts their business model, which is focused more on underwriting risk as the principal risk rather than investment risk. Many US non-life insurers believe that the incremental cost and effort of discounting outweigh the benefits for coverages that have short payout periods, such as physical car damage and health insurance. In addition, for some long-tail exposures, such as asbestos and product liability, they believe the amount and timing of cash flows is so unpredictable that discounting is not appropriate, and should only be applied in those limited instances where cash flows are fixed and reliably determinable.
46. In contrast, Australia, Canada, and Japan already discount non-life reserves. Further, the IASB staff outreach revealed that most European non-life direct and reinsurer respondents were comfortable with the modified approach proposed in the ED. This included using the full building block model, with discounting, for incurred claims.
47. In early March, both Boards tentatively agreed that all long-tail non-life claims (i.e., those with a claims settlement period of greater than a year) should be discounted. This would apply where the expected payout patterns are reasonably determinable, as well as for long-tail claims

in which it is questionable if the insurer will have to pay, when it will have to pay, and how much it will have to pay. Their rationale is that if the model requires that an insurer estimate an *amount* for uncertain claim payments, it is no more difficult to then estimate the potential *timing* of such payment on a portfolio basis. It was noted that any uncertainty in the timing of payment should be captured in the risk adjustment. The Boards also tentatively agreed that discounting should not be required when the effect of discounting would be immaterial. As part of future redeliberations on the modified approach, the staff is expected to draft guidance for determining when discounting a short-tail claim would be considered immaterial.

PwC observation: The Board's latest decisions are likely to be unpopular with US property/casualty writers who believe strongly that property/casualty liabilities should generally not be discounted unless the payment streams are fixed and reliably determinable.

Unbundling

48. Under the proposals, some components of insurance contracts would be unbundled (that is, separately accounted for under other guidance). Those components would include certain account balances, embedded derivatives, and goods and services not closely related to insurance coverage.
49. Many commented that the guidance as written is unclear, unnecessarily
- complex, and will have unintended consequences. For example, as written, universal life account balances would not be unbundled, while throughout the Boards' discussions such balances were one of the most common examples of components that many Board members believed should be unbundled. With regard to the general principle of unbundling, response in the US was mixed, with many suggesting that their views could change depending on where the Boards land on other issues, such as discount rates.
50. Some would prefer to see items such as account balances in universal life products and embedded derivatives unbundled if measurement outside the insurance model could lead to a significantly different measurement that would be more in line with related assets (e.g., amortized cost for account balance liabilities).
51. Health insurers believe that certain of their contracts that are principally administrative services only with stop loss protection should be split between the service and insurance components, while others are insurance contracts with integrated service components.
52. Many Europeans who will be subject to Solvency II prefer the non-unbundled approach, which is consistent with that proposed regulation. Opponents to unbundling also point to the complexity of identifying and separating the various components, which are typically designed and priced on an integrated basis. They note that arbitrary allocations of fees and costs would be needed, which could lead to subjective splits between

components and therefore reduce comparability. They believe that the proposed insurance model (a current value model) is an acceptable model for deposit components of insurance contracts, and, for embedded derivatives, is also substantially consistent with a fair value model given the requirement to use observable market inputs.

PwC observation: The Boards expect to debate unbundling issues over the next several months. At an education session in February, the Boards heard different perspectives on unbundling, after which they noted that if the objective is to present the risk from the underwriting activities separately from the investment activities, it would lead to unbundling. The Boards also acknowledged the level of judgment that will be involved in allocating among contract components if contracts were required to be unbundled. But they also acknowledged that some amount of allocation will be needed, even absent unbundling, to determine the appropriate rate at which to discount certain cash flows associated with the contract.

Presentation

53. The summarized margin approach proposed in the IASB ED and FASB DP would reflect the release of margins and changes in estimates in the income statement. Under this approach, premium revenue would no longer be presented. Instead, margin, changes in estimate, and experience adjustments would be shown.

A modified measurement approach and a more traditional earnings presentation is proposed for certain short-duration contracts that meet specified criteria.

54. Most respondents were uncomfortable eliminating information about premiums and claims from an insurer's income statement—considered a key performance metric. They believe that a decreasing revenue line, which is a consequence of the proposal, could distort a user's view of the magnitude of a company's operations.
55. As a result of comments from constituents, the Boards are reconsidering other alternatives, such as the expanded margin approach, the written premium approach (traditional life model), and the earned premium allocation approach (traditional non-life model). Variations of these approaches would include a model that incorporates information on both a traditional and margin basis, and one that unbundles contracts for performance reporting. The Boards understand that above all, the presentation model developed should address the needs of users such that insurers could reduce the number of non-GAAP measures presented.

PwC observation: The staff is currently exploring various alternative approaches to the summarized margin approach, and several groups have committed to provide the staff with alternate presentation formats. It remains to be seen whether an approach can be developed that can overcome the complexity involved in grossing up the margin presentation for both

revenue and expenses in what is essentially a balance sheet focused measurement model.

Transition

56. The IASB proposed a modified retrospective approach to transition, which drew little to no support. The FASB did not address transition in its DP, but was supportive of the IASB's proposals during deliberations. The ED proposed that the opening balance for in-force contracts at the transition date be limited to the present value of cash flows plus the risk adjustment, with no residual margin. This would eliminate income from residual margin amortization that would typically be present under the ED model. This transition approach could significantly reduce future profits on long-duration contracts, particularly for life insurers.
57. Since the issuance of the IASB ED, the IASB has concluded that its transition proposal was flawed and is seeking alternatives. Most constituents acknowledge the challenges associated with a full retrospective adoption. Respondents suggested several complex alternatives for consideration, but it is unknown whether they will gain traction due to their complexity.

Other issues

Reinsurance

58. Reinsurance is significant to the industry, yet little guidance on it exists in the proposals. Issues where respondents think additional guidance is

needed include whether risk transfer should only be assessed at inception, how/whether related contracts executed contemporaneously should be assessed, and accounting for loss portfolio transfers, commutations, and funds withheld arrangements. There were also concerns with day 1 recognition of cedant gains, especially among users and regulators, and how to measure the reinsurance contract when the coverage period for the reinsurance contract does not match that of the underlying contracts (e.g., whether the modified approach be used on the reinsurance if applicable to the underlying contracts). The staff agreed to spend more time on reinsurance, and bring this issue back to the Boards for redeliberation.

Recognition

59. Most insurers disagree with recognizing insurance contracts on the earlier of the date the insurer is bound or the date it is first exposed to risk, which is particularly difficult for contracts with open enrollment, such as health insurance. They question whether the benefits outweigh the operational costs and whether this is useful information, for example, in situations where reinsurance is recognized before the underlying insurance contracts are even written.

Contract boundary

60. Setting the contract boundary as the point where the insurer has the right or practical ability to reassess the risk is troublesome to health insurers and certain property/casualty insurers where regulatory restrictions on pricing exist. This requirement could potentially extend the accounting life of the contracts beyond their contractual term and require projection of long range premium and claim cash flows that would be very difficult to estimate.

Insurance contracts

Fundamental accounting changes proposed

What's inside:

Overview

Key provisions

Timing for comments

Addendum—Project status update

Reprinted from:

Dataline 2010–39
September 23, 2010
(Revised February 16, 2011*)

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- The FASB has issued a discussion paper seeking comments on its preliminary views on accounting for insurance contracts that would fundamentally change the accounting by insurers and other entities that issue contracts with insurance risk.
- The discussion paper is an outgrowth of the IASB and FASB's joint efforts to develop a single converged insurance standard. The FASB's release of the discussion paper follows the IASB's late July issuance of an exposure draft containing its proposals on the same topic. Both documents address recognition, measurement, presentation, and disclosure for insurance contracts.
- The discussion paper compares the IASB's proposal to the FASB's preliminary views to date and to current US GAAP. The FASB is asking constituents to consider whether the FASB should ultimately adopt some version of the IASB's proposal or whether targeted changes to existing US GAAP would be sufficient.
- There is greater urgency for the IASB to adopt some version of its exposure draft as a final standard since comprehensive guidance on insurance accounting does not currently exist under IFRS; a final IASB standard is expected in mid-2011.
- Given the potential impact of the changes being considered, management should consider assessing the implications of the possible changes on existing contracts and its current business practices and commenting on both documents.
- The comment letter period on the FASB discussion paper ends on December 15, 2010 (or November 30, 2010 for roundtable participants). The comment period for the IASB's exposure draft ends on November 30, 2010.

*The Addendum—Project status update in paragraph 63 of this Dataline was added on February 16, 2011 to briefly summarize the Board activities that have taken place since the FASB discussion paper was issued and the expected timetable for completion of the IASB and FASB projects.

The main details

1. The FASB issued a discussion paper, *Preliminary Views on Insurance Contracts*, on September 17, 2010 as part of the IASB and FASB's joint efforts to develop a single converged insurance standard. This followed the IASB's issuance of an exposure draft, *Insurance Contracts*, on July 30, 2010. The main details are as follows.

- Both the IASB exposure draft and FASB preliminary views (the "proposals") would apply to all entities that issue insurance contracts, not just insurers. The boards would utilize a broad definition of insurance contracts that could result in contracts issued by non-insurers being subject to the guidance, such as certain financial guarantee contracts, loans with waivers upon death, certain types of warranty contracts, and, under the FASB proposal, health insurance provided by employers.
- The accounting by policyholders (other than reinsurance) entering into insurance contracts is not addressed.
- Both proposals would require an insurer to measure its insurance contracts using a current measurement model, where estimates of the present value of cash flows are re-measured each reporting period. The estimated cash flows would be discounted at risk-free interest rates, adjusted for differences between the liquidity characteristic of the insurance contracts and corresponding risk-free instruments.

- The IASB approach would include an explicit risk adjustment for the uncertainty about the amount and timing of future cash flows that would be separately estimated and remeasured each period. The FASB approach would not.
- At contract inception, both proposals would defer and amortize any excess of expected cash inflows over outflows to eliminate any initial profit, but would recognize any losses immediately. This amount is referred to as the composite margin under the FASB approach and as the residual margin under the IASB approach.
- Cash flows under both proposals would be measured from the issuer's perspective (rather than a market participant perspective), although any market-related variables would be consistent with observable market prices.
- Incremental contract acquisition costs (such as commissions) would be included in the net cash flows, effectively deferring and amortizing them over future periods, although not as an explicit asset. All other acquisition costs would be expensed as incurred.
- Under both proposals, account balance, embedded derivative, and certain service components would be required to be unbundled and accounted for separately if they are not closely related to the insurance coverage.
- The IASB's proposal requires short duration contracts of approximately 12 months or less

to be measured using a simplified approach. The FASB has not settled on a view on this matter.

- Under both proposals, the income statement presentation would be driven by the measurement model. Issuers would not recognize premiums as revenue (except where the short duration simplified approach is used) but would separately show an underwriting margin and changes in cash flow estimates and experience variances. Supplemental disclosures would provide premium and claim information.
- The IASB expects to issue a final standard in mid-2011. An effective date has not been proposed yet, although it is expected that the IASB standard would not be effective before 2013. The FASB's next step, after gathering comments from constituents on the discussion paper and at the public roundtables planned with the IASB in December, will be to determine whether its exposure draft of a proposed standard should use some version of the model described in its discussion paper or instead make targeted changes to existing US GAAP.

PwC observation: The FASB's decision to issue a discussion paper reflects the fact that it has had less time to debate the issues. US GAAP also currently has specific accounting guidance for insurance contracts and so the need to address the accounting for insurance contracts is not as urgent as

for IFRS preparers. A key difference between the FASB and IASB approaches is the IASB's preference to include a specific risk adjustment on a current measurement basis and a residual margin compared to the FASB's preference for a single "locked in" composite margin.

Key provisions

Definition and scope

2. Both the FASB and IASB proposals would apply to all entities that issue insurance contracts, not just insurers. Both approaches utilize the IFRS 4 definition of an insurance contract, i.e., "a contract under which one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder."
3. As in IFRS 4, insurance risk is defined as any risk other than financial risk where financial risk is "the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract".

PwC observation: Some banks issue loans that include a waiver of the outstanding loan balance upon the death or disability of the customer. These contracts are likely to meet the definition of an insurance contract, but the extent to

which they would be affected by the proposals will depend on the unbundling rules, as discussed later in this Dataline. Financial guarantee insurance, mortgage guarantee insurance, trade credit insurance, and some letters of credit often issued by banks would be within the scope of the proposals. However, contracts that pay out regardless of whether the counterparty holds the underlying debt instrument or on a change of credit rating or credit index would continue to be accounted for as financial instruments. The scope of the discussion paper is generally consistent with existing US GAAP as it relates to insurers, but may result in changes in banks' accounting for certain types of instruments.

4. The proposals would exclude from the scope of the guidance certain contracts that meet the definition of insurance contracts. The exemptions carried forward from IFRS 4 include:
 - Product warranties issued by a manufacturer, dealer or retailer
 - Residual value guarantees provided by a manufacturer, dealer or retailer as well as a lessee's residual value guarantee embedded in a finance lease
 - Contingent consideration payable in a business combination
 - Employers' assets and liabilities under certain employee benefit plans
 - Insurance contracts that an entity holds as a policyholder (although a cedant will apply the proposals to reinsurance contracts that it holds)

5. The boards' approaches would exclude fixed fee service contracts that expose the service provider to risk because the level of service depends on an uncertain event (such as maintenance contracts where specified equipment is repaired after a malfunction). However, the proposals note that an insurer should apply the proposals to insurance contracts in which the insurer provides goods and services to the policyholder to compensate the policyholder for insured events.

PwC observation: The boards intended for fixed fee service contracts (such as roadside assistance contracts and repair services) to be outside of the scope of the proposals. However, the wording in the scope paragraphs includes contracts where the insurer provides goods or services to compensate the policyholder for insured events, which seem to include such contracts given the definitions within the proposals. Some contracts are not specifically mentioned in the guidance, and thus it is unclear whether they would be covered by the approaches under consideration.

Although medical coverage was not addressed in much detail during the FASB and IASB deliberations, the IASB ED references "insurance against medical costs" as being within the scope of its proposed guidance. This includes payments to be made in kind in which the insurer provides goods or services to the policyholder to settle the obligation. An example given in the proposed IASB application guidance is when an insurer uses its

own hospitals and medical staff to provide medical services covered by the contracts.

In addition, while the IASB proposes to exclude from the scope all employer assets and liabilities under employee benefit plans, including health insurance plans, the FASB has not reached a preliminary view as to whether employer provided health insurance should be excluded. If employer provided health coverage is included in the scope, this could greatly expand the number of non-insurance companies that would need to implement the FASB proposal, as many companies directly offer health benefits to employees. In contrast, in those situations where the employer is merely providing employees access to a third party health insurer and not taking on insurance risk, the employer would not be subject to the proposal.

6. The scope of the IASB ED includes financial instruments containing discretionary participating features, while the FASB preliminary view is that such contracts are financial instruments that should be excluded from the scope of insurance contract accounting. These are considered further in the section on discretionary participating features below.
7. Within the definition of an insurance contract is the requirement that there be an uncertain future event. IFRS 4 (and the FASB's and IASB's proposals) requires that at least one of the following be uncertain at the inception of an insurance contract:

- Whether an insured event will occur
- When the insured event will occur (timing risk)
- How much the insurer will need to pay if the insured event occurs (underwriting risk)

8. While US GAAP for reinsurance transactions (and, by analogy, for insurance transactions) requires both underwriting and timing risk, IFRS 4 and the proposals require only one or the other. However, the proposals would amend IFRS 4 guidance slightly to note that certain timing delays might be so significant so as to disqualify a contract from risk transfer because the delays could eliminate or significantly reduce uncertainty of cash flows.
9. The proposed guidance, taken from IFRS 4, notes that insurance risk is significant if an insured event could cause an insurer to pay significant additional benefits in any scenario, as compared to the benefits that would be payable if the insured event did not occur. The focus in IFRS 4 is on whether there is variability in the amount of claim/benefit payments that could be paid whereas US GAAP focuses on the significance of the potential claim benefit payments in relation to the premium received.

PwC observation: FASB members and some IASB members were uncomfortable with the application of insurance accounting for contracts that had no chance of loss to the insurer. As a result, late changes to the proposals borrow from US GAAP by noting that a contract would not transfer

significant insurance risk if there is not a scenario that has commercial substance in which the present value of net cash outflows can exceed the present value of the premiums. Given this revised guidance, it is unclear whether certain contracts that guarantee a return of premium would meet the definition of an insurance contract.

10. The significant insurance test is required to take into consideration the time value of money. In addition, unlike existing US GAAP, the risk transfer test can be met “even if the insured event is extremely unlikely or even if the expected (i.e., probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the contractual cash flows from the insurance contract.”

PwC observation: The proposed guidance differs somewhat from existing US GAAP, which requires the presence of both timing and underwriting risk, no timing delays, and a risk transfer test (at least for reinsurance) that focuses on “the reasonable possibility of significant loss” as measured by a comparison of contractual cash flows to contractual premium.

Measurement model

11. Both the FASB and IASB proposals would require a single measurement model for all insurance contracts that portrays a current assessment of the amount and timing of the future cash flows that the insurer expects

its existing insurance contracts to generate as it fulfills its rights and obligations under the contract. This measure consists of the following “building blocks:”

- An explicit, unbiased and probability weighted estimate (i.e., expected value) of future cash outflows less future cash inflows
- A discount rate applied to those cash flows to reflect the time value of money

The IASB approach would also include a third “building block,” an explicit risk adjustment to reflect the estimate of the effects of uncertainty about the amount and timing of those future cash flows, while the FASB proposal would not.

- 12.** The boards believe that there should be no “day one” profit recognition for insurance contracts, which would be consistent with the proposals in the revenue recognition project. As a result, if the present value of cash flows (plus the risk adjustment in the IASB model) gives rise to an asset, a composite margin (or residual margin in the IASB model) is added to eliminate any day one gain and therefore the contract is measured initially at nil. If the present value of the cash flows (plus the risk adjustment in the IASB model) is greater than zero, the insurer recognizes that present value as a loss, as it represents a loss on an onerous contract. Subsequent changes in the present value of cash flows (and the risk adjustment in the IASB model) could create an insurance asset or liability.

PwC observation: In the FASB model, a loss on day one would

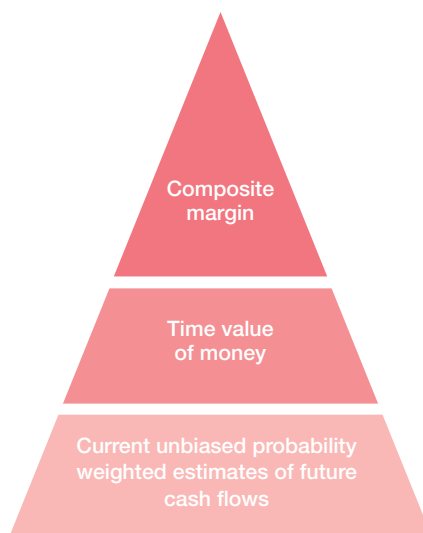


Figure 1: FASB Measurement model

be recognized when expected cash outflows are greater than the expected cash inflows. In the IASB model, a loss may be recognized in situations where in the FASB model it would not because the FASB model does not include an explicit risk adjustment in the measurement of expected cash flows.

- 13.** Both the FASB and the IASB propose that an insurer treat insurance contracts in a foreign currency as monetary items when applying foreign currency transaction guidance. In the FASB model, the requirement applies to all insurance contract cash flows and the composite margin. Similarly, in the IASB model, the requirement applies to all insurance contract cash flows, the risk adjustment, and the residual margin.

PwC observation: This will eliminate the accounting mismatches that arise under US GAAP and IFRS 4 when unearned premiums and deferred acquisition costs are treated as non-monetary items by property and casualty insurers.

Cash flows

- 14.** The cash flows included in both the FASB and IASB versions of the measurement model are an explicit, unbiased, and probability weighted

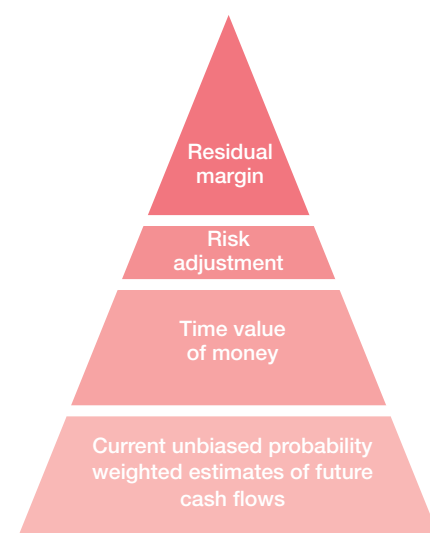


Figure 2: IASB Measurement model

estimate of the incremental future cash outflows less future cash inflows that will arise as the insurer fulfills the insurance contract. This expected value is determined by considering the range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for the particular outcome and the estimated probability of that outcome. The cash flows from each outcome are discounted and weighted by the probability factor to drive the expected present value. Unlike many current accounting models, which develop a single “best estimate,” all probabilities (even remote ones) are considered and weighted. The application guidance notes that not all cases will require the development of explicit scenarios. However, in cases where there are complex underlying factors that behave in a non-linear fashion, sophisticated stochastic modeling may be needed.

PwC observation: The expected value is based on an evaluation of all possible outcomes, considering the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The use of probability-weighted cash flows, while increasingly common in more recent accounting standards, is not an explicit element

of current estimates of life and non-life insurance liabilities in the US. The objective of this approach is to incorporate variability in the estimate of cash flows by identifying all possible scenarios and making unbiased estimates of the probability of each scenario. Such an approach results in a statistical mean, rather than a “best estimate” or “most likely” outcome. Some believe that the “actuarial central estimate” commonly used by property and casualty actuaries in their development of estimates of unpaid losses is consistent with the proposed approach. Whether the objective of the new measure can be achieved with existing methodologies and systems or whether major changes will be required to both remains to be seen.

15. The cash flows should include all incremental cash inflows and outflows arising from a portfolio of insurance contracts. A portfolio is defined as insurance contracts that are subject to broadly similar risks and managed together as a single pool. Cash outflows will include direct costs and systematic allocations of costs that relate directly to the contract or contract activities. These cash flows will include policy administration and maintenance costs but will exclude general overhead and income tax payments and receipts, which are recognized and measured under income tax accounting guidance. Cash flows should be current and reflect the perspective of the insurer, except for market variables, which should be consistent with observable market prices. The application guidance

notes that the use of a portfolio of replicating assets (a replicating asset is one whose cash flows exactly match the contract cash flows) would be an appropriate way of incorporating market variables.

16. Cash flows to be included in the building block measurement will include only those cash flows generated as the insurer fulfills the existing contract. Many contracts contain features such as extension or termination features or re-underwriting options, which make it difficult to determine the length of the contract. Thus, it is necessary to draw a contract boundary for these cash flows. The proposals would require that estimated cash flows be included to the point at which an insurer either is no longer required to provide coverage or has the right or the practical ability to reassess the risk of the particular policyholder and can set a price that fully reflects that risk.

PwC observation: The definition of the contract boundary could have an impact on certain health insurance and other contracts where a regulator imposes constraints on re-pricing for individual policyholders. In some territories these contracts are currently treated as short-duration contracts, but under the proposals the expected cash flows may extend beyond the one year boundary if the insurer cannot fully re-price and re-underwrite the individual policy. The FASB is seeking input from constituents on the implications of the recent US healthcare reform provisions on the definition of the contract boundary. Alternatively, there may

be contracts that are currently treated as long term in some territories where the proposals for the contract boundary will result in only cash flows for a shorter period being taken into account (for example if the contracts can be re-priced for a change in risk). If these contracts have significant acquisition costs that are recovered from cash flows in later periods beyond the contract boundary, this could lead to an initial loss being recognized.

17. Insurance contracts often include embedded options and guarantees, such as guarantees of minimum investment returns, maximum charges for mortality, surrender options, or options for the policyholder to reduce or extend coverage. The proposed measurement model requires the expected cash flows to reflect expected policyholder behavior, including features that allow policyholders to take actions to change the amount, timing or nature of the benefits they will receive.

PwC observation: In some countries insurers issue policy loans to customers secured against the insurance contracts. Insurers would need to consider whether these loans represent cash flows under the insurance contract or are separate financial instruments that would be accounted for under financial instruments accounting.

Discount rate

18. The discount rates applied in the building block model should be

consistent with observable current market prices for instruments with cash flows whose characteristics match those of the insurance liability in terms of timing, currency, and liquidity. Those characteristics are not reflected by using discount rates based on expected returns on actual assets backing those liabilities. For contracts where the cash flows do not depend on the performance of specific assets, the discount rates should reflect the yield curve for instruments that are essentially risk free with an appropriate adjustment for illiquidity. For contracts where the cash flows do depend wholly or partly on the performance of specific assets, the measurement of the insurance contracts should reflect that dependence. The present value of the fulfillment cash flows should not reflect the risk of non-performance of the insurer.

PwC observation: The recent credit crisis highlighted the difficulty in distinguishing between illiquidity and credit risk within market prices. In valuing insurance liabilities, there will be contracts that are clearly liquid due to policyholder surrender options and other contracts, for example, annuities, where the cash flows are predetermined and not flexible and hence illiquid. The challenge will be to determine when it is appropriate to apply an adjustment for illiquidity for contracts that fall in between these two extremes. There also will be complexities in the use of an interest rate curve instead of a single discount rate. In some situations, multiple curves may be required for contracts with different benefits, some of which

are based on investment returns and others that are not. By using current rates, investment asset and liability mismatches, such as duration and credit characteristics, will be measured in the financial statements at current assumptions as opposed to long-term assumptions used in many models today.

The boards are asking for specific comments on whether the fulfillment cash flows should reflect the non-performance risk of the insurer. In responding to this proposal insurers will need to consider the impact of financial instruments accounting on the measurement of financial assets backing the insurance contracts. In particular, will accounting mismatches arise if changes in the fair value of financial assets due to changes in the market price of credit risk are reflected in the income statement but the measurement of the liability excludes some of this market movement if it is attributed to the risk of non-performance by the insurer?

Risk adjustment

19. One of the most controversial issues in this project is whether, in addition to the probability weighted cash flows, an additional amount (referred to as an “explicit risk adjustment”), should be included in measuring the contract liability to reflect the effects of uncertainty inherent in the estimated future cash flows. After much deliberation, the IASB decided that an explicit risk adjustment should be part of the

building block measurement while the FASB decided that it should not.

20. The IASB proposal therefore includes an explicit risk adjustment for the effects of uncertainty about the amount and timing of future cash flows from the perspective of the insurer rather than from the perspective of a market participant. The risk adjustment is the maximum amount the insurer would rationally be willing to pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected. The risk adjustment is required to be included in the building block model in an explicit way, separate from the estimates of discounted future cash flows and separately disclosed. The IASB application guidance notes that care will be needed to ensure that risks are not duplicated. For example, if cash flows are measured using a replicating portfolio or other market observable inputs, then the measurement will already include the associated risk adjustment for these cash flows.

21. In order to address concerns over comparability and reliability, the IASB guidance limits the range of permitted techniques for calculating the risk adjustment to the “confidence-level” technique (value at risk), the “conditional tail expectation” technique (tail value at risk), or the “cost of capital” technique. Some application guidance on each of these approaches is given, including in what circumstances each technique might be appropriate. In addition, entities will be required to disclose the confidence level to which the risk adjustment corresponds, even

if a cost of capital or conditional tail expectation technique has been used.

- 22.** The IASB proposal requires the risk adjustment to be measured at a portfolio level. The adjustment will therefore allow for risk diversification within that portfolio but not between different portfolios within a group.

PwC observation: The cost of capital technique may differ from that used to price the contract or used for solvency purposes. The benefits of the explicit risk adjustment is that it reflects an explicit amount for risk included in the liability at each reporting period, reflects subsequent changes in risk, and ensures that an insurance liability includes a margin. An explicit risk adjustment is consistent with the pricing of financial instruments and written options as well as the proposals in the IAS 37 exposure draft on liabilities of uncertain timing or amount. It also reduces the amount of the residual margin that is amortized. The challenge for insurers to reliably and consistently measure the risk adjustment will vary from territory to territory depending on whether similar risk adjustment techniques are used for capital management or solvency requirements. The emergence of profit under each of the techniques will vary, as well as the drivers influencing the risk adjustment, for example, the price of capital will affect the cost of capital technique.

Composite margin (FASB approach)

- 23.** A majority of the FASB rejected the inclusion of an explicit risk

adjustment and instead decided on a composite margin approach. Under the composite margin approach, any positive difference between the present value of expected cash inflows and outflows calculated under the building block approach is recorded as the initial composite margin amount and amortized over the coverage and claim settlement period. Any negative amount is immediately expensed. The composite margin is presented as part of the insurance contract liability.

PwC observation: The inclusion of an explicit risk adjustment in the insurance liability estimate is an unfamiliar concept in non-fair value measurements of insurance liabilities (or similar types of uncertain liabilities) in the US today. While some see the need for an explicit margin to reflect the level of uncertainty inherent in a particular set of cash flows, many are concerned that estimating an explicit risk margin may reduce the reliability and comparability of the measure, while adding additional complexity and subjectivity to what is already a subjective estimate. In contrast, European companies will use a cost of capital approach in the regulatory construct of Solvency II to calibrate risk margins, and Australian property and casualty companies have had some experience with estimating risk margins for financial reporting purposes.

Opponents of an explicit risk adjustment, which includes a majority of the FASB, have expressed concerns with the appropriateness of an explicit risk adjustment in a non-fair value

measure and with the reliability and consistency of calculation methodologies for this risk adjustment. In addition, they note that there is no single technique for calculating the adjustment that is universally accepted and used, resulting in a potential comparability issue across insurers. Opponents note that even if a particular method is used, there is still much subjectivity in selecting the parameters of measurement, such as the appropriate confidence level. In addition, unlike other estimates, such as claims estimates, it is not possible to perform direct tests to assess retrospectively whether a particular risk adjustment is reasonable.

Subsequent measurement and the residual margin (IASB approach) or composite margin (FASB approach)

- 24.** Under the IASB approach, at the end of each reporting period, the insurance liability would be measured as the sum of the present value of fulfillment cash flows, including the risk adjustment, and the remaining residual margin. Therefore, at each reporting period, the liability will reflect current estimates of cash flows, current discount rates, and a risk adjustment that reflects the remaining risk of uncertainty about the amount and timing of those cash flows. Any changes in the estimates are recognized immediately in the income statement.

PwC observation: Recognizing changes in estimates in the income statement will lead to an increase in volatility of reported results for

many insurers that currently use fixed assumptions. Under the IASB proposal, changes in estimates would not be recognized in other comprehensive income (OCI). Some argue that this could result in accounting mismatches where assets are measured on an amortized cost basis and equities are measured at fair value through OCI. Another criticism of the proposals is that a gain on initial recognition would not be permitted to be recognized in the income statement, yet if there is a positive change in the estimates of cash flows on day two, it would be recognized immediately in the income statement.

25. The residual margin is calibrated at inception to an amount that avoids a gain being recognized when an insurer enters into the insurance contract. The residual margin is determined within a portfolio by date of inception and by length of the contract. The residual margin is recognized over the coverage period in a systematic way that reflects the exposure from providing insurance coverage. This is on the basis of time or, if claims are expected to be incurred in a different pattern, on the basis of the timing of expected claims.

PwC observation: It is not clear in the proposal whether the pattern of amortization of the residual margin in the income statement can change. For example, it is unclear whether the residual margin can be released if the occurrence of a claim means that the risk of any further claim is reduced or eliminated.

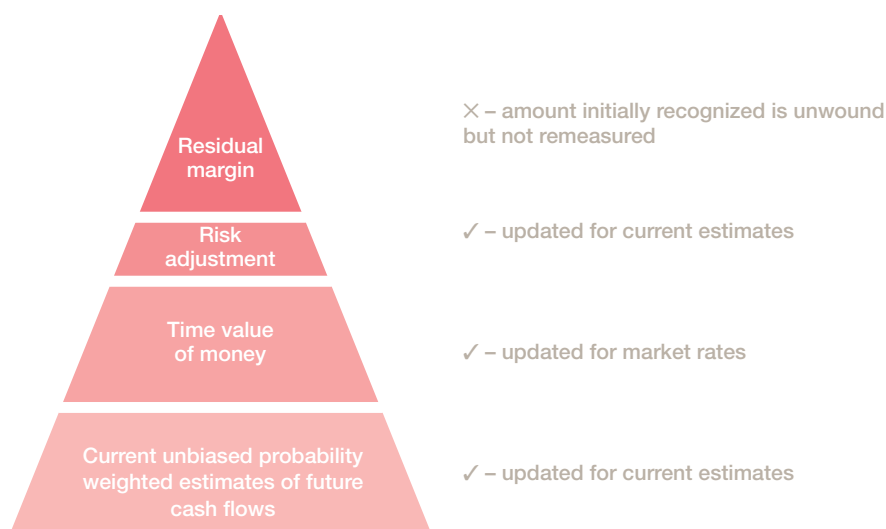


Figure 3: Subsequent measurement – IASB Approach

26. The residual margin is not adjusted when there are changes in estimates of both financial variables (such as discount rates and equity prices) and other estimates (such as expenses and lapses) unless a contract terminates. The residual margin accretes interest at the discount rate used at inception.

PwC observation: The IASB did not consider an alternative method for the subsequent measurement of the residual margin by recalibrating the residual at each reporting date considering all current information. Under this alternative, the residual margin could be restated at inception of the contract using updated experience (up to the reporting date) and assumptions of future cash flows. This would lead to part of the change in estimates being recognized immediately in the income statement and the remainder adjusting the unamortized portion of the residual margin and recognized over the remaining coverage period. However, such an approach would be complex to model for long term contracts.

27. The FASB's alternative model would have a single composite margin on inception of the contract. Under this approach the insurance liability at each reporting date would be the sum of the present value of probability-weighted cash flows (with no risk

adjustment) and the remaining composite margin. The composite margin would be amortized over both the coverage and claims handling period according to the following formula:

$$\frac{\text{Premium allocated to date} + \text{Claims and benefits paid to date}}{\text{Total expected contract premiums} + \text{Total expected claims and benefits}}$$

All of the amounts in the above formula would be undiscounted. Although the composite margin amount calculated at inception would not be re-measured to reflect any changes in risk and uncertainty, the amounts used in the formula above would be re-measured based on current estimates at each period end. As a result of this retrospective catch-up type of approach, the amortization pattern for the composite margin would be altered as changes in estimates in the ratio occur. Interest would not be accreted on the composite margin.

PwC observation: Supporters of the composite margin approach argue that this approach avoids the concern that a risk adjustment is inconsistent with the fulfillment objective of the proposal. The advantage of the approach is that it avoids the concern over comparability and consistency of different ways of calculating and calibrating a

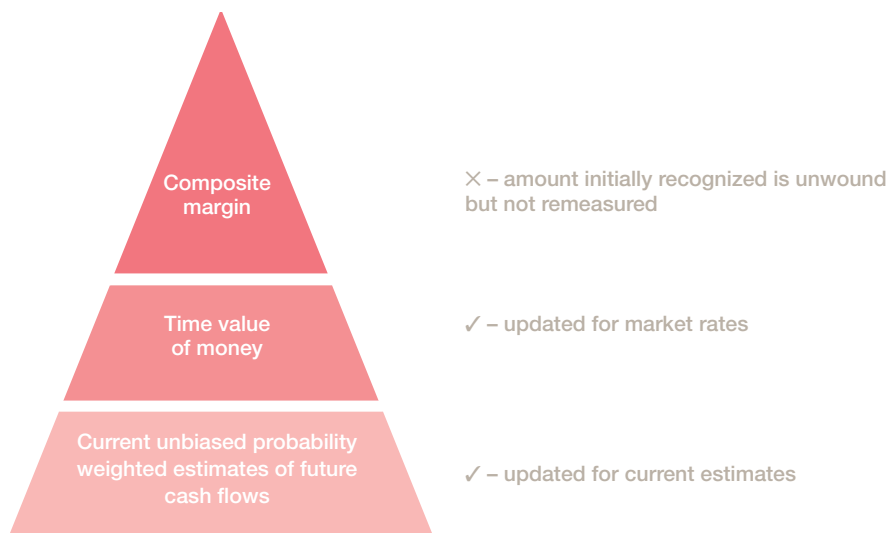


Figure 4: Subsequent measurement—FASB Approach

risk adjustment. It is also likely to be easier and less costly to implement.

Acquisition costs

28. Under both the FASB and IASB proposals, acquisition costs that arise from and are incremental to an individual contract are included in the present value of fulfillment cash flows. These are defined as “the costs of selling, underwriting, and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular insurance contract.” The inclusion of these costs in the fulfillment cash flows will reduce the composite margin (under the FASB approach) and the residual margin (under the IASB approach) on initial recognition of the contract. All other acquisition costs are expensed when they are incurred.

PwC observation: The restriction to incremental acquisition costs is consistent with the treatment of transaction costs in IFRS on financial instruments (IAS 39). However, it is more restrictive than current accounting in many territories, which may allow an element of allocated direct costs or overhead to be treated as deferred acquisition costs. Even under the newly revised definition of acquisition costs under US GAAP, both

incremental costs as well as certain direct costs of acquisition, such as the portion of internal salaried sales force, underwriting, and policy issue costs relating to successful contract sales, are capitalizable.

The proposals would mean that the distribution model may affect reported profits. Insurers that use independent intermediaries (or pay their internal sales force on a commission basis) are likely to incur a commission, which is usually incremental at the contract level and so will be a fulfillment cash flow in the building block approach. This treatment will result in the reduction of the recognized composite margin (FASB) or residual margin (IASB) on day one. When the commission is paid, it will be treated as a contract cash flow reducing the liability with no impact on the income statement. However, insurers that perform direct marketing or have a salaried in-house sales force will likely have lower acquisition costs that are considered incremental to a specific insurance contract. Thus, they will have a larger composite margin (FASB) or residual margin (IASB) for a contract that is recognized over the coverage period and will expense most of their acquisition costs immediately, which could give rise to an initial loss.

Simplified measurement model for pre-claims liability of short-duration contracts

29. The IASB proposal requires that for short-duration contracts of approximately one year or less that do not contain any embedded derivatives or options, the pre-claims obligation would be measured as the premium received at initial recognition plus the expected present value of future premiums that are within the boundary of the contract less the incremental acquisition costs of issuing the contract. For balance sheet purposes, this obligation will be offset by the expected present value of premiums and referred to as the pre-claims liability. Any claims that arise on these contracts would be measured at the present value of the fulfillment cash flows using the building block model (including the risk adjustment), as for all other insurance contracts.

30. An onerous contract test (which is similar in concept to the current liability adequacy or premium deficiency test) would be required under the IASB simplified approach for the pre-claims liability. At initial recognition and subsequently, a contract is onerous if the present value of fulfillment cash flows (including the risk adjustment) exceeds the carrying amount of the pre-claims obligation. In this case the insurer would recognize an additional liability for this difference and recognize an expense in the income statement. This onerous contract test would be performed at the portfolio level of contracts with a similar date of inception.

PwC observation: The performance of the onerous contract test for a portfolio of contracts with a similar date of inception may be at a lower level than current accounting practice would require. The definition of a portfolio may be open to different interpretations.

31. Under the IASB proposal, the pre-claims obligation would be reduced over the coverage period in a systematic way that reflects the exposure from providing insurance coverage. Similar to the residual margin in the IASB version of the building block model, this would be amortized based on the passage of time or the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time. Interest would accrete on the pre-claims liability at the current rate.

PwC observation: The IASB has proposed that the simplified measurement approach be used for the pre-claims liability of short-duration contracts that meet stipulated criteria. This means that property and casualty insurers may have to apply two different measurement models for similar contracts where only the contract term is different. The IASB considered whether to permit the use of the simplified approach rather than require it, given that it can be seen as a practical short cut. To enhance comparability the IASB decided to require the simplified approach if contracts meet the specified conditions.

The IASB ED is unclear about whether an insurer would be

allowed/required to release any pre-claims liability in the event that the occurrence of a claim curtails any of the remaining insurance coverage. It is also not clear whether the pattern of release of the pre-claims liability can change if the expectation of claim and benefit payment patterns change.

An assuming reinsurer that commits to reinsure policies written by an insurer in the next twelve months may not meet the short-duration contract criteria if the coverage period of the underlying contracts is considered to be the coverage period for the reinsurance contract.

32. During the joint deliberations, the FASB discussed the simplified measurement method proposed by the IASB but did not conclude on whether and when a simplified approach might be appropriate. In its discussion paper, the FASB asks constituents whether a “modified approach” might be appropriate and how the scope for such an approach should be defined. For example, should the scope be based on the duration of the coverage period, the duration of the claims payment period, the type of insurance, or current guidance?
33. The FASB discussion paper does not address how the modified approach might be applied to claims in the context of the FASB’s composite margin approach. For example, one issue to consider would be how claim liabilities would be calculated under the FASB’s version of a modified approach, i.e., with or without allocation of a composite margin. Use of an earned premium approach during the

coverage period, combined with the exclusion of a composite margin in the post-coverage period, would result in accelerated recognition of profit when compared to the composite margin building block approach. This would also typically result in accelerated recognition of profit compared to the current US GAAP model in which claim liabilities are not discounted.

Reinsurance

34. Both the FASB and IASB proposals require that reinsurance business assumed be measured using the same building block measurement approach as for other insurance contracts. Ceding commission paid to the ceding company would be treated as a reduction in premium.
35. For the ceding insurer, if the net cost of a ceded reinsurance contract exceeds the expected value of the recovery (including a risk adjustment in the IASB model), this excess would be recognized as a composite margin (residual margin in the IASB model) in the reinsurance asset. However, if the net cost of the reinsurance is less than the expected value of the recovery (including a risk adjustment in the IASB model), this would be recognized as an immediate gain. Ceding commission would be treated as a reduction of the premium ceded to the reinsurer.
36. The risk of non-performance by the reinsurer should be included on an expected value basis when estimating the fulfillment cash flows of the reinsurance asset.
37. As provided in existing US GAAP and IFRS 4, an insurer would not offset

reinsurance assets against insurance contract liabilities in the statement of financial position or offset income or expense from reinsurance contracts against the income or expense from insurance contracts.

PwC observation: While issuing a direct insurance contract cannot give rise to recognition of an initial profit, the proposals do allow a profit to be recognized when purchasing a reinsurance contract. Some argue that this is inconsistent with the treatment for financial instruments and with revenue recognition guidance.

The proposals do not provide any more guidance than current US GAAP and IFRS 4 on whether insurance companies providing fronting arrangements of linked insurance and reinsurance contracts should treat the inwards and outwards contracts as separate transactions or as a single contract for the purpose of applying the definition of insurance contracts and assessing the significance of insurance risk transfer. The IASB application guidance notes that “contracts entered into simultaneously with a single counterparty, or contracts that are otherwise interdependent, form a single contract.”

There may not be symmetry between the measure of the reinsurance asset by the cedant and the insurance liability as measured by the reinsurer for quota share reinsurance. Differences may arise from the assessment of the explicit risk adjustment due to the level

of risk diversification reflected or other entity specific assumptions. In addition, the reinsurer may include cash flows for contracts not yet written by the cedant.

Unbundling

38. An insurer would be required to unbundle components of a contract that are not closely related to the insurance coverage specified in that contract. In particular, under the FASB and IASB proposals the following components would be unbundled:

- Policyholder account balances that are credited with an explicit return where the crediting rate is based on the performance of a specified pool of assets. The crediting rate must pass on all investment performance and so the imposition of a ceiling on the return would not meet these criteria.
- Embedded derivatives that are separated from the host contract in accordance with existing bifurcation requirements for derivatives.
- Goods and services provided under the contract that are not closely related to the insurance coverage but have been combined for reasons that have no commercial substance.

PwC observation: Unbundling is an important aspect of the proposed accounting as the insurance measurement model differs from other measurement models (i.e., financial instrument and service revenue models). The unbundling

requirements are not accompanied by application guidance and hence policyholder account balances, charges and other assessments, cross subsidies, and other terms used in the proposals, including “*closely related*,” will be open for interpretation. It is also unclear how any acquisition costs would be allocated between the different components. Further, the boards’ discussions seemed to include an intention to unbundle universal life contracts into separate insurance and financial instrument components. However, some interpret the crediting rate criteria to preclude unbundling account balances that do not receive all the investment return from the associated assets.

39. The proposals require that in unbundling an account balance, an insurer regard all charges and fees assessed against the account balance as belonging to either the insurance component or another component, but not the investment component. The crediting rate used to determine the account balance is calculated after eliminating any cross-subsidy between that rate and charges or fees assessed against the account balance.

PwC observation: It is assumed that the account balance could be an asset such that loans under which the outstanding balance is waived upon death or disability could be unbundled into the loan balance (within the scope of financial instruments accounting) and an insurance element (within the scope of the insurance proposals) if they meet the crediting rate criteria.

Discretionary participating features

40. The IASB and FASB proposals include within their scope insurance contracts issued by insurers that provide the policyholder with both guaranteed benefits (for example, a death benefit) and a right to participate in the favorable performance of the relevant class of contracts, related assets, or both—“discretionary participation features.” The proposals note that payments arising from the participating feature should be included in the measurement of insurance contracts in the same way as any other contractual cash flows (i.e., on an expected present value basis).

41. Insurers also issue investment contracts with participating features that are not insurance contracts, but give the policyholder guaranteed benefits and additional benefits, which are, to a varying degree, at the discretion of the insurer. The IASB ED includes these contracts in its scope if there are also insurance contracts that provide similar contractual rights to participate in the performance of the same insurance contracts, the same pool of assets, or the profit of the same company, fund, or other entity. Otherwise such contracts would be within the scope of the financial instruments standard. The FASB would include all investment contracts with discretionary participating features within the financial instruments standard.

PwC observation: Participating contracts often include guarantees. The proposals acknowledge that where cash flows depend on the performance of particular

assets, the measurement of the insurance contract should reflect that interdependence and this could be through the use of a replicating portfolio technique. It is assumed that guarantees included in contracts with participating features will be measured on a market consistent basis. This could result in a fairly significant liability attaching to the guarantees compared to the measurement under existing accounting policies.

42. If investment contracts with discretionary participating features are within the scope of the insurance contracts standard, the boundary of the contract is the point at which the contract holder no longer has a contractual right to receive benefits from the participating features in that contract.

43. Under the IASB ED, the residual margin on investment contracts with discretionary participating features is recognized in the income statement over the life of the contract on a systematic basis (passage of time or on the basis of the fair value of the assets under management if that pattern differs significantly from the passage of time).

PwC observation: The guidance in the exposure draft suggests that the expected cash flows would include payments to current or future policyholders as a result of participation features. It is not clear how future contracts would be within the boundary of existing contracts and what the implications of this would be for mutual insurers or inherited estates.

Recognition and derecognition

44. The IASB and FASB proposals are consistent with regard to recognition and derecognition of insurance contracts. An insurer would recognize an insurance contract at the earlier of when the insurer is bound by the terms of the contract or when the insurer is exposed to the risk under the contract.

PwC observation: Whether an insurer is bound by an insurance contract will depend on the legal requirements in the territories in which it operates. The period an insurer is exposed to the risk under the contract may not be the same as the insurance coverage period. The recognition criteria will change the way many insurers, especially reinsurers, account for insurance contracts, as contracts will be recognized earlier than the date on which the insurance coverage commences. During the period between the recognition date and the date coverage commences, the insurer would be required to remeasure its obligations using current estimates, including changes in discount rates, and record changes in those obligations in the financial statements. For contracts measured using the simplified approach, the insurer would be required to perform a liability adequacy test, which could result in recognizing a loss in the income statement. The insurer would not commence the amortization of the composite margin (or residual margin) until the coverage period commences.

45. An insurer would derecognize an insurance contract liability (or a part of an insurance contract liability) when it is extinguished. This is when the obligations in the contract are discharged, cancelled, or expire. At this point the insurer is no longer at risk and is no longer required to transfer any economic resources to satisfy the insurance obligation.

PwC observation: Reinsurers that write treaties covering a cedant's insurance contracts to be issued in the upcoming year at a constrained price would be required to recognize the contract in accordance with the measurement model, i.e., estimating expected cash flows for underlying direct contracts that have not yet been written. However, entering into a reinsurance agreement does not result in derecognition of the insurance contract liability unless there is a novation of the direct contract. Unlike US GAAP and existing IFRS in respect of financial instruments, the proposals do not contain any guidance on when a substantial modification to an insurance contract should be accounted for as an extinguishment of the contract.

Portfolio transfers and business combinations

46. The FASB and IASB proposals require an insurer to measure a portfolio of insurance contracts acquired in a portfolio transfer at the higher of:
- The consideration received after adjusting for any other assets or liabilities acquired in the same

transaction. In this case the excess of the consideration over the present value of the fulfillment cash flows (including a risk adjustment in the IASB model) establishes the composite margin (or the residual margin in the IASB model) at initial recognition; or

- The present value of the fulfillment cash flows (including a risk adjustment in the IASB model). If the present value of the fulfillment cash flows exceeds the consideration received, the excess results in a loss, which is recognized immediately in the income statement.
47. A portfolio of insurance contracts acquired in a business combination will be measured at the higher of:
- The fair value of the portfolio. In this case the excess of fair value over the present value of fulfillment cash flows (including a risk adjustment in the IASB model) establishes the composite margin (or the residual margin in the IASB model); or
 - The present value of the fulfillment cash flows (including a risk adjustment in the IASB model). If this amount exceeds the fair value of the portfolio, the excess would increase the amount of goodwill.

PwC observation: The proposals deviate from the principles in US GAAP and IFRS business combination guidance in that the insurance contracts may not be measured at fair value in some instances but instead would be subject to the same principles as applied to other insurance contracts issued by the insurer. The current practice of recognizing

a separate asset for the value of business acquired (VOBA or PVIF) would be eliminated.

Unit-linked contracts

48. A unit-linked contract (sometimes called a separate account or variable contract) is one where some or all of the benefits are determined by the price of units in an internal or external investment fund. Under the IASB and FASB proposals, unit-linked assets and liabilities would be presented as separate line items in the statement of financial position and not commingled with the insurer's other assets and liabilities. Income and expense from unit-linked contracts would be presented as a single line item in the income statement. Income and expense from pools of assets underlying these contracts would be presented as a single line item as well, not commingled with income and expense from the insurer's other assets.
49. In proposed amendments to IFRS 9, IAS 32, and IAS 16, the IASB would require entities to recognize treasury shares and owner occupied property at fair value with changes in fair value recognized in profit or loss to the extent those fair value changes relate to the interest of unit-linked contract holders in the pool of assets. While the FASB had agreed to this accounting during deliberations, there is no discussion of this issue in the FASB DP.

PwC observation: Both insurance contracts and other financial instruments can meet the unit-linked

contract definition. It is unclear how the unbundling rules for account balances link with the presentation requirements for unit-linked contracts. The boards' intent seemed to be for this presentation to apply to the account balance of a unit-linked contract. However, the proposals require any unbundled account balances within unit-linked contracts to be accounted for under the financial instruments standard. Similarly, the single line presentation would also not apply to unit-linked investment contracts unless a similar requirement were to be included in financial instruments guidance. Further, the proposed amendments to IFRS 9, IAS 32, and IAS 16 refer to treasury shares issued by and property occupied by an insurer. It is not clear whether these amendments would apply only to insurance contracts or whether they would also apply to unit-linked investment contracts.

Presentation: Statement of comprehensive income

50. The following minimum line items would be required to be presented in the statement of comprehensive income under both the FASB and IASB proposals:

- Underwriting margin (i.e., the release of the composite margin under the FASB model). Under the IASB model, the underwriting margin would comprise both the change in the risk adjustment and the release of the residual margin, disaggregated in the income statement or the notes. Gains and losses

at initial recognition, disaggregated in the income statement or the notes into losses on portfolio transfers, gains on buying reinsurance, and day one losses.

- Non-incremental acquisition costs.
- Experience adjustments and changes in estimates, disaggregated in the income statement or the notes into experience adjustments, changes in cash flow estimates and discount rates, and reinsurance impairment losses.
- Interest on insurance liabilities (presented to highlight the relationship with investment return on assets backing those liabilities).

51. Under the IASB proposal, for the pre-claim liability when the short-duration contract approach is used, the insurer should present:

- Underwriting margin (disaggregated in the income statement or the notes into premium revenue, being the reduction in the pre-claim liability from providing insurance coverage, claims incurred, expenses incurred, and amortization of incremental acquisition costs).
- Changes in liability for onerous contracts.

52. Other than for the pre-claim liability as noted above, premiums, claims expenses, and other expenses included in the measurement of the liability are not presented in the statement of comprehensive income but are treated as deposit receipts/payments under both the FASB and IASB proposals.

PwC observation: The presentation model is driven by the

measurement model. For many insurers, the proposed statement of comprehensive income will be a significant change from the way insurers present their results today. Property and casualty insurers that write contracts accounted for under the simplified measurement approach and also write contracts measured under the building block measurement model will not be able to show premium income on all insurance contracts on the face of the income statement. Conglomerate groups will also need to consider how they will present their combined results. It is unclear how subsequent changes in the claims liability would be presented in the simplified measurement approach underwriting margin, as these liabilities are under the building block measurement model.

Management, analysts, and investors will need to be educated in the new presentation format and the implications of the building blocks approach on reported earnings. It will take some time to become accustomed to not having premiums, claims, incremental acquisition costs, and administrative expenses (to the extent they are included in the building block cash flows) presented on the face of the income statement.

Disclosure

53. Under the FASB and IASB proposals an insurer would disclose qualitative and quantitative information about the amounts recognized in the financial statements and the nature and

extent of risks arising from insurance contracts to help users understand the amount, timing, and uncertainty of future cash flows arising from those contracts. An insurer should aggregate or disaggregate information so that useful information is not obscured. The proposed disclosure requirements build on the current IFRS 4 requirements and have been amended to also require the following disclosure that flows from the measurement model.

54. The proposals require a reconciliation from the opening to the closing aggregate insurance and reinsurance balances for each of the following:

- (a) Insurance contract liabilities and assets
- (b) Risk adjustments included in (a)
- (c) Residual (or composite) margins included in (a)
- (d) Reinsurance assets arising from reinsurance contracts held as cedant
- (e) Risk adjustments included in (d)
- (f) Residual (or composite) margins included in (d)
- (g) Impairment losses recognized on reinsurance assets

55. Each reconciliation as required above should show at a minimum:

- The carrying amount at the beginning of the period
- New contracts recognized during the period
- Premiums received
- Payments with separate disclosure of claims, expenses, and incremental acquisition costs
- Other cash paid

- Income and expenses recognized in profit or loss
- Amounts relating to portfolio transfers or business combinations
- Net exchange differences arising from translation of foreign currency amounts

56. An insurer should disclose the methods used and processes for determining the inputs to the fulfillment cash flows. Under the IASB proposal, an insurer should also disclose the methods and inputs to determine the risk adjustment, including disclosure of the confidence level to which the risk adjustment corresponds (when the insurer uses the conditional tail expectation or cost of capital methods).

57. The proposals also include a requirement to disclose a measurement uncertainty analysis of the inputs that have a material effect on the measurement. If changing one or more of the inputs in the building blocks to a different amount that could reasonably have been used in the circumstances would have resulted in a materially different measurement, the insurer would be required to disclose that effect. In determining this effect the insurer should ignore remote scenarios but include the effect of correlation between inputs. Significance is judged with reference to profit or loss and total assets or total liabilities.

58. The disclosure about the nature and extent of risks arising from insurance contracts are similar to current IFRS 4 requirements for insurance contracts but would be expanded to require disclosure about information on the regulatory framework in which

the insurer operates, for example, minimum capital requirements or required interest rate guarantees.

59. The proposed disclosure requirements would retain the IFRS 4 requirement to present claims development tables, initially for at least 5 years. After adoption of the standard, claims development tables would be built up to 10 years. The requirement would not apply to claims that are settled within one year.

PwC observation: The proposed disclosure requirements are more detailed than currently required and may significantly impact the system requirements of insurers. Systems will have to be able to capture and produce information sufficient to present the reconciliation of movements in the insurance and reinsurance balances.

Transition

60. Because the FASB proposal is merely a discussion paper rather than an exposure draft, no transition guidance is provided. However, the IASB ED envisages retrospective application for all in-force contracts with no grandfathering of past practices. At the beginning of the earliest period presented, an insurer would:

- Measure each portfolio of insurance contracts at the present value of the fulfillment cash flows (including a risk adjustment), which would exclude any residual margin
- Derecognize any existing balance of deferred acquisition costs

- Derecognize any intangible assets arising from insurance contracts assumed in previous business combinations (excluding customer relationships/lists that relate to future contracts)

61. At the start of the earliest period presented, when the insurer would first apply the proposed standard, insurers would be permitted to redesignate a financial asset as measured at fair value with changes in fair value recognized in profit and loss but not to redesignate a financial asset that is currently measured at fair value with changes in fair value recognized in profit or loss to amortized cost.

PwC observation: The extent of the opening retained earnings adjustment on the initial application of the IASB standard will be influenced by many factors, including the profitability of the business written as well as the previous accounting policies applied (including the level of prudence in those previous measurements). Insurers that write longer term contracts are likely

to be concerned that profit in excess of the risk adjustment that would have been recognized in the income statement in future periods will now be recognized in equity on transition. As a result of these transition provisions, contracts in-force at transition will have less profit in future periods than new business due to the lack of a residual margin being recognized at transition. The proposed standard does not allow insurers to implement the proposals in full retrospectively.

Timing for comments

62. The comment period on the FASB discussion paper ends on December 15, 2010 (or November 30, 2010 for roundtable participants). The comment period for the IASB's exposure draft ends on November 30, 2010, and a final IASB standard is expected in mid-2011. Given the potential impact of the proposed changes, we encourage management

to engage in the comment letter process and respond formally to the boards on the questions included in both the FASB discussion paper and the IASB exposure draft.

Addendum—Project status update

63. The Boards heard input from constituents at the three joint roundtables held in December 2010. In addition, over 250 comment letters were received by the IASB on its exposure draft, and over 70 letters were received by the FASB on its discussion paper. Key issues identified include the discount rate, margins, the modified approach for short-duration contracts, financial statement presentation, acquisition costs and unbundling. The proposed timetable calls for redeliberations through May 2011 with the IASB projecting issuance of a final standard by June 2011 and with a potential FASB exposure draft issued at or around the same time.

***To have a deeper conversation
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US GAAP Convergence & IFRS Consolidation

March 2011

Coming into focus

FASB proposes consolidation changes

What's inside:

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Upcoming changes to the consolidation model for asset managers

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Expected changes are not limited to VIEs

Reaction to the proposed changes

What's next?

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Refer also to the summary publication for a discussion of the consolidation for investment companies project.

Overview

The FASB has proposed changes to the guidance for evaluating whether a decision maker or service provider must consolidate a variable interest entity (VIE). These changes will have a considerable impact on asset managers. Several of the proposed changes incorporate feedback from asset managers on ways to better reflect the relationship they have with their investment products. However, it is likely that the new proposed changes will still generate a significant amount of discussion between the FASB and those in the asset management industry.

The proposed changes are designed to replace the existing guidance on principal and agency relationships and to end the deferral of FAS 167, *Amendments to FASB Interpretation No. 46(R)*¹, for certain investment entities.

The FASB is also expected to propose amendments to the existing guidance for evaluating whether kick-out rights held by limited partners of voting interest entities (VOEs) are substantive. This is to align the control guidance for VOEs with the guidance for VIEs. As many asset managers granted simple majority kick-out rights to their investment funds to avoid consolidation, this change could result in these investment funds being consolidated.

While changes to the principal and agency analysis would be consistent with the IASB model, the FASB has elected not to pursue a converged consolidation model.

The FASB's exposure draft is expected to be issued before the end of the first quarter of 2011.

¹ Codified in ASC 810

Upcoming changes to the consolidation model for asset managers

Consolidation analyses for asset managers have been challenging as a result of standards being implemented or debated during recent years. Following the Enron revelations regarding off-balance sheet vehicles, the FASB introduced separate consolidation models for (1) economic risk and rewards and (2) voting rights, which led to wholesale changes in fund and partnership structures. More recently, as a result of lessons learned from the financial crisis, the FASB moved away from the economic risk and rewards model to more of a decision-making analysis for VIEs. However, once adopted, this new approach would have caused asset managers to consolidate many of the funds that they managed—an unintended implication that caught many off-guard. Despite getting off to a late start, the asset management industry was able to convince the FASB of the need for a temporary deferral from applying this new VIE guidance to most investment funds.

These experiences have spurred asset managers to become increasingly engaged in the standard-setting process. Recently, they were active participants in the November 2010 consolidation roundtable discussions held by the FASB. Their objective is simple: to encourage the accounting standard setters to arrive at a model that they feel best depicts the relationships between themselves and their products and investors.

The focus of the most recent discussions has been what steps the FASB should take to address the temporary deferral of FAS

167. In January 2011, the FASB decided to propose targeted changes to the VIE consolidation model by introducing guidance on the factors to be considered in determining whether an asset manager is considered a principal or merely an agent performing its role on behalf of the investors. If the analysis indicates that the asset manager is acting in a principal role for a particular entity, then they will likely be required to consolidate that entity. In addition, the expected changes will likely seek to align the VIE consolidation guidance with the VIE guidance for evaluating whether removal (“kick-out”) and participating rights are substantive. These proposed targeted changes will be consistent with similar changes that will be finalized by the IASB this quarter.

Agent vs. principal—a factors-based approach

The FASB has outlined four primary qualitative factors that would need to be considered in the analysis to determine whether the asset manager is acting as a principal or agent: (1) the scope of the asset manager’s decision-making authority, (2) the rights held by others, (3) the asset manager’s compensation, and (4) other interests held by the asset manager. These factors would replace the existing guidance in FAS 167.

Many asset managers are supportive of the move to a more factors-based approach based on feedback from the recent roundtables. Some of the new factors appear to address several of the issues raised by industry participants, but still leave some questions unanswered. It will be important to understand the weight of each factor and its relationship with the other factors

to determine whether an entity is acting as a principal or an agent. For example, many believe that economic interests held by the asset manager may become the most important factor, but how to weigh that factor against factors such as whether an entity has an independent board or a highly-regulated product, such as a registered investment company, will likely generate much debate. This is especially relevant since the FASB is unlikely to provide any “bright lines” regarding how to apply the factors.

Decision-making authority

Assessing the scope of the asset manager’s decision-making authority is central to the analysis under the proposal. In particular, the FASB has indicated that for an entity that requires no significant ongoing decision-making or for whom decision-making is restricted by laws or regulations, the analysis should consider the design of the entity and who benefits from this design when determining which party may have power.

The addition of this as a factor in the analysis is reflective of the asset managers’ feedback from comment letters and at the roundtables. Asset managers with highly regulated products, such as 1940 Act mutual funds, were keen to point out their decision-making rights were highly restricted due to the requirements of the regulations. While perhaps not as compelling, asset managers that advise private vehicles noted that investment guidelines are set up based on potential market demands or perceived needs of investors. Many noted that these investment guidelines and regulatory requirements suggest their role is more as an agent than a principal.

Rights held by others

The conclusion that only single party kick-out rights are relevant to the consolidation analysis under FAS 167 received a significant amount of pushback from asset managers and continued to be an area of debate under the VIE model. In a significant change from the current VIE guidance; the expected proposal would require substantive kick-out rights held by more than one party to be considered in the analysis. However, the larger the group of investors required to exercise the kick-out rights, the less weight such rights will have in the analysis.

While a positive move in the view of asset managers, we can anticipate further debate on the number of parties that can hold kick-out rights before such rights no longer would be considered a relevant factor. Likely much of the debate will focus on the examples expected in the proposal and at what level do substantive kick-out rights become too widely dispersed. Many in the industry will still promote the view that a simple majority represents the determinative factor as to who controls the entity regardless of the number of investors. Substantive kick-out rights held by only one party would continue to be determinative and result in consolidation by the holder of that right.

In addition, the FASB reaffirmed its view that liquidation rights, but not redemption rights, would be viewed in a manner similar to kick-out rights. Again, many in the asset management industry have stated that redemption rights are also a key factor to consider in the analysis, as fees are derived from assets held in the fund. In their view, the ability to remove assets from the fund compels the asset manager to act in the best interests of the investors reinforcing the notion that this is an agency relationship.

Kick-out rights held by board of directors will also be a factor in the analysis. Removal rights held by a substantive independent board will likely be given greater weight in reaching a conclusion that consolidation is not required. The asset management industry views independent boards, and the ability of shareholders to elect their members, to be a key determination in the consolidation analysis. Consequently, industry participants will likely advocate for even more weight to be placed on the rights of shareholders and boards in the analysis.

Compensation and other interests

The FASB has indicated that an asset manager's compensation together with its other economic interests in the VIE will be the most significant factors in the assessment under the new proposal. This is consistent with feedback from asset managers and one of the areas that received the most discussion at the roundtables. While not determinative, whether the compensation arrangement is above or below a typical market fee arrangement, coupled with the significance of the asset manager's other interests in the entity would weigh heavily in the analysis.

Assessment of manager fees has often been difficult in the current analysis. Many in the industry note that market-based fees align the interests of the asset managers with investors in the fund. Some view that non-receipt of fees, or said differently, expected reduction in fees from decreases in assets under management, should be included in the analysis; however, the FASB has stated that this will likely not be part of the analysis in the new proposal. What is uncertain at this time is whether the presence of a non-market based arrangement

would, alone or in combination with other factors, be sufficient to conclude that the asset manager is a principal.

For economic interests in investment products, the analysis will only have to consider downside risk when fees and compensation are market-based. However, this makes larger investments by asset managers in their funds likely to tilt the analysis towards a principal conclusion. The FASB view is that the more exposure to downside risk, the more likely the asset manager will make decisions in its own interest. Asset managers will likely dispute this view, stating that economic interests in the fund better align their interests with that of investors and can even be required by those same investors. We can expect vigorous debate on this point. It is likely that many will desire additional guidance on what the tipping point will be in the analysis of economic interests.

One impact of the new approach is that a fact pattern where the asset manager has a subordinated and/or performance fee and little to no investment in the fund may not lead to consolidation. As a result some collateralized debt obligation and collateralized loan obligation managers could potentially see some of their products deconsolidated under this proposed model.

One area the FASB has not specifically discussed is the treatment of guarantees or other support provided by the asset manager, particularly for their money market funds. While many of these guarantees have expired as money market funds have stabilized, there remains the issue of whether asset managers will have to assess any implied guarantees for these types of products under the new proposal. It is presently unclear how much weight to place on these arrangements in the consolidation analysis.

Expected changes are not limited to VIEs

In order to improve consistency in the assessment of kick-out rights under all consolidation guidance, the proposal is expected to align the VOE approach with the approach under the VIE consolidation model. The presumption under the existing VOE consolidation model that a general partner controls a limited partnership can currently be overcome if a simple majority of limited partners can remove the general partner (i.e., kick-out rights) by means of a substantive vote. However, under the new proposal, simple majority kick-out rights may no longer be indicative of control by the holder of those rights.

When the kick-out rights guidance was originally developed, many fund managers granted these rights to their limited partners to overcome the presumption that they have control, and avoid consolidation of the funds they manage. The proposed change to the kick-out rights guidance could cause many of the limited partnerships that currently fall within the VOE consolidation model to be evaluated as VIEs. This, in turn, would trigger a requirement to assess whether the manager is acting as a principal or as an agent, and could, in some situations, result in the fund manager having to consolidate.

Reaction to the proposed changes

Feedback from previous consolidation standard setting and the recent FASB roundtables suggest that the proposals are likely to have a significant impact on asset managers and financial institutions that issue structured products. While generally there is asset management industry support for a factors-based analysis for determining whether a manager is acting as a principal or an agent, some constituents believe that specific guidance will be needed to prevent inconsistent application of the standard. Many in the industry believe that there are other important factors that should form part of the analysis, including the existence and powers of boards, an assessment of whether performance-based fees are market-based, and an emphasis on downside risk exposure.

Further, many are concerned with the proposal to align kick-out right under the VOE and VIE models because of the effect on many limited partnership structures that are prevalent today. Many of these structures are VOEs that are not consolidated by the asset manager (general partner) due to the existence of investor rights to remove the manager or liquidate the partnership by a simple majority vote. The move to a more qualitative assessment of the voting rights may lead to more entities being considered VIEs and subject to the more onerous consolidation analysis.

What's next?

In early March the FASB will meet for a final time to discuss the changes before exposing the proposal for public comment by the end of March 2011. A final standard is expected before the end of the year. Separately, the FASB is also expected to issue an exposure draft on the definition of an investment company by the end of second quarter 2011. While the FASB has not yet indicated the planned effective date for either standard, it is likely that they will require the two standards to be adopted concurrently, because the current deferral of FAS 167 is dependent on the definition of an investment company.

***To have a deeper conversation
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US GAAP Convergence & IFRS

Financial statement presentation

March 2011

Financial statement presentation

A look at the FASB and IASB's Staff Draft

What's inside:

Overview

Key provisions

Comment letters, field tests, and research study

Differences between FASB and IASB staff drafts

Next steps

Business implications

Appendix: Examples of revised financial statement format

Reprinted from:

Dataline 2010–35

August 26, 2010

(Revised February 3, 2011*)

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- The FASB and IASB (the “boards”) have completed their initial redeliberation of the key issues from their 2008 Discussion Paper and issued a Staff Draft of the Exposure Draft on Financial Statement Presentation (“staff draft”). The staff draft is intended to facilitate additional outreach efforts. The boards are not formally inviting comments on the staff draft but would welcome any input provided.
- The staff draft contains significant changes from the Discussion Paper and incorporates much of the feedback from comment letters and field tests. Key changes being proposed are:
 - assets, liabilities, revenues, and expenses would be categorized as operating, investing, and financing, with a separate section for taxes and discontinued operations,
 - the direct method would be used for the Statement of Cash Flows, with certain indirect information also presented,
 - a “roll forward” would be presented in the notes of significant Statement of Financial Position line items,
 - information would be disaggregated by function (e.g., cost of sales, selling, and marketing) on the face of the Statement of Comprehensive Income and by nature (e.g., bad debt, advertising) in the notes, and
 - expansive segment disclosures would be required (FASB only).
- This project was re-prioritized under the modified convergence strategy in June 2010 with an expectation to release an exposure draft in the first quarter of 2011. However, the boards acknowledged in October that they do not currently have the capacity necessary to address the issues raised on this project. At their October joint meeting, the boards decided to delay activities on this project until after June 2011.

* The At a glance (third bullet), Background (paragraph 2), and Next steps (paragraph 16) sections of this Dataline were revised to reflect the Boards' decision at their October joint meeting to delay activities on the project until after June 2011.

Background

1. The boards' objective for the Financial Statement Presentation project is to address investor and other financial statement users' concerns that the existing requirements permit too many alternative presentations and that the information in financial statements is highly aggregated and inconsistently presented, making it difficult to fully understand the relationship between an entity's financial statements and its financial results. The project was added to the FASB/IASB Memorandum of Understanding as a joint project in 2006. The boards issued a Discussion Paper in 2008 setting out their preliminary views on financial statement presentation. The FASB and IASB have concluded their initial redeliberations on the Discussion Paper. The boards have issued the staff draft to allow for additional outreach efforts and evaluate concerns about (1) the costs versus benefits of the proposals and (2) the implications for financial institutions.
2. The staff asked users and preparers of financial statements how the proposed changes would benefit them, and is evaluating the effort and cost involved in adopting the proposed changes in their circumstances. The boards have performed the following types of outreach:
 - **General**—to ensure that participants have a clear understanding

of the draft proposals, particularly the changes that have been made to the proposed presentation model since the 2008 Discussion Paper (see discussion in PwC observation in "Comment letters, field tests and research study" section for significant modifications to the proposals outlined in that paper),

- **Investors**—the boards have asked users (from various countries) to evaluate how the proposed changes would benefit their analysis and resource allocation decisions, and
- **Field test**—the boards have asked preparers of financial statements to evaluate the effort and cost involved in adopting the proposals.

The staff expects to complete the outreach activities by the end of January and plans to present its findings to the boards in March 2011.

3. The staff draft reflects the boards' collective tentative decisions through April 2010 and includes other disclosures and matters that were not part of the original Discussion Paper (e.g., segments, roll-forward analysis, transition). These tentative decisions are subject to change until the boards issue a final standard. This Dataline summarizes the key tentative decisions reached by the boards and reflected in the staff draft, together with information we have

obtained through our observations of board meetings and project updates published by the boards.

Key provisions

Scope

4. The boards intend the proposal to apply to all entities *except*:
 - Not-for-profit entities,
 - Entities within the scope of the IASB's SME standard, and
 - Benefit plans within the scope of IAS 26, *Accounting and Reporting by Retirement Benefit Plans*, or ASC Topics 960, 962, and 965.

Core principles of financial statement presentation

5. An entity shall present information in its financial statements in a manner that:
 - Disaggregates information to explain the components of its financial position and financial performance, and
 - Portrays a cohesive financial picture of the entity's activities.

The boards believe that the revised format will allow users of the financial statements to better understand an entity's performance by separating its financial position, changes in financial position, and cash flows between core

operations and other activities. The proposed new financial statement categories would be as follows:

	Statement of Financial Position	Statement of Comprehensive Income	Statement of Cash Flows
	Cohesiveness →		
Disaggregation ↓	Business section - Operating category - Operating finance subcategory - Investing category	Business section - Operating category - Operating finance subcategory - Investing category	Business section - Operating category - Investing category
	Financing section - Debt category - Equity category	Financing section Debt category	Financing section
	Income tax section	Income tax section	Income tax section
	Discontinued operations section	Discontinued operations section	Discontinued operations section
		Other comprehensive income section	

Statement of Financial Position

6. The boards are proposing the following changes to the Statement of Financial Position:

- Assets and liabilities are to be classified as arising from business or financing activities.
- Assets and liabilities arising from business activities are to be segregated between operating, investing, and financing arising from operating activities.
 - The operating category reflects the entity's business activities

that relate to the generation of revenues (e.g., accounts receivable, inventory, accounts payable).

- The investing category reflects the entity's activities that generate non-revenue income (e.g., purchase and sale of investments, dividends received on equity investments, equity method investments).
- The financing arising from operating activities (operating finance subcategory) reflects activities that (a) do not meet the definition of financing

activities, (b) are initially long term, and (c) have a time value of money component that is reflected by either interest or an accretion of the liability due to the passage of time (e.g., accrued pension liability, lease liability).

- Financing activities include items that relate to an entity obtaining (or repaying) capital and consist of two categories: debt (e.g., issuing loans, notes, obtaining a mortgage on a building, interest payable on a note) and equity (e.g., issuing shares or other equity instruments,

common, preferred, and treasury shares, distribution to owner).

- Income taxes and discontinued operations are to be displayed separately from business and financing activities. The income tax section should include all current and deferred income tax assets and liabilities.
- Entities are to display subtotals for total assets, total liabilities, short-term assets, short-term liabilities, long-term assets, and long-term liabilities.
- Information is to be presented in a manner that best reflects the way the assets or liabilities are used by the entity in operating the business.
- An entity may use an asset or liability for more than one function. For example, a building may be used as part of an entity's operations but may also be used partly as an investment property. The building is classified in the section or category of predominant use.
- An entity with multiple reportable segments classifies its assets and liabilities at the reportable segment level. For example, an entity may have two reportable segments, manufacturing and retail, each with a portfolio of financial instruments. In the manufacturing segment, financial liabilities may be used to fund ongoing operations and therefore are classified in the financing debt category. In the retail segment, financial instruments may provide a return to an entity but will not be used to fund the activities of the retail business and therefore

will be classified in the investing category. Thus, similar assets and liabilities may appear in multiple sections of the statement of financial position.

PwC observation: We expect the Exposure Draft to contain additional guidance to help determine which items should be included in the operating versus investing categories or financing section. The boards will also require entities to explain in the notes to the financial statements the basis for classifying items within the sections, categories, and subcategories, and how classification relates to the entity's activities.

Statement of Comprehensive Income

7. As with the Statement of Financial Position, income and expenses are to be classified as business or financing activities.
 - Business activity is to be segregated between operating, investing, and financing arising from operating activities.
 - Financing activity includes items that relate to an entity obtaining (or repaying) capital and consists of debt.
 - Income taxes and discontinued operations are to be displayed separately from business and financing activities.
 - Entities are to display net income, other comprehensive income, total comprehensive income, and earnings per share. The boards have published separate proposals

to require entities to prepare a single statement of comprehensive income. The boards are proceeding with these proposals as a separate project and the staff draft has been prepared on the basis that a single statement of comprehensive income has been adopted.

- The proposal does not change how EPS is calculated or what constitutes other comprehensive income.
- Entities are to present separately, in the appropriate section, category, or subcategory in the Statement of Comprehensive Income, material events or transactions that are unusual or occur infrequently, along with a narrative describing each event and its financial effects. Entities are not to describe any item of income or expense as an extraordinary item either in the Statement of Comprehensive Income or in the notes. This is consistent with IAS 1, which prohibits the presentation of items of income and expense as extraordinary items.
- All entities are to disaggregate their income and expense items by function on the Statement of Comprehensive Income and provide information disaggregated by nature in the notes. Entities will also disaggregate items according to the measurement basis.
- When disaggregation by nature is useful in understanding the amount, timing, and uncertainty of future cash flows, the entity would present its income and expenses by nature in the Statement of Comprehensive Income. The FASB also requires that multi-segment

entities present information by nature in the segment note, and single segment entities in a separate note.

- Function refers to the primary activity in which an entity is engaged, such as selling goods, providing services, etc. Nature refers to the economic characteristics or attributes that distinguish assets, liabilities, and income and expense items (e.g., disaggregating total revenues into wholesale revenues and retail revenues, or disaggregating total cost of sales into materials, labor, transport, and energy costs). Measurement basis refers to the method or basis used to measure an asset or a liability, such as fair value or historical cost.

PwC observation: Most respondents to the boards' Discussion Paper indicated that a financial statement user's ability to assess future earnings and cash flows would be enhanced by presenting information by both function and nature. Providing the by-nature information is a change from current practice, and when presented at the segment level will result in incremental work.

Statement of Cash Flows

8. The boards have tentatively concluded that all entities, including financial service entities, will be required to present cash flows using the direct method and that a reconciliation from operating income to net cash from operating activities (i.e., an

indirect reconciliation) should also be presented on the face of the financial statements.

PwC observation: The boards rationale for requiring a direct method cash flow statement is that this would make the information more intuitive and understandable to a broad range of users, improve the ability to predict future cash flows, and provide insight into an entity's cash conversion cycle.

- The staff draft suggests that direct method cash flow information could be prepared either (1) directly through the accounting records of the company or (2) indirectly by identifying the activities that make up the changes in asset and liability balances. This is a modification from the boards' 2008 Discussion Paper.

PwC observation: This is a significant change from what was proposed in the Discussion Paper and is the direct result of feedback received, mainly from preparers, on the difficulty of preparing a direct method cash flow statement. This gives preparers a choice of how to gather the information needed for a direct method cash flow statement. Although a system change may not be necessary if an entity chose the "indirect" option of preparing the direct method cash flow statement, the entity would need to develop a policy, document and implement a process, and test the estimates used for accuracy.

- Entities will be required to disaggregate cash flows in the Statement

of Cash Flows by classes of cash receipts and payments so that the statement of cash flows shows how the entity generates and uses cash and should reflect the nature of the income or expense to which the cash flow is related. Examples of cash receipts and payments that reflect the nature of the income or expense include:

- Operating activities: cash received from customers, cash paid for labor, and cash paid for advertising
- Investing activities: cash received from dividends, interest, and rents
- Financing activities: cash paid for interest
- The staff draft proposes a revision to the cash flow netting guidance in both IFRS and US GAAP to prohibit an entity from reporting loan originations and repayments net unless the loan meets the criteria set out for netting cash flows (that is, turnover is quick, the amounts are large, and the maturities are short).
- Entities with funds held on deposit are to present cash inflows and outflows so that the Statement of Cash Flows reflects transactions between the entity and its depositors as if they were settled by external funds.
- Non-cash transactions (e.g., share-based payments, acquisition of assets under a finance lease, or the conversion of debt to equity) are to be presented as a supplement to the statement of cash flows.
- The staff draft proposes that information about limitation and

restrictions on the availability of cash and short-term investments should be disclosed in the notes to the financial statements.

PwC observation: Financial services entities, specifically banks, raised concerns that the direct method of presenting cash flows is not meaningful for financial institutions and impractical to do. At this juncture, the boards' decision is to require all entities to use the direct method of presenting cash flows. However, the boards are seeking input from financial services entities to understand the implications for financial institutions in using the direct method.

Roll-forward analysis

9. All entities (except nonpublic entities) will be required to provide a "roll-forward" presentation of changes in assets and liabilities that management regards as important for understanding the current period change in the entity's financial position. This presentation would include an analysis and explanation of the nature of transactions and other events that gave rise to changes in the account balances. Each roll-forward should separately distinguish:

- Cash inflows and cash outflows
- Non-cash (accrual) transactions that are repetitive and routine in nature (e.g., credit sales, wages, material purchases)
- Non-cash transactions or events that are nonroutine or nonrepetitive in nature (e.g., acquisition or disposition of a business)

- Accounting allocations (e.g., depreciation)
- Accounting provisions and reserves (e.g., bad debts, obsolete inventory)
- Remeasurements—which are amounts recognized in comprehensive income that reflect the effects of a change in the net carrying amount of an asset or liability, and result from: (a) a change in (or transacting at) a current price or value; (b) a change in an estimate of a current price or value; or (c) a change in any estimate or method used to measure the carrying amount of an asset or liability. Examples are fair value changes, foreign currency translations, and impairment losses.

PwC observation: The preparer community has voiced concerns that the roll-forward analysis will be difficult to prepare due to all the categories that would need to be separately displayed, especially due to the overlap between the categories.

10. The staff draft also proposes that entities disclose information about remeasurements in a single note. This note would present separately the remeasurement component of items of income and expense recognized in the Statement of Comprehensive Income, with the intent to show significant remeasurements. Remeasurements should be disclosed by section, category, and subcategory and for other comprehensive income. The information would be comparative, and a narrative would also be required.

PwC observation: The boards believe that the disclosure of remeasurements will provide users with information they currently do not have that will help them assess the amount, timing, and uncertainty of future cash flows.

Segments

11. The FASB will also propose that entities disclose the following for segments:

- Operating cash flows by segment
- Income and expense information by nature for each reportable segment. This income and expense information by nature will be disclosed regardless of whether it is regularly reviewed by or provided to the chief operating decision maker.
- A measure of each of the following for each reportable segment regardless of whether that measure is regularly reviewed by or otherwise provided to the chief operating decision maker:
 - Operating profit or loss
 - Operating assets
 - Operating liabilities
 - Operating cash flows
- The total of the reportable segments' operating profit or loss, operating asset, operating liabilities, and operating cash flows must be reconciled to the entity's corresponding consolidated totals.
- The activities of all operating segments that are not reportable segments separately from all other information in the segment note.

PwC observation: We expect the segment disclosures to be proposed by the FASB to result in a substantive difference in the volume of disclosures between IFRS and US GAAP. The IASB is requiring disaggregated information at the entity level (not by reportable segment).

Comment letters, field tests, and research study

12. The boards received over 200 comment letters (mainly from preparers) on the Discussion Paper in 2008, conducted two separate field tests (a preparer field test with 31 companies, and an analyst field test with 43 analysts), and conducted a research study with 60 experienced credit analysts.

13. The majority of the respondents supported the project's principles and overall objectives, but most preparers did not support the direct method of presenting cash flows (except for respondents from Australia where the direct method is currently required). Most financial statement users supported the direct method, as they believe it would make the quality of earnings more transparent. In response to comment letters, field tests, and research, the boards have, in addition to the foregoing:

- Modified certain aspects of the proposed model to reduce the costs of implementation (e.g., replacing the line-by-line reconciliation with the roll-forward analysis),

- Will require a reconciliation of operating income to operating cash flows in the Statement of Cash flows to provide users with a measure similar to indirect cash flow information that will accompany the direct cash flow information, and
- Concluded that requiring all disaggregated information to be presented on the face of the financial statements would be too costly and potentially confusing. (The staff draft proposes the presentation of information by function on the face of the statements, and by nature in the notes.)

14. The Appendix to this Dataline includes examples of the expected form and content of the financial statements under the proposed model. The Appendix includes the following:

- Statement of Comprehensive Income
- Statement of Financial Position
- Statement of Cash Flows
- A note disclosure of expenses disaggregated by nature
- Analysis of changes in selected significant line items on the Statement of Financial Position

Differences between FASB and IASB staff drafts

15. While the Financial Statement Presentation project is a joint project, the FASB and IASB tentative

decisions differ in the following significant ways:

- **Minimum line item requirements**—the IASB will require minimum line items on the Statement of Financial Position. The FASB believes the disaggregation principles proposed in the staff draft provide enough guidance on which line items should be presented.
- **Net debt reconciliation**—users of financial statements usually refer to an analysis of changes in specific line items (all the line items in the debt category, cash, any short-term investments, and finance leases) as a net debt reconciliation. The IASB will require this reconciliation to be included in a single note. The FASB will not propose a similar disclosure because users of financial statements in the United States have not requested that information.
- **Segments**—the FASB will propose that an entity with more than one reportable segment should be required to present by-nature income and expense information for each reportable segment in its segment note. As a result, the FASB is proposing changes to segment reporting requirements. The IASB did not want to amend IFRS 8 at this time and will only require disaggregated information on an entity basis either in the Statement of Comprehensive Income or in a separate note.
- **Overall disclosures**—the FASB and IASB differ slightly on what disclosures they will require in the notes related to various items.

Next steps

16. The boards have not formally invited comments on the staff draft, but would welcome input. The boards' outreach efforts extended through the end of 2010. As part of those efforts, they asked financial statement users to evaluate the benefits of the proposals and asked financial statement preparers to evaluate the cost of adopting the proposals. They also conducted additional field tests and research, as well as met with financial institutions to discuss the proposals. At their October 2010 joint meeting, the boards discussed some of the significant concerns raised through these ongoing outreach activities and acknowledged that they would need to dedicate resources to appropriately address them. Given the higher priority of several other major projects (such as the projects on financial instruments, revenue recognition, and leasing), the boards concluded that the financial statement presentation project should be delayed. The boards plan to revisit this project in March 2011 in order to consider next steps but at the present time do not expect to fully return to the project until after June 2011.

17. The Exposure Draft is expected to propose full retrospective application and will require one comparative period for a complete set of financial statements. In the first year of adoption, however, three Statements of Financial Position would be required.

PwC observation: The requirement to present only one comparative period would conflict with current

SEC guidance, which requires two comparative periods for the Statement of Comprehensive Income, Statement of Cash Flows, and Changes in Stockholders Equity. The boards have yet to discuss this matter with the SEC.

18. The Exposure Draft is not expected to include an effective date. Rather, the Exposure Draft will include a question soliciting information about the amount of time needed to implement the proposed changes. Both boards, however, have indicated that the effective date for the final standard would provide sufficient time for reporting entities to prepare for and implement the proposed changes.

Business implications

19. Although this project deals with the presentation of financial data, the magnitude of the changes being proposed are significant and preparers should consider the following potential business implications:

- **System Changes**—entities will need to assess the adequacy of existing systems to determine the extent to which those systems are capable of gathering the necessary data (i.e., direct method information, the nature and function information, etc.).
- **Processes and Controls**—entities may have to update processes and controls over financial reporting to address the changes required to comply with new financial statement presentation guidance.

- **Disaggregation**—the proposal would require more expansive disclosures (e.g., segments, by nature, roll-forward analysis, remeasurements) in the notes. Entities will need to identify where potential data gaps exist and the disclosures will likely result in incremental work.
- **Overall cost of implementing the proposal**—the proposed changes could result in incremental costs to preparers.

Appendix

Examples of revised financial statement format

This Appendix includes the following examples:

- **Example 1:** Statement of Comprehensive Income (Manufacturing Entity)
- **Example 2:** Statement of Financial Position (Manufacturing Entity)
- **Example 3:** Direct Method Statement of Cash Flows (Manufacturing Entity)
- **Example 4:** Statement of Comprehensive Income (Financial Services Entity)
- **Example 5:** Statement of Financial Position (Financial Services Entity)
- **Example 6:** Direct Method Statement of Cash Flows (Financial Services Entity)
- **Example 7:** Disaggregation of Expenses by Nature
This is an example of the disaggregated disclosure of expenses by nature that would be required in the Notes to the financial statements.
- **Example 8:** Disaggregation of a Multisegment Entity
This is an example of the disaggregated by-nature operating income and expense information Entity Z discloses in its segment note.
- **Example 9:** Analysis of Changes in Select Significant Line Items
This is an example of the “roll-forward” of significant Statement of Financial Position line items. The required narratives are not included in this example.

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Example 1: Statement of Comprehensive Income (Manufacturing Entity)¹

	For the years ended Dec. 31,	
	20X1	20X0
BUSINESS		
Operating		
Revenue	3,487,600	3,239,250
Cost of goods sold	(1,956,629)	(1,816,903)
Gross profit	1,530,971	1,422,347
Selling expenses	(153,268)	(130,034)
General and administrative expenses	(469,754)	(433,950)
Other operating income (expense)	17,663	(2,025)
Impairment loss on goodwill	-	(35,033)
Operating income before operating finance costs	952,612	821,305
Operating finance costs	(33,235)	(33,250)
Total operating income	892,377	788,055
Investing		
Dividend and interest income	62,619	55,500
Earnings in Company A (equity method)	23,760	22,000
Realized gain on securities	18,250	7,500
Fair value change in investment in Company B	7,500	3,250
Total investing income	112,129	88,250
TOTAL BUSINESS INCOME	1,004,506	876,305
FINANCING		
Debt		
Interest expense	(111,352)	(110,250)
TOTAL FINANCING EXPENSE	(111,352)	(110,250)
Income from continuing operations before taxes	893,154	766,055
INCOME TAX		
Total Income tax expense	(333,625)	(295,266)
Income from continuing operations	599,529	470,789
DISCONTINUED OPERATION		
Loss on discontinued operation	(32,400)	(35,000)
Income tax benefit	11,340	12,250
NET LOSS ON DISCONTINUED OPERATION	(21,060)	(22,750)
NET INCOME	538,469	448,039
OTHER COMPREHENSIVE INCOME (net of tax)		
Gains on available-for-sale securities arising during the year	29,056	20,150
Amounts reclassified into earnings	(11,863)	(4,875)
Unrealized gain on securities (investing)	17,193	15,275
Gains on futures contracts arising during the year	3,784	3,503
Amounts reclassified into earnings	(1,959)	(1,813)
Unrealized gain on futures contracts (operating)	1,825	1,690
Foreign currency translation adjustment on equity method investee (investing)	(1,404)	(1,300)
	2,094	(1,492)
TOTAL OTHER COMPREHENSIVE INCOME	19,708	14,173
TOTAL COMPREHENSIVE INCOME	558,177	462,212
Net income per share—basic	7.07	6.14
Net income per share—diluted	6.85	5.90

¹ Reproduced from FASB staff draft issued July 1, 2010.

Example 2: Statement of Financial Position (Manufacturing Entity)²

	For the years ended Dec. 31,	
	20X1	20X0
BUSINESS		
Operating		
Cash (see Note 6)	74,102	61,941
Accounts receivable, trade (net of allowance)	922,036	527,841
Inventory	679,474	767,102
Prepaid advertising and other	86,552	78,150
Total short-term operating assets	1,762,164	1,435,034
Property, plant, and equipment (net of accumulated depreciation)	2,838,660	3,064,200
Goodwill and other intangible assets	189,967	189,967
Total long-term operating assets	3,028,627	3,254,167
Advances from customers	(182,000)	(425,000)
Accounts payable trade	(612,556)	(505,000)
Wages, salaries, and benefits payable, and share-based compensation liability	(212,586)	(221,165)
Total short-term operating liabilities	(1,007,142)	(1,151,165)
Total long-term liabilities	(3,848)	(1,850)
Net operating assets before operating finance	3,779,801	3,536,186
Operating finance		
Short-term portion of lease liability and interest payable on lease liability (see Note 6)	(50,000)	(50,000)
Total short-term operating finance liabilities	(50,000)	(50,000)
Accrued pension liability	(293,250)	(529,500)
Long-term portion of lease liability (see Note 6)	(261,325)	(296,500)
Decommissioning liability	(29,640)	(14,250)
Total long-term operating finance liabilities	(584,215)	(840,250)
Total operating finance liabilities	(634,215)	(890,250)
Net operating assets	3,145,586	2,645,936
Investing		
Short-term investments (see Note 6)	1,100,000	800,000
Available-for-sale securities (see Note 6)	473,600	485,000
Total short-term investing assets	1,573,600	1,285,000
Equity method investment in Company A	261,600	240,000
Investment in Company B at fair value	46,750	39,250
Total long-term investing assets	308,350	279,250
Total investing assets	1,881,950	1,564,250
NET BUSINESS ASSETS	5,027,536	4,210,186

² Reproduced from FASB staff draft issued July 1, 2010.

Example 2 (continued)

	For the years ended Dec. 31,	
	20X1	20X0
FINANCING		
Debt		
Short-term debt and interest payable (see Note 6)	(702,401)	(512,563)
Dividends payable	(20,000)	(20,000)
Total short-term debt	(722,401)	(532,563)
Total long-term debt (see Note 6)	(2,050,000)	(2,050,000)
Total debt	(2,772,401)	(2,582,563)
EQUITY		
Common stock (par .01, 100,000 shares authorized and issued both years; 76,149 and 73,000 shares outstanding December 31, 20X1 and 20X0, respectively)	(761)	(730)
Additional paid-in capital	(1,514,839)	(1,506,770)
Treasury stock	88,360	164,500
Retained earnings	(1,100,358)	(648,289)
Accumulated other comprehensive income	(158,081)	(138,373)
Total equity	(2,685,679)	(2,129,662)
TOTAL FINANCING	(5,458,080)	(4,712,225)
INCOME TAX		
Income taxes payable	(72,514)	(63,678)
Deferred tax asset	46,226	89,067
NET INCOME TAX (LIABILITY ASSET)	(26,288)	25,389
DISCONTINUED OPERATION		
Assets of discontinued operation	856,832	876,650
Liabilities of discontinued operation	(400,000)	(400,000)
NET ASSETS OF DISCONTINUED OPERATION	456,832	476,650
Total short-term assets	4,192,596	3,596,684
Total long-term assets	3,383,203	3,622,484
TOTAL ASSETS	7,575,799	7,219,168
Total short-term liabilities	(2,252,057)	(2,197,406)
Total long-term liabilities	(2,638,063)	(2,892,100)
TOTAL LIABILITIES	(4,890,120)	(5,089,506)

Example 3: Direct Method Statement of Cash Flows (Manufacturing Entity)³

	For the years ended Dec. 31,	
	20X1	20X0
BUSINESS		
Operating		
Cash collected from customers	2,812,741	2,572,073
Cash paid for labor	(810,000)	(845,000)
Cash paid for materials	(935,554)	(785,000)
Cash contribution to pension plan	(340,200)	(315,000)
Other operating cash outflows	(260,928)	(242,535)
Cash paid for lease	(50,000)	-
Capital expenditures	(54,000)	(50,000)
Disposal of property, plant, and equipment	37,650	-
Sale of receivables	8,000	10,000
Net cash flows from operating activities	407,709	344,538
Investing		
Net change in short-term investments	(300,000)	(800,000)
Investment in Company A	-	(120,000)
Dividends and interest received	62,619	55,500
Purchase of equity securities	-	(130,000)
Sale of equity securities	56,100	51,000
Net cash flows from investing activities	(181,281)	(943,500)
NET CASH FLOWS FROM BUSINESS ACTIVITIES	226,428	598,962
FINANCING		
Dividends paid	(86,400)	(80,000)
Interest paid	(83,514)	(82,688)
Proceeds from reissuance of treasury stock	84,240	78,000
Proceeds from issuance of treasury stock	162,000	150,000
Proceeds from issuance of long-term debt	-	250,000
NET CASH FLOWS FROM FINANCING ACTIVITIES	76,326	315,312
Net cash flows from continuing operations before taxes	302,754	(283,650)
INCOME TAX		
Total cash paid for income tax	(281,221)	(193,786)
Change in cash before discontinued operation and effect of foreign exchange	21,533	(477,436)
DISCONTINUED OPERATION		
Net cash outflows from discontinued operation	(12,582)	(11,650)
Effect of foreign exchange	3,210	1,027
Change in cash	12,161	(488,059)
Beginning cash	61,941	550,000
Ending cash	74,102	61,941

³ Reproduced from FASB staff draft issued July 1, 2010

Example 3 (continued): Supplemental Cash Flow Information (Manufacturing Entity)⁴

	For the years ended Dec. 31,	
	20X1	20X0
Operating income	892,377	788,055
Adjustment to reconcile operating income to net cash flows from operating activities:		
Gain on disposal of property, plant, and equipment	(22,650)	-
Depreciation and amortization	279,120	273,500
Loss on sale of receivable	4,987	2,025
Bad debt expense	23,068	15,034
Loss on obsolete and damaged inventory	29,000	9,500
Share-based compensation	22,023	17,000
Impairment loss on goodwill	-	35,033
Other noncash items	1,189	1,100
Net change in asset and liability accounts		
Accounts receivable, trade	(422,250)	(431,663)
Inventory	58,628	48,398
Advances from customers	(243,000)	(225,000)
Accounts, salaries, and share-based compensation payable	76,954	91,665
Other assets and liabilities	3,259	(7,409)
Net pension liability	(236,250)	(220,500)
Cash inflows and outflows from other operating activities		
Sale of property, plant, and equipment	37,650	-
Capital expenditure	(54,000)	(50,000)
Cash paid on lease liability	(33,500)	-
Net cash flows from operating activities	407,709	344,538
Supplemental information about non-cash activities		
Capitalization of equipment in exchange for lease	-	330,000

⁴ Reproduced from FASB staff draft issued July 1, 2010.

Example 4: Statement of Comprehensive Income (Financial Services Entity)⁵

	For the years ended Dec. 31,	
	20X1	20X0
BUSINESS		
Operating		
Interest income		
Loans and leases, including fees	220,320	204,000
Trading securities	1,399	1,295
Securities available-for-sale	23,539	54,795
Federal funds sold	3,672	3,400
Interest expense		
Interest checking deposits	(564)	(414)
Savings deposits	(21,644)	(20,290)
Federal funds purchased	(19,224)	(17,800)
Time deposits	(46,296)	(41,170)
Net interest income	161,202	150,816
Provision for credit losses	(12,853)	(11,922)
Net interest income after provision for credit losses	148,349	138,894
Non-interest operating income (expense)		
Mortgage banking revenue	7,907	8,931
Service charges on deposits	32,079	31,033
Wages, salaries, and benefits expense	(38,000)	(35,000)
Occupancy expense	(6,860)	(7,000)
Share-based compensation expense	(36,172)	(17,000)
Depreciation expense	(6,400)	(5,850)
Realized losses and gains	(87)	4,260
Impairment loss on goodwill	-	(9,000)
Amortization of core deposit intangibles	(2,658)	(3,544)
Transaction processing expense and other	(23,298)	(25,049)
Total operating income	74,860	80,675
Investing		
Earnings in Company S (equity method)	3,780	3,500
Fair value change in investment in Company R	(7,500)	3,250
Dividend income from Company R	2,700	2,500
Total investing income	(1,020)	9,250
TOTAL BUSINESS INCOME	73,840	89,925
FINANCING		
Debt		
Interest expense on debt	(47,127)	(44,457)
TOTAL FINANCING EXPENSE	(47,127)	(44,457)
Income before income tax	26,713	45,468

⁵ Reproduced from FASB staff draft issued July 1, 2010.

Example 4 (continued)

	For the years ended Dec. 31,	
	20X1	20X0
INCOME TAX		
Total income tax expense		
NET INCOME		
OTHER COMPREHENSIVE INCOME, NET OF TAX		
(Loss) gain on available-for-sale securities arising during the year	31,044	29,250
Amounts reclassified into earnings	(1,404)	(1,300)
Unrealized gain (loss) on available-for-sale securities (operating)	(32,448)	27,950
Gains on futures contracts arising during the year	583	539
Amounts reclassified into earnings	(400)	(370)
Unrealized gain on futures contract (operating)	183	169
Foreign currency translation adjustment on equity method investee (investing)	(540)	(500)
TOTAL OTHER COMPREHENSIVE (LOSS) INCOME	(32,805)	27,619
TOTAL COMPREHENSIVE (LOSS) INCOME, NET	(15,366)	53,950
Net income per share-basic	0.17	0.26
Net income per share-diluted	0.16	0.24

Example 5: Statement of Financial Position (Financial Services Entity) ⁶

	For the years ended Dec. 31,	
	20X1	20X0
BUSINESS		
Operating		
Assets		
Cash	22,871	25,993
Federal funds sold	45,800	35,000
Advances and loans to banks	15,203	10,279
Trading securities at fair value	34,022	32,685
Securities available-for-sale at fair value	653,636	744,812
Derivatives at fair value	655	315
Interest receivables on loans and leases (see Note 3)	180,570	79,000
Loans and leases, net (see Note 3)	3,836,442	3,844,975
Premises and equipment, net	195,250	176,650
Goodwill, core deposit, and other intangible assets	84,165	86,824
Total operating assets	5,068,614	5,036,533
Liabilities		
Noninterest bearing deposits	(607,717)	(646,217)
Interest checking deposits	(78,846)	(72,156)
Savings deposits	(1,352,372)	(1,292,728)
Time deposits	(1,236,335)	(1,154,039)
Total deposits	(3,338,270)	(3,165,140)
Federal funds purchased	(404,704)	(376,300)
Wages payable and share-based compensation liability	(106,172)	(67,000)
Litigation provision	(3,846)	(1,850)
Total operating liabilities	(3,852,992)	(3,610,290)
Net operating assets	1,215,622	1,426,243
Investing		
Equity method investment in Company S	53,240	50,000
Investment at fair value in Company R	31,750	39,250
Total investing assets	84,990	89,250
NET BUSINESS ASSETS	1,300,612	1,515,493

⁶ Reproduced from FASB staff draft issued July 1, 2010.

Example 5 (continued)

	For the years ended Dec. 31,	
	20X1	20X0
INCOME TAX		
Deferred tax asset	34,391	17,945
Income taxes payable	(2,087)	(4,306)
NET INCOME TAX ASSET	32,304	13,639
FINANCING		
Debt		
Interest payable	(93,360)	(89,446)
Dividends payable	(20,000)	(20,000)
Long-term debt	(727,313)	(832,101)
Total debt	(840,673)	(943,547)
Equity		
Common stock (25 par, 500,000 shares authorized, 100,000 issued and outstanding in both years)	(25,000)	(25,000)
Additional paid-in capital	(105,642)	(101,025)
Treasury stock	55,918	59,725
Retained earnings	(347,005)	(415,966)
Accumulated other comprehensive income	(70,514)	(103,319)
Total equity	(492,243)	(585,585)
TOTAL FINANCING	(1,332,916)	(1,529,132)
Total assets	5,187,995	5,143,728
Total liabilities	(4,695,752)	(4,558,143)

Example 6: Statement of Cash Flows (Financial Services Entity)⁷

	For the years ended Dec. 31,	
	20X1	20X0
BUSINESS		
Operating		
Interest received from loans	118,750	125,000
Cash interest received from available-for-sale securities	11,875	12,500
Cash interest received from federal funds sold	3,672	3,400
Cash interest paid from federal funds purchased	(19,224)	(17,800)
Interest paid—interest checking deposits	(61,220)	(68,150)
Total interest collected, net of interest paid	53,853	54,950
Mortgage banking revenue	7,907	8,931
Service charges on deposits	32,079	31,033
Wages, salaries, and benefits	(35,000)	(30,000)
Other net cash outflows	(28,159)	(30,200)
Cash received for interest and fees, net of cash paid for expenses	30,680	34,714
Cash flows related to operating assets and liabilities	86,400	80,000
Principal collected on loans	(103,680)	(96,000)
Cash paid for loan originations	2,375	2,500
Cash received from trading securities		
Cash received from deposits, net		
Interest checking deposits	6,545	6,170
Savings deposits	58,300	61,500
Time deposits	76,500	76,100
Noninterest-bearing deposits	24,500	25,000
Cash from federal funds purchased, net of federal funds sold	17,604	16,300
Cash paid for advances and loans to banks, net	(4,924)	(406)
Purchase of equipment	(25,000)	(25,000)
Sale of loans	8,000	10,000
Purchase of available-for-sale securities	-	(130,000)
Sale of available-for-sale securities	55,080	51,000
Received from settlement of derivatives	340	315
Net cash flows from operating activities	232,720	112,193
Investing		
Investment in Company S (equity method)	-	(12,000)
Dividends received from Company R	2,700	2,500
Net cash from investing activities	2,700	(9,500)
NET CASH FROM BUSINESS ACTIVITIES	235,420	102,693
INCOME TAX		
Total cash paid for income taxes	(10,566)	(15,667)

⁷ Reproduced from FASB staff draft issued July 1, 2010.

Example 6 (continued)

	For the years ended Dec. 31,	
	20X1	20X0
FINANCING		
Cash dividends paid	(86,400)	(80,000)
Proceeds from issuance of long-term debt	-	135,780
Debt repayments	(109,989)	(106,788)
Interest paid	(40,011)	(43,212)
Proceeds from reissuance of treasury stock	8,424	7,800
NET CASH USED IN FINANCING ACTIVITIES	(227,976)	(86,420)
Change in cash	(3,122)	606
Beginning cash	25,993	25,387
Ending cash	22,871	25,993

Example 6 (continued): Supplemental Cash Flow Information (Financial Services Entity)⁸

	For the years ended Dec. 31,	
	20X1	20X0
Operating income	74,860	80,675
Adjustments to reconcile operating income to cash flow from operating activities		
Provision for credit losses	12,853	11,922
Share-based compensation	36,172	17,000
Depreciation and amortization	9,058	9,394
Realized losses (gains)	87	(4,260)
Impairment loss on goodwill	-	9,000
Other non-cash items	1,997	1,850
Change in operating assets and liabilities		
Change in interest receivable	(112,257)	(87,090)
Change in advances and loans to banks	(4,924)	(406)
Net increase in deposits	173,130	162,493
Cash received from federal funds purchased, net	17,604	16,300
Other	3,000	5,000
Sale (purchase) of operating assets and liabilities		
Purchase of available-for-sale securities	-	(130,000)
Sale of available-for-sale securities	55,080	51,000
Sale of loans	8,000	10,000
Loan repayment	86,400	80,000
Loan origination	(103,680)	(96,000)
Purchase of equipment	(25,000)	(25,000)
Proceeds from settlement of derivatives	340	315
Net cash flows from operating activities	232,720	112,193

⁸ Reproduced from FASB staff draft issued July 1, 2010.

Example 7: Disaggregation of Expenses by Nature⁹

	For the years ended Dec. 31,	
	20X1	20X0
Wholesale sales	2,790,080	2,591,400
Retail sales	697,520	647,850
Total revenue	3,487,600	3,239,250
Cost of goods sold		
Materials	(1,039,104)	(921,300)
Compensation expense	(405,000)	(450,000)
Pension expense	(43,175)	(39,250)
Overhead-depreciation	(219,300)	(215,000)
Transportation and other	(160,800)	(135,000)
Change in inventory	(60,250)	(46,853)
Loss on obsolete and damaged inventory	(29,000)	(9,500)
Total cost of goods sold	(1,956,629)	(1,816,903)
Selling expenses		
Advertising	(60,000)	(50,000)
Compensation	(56,700)	(52,500)
Bad debt	(23,068)	(15,034)
Other selling	(13,500)	(12,500)
Total selling expenses	(153,268)	(130,034)
General and administrative expenses		
Compensation	(321,300)	(297,500)
Pension	(43,175)	(39,250)
Depreciation	(59,820)	(58,500)
Share-based compensation	(22,023)	(17,000)
Other general and administrative	(23,436)	(21,700)
Total general and administrative expenses	(469,754)	(433,950)
Other operating		
Gain on disposal of property, plant, and equipment	22,650	-
Loss on sale of receivables	(4,987)	(2,025)
Impairment loss on goodwill	-	(35,033)
Total other operating income (expenses)	17,663	(37,058)
Operating income before operating finance costs	925,612	821,305
Operating finance costs		
Interest cost-pension	(30,800)	(2,800)
Expected return on pension plan assets	13,200	12,000
Interest expense on lease liability	(14,825)	(16,500)
Accretion expense on decommissioning liability	(810)	(750)
Total operating finance costs	(33,235)	(33,250)
Total operating income	892,377	788,055

⁹ Reproduced from FASB staff draft issued July 1, 2010.

Example 8: Disaggregation of a Multisegment Entity¹⁰

	For the Year Ended December 31, 20X1			
	Retail	Fabrication	Corporate	Total
BUSINESS				
Operating Revenue	2,545,400	650,000	-	3,195,400
Cost of goods sold				
Materials ^(a)	(1,167,000)	(181,000)	-	(1,348,000)
Labor	(130,000)	(50,000)	-	(180,000)
Rent	(62,000)	(25,000)	-	(87,000)
Depreciation	(67,500)	(14,000)	-	(81,500)
Other	(23,000)	(8,230)	-	(31,230)
Total cost of goods sold	(1,449,500)	(278,230)	-	(1,727,730)
Selling				
Labor	(86,500)	-	-	(86,500)
Advertising	(75,000)	(6,900)	-	(81,900)
Other expense	(36,500)	-	-	(36,500)
Total selling	(198,000)	(6,900)	-	(204,900)
Research and development				
Labor	(143,200)	-	-	(143,200)
Rent	(53,000)	-	-	(53,000)
Other	(36,000)	-	-	(36,000)
Total research and development	(232,000)	-	-	(232,200)
Administration				
Labor	(114,000)	(10,000)	(60,000)	(184,000)
Audit	-	-	(30,000)	(30,000)
Legal	-	-	(35,000)	(35,000)
Other	(39,900)	(5,900)	(30,000)	(75,800)
Total administration	(153,900)	(15,900)	(155,000)	(324,800)
Operating finance				
Expected return on plan assets	-	-	650	650
Interest on lease expense	-	-	(2,500)	(2,500)
Other interest costs	-	-	(3,000)	(3,000)
Pension interest costs	-	-	(18,200)	(18,200)
Total operating finance costs	-	-	(23,050)	(23,050)
Total operating income ^(a)	511,800	348,970	(178,050)	682,720
Total operating cash flow by segment	(3,000)	142,202	(135,000)	4,202
Capital expenditures	50,000	-	-	50,000
Non-operating interest expense	-	-	(93,450)	(93,450)
As of December 31, 20X1				
Total assets	4,772,852	1,906,434	-	6,679,286
Total operating assets	3,958,160	1,744,784	-	5,702,944
Total operating liabilities	(1,109,130)	(612,859)	-	(1,721,989)

(a) Differences between segment information presented and consolidated statements are the result of internal accounting for inventory on a FIFO basis that amounts to lower materials cost of 180,000 for the year ended December 31, 20X1.

¹⁰ Reproduced from FASB staff draft issued July 1, 2010

Example 9: Analysis of Changes in Select Significant Line Items (Roll-forward Analysis)¹¹

	Long-term debt	Short-term debt	Interest payable
Beginning balance, January 1, 20X0	(1,950,000)	(250,000)	(85,001)
Cash received from issuance of debt	(250,000)	(150,000) ^(a)	-
Cash paid for interest	-	-	82,688
Accrual-interest	-	-	(110,250)
Amounts reclassified to discontinued operations	150,000	-	-
Ending balance, December 31, 20X0	(2,050,000)	(400,000)	(112,563)
Cash received from issuance of debt	-	(162,000) ^(a)	-
Cash paid for interest	-	-	83,514
Accrual-interest	-	-	(111,352)
Ending balance, December 31, 20X1	(2,050,000)	(562,000)	(140,401)

(a) Increases in short-term debt consist of amounts drawn on a short-term credit facility.

	Accounts receivable, net	Customer advances
Beginning balance, January 1, 20X0	339,500	(650,000)
Cash collections ^(a)	(2,282,073)	(300,000)
Revenue accrual	2,714,250	525,000
Remeasurement-loss on sale of receivables	(2,025)	-
Amounts allocated for bad debts	(17,741)	-
Remeasurement-change in estimate for bad debts ^(b)	2,707	-
Amounts reclassified to discontinued operations	(225,000)	-
Remeasurement-foreign exchange adjustment	(1,777)	-
Ending balance, December 31, 20X0	527,841	(425,000)
Cash collections ^(a)	(2,496,741)	(324,000)
Revenue accrual	2,920,600	567,000
Remeasurement-loss on sale of receivables	(4,987)	-
Amounts allocated for bad debts	(23,068)	-
Remeasurement-foreign exchange adjustment	(1,609)	-
Ending balance, December 31, 20X1	922,036	(182,000)

(a) Cash collections include both amounts collected from customers as well as cash collected from the sale of receivable balances.

(b) Assumptions related to the allowance for bad debt were changed during the period resulting in an additional bad debt expense in 20X0.

Note: The above examples illustrate analysis of changes from a Statement of Financial Position (SFP) perspective. Such disclosures would be combined with or replace disclosures currently required by IFRS or US GAAP.

¹¹ Reproduced from FASB staff draft issued on July 1, 2010.

***To have a deeper conversation
about how this subject may affect
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US GAAP Convergence & IFRS Contingencies

March 2011

Disclosure of certain loss contingencies

An analysis of the FASB's proposed changes

What's inside:

Overview

Key provisions

SEC staff views

IASB loss contingencies project

Reprinted from:

Dataline 2010–32

August 3, 2010

(Revised February 1, 2011*)

Note:

As developments in this area are ongoing, reference should also be made to this publication's webpage (www.pwc.com/us/jointprojects) where you will find an electronic version of the original publication along with subsequent updates.

Overview

At a glance

- In July 2010, the Financial Accounting Standards Board (FASB or the “Board”) issued an exposure draft of a proposed Accounting Standards Update, *Contingencies—Disclosure of Certain Loss Contingencies* (the proposal). The objective of the Board is to require enhanced disclosure of certain loss contingencies, including litigation, environmental remediation, and product warranty liabilities.
- The proposed disclosures consist of qualitative and quantitative information about loss contingencies that will enable financial statement users to understand their nature, potential magnitude, and potential timing (if known). The disclosures would include publicly available quantitative information, such as the claim amount for asserted litigation contingencies, other relevant nonprivileged information about the contingency, and, in some cases, information about possible recoveries from insurance and other sources. Public companies would be required to provide a tabular reconciliation (i.e., a rollforward) of recognized loss contingencies from the beginning to the end of the reporting period.
- In November 2010, the Board discussed its redeliberation plan, including whether investor concerns about the current disclosures reflect a compliance issue with existing guidance or a need for more guidance. The Board also acknowledged the recent initiatives by the SEC staff to improve compliance with the guidance in this area through emphasis in comment letters, speeches, a “Dear CFO” letter, and other means.
- The Board will evaluate whether disclosures in 2010 year-end financial reports improve as a result of the SEC staff's emphasis prior to deciding whether an amendment of the existing standard is still needed. At that time, the Board will decide whether any future redeliberations are needed or whether additional outreach should be conducted. This decision delays the project until the second quarter of 2011 at the earliest.

*Sections entitled At a glance (third and fourth bullets), Background (paragraphs 4 and 5), Transition and effective date (paragraphs 17–19), and IASB loss contingencies project (paragraph 26) have been revised and a new section entitled SEC staff views (paragraphs 20–25) has been added to reflect the delayed timing of this project and incorporate relevant views expressed by the SEC staff.

Background

1. In 2007, the Board added a project to its agenda to address constituents' concerns that disclosures about loss contingencies under existing guidance do not provide adequate and timely information to assist them in assessing the likelihood, timing, and amount of future cash outflows associated with loss contingencies.
2. To address these concerns, the Board issued an exposure draft in June 2008 (the original proposal) seeking comments on proposed disclosures of certain loss contingencies. The comment period ended in August 2008. At its August 2009 meeting, the Board began to consider the feedback that it had received on its original proposal. That feedback came from over 240 comment letters on the exposure draft, a limited field test, and two roundtable discussions, in addition to other feedback from the marketplace. The Board resumed its redeliberations on this project in April 2010, which resulted in the issuance of the July 2010 proposal.
3. The requirements in the July 2010 proposal represent a significant departure from the original proposal and are intended to address certain of the concerns raised by constituents. However, like the original proposal, the July 2010 proposal will require more disclosure of publicly available, factual information pertaining to loss contingencies than current GAAP requires. The Board believes that this proposal will not require disclosures that will prejudice a company's case in legal proceedings. The comment period for the proposal ended in September 2010, and the Board received approximately 380 comment letters.
4. In October 2010, the Board ruled out the 2010 year-end effective date included in the proposal. In November 2010, the Board discussed its plan for redeliberations. At that time, the Board acknowledged the concerns of some constituents that insufficient loss contingency disclosures may indicate a compliance issue with the existing guidance rather than a need for a new standard. The Board also acknowledged the recent initiatives by the SEC staff to improve compliance with the guidance in this area through emphasis in comment letters, speeches, a "Dear CFO" letter, and other means. In light of the SEC staff's emphasis, the Board decided to evaluate whether there is improved disclosure of loss contingencies during the 2010 year-end financial reporting cycle. At that time, the Board will decide whether any future redeliberations are needed or whether additional outreach should be conducted.
5. This Dataline provides a summary of specific aspects of the proposal, recent views expressed by the SEC staff in this area, and our insights on selected matters. It updates the discussions set out in Datalines 2009–44 and 2010–22. The proposal is tentative and subject to change until a final standard is issued.

PwC observation: In our comment letter on the original proposal, we stated that an important first step is for the Board to demonstrate that the current disclosures on loss contingencies warrant

change. Although the current proposal addresses certain of the other points that we raised in our comment letter, it provides no additional justification as to why the Board believes that a change is warranted. While we believe the July 2010 proposal is an improvement over the original proposal, in certain areas the changes may not be sufficient to address the concerns raised by many preparers and members of the legal community, especially those related to legal contingencies. Accordingly, the comment letters on the July 2010 proposal submitted by those groups express concerns that are similar to the concerns they expressed to the Board about its original proposal.

Key provisions Scope

6. The Board affirmed that the scope of the new standard would include all loss contingencies that are within the scope of either the existing contingencies standard or business combinations standard, except for the following:
 - Guarantees (other than product warranties)
 - Liabilities of insurance entities covered by specialized industry guidance
 - Certain liabilities for employment-related costs, including stock issued to employees, pensions and other postemployment benefits
 - Income tax uncertainties

PwC observation: We believe that the most common types of contingencies that would be within the scope of the proposed standard are litigation, environmental remediation, withdrawal obligations related to a multi-employer pension plan, certain non-income-based tax uncertainties, and product warranties.

Disclosure principles

7. The Board decided on two overall disclosure principles, summarized below:
 - During early stages of a contingency's life cycle, a company should disclose information (quantitative and qualitative) that allows users of its financial statements to better understand the nature, potential magnitude, and potential timing (if known) of a loss contingency. This disclosure should be more extensive in subsequent reporting periods as more information becomes available.
 - A company may aggregate disclosures about similar contingencies (for example, by class or type). Judgment will be required to determine the basis for aggregation; that basis also should be disclosed. The Board has provided implementation guidance to assist in making these judgments. It may not be appropriate, for example, to aggregate disclosures related to environmental contingencies with contingencies related to product liability claims, or disclosures related to individual litigations

with those related to class-action lawsuits.

PwC observation: The Board believes that by limiting disclosure requirements to publicly available, factual information and allowing the disclosures of similar contingencies to be aggregated, the disclosures should not impact the outcome of the contingency. Accordingly, the proposal does not include a prejudicial exemption. Judgment will be required to determine the most appropriate basis for aggregation. A company will need to consider whether the nature, risk profiles, and time horizons of contingencies are similar enough to permit aggregated disclosures. For example, a lawsuit in the US may not have the same risk profile as a lawsuit involving similar claims in a non-US jurisdiction. Aggregation of disclosures is intended to help mitigate prejudicial concerns, although that may not be possible where a company has only one significant contingency or only one contingency of a specific type that the company concludes cannot be aggregated with other types of contingencies.

Disclosure threshold

8. The Board maintained the existing disclosure threshold requirements for both asserted and unasserted claims and assessments, except that asserted remote contingencies may require disclosure under the proposed standard. Disclosure of asserted remote contingencies may be necessary

to alert users about a company's vulnerability to a potential "severe impact" due to the contingency's nature, potential magnitude, or potential timing (if known). A company will need to exercise judgment in assessing the facts and circumstances pertaining to the contingency to determine whether the threshold has been met. In making this judgment, a company may consider the potential effect on operations, expected costs, and the amount of effort management may need to devote to resolve the contingency.

9. The threshold for determining that an impact may be "severe" is higher than the threshold for determining that an impact is "material." "Severe" is a significant financially disruptive effect on the normal functioning of an entity. The Board selected this terminology in an attempt to avoid inundating financial statement users with disclosures of frivolous claims or information that may be of questionable value when making investment decisions. The Board affirmed that the amount of damages claimed by the plaintiff, by itself, does not necessarily create the need to disclose a remote contingency (although it could be one of the factors to consider).

PwC observation: It may be challenging for management and legal counsel to make judgments as to which remote contingencies meet the threshold for disclosure, as there is no specific guidance or triggering mechanism for this determination in the proposal. For example, uncertainty may arise when determining the appropriate time horizon to use in evaluating

whether a remote contingency meets the disclosure threshold. The 2008 exposure draft proposed that a contingency have a severe “near-term” (i.e., within the next year) impact to be considered for disclosure. The July 2010 proposal does not contain similar language, which may make determining the threshold challenging. Further, once management decides which contingencies meet the disclosure threshold, sharing the supporting documentation that was considered in making those judgments with auditors could expose a company to claims that it has waived the attorney-client privilege or other legal protections. In addition, some believe that providing these disclosures could increase the risk of copy-cat claims against the company.

10. The proposal also provides additional guidance for determining whether an unasserted claim meets the threshold for disclosure. Specifically, the proposal states that, among other things, a company should consider the existence of reputable scientific or industry publications that it is aware of that indicate potential significant hazards related to the company’s products or services.
11. The proposal also affirms that potential loss recoveries from insurance or other indemnification arrangements should not be considered when assessing materiality in determining if a contingency should be disclosed. However, if a contingency is disclosed, a company will be required to disclose information about possible recoveries

in certain circumstances, as discussed in paragraph 13 below.

Disclosure requirements

12. The proposal would require that a company provide the following qualitative disclosures about a loss contingency (including remote contingencies) or classes of similar contingencies that meet the threshold for disclosure:
 - Qualitative information to enable users to understand their nature and risks
 - During early stages of asserted litigation contingencies, the contentions of the parties, for example, the basis for the claim, amount of damages claimed by the plaintiff, and the basis for the company’s defense (or a statement that the company has not yet formulated its defense) would be disclosed. In subsequent periods, as more information about a potentially unfavorable outcome becomes available (e.g., as the litigation gets closer to resolution), the disclosure should be more extensive. Additionally, if known, the anticipated timing of, or the next steps in, the resolution of individually material asserted litigation contingencies should be disclosed.
 - For individually material contingencies, disclosures should be detailed enough to enable readers to obtain additional information from publicly available sources (e.g., court records). For example, for a litigation contingency, a company should disclose the name of the court/agency in which the

proceedings are pending, the date the claim was instituted, the principal parties to the suit, a description of the alleged underlying facts, and the current status of the litigation contingency.

- As noted in paragraph 7 above, when disclosure is provided on an aggregated basis, a company should disclose the basis for aggregation and information that would enable financial statement users to understand the nature, potential magnitude, and potential timing (if known) of loss. For example, a company may have aggregated claims based on its different segments or product lines, or by similar types of contingencies. The proposal provides an example that if a company has a large number of similar claims outstanding, the company should consider disclosing the activity in that population of claims, such as the total number of claims outstanding, the average amount claimed, and the average settlement amount.

PwC observation: Certain disclosures are required for those contingencies that are individually material. There may be different views on the most appropriate basis for determining the materiality of a contingency, for example, whether materiality should be assessed based on the claim amount, management’s best estimate of loss, or some other measure. Management will need to exercise judgment and be able to support its position in making these assessments.

13. The proposal would require that a company provide the following quantitative disclosures about a loss contingency (including remote contingencies, except as noted below) or classes of similar contingencies that meet the threshold for disclosure:

- Publicly available quantitative information; this might include the amount claimed by the plaintiff or, in the absence of a claim amount, the amount of damages indicated in the testimony of expert witnesses in the case of a litigation contingency.
- An estimate of the possible loss or range of loss and the amount accrued, if any; if the possible loss or range of loss cannot be estimated, the company should make a statement that an estimate cannot be made and the reason why that is the case. However, these disclosures are not required for remote contingencies that meet the threshold for disclosure.
- Other nonprivileged information that would be relevant to users of financial statements to enable them to understand and/or assess the possible loss.
- Possible recoveries from insurance arrangements if this information has been provided to the plaintiff, is discoverable by the plaintiff or a regulatory agency, or relates to a recognized receivable. However, for financial statement presentation purposes, accrued contingent liabilities and potential recovery amounts from insurance arrangements or other sources that have been recognized should not be

netted or offset. A company should also describe whether a claim for coverage under an insurance or indemnification arrangement has been contested or denied.

PwC observation: Disclosing the amount accrued may raise prejudicial concerns, especially if a company is unable to aggregate such disclosure with others of a similar type or class. Disclosing insurance or indemnification recovery information may also raise prejudicial concerns, particularly in those situations in which such information had not been provided previously to a plaintiff.

Tabular reconciliation

14. For each annual and interim reporting period for which an income statement is presented, public companies would be required to disclose a tabular reconciliation (i.e., a rollforward) of loss contingencies (by class) for which an accrual has been recorded in the financial statements.

PwC observation: Nonpublic companies will be exempt from the requirement to present the rollforward. The Board believes that this exemption is consistent with the tentative decisions on its joint project with the International Accounting Standards Board on financial statement presentation to exempt nonpublic companies from certain requirements to present a reconciliation of significant balance sheet accounts in the notes to the financial statements.

15. Companies would describe significant activity in the reconciliation and the line items in the balance sheet and income statement where loss contingencies are included. The disclosure would include the following information:

- The carrying amounts of the accruals at the beginning and end of the period
- Increases (i.e., amounts accrued during the period) for new loss contingencies recognized during the period
- Increases for changes in estimates for loss contingencies recognized in prior periods
- Decreases for changes in estimates for loss contingencies recognized in prior periods
- Decreases for cash payments or other forms of settlements during the period

The Board decided that loss contingencies for which the underlying cause and ultimate settlement occur in the same period should be excluded from the tabular reconciliation.

PwC observation: Some constituents have raised concerns that presenting the changes, and related descriptions of the changes, in a contingency accrual from period to period may be prejudicial. They contend that changes in the accrual could be associated with specific developments in the case during that reporting period, which could provide plaintiffs with information that could be detrimental to a company's legal defense.

16. All loss contingencies recognized in a business combination should also be included in the rollforward but presented separately if they have a different measurement attribute. For example, acquired warranty contingencies measured at fair value in a business combination would be presented separately from warranty contingencies that originated in the normal course of business and were recorded at management's best estimate.

PwC observation: Generally, the proposal would require companies to capture data at a more detailed level than under current practice. Companies will need to consistently evaluate more information and make more judgments on a greater population of contingencies, and establish reporting protocols, frameworks for making consistent judgments, bases for aggregation, and appropriate internal controls. Companies may also require more frequent and detailed communications with outside counsel to meet the disclosure requirements in the proposal.

Transition and effective date

17. The proposal includes an effective date of 2010 for calendar year-end public companies, with a one-year deferral for nonpublic companies. However, with the delay of the project (discussed in paragraph 19), those effective dates were ruled out. If and when a final standard is issued, the Board will determine new effective

dates. The definitions of public and nonpublic companies for purposes of applying the proposed requirements would be the same as the definitions used in applying the guidance for disclosures of uncertain income tax positions.

18. The proposed disclosures would only be a current-year requirement in the year of adoption. Companies presenting comparative financial statements in the year of adoption would not be required to revise disclosures for previous periods that are presented for comparative purposes.
19. As discussed in paragraph 4, the Board has decided to evaluate whether the disclosure of loss contingencies in 2010 year-end financial reports improves before it decides whether an amendment to the existing standard is still needed. This decision delays the project until the second quarter of 2011 at the earliest, and most likely until the second half of 2011.

PwC observation: In light of the enhanced focus on 2010 loss contingency disclosures by the SEC staff and the FASB, companies may find it beneficial to refresh their understanding of the requirements in the existing standard and ensure that the disclosures being made in 2010 year-end financial statements are robust.

SEC staff views

20. The SEC staff over the course of 2010 emphasized in comment letters, speeches, and a "Dear CFO letter"

issued in October 2010, the required disclosures under the existing standard for loss contingencies. When an accrual has been made, disclosure of the nature of the accrual, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

21. The staff has also cautioned in comment letters and speeches that, in general, the first disclosure regarding a contingency should not be in the same reporting period when an accrual for the contingency is recognized. This applies to annual and quarterly reporting, as SEC regulations require the disclosure of material contingencies in interim financial statements (and that would be the case regardless of whether there have been any changes from the most recent year-end). Further, the staff generally expects that disclosures related to a particular case will become more robust as the life cycle of the case progresses and the matter moves closer to resolution or settlement.

22. For a contingency with a reasonably possible likelihood of loss, the required disclosures include the nature of the contingency and an estimate of the possible loss or range of loss amounts, or a statement that such an estimate cannot be made. The staff has highlighted three possible ways in which to comply with this requirement: (i) provide an estimate of the possible loss or range of loss, (ii) disclose that the possible loss or range of loss above the amount accrued is not material to the financial statements as a whole, or (iii) disclose that an estimate cannot be made.

Management should be prepared to support its position with contemporaneous documentation. If management discloses that an estimate cannot be made, the documentation should evidence the process followed and the analysis performed in reaching that conclusion.

23. The staff would likely consider it unusual that a company could not reasonably estimate a range of loss for at least some of the cases in its portfolio of contingencies. The staff has suggested that when the possible loss or range of loss for certain contingencies can be estimated, aggregated disclosure of the possible loss or range of loss for these items is permissible. The staff has cautioned that it would not be acceptable to justify the lack of a required disclosure by stating that a high level of confidence or certainty cannot be assured in attempting to estimate the possible loss or range of loss.

24. When evaluating the materiality of a particular matter for disclosure, the staff has indicated that it is not appropriate to offset the potential loss with potential recoveries from insurance arrangements, as the possible cash outflows and inflows are each subject to an independent set of risks. Inappropriately offsetting such amounts could understate the volume and magnitude of potential losses.

25. Regarding other reporting requirements outside of the financial statements, the staff would expect discussion of material contingencies and uncertainties in the Management Discussion and Analysis section of a filing if such matters had a significant impact on the results of operations or are indicative of trends that could impact the business in the future. Additionally, the disclosures made about a particular matter in the “Legal Proceedings” section of the filing and the disclosures related to that matter in the footnotes to the financial statements may be different, as those disclosures have different objectives. The legal proceeding disclosure is more prescriptive in nature and triggered by a specific quantitative threshold (claim amounts greater than 10% of current assets), whereas the GAAP disclosures are intended to be more of an analysis regarding the likelihood of loss, the nature of the case, and a quantification of possible losses.

PwC observation: The SEC staff’s views that the disclosures should become more robust as the life cycle of a case progresses, the ability to aggregate disclosures, and the prohibition on offsetting contingent losses with potential insurance recoveries, are all consistent with the guidance included in the FASB’s proposal.

IASB loss contingencies project

26. While the scope of the Board’s proposal is limited to disclosures of loss contingencies, the International Accounting Standards Board (IASB) has an active project to reassess the recognition, measurement, and disclosure aspects of its standard on loss contingencies. Despite the similar timing, the Board’s project and the IASB’s project are not being conducted jointly. The IASB issued an exposure draft with its proposal in January 2010, with a comment period that ended in May 2010. The IASB began the process of evaluating the comment letters received and redeliberating certain aspects of the proposal in October 2010, but has postponed further redeliberations until the second half of 2011. Based on its published timeline, the IASB plans to expose a revised proposal during the second half of 2011.

PwC observation: Companies reporting under US standards may have an interest in the IASB’s proposal even though it is not part of a joint project with the FASB. With the trend towards having converged US and international standards, the decisions made by the IASB could influence any future project to reassess the accounting for loss contingencies under US standards.

***To have a deeper conversation
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