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IN THE HEADLINES
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April 2011 IASB meetings

The April meetings of the IASB[1] took place on 6, 7, 12 – 15 and 27 April 2011. The summary below combines the outcomes of the individual sessions from the April meetings. In a number of sessions the IASB held joint discussions with the FASB[2]. The following projects were discussed:

- financial instruments: hedge accounting
- financial instruments: impairment
- insurance contracts
- leases
- revenue recognition.

Financial instruments project: hedge accounting

The IASB began redeliberating on the exposure draft on hedge accounting. Issues discussed include:

- scope of hedge accounting
- sub-LIBOR issue
- eligibility of cash instruments as hedging instruments
- time value for zero-cost collars
- accounting for fair value hedges
- nominal components-layers.

Highlights

- Hedge accounting to be allowed for equity investments at fair value through other comprehensive income
- Expected losses on financial assets to be discounted
- Tentative decisions reached on 'top down' approach to determine discount rate for insurance contracts
- Leases to be classified as finance leases or other-than-finance leases; both on balance sheet for lessees but with a straight-line expense for the latter
- Tentative decisions reached on determination of transaction price for revenue recognition when consideration is uncertain

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Scope of hedge accounting

The IASB discussed whether exposures that affect comprehensive income should be eligible for hedge accounting. The IASB tentatively decided to allow the application of hedge accounting to equity investments at fair value through other comprehensive income. Any hedge ineffectiveness would be presented in other comprehensive income.

The IASB also tentatively decided that hedge accounting would not be available to other exposures that affect comprehensive income.

Sub-LIBOR issue

With regard to the 'full' LIBOR risk component, the IASB noted that:

- an objective of hedging an interest margin has no effect on whether a full LIBOR component can be identified;
- the fact that a margin is being hedged does not change the implications of sub-LIBOR interest but should be taken into consideration when determining the hedged item; and
- imputing a full LIBOR component is tantamount to 'synthetic accounting' instead of hedge accounting.

The IASB noted that the existence of a floor affects the ability to designate a full LIBOR component and tentatively confirmed the proposals in paragraphs B24 through B26 of the exposure draft, which require that a designated component of the cash flows of a financial asset or financial liability must be less than or equal to the total cash flows of the asset or liability. However, the IASB also noted that it would be helpful to clarify in the requirements that for an asset or liability with a negative spread an entity could designate all of the cash flows of the entire financial asset or financial liability as the hedged item with regard to benchmark interest rate risk although hedging ineffectiveness may arise.

Eligibility of cash instruments as hedging instruments

The IASB discussed whether cash instruments measured at amortised cost can be eligible hedging instruments for risks other than foreign exchange risk. The IASB tentatively confirmed that the eligibility criteria for hedges of other than foreign exchange risk as proposed in the exposure draft would allow only cash instruments at fair value through profit or loss to be eligible hedging instruments.

The IASB noted that if a cash instrument is accounted for at fair value through profit or loss as a result of electing the fair value option, then the eligibility of the cash instrument as a hedging instrument depends on the circumstances. The IASB also noted that it would be inappropriate to prohibit designation of such cash instruments as hedging instruments.

Concerning financial liabilities designated under the fair value option and for which the changes in fair value attributable to the credit risk component are recognised in other comprehensive income, the IASB tentatively decided to clarify that such liabilities are not eligible hedging instruments.

Time value for zero-cost collars

The IASB discussed whether any final requirements for accounting for the time value of options should also extend to the time value of zero-cost collars. A zero-cost collar is a combination of a purchased and a written option, one being a put and one being a call option with a net nil time value at inception.

The IASB tentatively decided that the final requirements for the accounting for time value of options should also apply to zero-cost collars.

Accounting for fair value hedges

The IASB discussed presentation in the statement of comprehensive income, presentation in the statement of financial position and linked presentation for fair value hedges.

Presentation in the statement of comprehensive income

The IASB redeliberated the proposals under which the gain or loss on the hedging instrument and the hedged item would be presented in other comprehensive income with the ineffective portion presented in profit or loss. The IASB tentatively decided to retain the requirement in IAS 39 *Financial Instruments: Recognition and Measurement*, i.e. gains and losses from hedging instruments and hedged items for a fair value hedge are presented in profit or loss. However, the IASB also tentatively decided to require disclosure in the notes of the effects of fair value hedges and cash flow hedges on profit or loss and other comprehensive income, respectively. Such disclosures would include the gross gain or loss from the hedged item and the hedging instrument as well as hedge ineffectiveness.

Presentation in the statement of financial position

The IASB redeliberated the proposals under which the gain or loss on the hedged item attributable to the hedged risk would be presented as a separate line item in the statement of financial position. The IASB tentatively decided to retain the requirements in IAS 39, i.e. a direct adjustment of the hedged item for the effects of fair value hedging, but with a requirement to disclose the fair value hedge adjustment in the notes.

Linked presentation

The IASB tentatively decided to retain the proposal not to allow linked presentation for fair value hedges, subject to doing further outreach.

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Nominal components – layers

The IASB tentatively decided:

- to confirm the proposals to allow layer-based designation of a hedged item when the item does not include a prepayment option whose fair value is affected by changes in the hedged risk;
- that partially prepayable items in a layer-based designation of the hedged item should be allowed for those amounts that are not prepayable at the time of designations;
- that a designation of a layer that contains a prepayment option should be allowed if it includes the effect of the related prepayment option when determining the change in fair value of the hedged item; and
- not to differentiate between written and purchased prepayment options for the purpose of the eligibility of layer-based designation of hedged items.

Other matters

The IASB discussed accounting for 'funding swaps', i.e. currency derivatives used to protect assets in a foreign currency against foreign exchange risk when banks invest in such assets using funding in the local currency that exceeds the amounts they can invest in the domestic markets. The IASB is expected to discuss possible alternatives to better reflect the economics of such transactions in future meetings.

The IASB also discussed macro hedge accounting. No decision was made.

Financial instruments project: impairment

The IASB and the FASB (the Boards) discussed interest revenue recognition and the definition of amortised cost. The Boards tentatively decided that to determine interest revenue the effective interest rate would be applied to an amortised cost balance that is not reduced for credit impairment.

Further, the Boards discussed whether a loss estimate should be discounted and, specifically, whether expected losses should be measured as principal only on an undiscounted basis or as shortfalls in cash flows, including both principal and interest, on a discounted basis. The Boards tentatively decided that the measurement of expected losses should reflect the effect of discounting. Any finalised guidance will clarify that a variety of techniques can be used to measure this amount and that the unit of account does not have to be an individual loan.

Finally, the Boards discussed several alternatives on whether to unwind any discount on expected losses through the interest revenue or impairment line items. The Boards tentatively decided to include the unwinding of the discount in the impairment line item. The Boards are expected to consider whether to require disclosure of the effect of the unwinding on the allowance account in future meetings, after considering any operational issues. Following these discussions, the Boards tentatively decided that they do not need to consider the inclusion of a non-accrual principle for an impairment accounting model.

Insurance contracts project

Guidance for calculating the discount rate

In a previous meeting, the Boards tentatively decided an insurer could use a top down approach to determine a discount rate that reflects the characteristics of the insurance contract liability. In this meeting, the Boards tentatively decided the following with regards to the application of the top down approach.

- An appropriate yield curve should be determined by an insurer on the basis of current market information and must reflect current market returns either for the actual portfolio of assets the insurer holds or for a reference portfolio of assets with similar characteristics to those of the insurance contract liability.
- The insurer should use an estimate that is consistent with the IASB's guidance on fair value measurement if there are no observable market prices for some points on that yield curve.
- Cash flows of the instruments should also be adjusted in the following two ways so that they mirror the characteristics of the cash flows of the insurance contract liability:
  - Adjust for differences between the timings of the cash flows to ensure that the assets in the portfolio selected as a starting point are matched by the duration of the liability cash flows.
  - Adjust for risks inherent in the assets that are not inherent in the liability.
- An insurer using a top down approach need not make adjustments for remaining differences between the liquidity inherent in the liability cash flows and the liquidity inherent in asset cash flows.

Modified approach for the pre-claim period

The Boards discussed whether a different approach should be used for the accounting in the pre-claims period for contracts that meet specified criteria. The Boards discussed what the criteria would be and whether the different approach was a proxy for the building block approach or a separate model.

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The Boards tentatively decided:

- to consider whether the pre-claims obligation should reflect the time value of money, based on their tentative decision in the revenue recognition project;
- to require an insurer to reduce the measurement of the pre-claims obligations over the coverage period on the basis of time, but on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time; and
- to require an insurer to perform an onerous contract test if facts and circumstances indicate that the contract has become onerous in the pre-claims period.

Further, the IASB tentatively decided that an insurer should deduct from the pre-claims obligation measurement the acquisition costs that would be included in the measurement of the insurance contract liability under the building block approach. The FASB did not vote on this issue.

Leases project

The significant tentative decisions made by the Boards in their joint April meetings include the following.

- There are two types of leases, finance leases and other-than-finance leases, both on balance sheet for lessees but with a straight-line expense for the latter.
- Variable lease payments will be recognised leased assets/ liabilities if they depend on a rate or index or are disguised fixed leased payments.
- The definition of a lease will refer to a specified asset and use the control concept developed in the revenue project.

Refer *IFRS – Leases Newsletter Issue 5* for more details.

Revenue recognition project

The issues the Boards discussed in the April meeting include:

- transaction price determination
- transaction price allocation
- licences and rights to use
- sale and repurchase agreements
- fulfillment costs.

Transaction price determination

The Boards discussed how an entity would determine the transaction price and recognise revenue when the customer promises an amount of consideration that is uncertain.

The Boards tentatively decided that:

- an entity's objective when determining the transaction price is to estimate the total amount of consideration to which the entity would be entitled under the contract;
- an entity should estimate either the probability-weighted amount or the most likely amount depending on which is most predictive of the amount of consideration to which the entity would be entitled;
- an entity should recognise revenue at the amount allocated to a satisfied performance obligation unless the entity is not reasonably assured to be entitled to that amount, which would be the case if:
  - the customer could avoid paying an additional amount of consideration without breaching the contract;
  - the entity has no experience with similar types of contracts, or no other persuasive evidence; or
  - the entity has experience, but that experience is not predictive of the outcome of the contract based on an evaluation of the factors proposed in the exposure draft.

Transaction price allocation

The Boards tentatively decided that if the standalone selling price of a good or service underlying a separate performance obligation is highly variable, then the most appropriate technique to estimate the standalone selling price may be a residual technique. This generally involves determining the standalone selling price as the total transaction price less the standalone selling prices of other goods or services in the contract.

The Boards also tentatively decided that an entity should allocate a portion of the transaction price entirely to one (or more) performance obligation if both of the following conditions are met:

- the contingent payment terms of the contract relate specifically to the entity's efforts to satisfy that performance obligation or a specific outcome from satisfying that separate performance obligation; and
- the amount allocated, including the change in the transaction price, to that particular performance obligation is reasonable, relative to all of the performance obligations and payment terms, including other potential contingent payments, in the contract.

Licences and rights to use

The Boards tentatively decided that licenses or other rights to use granted to a customer give rise to a performance obligation that the entity satisfies when the customer obtains control of the rights. If there are other performance obligations in the contract, then an entity should consider

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whether the rights give rise to a separate performance obligation or whether the rights should be combined with those other performance obligations.

Sale and repurchase agreements

The Boards discussed how an entity should account for an agreement in which the entity sells an asset to a customer and grants the customer the right to require the entity to repurchase the asset at a price below the original sales price.

The Boards tentatively decided that if the customer has a substantial economic incentive to exercise that right, then the entity should account for the agreement as a lease. To make that determination an entity should consider various factors including the relationship of the repurchase price to the expected market value of the asset at the date of repurchase and the amount of time until the right expires.

Fulfillment costs

The Boards also discussed the accounting for costs of fulfilling a contract with a customer and affirmed the guidance in the exposure draft, subject to minor drafting improvements. They clarified that the costs that relate directly to a contract include costs that are incurred before the contract is obtained if those costs relate specifically to an anticipated contract.

Abbreviations

1 IASB: International Accounting Standards Board

2 FASB: US Financial Accounting Standards Board

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