May 2011 IASB meetings

The summary below combines the outcomes of the individual sessions from the IASB's[1] May meetings and those held on 1 and 2 June. In a number of sessions the IASB held joint discussions with the FASB[2]. The following projects were discussed:

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

Annual improvements project

The IASB assessed proposed improvements for the 2009-2011 cycle and discussed issues not to be included within the annual improvements cycle for 2010-2012.

Proposed improvements for the 2009-2011 cycle

The IASB agreed with the staff's assessment that the issues that they had approved for inclusion in the forthcoming exposure draft at earlier meetings met the new criteria approved by the trustees in February 2011.

The proposed amendments relate to the following.

- First-time Adoption of IFRSs – repeat application and clarification of the borrowing costs exemption.
- Presentation of Financial Statements – clarification of requirements for comparative information and enhanced consistency with the Conceptual Framework published in September 2010.
- Property, Plant and Equipment – classification of servicing equipment.

Highlights:

- IASB tentatively agree to a 90-day comment period for the annual improvements exposure draft
- Requirement to achieve 'other than accidental offsetting' in hedge accounting clarified
- Boards agree to develop a variation of previous proposals for the financial instruments impairment project
- Reinsurance recognition criteria revised
- Boards split on lessor accounting model
- Proposals for revenue disclosures and for assets arising from contract acquisition or fulfilment costs clarified

- Financial Instruments: Presentation – accounting for the income tax consequences of distributions.
- Interim Financial Reporting – reporting segment information for total assets in interim reports.

The IASB tentatively agreed to a 90-day comment period for the exposure draft expected to be published in June 2011.

Issues not to be included in the next cycle

The IASB agreed that the following issues did not meet the annual improvements criteria.

- Business Combinations – hedging the foreign exchange risk in a business combination, and settlement of a pre-existing relationship between the acquirer and the acquiree.
- Accounting Policies, Changes in Accounting Estimates and Errors – hierarchy of guidance to select an accounting policy.
- Impairment of Assets – accounting for impairment testing of goodwill when non-controlling interests are recognised.
- Biological Assets – illustrative examples on presentation of revenue in the profit or loss account.

Financial instruments project: hedge accounting

The IASB continued redeliberating on the exposure draft on hedge accounting and discussed hedge effectiveness, accounting for time value of options, rebalancing and voluntary discontinuation. An education session on macro hedging also took place.

Hedge effectiveness

The IASB discussed:

- clarification of the requirement of achieving 'other than accidental offsetting'; and
- the meaning of the requirement that a hedging relationship should minimise expected hedge ineffectiveness and produce an unbiased result.

Other than accidental offsetting

The IASB noted that the criterion of 'other than accidental offsetting' was intended to comprise two aspects.

- The notion of an economic relationship between the hedged item and the hedging instrument, which gives rise to offset.
- The effect of credit risk on the level of offsetting gains or losses on the hedging instrument and the hedged item, which may reduce or modify the extent of offsetting.

The IASB tentatively decided to disaggregate the term 'other than accidental offsetting' and directly refer to the two aspects in conjunction with application guidance.

Unbiased result and minimised hedge ineffectiveness

The IASB discussed the elements of the objective of the hedge effectiveness assessment namely that:

- the hedging relationship:
  - would produce an unbiased result;
  - would minimise expected hedge ineffectiveness; and
  - should not reflect a deliberate mismatch between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness; and
- the entity has no expectations that the changes in the fair value of the hedging instrument would systematically either exceed or be less than the changes in the fair value of the hedged item such that it would produce a biased result.

The IASB noted that:

- the reference to an 'unbiased' result was confusing and that the proposals could be perceived as requiring entities to identify the perfect hedging instrument as a starting point for hedge accounting instead of the instrument that is actually being used as the hedge;
- reference to unbiased creates the issue of referring to 'umbrella' terms that introduce abstraction and make the requirements less understandable; and
- the proposed requirement that the entity should have no expectations that the changes in fair value of the hedged item would systematically either exceed or be less than the changes in the fair value of the hedged item can create a problem because:
  - the fair value of the hedging instrument at the time of designation is a present value; and
  - as a result there would be an expectation that the changes in the value of the hedging instrument would systematically exceed or be less than those of the hedged item. The IASB considered that this was neither intended nor useful.

The IASB tentatively decided to remove:

- the references to the umbrella terms 'unbiased' and 'minimising expected hedge ineffectiveness'; and
- the requirement that an entity should have no expectation that the changes in the value of the hedging instrument would systematically either exceed or be less than the change in value of the hedged item.

The IASB tentatively decided that an entity's designation of the hedging instrument should be based on the economic hedge, which is the quantity of:

- the hedged item that it actually hedges; and
- the hedging instrument that it actually uses to hedge that quantity of the hedged item.

However, the IASB also tentatively decided that an entity should not designate a hedging relationship such that it reflects an imbalance between the weightings of the hedged item and hedging instrument that would create hedge ineffectiveness in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting.

Accounting for time value of options

The IASB discussed:

- whether the time value of an option should always be expensed over the life of an option although such an accounting treatment would not provide an outcome that aligns with the view of the time value paid as a cost of hedging; it can result in expenses in periods that are unrelated to how the hedged exposure affects profit or loss;
- whether the proposals could be simplified by removing the differentiation between transaction related and time period related hedged items although doing so would be inconsistent with other IFRSs and treat unlike situations as alike; and
- whether it is appropriate to defer the time value of options for transaction related hedged items although the time value paid is not an asset itself but is an ancillary cost that is capitalised as part of the measurement of the asset acquired or liability assumed; this is consistent with how other IFRSs treat ancillary costs and an impairment test would ensure that amounts that are not expected to be recoverable are not deferred.

The IASB also considered whether paraphrasing the requirements as a single general principle would clarify the accounting for transaction and time period related hedged items and whether it should provide an accounting choice to account for the time value of options either as:

- proposed in the exposure draft; or
- in accordance with the treatment in IAS 39 *Financial Instruments: Recognition and Measurement*.

The IASB noted that

- a single principle that was suggested by the feedback received would not accurately reflect the accounting for hedges of firm commitments so tentatively decided not to use that principle but preferred to provide further explanation in the basis for conclusions; and
- the treatment in IAS 39 characterises the time value of an option as a trading gain or loss; this is not a faithful representation of the time value and would impair the comparability of financial statements. As a result, the IASB tentatively decided to not introduce an accounting choice.

The IASB tentatively confirmed the accounting outcomes for the accounting for time value of options as proposed in the exposure draft, i.e. that the accounting would depend on the nature of the hedged item, and to expand the application guidance in the exposure draft.

Designating combinations of options as the hedging instrument

The IASB discussed the restriction on designating a stand-alone written option in combination with a purchased option as a hedging instrument and noted that instead of entering into one collar contract, entities often enter into two separate option contracts that in effect achieve the economic outcome of a collar contract. Under the exposure draft and IAS 39, the collar contract is eligible as a hedging instrument if it does not result in a net written option. However, designating two or more instruments in combination as the hedging instrument is not allowed if one of them is a written or a net written option.

The IASB tentatively decided to amend the requirements such that a combination of a written and a purchased option can be jointly designated as the hedging instrument provided that the combination is not a net written option. The IASB noted that whether a combination of a written and a purchased option is a net written option would require considering the same aspects as the evaluation of whether a collar constitutes a net written option.

Rebalancing

The IASB discussed two main issues arising from the feedback on the proposals:

- whether rebalancing should be mandatory or voluntary, and what the frequency of rebalancing should be; and
- what the scope of the rebalancing provisions should be.

Mandatory versus voluntary rebalancing

Given the purpose of rebalancing is to maintain compliance with hedge effectiveness over the life of the hedging relationship, the IASB considered that rebalancing should be aligned with its tentative decision on the hedge effectiveness assessment.

Therefore a hedging relationship should be rebalanced if the hedge ratio used for risk management purposes changes or if rebalancing was required to prevent the hedge ratio resulting in an imbalance that would create hedge ineffectiveness in order to achieve an outcome that is inconsistent with the purpose of hedge accounting.

The automatic rebalancing would make the notion of 'proactive' rebalancing obsolete.

Scope of rebalancing

The feedback on the exposure draft also requested clarification of the scope of the term 'rebalancing', the interaction between rebalancing and risk management, and whether rebalancing is used in a narrow sense in order to maintain a hedge ratio that complies with the hedge effectiveness assessment or whether it also includes other changes to the quantities of the hedged item and hedging instrument.

The IASB tentatively decided to align the notion of rebalancing with the IASB's tentative decision on the hedge effectiveness assessment. Therefore, after the start of a hedging relationship, an entity would rebalance that hedging relationship for hedge accounting purposes when it adjusts the quantities of the hedging instrument or the hedged item in response to changes in circumstances that affect the hedge ratio of that hedging relationship. However, the hedging relationship for hedge accounting purposes would have to use a different hedge ratio than for risk management purposes if:

- the hedge ratio would reflect an imbalance that would create hedge ineffectiveness in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting; or
- for risk management purposes, an entity would retain a hedge ratio that in new circumstances would reflect an imbalance that would create hedge ineffectiveness in order to achieve an outcome that is inconsistent with the purpose of hedge accounting, i.e. an entity must not create an imbalance by omitting to adjust the hedge ratio.

Voluntary discontinuation

While some commentators argued that voluntary discontinuation should be allowed given that hedge accounting is optional, others agreed with the proposals but asked the IASB to clarify the interaction with the risk management objective and strategy.

As a result the IASB discussed two main issues:

- whether voluntary discontinuation should be permitted; and
- the clarification of the interaction between the proposed requirements for discontinuing hedge accounting and the risk management objective and strategy.

The IASB considers that if an entity chooses to apply hedge accounting it aims to represent in the financial statements the effect of pursuing a particular risk management strategy by using that kind of accounting.

Therefore, the ability to voluntarily discontinue hedge accounting would undermine the aspect of consistency over time in accounting for that type of hedging relationship, and would result in a misalignment with the entity's risk management objective. Hence this would be inconsistent with the overall objective of the new hedge accounting model.

With regards to the relationship between the risk management strategy and the risk management objective, and at what level these notions would apply, the IASB noted that the concerns resulted from two scenarios:

- hedge accounting approaches that are a surrogate of dynamic hedging; and
- hedging relationships that at a specific stage turn into a natural hedge.

The IASB concluded that the risk management strategy is the highest level at which an entity determines how it manages its risk while the risk management objective for a hedging relationship relates to how the particular hedging instrument designated is used to hedge a particular exposure, i.e. the risk management objective applies at the hedging relationship level. This means that even if the risk management strategy remains the same, a particular risk management objective might change for a previously designated hedging relationship.

The IASB tentatively decided:

- to add guidance showing how the risk management objective and the risk management strategy relate to each other using examples contrasting these two notions; and
- to confirm the proposals in the exposure draft and hence prohibit voluntary discontinuation of hedge accounting when the risk management objective remains the same and all the other qualifying criteria are still met.

Financial instruments project: impairment

The Boards considered the following alternatives to progress this project:

- finalise the approach developed by:
  - the IASB based on deliberations before the convergence discussions, i.e. a time-proportional approach for a 'good book' and full lifetime expected losses for a 'bad book'; or
  - the FASB based on deliberations before the convergence discussions, i.e. recognise losses expected to occur in the foreseeable future' period;

- finalise the model in the supplemental document taking into consideration feedback received; or
- develop a variation of the previous proposals, taking into account the feedback from the Boards' original exposure drafts and the supplemental document.

The Boards tentatively decided to pursue the last alternative. A working group consisting of Board members and senior staff is expected to develop suggestions to move forward, to be presented to the Boards within a reasonably short time.

Insurance contracts project

During May the discussions mainly focused on:

- the measurement of policyholder participation
- risk adjustment as compared to composite margin
- assets backing insurance contract liabilities
- use of other comprehensive income
- reinsurance.

Key points to note are:

- the Boards continue to have different views on risk adjustment and composite margin;
- IFRS 9 will not be re-opened at this point in time;
- day one gains for reinsurance are expected to be prohibited;
- reinsurance recognition criteria are expected to be revised; and
- enhanced guidance for significant risk transfer in reinsurance arrangements and for the risk of non-performance when estimating the present value of the fulfilment cash flows are expected to be developed.

Additionally, the IASB Insurance Working Group met and discussed the Boards' tentative decisions on the following:

- use of other comprehensive income;
- unbundling;
- measurement of policyholder participation;
- modified approach for short-duration contracts;
- discount rate proposals; and
- the IASB's work plan.

Refer *IFRS – Insurance Newsletter* Issues 16 and 17 for more details.

Leases project

At the joint meeting the Boards decided:

- to abandon proposals for other-than-finance lease accounting;
- that lessees should apply a single right-of-use model with a front-loaded lease expense profile; and
- that the exception for short-term leases should be reconsidered.

The Boards were split on the lessor accounting model and staff were asked to develop alternatives that may bridge the gap.

Refer to *IFRS – Leases Newsletter* Issue 6 for more details.

The Boards made the following additional decisions on subsequent measurement issues relating to lessees.

- The liability to make lease payments would be treated as a monetary item with foreign exchange differences recognised in profit or loss.
- Impairment of the right-of-use asset would be referred to in existing guidance in IAS 36 *Impairment of Assets*.
- An entity would be permitted to revalue the right-of-use asset.
- For residual value guarantees included in the measurement of the lessee's right-of-use asset, a lessee would:
  - amortise the expected amount payable consistently with other lease payments included in the measurement of the right-of-use asset;
  - reassess the expected amount payable when there is an indication of significant change in the amount expected to be payable; and
  - record any change in the lessee's lease liability as a result of the reassessment in profit or loss if the changes relate to the current period, and against the right-of-use asset if the changes relate to future periods. The allocation between current and future periods would reflect the pattern the economic benefits of the right-of-use asset will be consumed or were consumed. If that pattern cannot be determined reliably, then the entire change in estimate would be recorded against the right-of-use asset.

Revenue recognition project

The issues the Boards discussed included:

- presentation and disclosures of contracts with customers;
- assets arising from contract acquisition or fulfilment costs: disclosure, impairment, amortisation and recognition;
- onerous contracts; and
- costs of products manufactured for delivery under long-term production programmes.

On the last point, the Boards agreed that the accounting for those costs is not in the scope of the revenue recognition project.

An education session also took place on how the proposed revenue recognition model would affect current accounting practice in the telecommunications industry.

Presentation and disclosures of contracts with customers

The Boards tentatively decided to retain the presentation and disclosure requirements that were proposed in the exposure draft on revenue recognition, but making the amendments and clarifications described under the headings that follow.

Presentation of contract assets and contract liabilities

An entity need not use labels such as 'contract asset' and 'contract liability'. However, it should disclose sufficient information to enable users of the financial statements to distinguish clearly between unconditional rights to consideration (a receivable whether billed or unbilled) and conditional rights to consideration (a contract asset).

Disaggregation of revenue

The Boards tentatively decided that:

- the revenue standard should not mandate specific categories, but should provide a clear disaggregation principle and examples of categories that might be appropriate;
- an entity should disaggregate revenue in the statement of comprehensive income or in the notes to the financial statements, but would not be required to also disaggregate the impairment loss allowance for customers' credit risk that is presented adjacent to revenue.

Reconciliation of contract assets and contract liabilities

The Boards clarified that an entity should only include additional line items in the reconciliation of contract assets and contract liabilities if those additional reconciling items would be needed to understand the change in the balance of a contract asset or contract liability.

Disclosure of remaining performance obligations

The Boards tentatively decided that an entity should:

- disclose the amount of the transaction price allocated to remaining performance obligations for contracts that have both:
  - an original expected contract duration of more than one year; and
  - terms and conditions of the contract that result in the entity being required to apply each step of the revenue model, i.e. to determine the transaction price and to allocate that transaction price to the separate performance obligations, in order to recognise revenue; and
- explain when it expects those amounts to be recognised as revenue, either on a quantitative basis in time bands that would be most appropriate for the duration of the contract or by using a mixture of quantitative and qualitative information.

Assets arising from contract acquisition or fulfilment costs

Disclosures about assets arising from contract acquisition or fulfilment costs

The Boards tentatively decided that, for each reporting period, an entity should disclose a reconciliation of the carrying amount of an asset arising from the costs to acquire or fulfil a contract with a customer, by major classification, e.g. acquisition costs, pre-contract costs, and setup costs, at the beginning and end of the period separately presenting:

- additions
- amortisation
- impairments
- impairment losses reversed (not applicable in US GAAP).

The Boards tentatively decided that an entity should provide qualitative disclosures about the method used to determine the amortisation for the period and the circumstances that led to the reversal of impairment losses.

Impairment of assets arising from contract acquisition or fulfilment costs

The Boards tentatively decided that an entity should recognise an impairment loss to the extent that the carrying amount of the asset exceeds the amount of consideration to which the entity expects to be entitled in exchange for the goods or services to which the asset relates, less the remaining costs that relate directly to providing those goods or services.

To determine the amount to which an entity expects to be entitled, an entity should use the principles for determining the transaction price.

Amortisation of assets arising from contract acquisition or fulfilment costs

The Boards tentatively decided to retain the exposure draft proposal that would require an entity to amortise the asset on a systematic basis consistent with the pattern of transfer of goods or services to which the asset relates. The Boards clarified that the asset could relate to goods or services to be provided under future contracts with the same customer, e.g. renewal options.

Recognition of an asset from contract acquisition costs

The Boards tentatively decided that, as a practical expedient, for contracts with a duration of 12 months or less, an entity should be permitted to recognise contract acquisition costs as an expense when incurred.

Onerous contracts

The Boards tentatively decided to limit the application of the onerous test to performance obligations that an entity satisfies over time, e.g. long-term service contracts.

Also the Boards tentatively decided that the costs that an entity should include when applying the onerous test are the lower of:

- the costs that relate directly to satisfying the performance obligation, as defined in the exposure draft; or
- any amounts that the entity would have to pay to cancel the contract.

Abbreviations

1 IASB: International Accounting Standards Board

2 FASB: US Financial Accounting Standards Board

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