

Welcome to IASB Update

This IASB Update is a staff summary of the tentative decisions reached by the Board at a public meeting. As a project progresses the Board may modify its earlier tentative decisions. Tentative decisions do not change existing requirements until those decisions are incorporated in a new or amended standard.

The IASB met in London from Tuesday 12 April to Friday 15 April. The sessions on Tuesday and Wednesday and on Thursday morning were held jointly with the US-based FASB.

The joint discussions focused on four projects: revenue recognition, leases, insurance contracts, and impairment of financial assets. The IASB-only sessions focused on hedge accounting (which the FASB joined by video) and an update of activities of the IFRS Interpretations Committee.

The boards discussed uncertain consideration in relation to revenue recognition and leases. The revenue recognition sessions also focused on allocating the transaction price, licences and rights to use, fulfilment costs, and sale and repurchase agreements. The leases sessions also focused on the definition of a lease and whether there should be one or two accounting approaches for leases.

The session on insurance focused on the use of a 'top-down approach' to determine a discount rate.

The impairment sessions included consideration of feedback from the outreach activities and comment letters on the joint supplementary document *Financial Instruments: Impairment*, interest income recognition and the definition of amortised cost and whether to discount a loss estimate.

In the sessions on hedge accounting the IASB began its redeliberations on the exposure draft *Hedge Accounting* and discussed the objective of hedge accounting and accounting for 'funding swaps', designating risk components of financial instruments that bear interest below a benchmark rate (the 'sub-LIBOR' issue), the eligibility of non-derivative financial instruments as hedging instruments (including the interaction with the fair value option) and macro hedge accounting.

During board week Sir David Tweedie, Chairman of the IASB, and Leslie Seidman, Chairman of the FASB, recorded an interview in which they review the achievements of the convergence programme so far and the time line for completing the remaining elements of the programme. To listen to the interview and read a transcript, please [click here](#).

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Future Board meetings

The IASB meets at least once a month for up to five days.

The next Board meetings in 2011 are:

4 May
11 May
16-20 May

To see all Board meetings for 2011, [click here](#).

Archive of IASB Update Newsletter

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Podcast summaries

To listen to a short Board meeting audio summary (podcast) or previous Board meetings, [click here](#).

The topics discussed at the joint IASB/FASB board meeting were:

- Financial instruments: impairment
- Insurance contracts
- Leases
- Revenue recognition

The topics discussed at the IASB Board meeting were:

- Financial instruments: hedge accounting
- IFRS Interpretations Committee - update from last meeting

Sessions held jointly with the FASB

Financial instruments: impairment

The IASB and FASB discussed feedback from the outreach activities and comment letters on the joint supplementary document *Financial Instruments: Impairment*, interest income recognition and the definition of amortised cost and whether to discount a loss estimate.

The joint supplementary document was issued in January 2011 and the comment letter deadline was 1 April 2011. The boards discussed feedback from the comment letters received on the document along with the results of outreach activities during the comment period.

The boards also discussed interest revenue recognition and the definition of amortised cost. They 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. All IASB and FASB members present agreed.

Subsequently, the boards discussed whether to discount a loss estimate and, specifically, whether expected losses should be measured as principal only on an undiscounted basis or as all shortfalls in cash flows (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. All IASB and FASB members present agreed.

The boards then discussed several alternatives on whether to unwind any discount on expected losses through interest revenue (either separately presented or in a net presentation), or through impairment losses. The boards tentatively decided to include the unwinding of the discount in the impairment losses line item and, after considering any operational issues, will later consider whether to require disclosure of the effect of the unwinding on the allowance account. All FASB members and 9 IASB members accepted this alternative.

As a result of these discussions, the boards tentatively decided that they did not need to consider the inclusion of a non-accrual principle for an impairment accounting model.

In subsequent meetings feedback received on the supplementary document will be considered as the boards continue to develop the impairment accounting model.

Insurance contracts

The IASB and FASB continued their discussions of insurance contracts by considering the use of a top-down approach to determining a discount rate.

The boards' relevant previous tentative decisions on the discount rate were:

- 17 February 2011 meeting - the discount rate for non-participating contracts ([click here](#) for more information)
- 14 March 2011 meeting - the discount rate for participating contracts ([click here](#) for more information)

Top-down approaches to discount rates

The boards tentatively decided on 17 February that an insurer could use either a 'top-down' or a 'bottom-up' approach to determine discount rates that reflect the characteristics of the insurance contract liability (rather than how the insurer funds the liability). At this meeting, the boards tentatively decided that in applying the top-down approach:

- a. an insurer shall determine an appropriate yield curve on the basis of current market information. The insurer may base its determination of the yield curve for the insurance contract liability on a yield curve that reflects current market returns for the actual portfolio of assets the insurer holds or for a reference portfolio of assets with characteristics similar to those of the insurance contract liability.
- b. if there are no observable market prices for some points on that yield curve, the insurer shall use an estimate that is consistent with the boards' guidance on fair value measurement, in particular for Level 3 fair value measurement.
- c. the cash flows of the instruments shall be adjusted so that they reflect the characteristics of the cash flows of the insurance contract liability. In adjusting the cash flows, the insurer shall make both of the following adjustments:
 - i. Type I, which adjust for differences between the timing of the cash flows to ensure that the assets in the portfolio (actual or reference) selected as a starting point are matched with the duration of the liability cash flows.
 - ii. Type II, which adjust for risks inherent in the assets that are not inherent in the liability. In the absence of an observable market risk premium for risks inherent in the asset but not inherent in the liability, the entity uses an appropriate technique to determine that market risk premium, consistent with (b).
- d. 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 the asset cash flows.

All board members supported this decision.

Next steps

The boards will continue their discussion on insurance contracts at their joint meeting on 27 April 2011.

Leases

At the February 2011 joint board meeting, the FASB and the IASB tentatively decided that the lessee's liability and the lessor's receivable should include lease payments that meet a high threshold; lease payments for which the variability lacks economic substance; and lease payments that depend on an index or a rate. At that meeting, the boards asked the staff to perform targeted outreach on those tentative decisions.

Having considered the feedback received and additional staff analysis, the boards:

- confirmed that the measurement of the lessee's liability and the lessor's receivable should include lease payments that are in-substance fixed lease payments but are structured as variable lease payments in form.
- changed their tentative decision in relation to lease payments that meet a high threshold and decided that in such cases (ie when the payments are less certain) those amounts should not be included in the measurement of the lessee's liability and the lessor's receivable.

The boards will discuss lease payments that depend on an index or a rate, including reassessment, at a future meeting. In addition, the boards asked the staff to consider appropriate disclosures for variable lease payments for future discussions.

Definition of a lease

In the *Leases* exposure draft, the boards defined 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.

The boards tentatively decided the following in relation to applying that definition, having considered feedback received from targeted outreach meetings held during March 2011 as well as feedback received in comment letters and through other outreach:

- a. An entity would determine whether a contract contains a lease on the basis of the substance of the contract, by assessing whether:
 - i. the fulfilment of the contract depends on the use of a specified asset; and
 - ii. the contract conveys the right to control the use of a specified asset for a period of time.
- b. A contract would convey that right to control the use if the customer has the ability to direct, and receive the benefit from, the use of a specified asset throughout the lease term. Guidance on separating the use of a specified asset from other services should be aligned with the boards' tentative decisions in March 2011 relating to the separation of lease and non-lease components.
- c. A 'specified asset' refers to an asset that is explicitly or implicitly identifiable.
- d. A physically distinct portion of a larger asset of which a customer has exclusive use is a specified asset. A capacity portion of a larger asset that is not physically distinct (eg a capacity portion of a pipeline) is not a specified asset.

All board members supported these decisions.

Joint education sessions: 6 and 7 April

In the education sessions during the week of 4 April, the FASB and the IASB discussed the definition of a lease, variable lease payments, whether there should be one or two accounting approaches for leases, and when there are two accounting approaches for leases, how to determine which accounting approach to apply.

The sessions were only for educational purposes and included an overview of the feedback received from the targeted outreach on these issues. The boards were not asked to make any decisions on these issues.

The boards continued these discussions in the board meeting this week.

Lessee accounting

The boards tentatively decided that there should be two accounting approaches for lessees. Lessees would use guidance similar to that in IAS 17 *Leases* to determine which accounting approach to apply. 7 IASB members and 1 FASB member did not support this decision.

For both lessee accounting approaches, the boards affirmed their proposals in the *Leases* exposure draft that a lessee would:

- initially recognise a liability to make lease payments and a right-of-use asset, both measured at the present value of lease payments.
- subsequently measure the liability to make lease payments using the effective interest method.

All board members supported the decision.

For finance leases, a lessee would, consistently with the proposals in the exposure draft:

- amortise the right-of-use asset on a systematic basis that reflects the pattern of consumption of the expected future economic benefits in accordance with IAS 38 *Intangible Assets* or Topic 350 *Intangibles-Goodwill and Other*.
- present amortisation of the right-of-use asset and interest expense on the liability to make lease payments, either in profit or loss or in the notes.

All board members supported the decision.

For other-than-finance leases, a lessee would:

- amortise the right-of-use asset in a manner that would result in total lease expense being recognised over the lease term on a straight-line basis (representing the sum of amortisation of the right-of-use asset and interest expense on the liability to make lease payments), unless another systematic basis is more representative of the time pattern of the total lease expense. 3 IASB members did not support this decision.
- present amortisation of the right-of-use asset and interest expense on the liability to make lease payments together as a single line item within operating expense (eg as rent expense). 4 IASB members and 1 FASB member did not support this decision.

Lessor accounting

The boards tentatively decided that there should be two accounting approaches for leases for lessors. Lessors would use guidance similar to that in IAS 17 *Leases* to determine which accounting approach to apply. 5 IASB members and 1 FASB member did not support this decision.

The boards discussed the two accounting approaches that would be applied by lessors, but did not make any decisions.

Next steps

The boards will continue their redeliberations of the *Leases* exposure draft in May 2011.

Revenue recognition

The IASB and the FASB discussed determining the transaction price, allocating the transaction price, licences and rights to use, fulfilment costs, and sale and repurchase agreements.

Determining the transaction price

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:

1. An entity's objective when determining the transaction price is to estimate the total amount of consideration to which the entity will be entitled under the contract.
2. To meet that objective, an entity should estimate either of the following amounts depending on which is most predictive of the amount of consideration to which the entity will be entitled:
 - a. the probability-weighted amount, or

- b. the most likely amount.
3. 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. That would be the case in each of the following circumstances:
 - a. the customer could avoid paying an additional amount of consideration without breaching the contract (eg a sales-based royalty).
 - b. the entity has no experience with similar types of contracts (or no other persuasive evidence).
 - c. 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 (for example, susceptibility to factors outside the influence of the entity, the amount of time until the uncertainty is resolved, the extent of the entity's experience, and the number and variability of possible consideration amounts).

The first two decisions were supported by all members of both boards. The third decision was supported by 14 members of the IASB and all members of the FASB.

Allocating the transaction price

The boards discussed how an entity should allocate the transaction price on a relative selling price basis.

The boards tentatively decided that if the standalone selling price of a good or service underlying a separate performance obligation is highly variable, the most appropriate technique to estimate a standalone selling price may be a residual technique. Using a residual technique, an entity would determine a standalone selling price by reference to the total transaction price less the standalone selling prices of other goods or services in the contract. That decision was supported by all members of both boards.

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

1. 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
2. the amount allocated (including the change in the transaction price) to that particular performance obligation is reasonably relative to all of the performance obligations and payment terms (including other potential contingent payments) in the contract.

That decision was also supported by all board members.

Licences and rights to use

The boards discussed how an entity should account for contracts in which the entity grants a license or other rights to a customer. The boards tentatively decided that the promised rights give rise to a performance obligation that the entity satisfies at the point in time when the customer obtains control (ie the use and benefit) of the rights. If there are other performance obligations in the contract, an entity should consider whether the rights give rise to a separate performance obligation or whether the rights should be combined with those other performance obligations. All members of both boards supported that decision.

Fulfilment costs

The boards discussed the accounting for costs of fulfilling a contract with a customer and affirmed the guidance proposed in the exposure draft subject to minor drafting improvements. Specifically, the boards decided:

1. not to amend the scope of the proposed guidance on fulfilment costs in the final standard. 13 members of the IASB and 5 members of the FASB supported that decision.
2. 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. All IASB members and 6 members of the FASB supported that decision.
3. that the costs of abnormal amounts of wasted materials, labour or other resources that were not considered in the price of the contract should be recognised as an expense when incurred. All members of both boards supported that decision.

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 significant economic incentive to exercise that right, the customer effectively pays the entity for the right to use the asset for a period of time. Consequently, the entity should account for the agreement as a lease. To determine whether a customer has a significant economic incentive to exercise their right, 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. That decision was supported by all members of both boards

Next steps

In May 2011, the boards will discuss the following topics:

1. disclosures,
2. transition, and
3. fulfilment costs: amortisation and impairment.

IASB-only sessions

Financial instruments: hedge accounting

At this meeting the IASB began its redeliberations on the exposure draft *Hedge Accounting* and discussed the objective of hedge accounting and accounting for 'funding swaps', designating risk components of financial instruments that bear interest below a benchmark rate (the 'sub-LIBOR' issue), the eligibility of non-derivative financial instruments as hedging instruments (including the interaction with the fair value option); and macro hedge accounting.

Objective of hedge accounting

In view of the objective of hedge accounting the Board discussed whether exposures that affect comprehensive income should be eligible for hedge accounting.

Many respondents and outreach participants believe that items that affect other comprehensive income, in particular equity investments at fair value through other comprehensive income (FVTOCI), should be eligible for hedge accounting, because they believe that this provides a better reflection of the risk management activities of an entity. Some respondents and outreach participants are also of the view that hedge accounting should be generally available to exposures that affect comprehensive income.

The Board discussed this feedback and the staff analysis and tentatively decided to allow the application of hedge accounting to equity investments at FVTOCI. Any hedge ineffectiveness will be

presented in other comprehensive income (OCI). 8 Board members supported this decision, with 7 against.

The Board also considered whether hedge accounting should be available more generally for exposures that affect other comprehensive income. The Board tentatively decided that only equity investments at FVTOCI would be eligible for hedge accounting and that hedge accounting would not be available to other exposures that affect comprehensive income. 13 Board members supported this decision, with 2 against.

Funding swaps

The Board discussed the feedback received from comment letters and outreach on 'funding swaps'. Banks that have funding in their local currency that exceeds the amounts they can invest in their domestic markets often invest in assets in a foreign currency and protect these against foreign exchange risk and stabilise the net interest margin using currency derivatives. These currency derivatives are commonly referred to as 'funding swaps'. The Board noted that the current accounting for funding swaps under IAS 39 *Financial Instruments: Recognition and Measurement* and the exposure draft might not reflect the economics of such transactions.

The Board intends to explore possible alternatives (eg extending the treatment proposed in the exposure draft for the time value of options to forward points) to better reflect the economics of such transactions.

The 'sub-LIBOR' issue

At this meeting the Board discussed the issue of hedging on a risk components basis when the total cash flows of the hedged item are less than the total cash flows of a risk component that would reflect the full benchmark risk (using LIBOR as an example). The Board discussed the main issues raised in responses in the comment letters and during the outreach, which asked the Board to consider hedging that aims to lock in a margin. These were:

- Is there a 'full' LIBOR component of an interest bearing financial asset or financial liability if the interest rate of the instrument is lower than LIBOR? If so, should that LIBOR-component be eligible for designation as a hedged item?
- Does the existence of a floor of the interest-bearing financial asset or financial liability affect whether it is possible to designate a hedged item on a full LIBOR risk components basis?

Existence of a 'full' LIBOR risk component

The Board noted that an objective of hedging an interest margin has no effect on the question of whether a full LIBOR component can be identified. This is because the level of the margin is influenced by whether the instruments involved in the hedging relationship result in negative interest on their own.

In addition, the mere fact that a margin is being hedged (to lock it in) does not change the implications of sub-LIBOR interest because even when the objective is to lock in a margin there is an economic mismatch (ie the possibility of the margin becoming variable for particular levels of LIBOR). That fact should be taken into consideration when determining the hedged item.

The Board also noted that imputing a full LIBOR component is tantamount to 'synthetic accounting' instead of hedge accounting. This is because the change in the fair value of the hedging derivative is deferred in OCI and recycled to profit or loss through interest accrual even though there is no offsetting change in the fair value of the hedged item. Hence, hedge ineffectiveness is inappropriately accumulated in OCI, deferred to the accrual period and the hedging derivative is accrual accounted for (in profit or loss) irrespective of an offsetting gain or loss on the hedged item.

Impact of the existence of a floor of the interest-bearing sub-LIBOR financial

instrument

The Board noted that the existence of a floor affects the ability to designate a full LIBOR component. If there is no floor the instrument(s) may end-up in a scenario of receiving interest on a liability and paying interest on an asset if the benchmark rate falls below the absolute value of the negative spread to LIBOR. In that situation the interest bearing instrument generates changes in the LIBOR-related variability of cash flows that match those of the interest rate derivative used to lock in the margin.

Therefore, the Board tentatively confirmed the proposals in the exposure draft (as described in paragraphs B25 and B26 of the exposure draft). However, the Board noted that there is some confusion about how a risk component could be designated in accordance with these proposed requirements (which are the same as those in IAS 39 *Financial Instruments: Recognition and Measurement*). Hence, the Board noted that it would be helpful to clarify, when finalising the requirements, that for an asset or liability with a negative spread an entity could still 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, thus hedging the change in the fair value or cash flows of that entire liability that is attributable to changes in LIBOR. Hedge ineffectiveness could arise but hedge accounting per se is not prohibited. All Board members present supported this decision.

Eligibility of cash instruments as hedging instruments

The Board discussed the issue of eligibility of cash instruments as hedging instruments. Specifically, the Board discussed the two main issues raised in the comment letter responses and outreach activities in relation to the proposals for the eligibility of cash instruments as hedging instruments. These were:

- whether to extend the eligibility criteria to cash instruments that are not measured at fair value through profit or loss; and
- the interaction between the use of the fair value option and the eligibility criteria for cash instruments.

Extension of the eligibility criteria

The Board discussed the possibility of also allowing cash instruments measured at amortised cost to be eligible hedging instruments for risks other than foreign exchange risk.

The Board noted that if eligibility was expanded to accommodate instruments measured at amortised cost it would require a change to the measurement basis as a result of the application of hedge accounting. The Board noted that this will raise several issues and potential complexity in the context of the interaction between the classification and measurement required in IFRS 9 *Financial Instruments*.

As a result, the Board tentatively confirmed that the eligibility criteria as proposed in the exposure draft (for hedges of other than foreign exchange risk) allow only cash instruments at fair value through profit or loss to be eligible hedging instruments. All Board members present supported this decision.

Interaction with the fair value option

Regarding the interaction between the use of the fair value option and the eligibility criteria for cash instruments, the Board discussed whether:

- the ability to designate a cash instrument should be restricted by the fact that the cash instrument is at fair value through profit or loss as a result of the application of the fair value option; and
- whether there should be a distinction between financial assets and financial liabilities designated as at fair value through profit or loss under the fair value option.

The Board noted that when a cash instrument is accounted for at fair value through profit or loss as a result of electing the fair value option the appropriateness of its use as a hedging instrument depends on the circumstances. Any designation as a hedging instrument must not contradict the entity's election of the fair value option (eg re-create the accounting mismatch that the fair value option addressed by using the instrument designated at fair value through profit or loss as a hedging instrument to hedge another item).

In addition, the Board noted that a prohibition to designate as hedging instruments cash instruments that are accounted for at fair value through profit or loss as a result of electing the fair value option would be inappropriate (as it would not differentiate circumstances and hence, for example, preclude the ability to designate such instruments at a later stage when the original accounting mismatch underpinning the election of the fair value option would no longer exist).

Regarding 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 OCI, the Board noted that the non-recyclable OCI classification of the credit risk related changes in the fair value of the liability under the fair value option would have to be overridden in order to comply with the hedge accounting requirements.

Therefore, the Board tentatively decided to clarify that liabilities for which the part of the fair value change related with own credit is recognised in OCI under the fair value option are not eligible as hedging instruments. All Board members present supported this decision.

Macro hedge accounting

The Board also discussed macro hedge accounting. Following an analysis of risk management of items with optionality on the basis of expected behaviour at a portfolio level, a preliminary overview of topics and a timetable for the macro hedge accounting project as a whole was discussed.

The Board will discuss hedge accounting at the next meeting on 28 April.

IFRS Interpretations Committee - update from last meeting

The IASB received an update from the March 2011 meeting of the IFRS Interpretations Committee. Details of the meeting were published in IFRIC Update, available by [clicking here](#).

Note that the information published in this newsletter originates from various sources and is accurate to the best of our knowledge. However, the IASB and the IFRS Foundation do not accept responsibility for loss caused to any person who acts or refrains from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.