

Welcome to IASB Update

The IASB held public sessions on Tuesday 31 May to Thursday 2 June. Most of the sessions focused on projects being undertaken with the FASB, the US standard-setter. Members of the FASB participated in the meeting via video from their offices in Norwalk.

In the joint sessions the boards discussed aspects of the insurance contracts, leasing and revenue recognition contracts projects. The boards also considered representations from the International Swaps and Derivatives Association and London clearing house group LCH.Clearnet, in relation to offsetting financial assets and liabilities.

In the IASB-only sessions the Board considered aspects of the hedge accounting project—both the general hedge accounting model and macro hedging. FASB staff members participated via video.

All Board members were present for the insurance and revenue discussions. One IASB member was not able to attend the remaining sessions.

The next public sessions will be held in London in the week beginning 13 June. The public sessions are scheduled to commence late in the morning of 13 June. The sessions on Monday, Tuesday and Wednesday morning will be held jointly with the FASB. There will be additional IASB-only sessions on Wednesday afternoon.

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

- Asset and liability offsetting: education session with representatives of ISDA
- Insurance contracts
- Leases
- Revenue recognition

The topics discussed at the IASB meeting were:

- IFRS 9: Financial instruments—hedge accounting
- IFRS 9: Financial instruments—hedge accounting: Macro hedging education session

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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:

13-17 June
18-22 July

To see all Board
meetings for 2011,
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IASB/FASB sessions

Asset and liability offsetting: education session with representatives of ISDA

Representatives from the International Swaps and Derivatives Association (ISDA) and London clearing house group LCH.Clearnet participated in a joint education session to further discuss the role of collateral in the OTC derivatives settlement process. The staff separately presented an analysis of issues involving the unit of account and collateral to the boards. The boards instructed the staff to further analyse conditional versus unconditional netting requirements as well as collateral and unit of account issues. No decisions were made at this meeting.

Insurance contracts

The IASB and FASB continued their discussions on insurance contracts by discussing the accounting for reinsurance. They tentatively decided the following:

1. If a reinsurance contract does not transfer significant insurance risk because the assuming company is not exposed to a loss, the reinsurance contract is nevertheless deemed to transfer significant insurance risk if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts is assumed by the reinsurer. A loss is defined as an excess of the present value of the cash outflows over the present value of the premiums.

All members of the IASB and the FASB supported this decision.

2. An insurer should assess the significance of insurance risk at the individual contract level. Contracts entered into simultaneously with a single counterparty for the same risk, or contracts that are otherwise interdependent that are entered into with the same or a related party, should be considered a single contract for the purpose of determining risk transfer.

All members of the IASB and the FASB supported this decision.

3. A cedant should not recognise a reinsurance asset until the underlying contract is recognised, unless the amount paid under the reinsurance contract reflects aggregate losses of the portfolio of underlying contracts covered by the reinsurance contract. If the reinsurance coverage is based on aggregate losses, the cedant should recognize a reinsurance asset when the reinsurance contract coverage period begins. An onerous contract liability should be recognized if management becomes aware in the pre-coverage period that the reinsurance contract has become onerous.

All members of the IASB and the FASB supported this decision.

4. The ceded portion of the risk adjustment should represent the risk being removed through the use of reinsurance.

All members of the IASB supported this decision; the FASB did not vote on this issue.

5. If the present value of the fulfillment cash flows (including the risk adjustment under the IASB's tentative decisions) for the reinsurance contract is:
 - a. Less than zero and the coverage provided by the reinsurance contract is for future events, the cedant should establish that amount as part of the reinsurance

recoverable, representing a prepaid reinsurance premium and should recognise the cost over the coverage period of the underlying insurance contracts.

All members of the FASB and 8 members of the IASB supported this decision; 7 members of the IASB opposed this decision.

- b. Less than zero and the coverage provided by the reinsurance contract is for past events, the cedant should recognise the loss immediately.

All members of the FASB and the IASB supported this decision.

- c. Greater than zero, the cedant should recognise a reinsurance residual or composite margin.

All members of the FASB and 11 members of the IASB supported this decision; 4 members of the IASB opposed this decision.

- 6. The cedant should estimate the present value of the fulfillment cash flow for the reinsurance contract, including the ceded premium and without reference to the residual/composite margin on the underlying contracts, in the same manner as the corresponding part of the present value of the fulfillment cash flows for the underlying insurance contract or contracts, after remeasuring the underlying insurance contracts on initial recognition of the reinsurance contract.

All members of the FASB and 14 members of the IASB supported this decision; 1 member of the IASB opposed this decision.

- 7. When considering non-performance by the reinsurer:

- a. The cedant would apply the impairment model for financial instruments when determining the recoverability of the reinsurance asset.
- b. The assessment of risk of non-performance by the reinsurer should consider all facts and circumstances, including collateral.
- c. Losses from disputes should be reflected in the measurement of the recoverable when there is an indication that on the basis of current information and events, the cedant may be unable to collect amounts due according to the contractual terms of the reinsurance contract.

All members of the IASB and the FASB supported these decisions.

Leases

The IASB and the FASB continued their discussion on leases and discussed subsequent measurement issues relating to lessees, including foreign exchange differences, impairment, revaluation and residual value guarantees.

Foreign exchange differences

The boards discussed the accounting by lessees for leases denominated in a foreign currency. The boards tentatively decided that foreign exchange differences related to the liability to make lease payments should be recognised in profit or loss, consistently with foreign exchange guidance in existing IFRSs and US GAAP. 13 IASB members and all FASB members agreed.

Impairment

The boards discussed impairment of the lessee's right-of-use asset. The boards tentatively decided to reaffirm the proposal in the exposure draft to refer to existing guidance in IFRSs and US GAAP for impairment of the right-of-use asset.

All board members present agreed.

Revaluation (IASB only)

The IASB discussed revaluation of the lessee's right-of-use asset. The IASB tentatively decided to reaffirm the proposals in the *Leases* exposure draft allowing revaluation of the right-of-use asset. All IASB members present agreed.

Residual value guarantees

The boards discussed the subsequent measurement of residual value guarantees by lessees (excluding guarantees provided by an unrelated third party) and tentatively decided that:

- The amounts expected to be payable under residual value guarantees included in the measurement of the lessee's right-of-use asset should be amortised consistently with how other lease payments that are included in the measurement of a right-of-use asset are amortised. That is, amortisation should be on a systematic basis from the date of commencement of the lease to the end of the lease term, or over the useful life of the underlying asset, if this is shorter. The method of amortisation should reflect the pattern in which the economic benefits of the right-of-use asset are consumed or otherwise used up. If that pattern cannot be determined reliably, a straight-line amortisation method should be used. All board members present agreed.
- The amounts expected to be payable under residual value guarantees that are included in the measurement of the lessee's liability to make lease payments should be reassessed when events or circumstances indicate that there has been a significant change in the amounts expected to be payable under residual value guarantees. An entity would be required to consider all relevant factors to determine whether events or circumstances indicate that there has been a significant change. All board members present agreed.
- The amount of the change to the lessee's liability to make lease payments arising from changes in estimates of residual value guarantees should be recognised (a) in net income to the extent that those changes relate to current or prior periods and (b) as an adjustment to the right-of-use asset to the extent those changes relate to future periods. The allocation for changes in estimates of residual value guarantees should reflect the pattern in which the economic benefits of the right-of-use asset will be consumed or were consumed. If that pattern cannot be determined reliably, an entity should allocate changes in estimates of residual value guarantees to future periods. 12 IASB members and all FASB members agreed.

Revenue recognition

The IASB and the FASB discussed how an entity should account for the costs of products manufactured for delivery under long-term production programs. The boards noted the potential to improve and converge the financial reporting for those costs. However, they agreed that the accounting for those costs is not in the scope of the revenue recognition project.

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IASB sessions

IFRS 9: Financial instruments—hedge accounting

At this meeting the IASB continued its redeliberations on the exposure draft *Hedge Accounting* (the ED) and discussed the accounting for options as hedging instruments, rebalancing of a hedging relationship and voluntary discontinuation of hedge accounting.

Accounting for time value of options

The Board discussed whether the time value of an option should always be expensed over the life of an option instead of applying the accounting as proposed in the ED. The Board noted that such an accounting treatment would not provide an outcome that aligns with the view of the time value paid as a cost of hedging as it can result in recognising an expense in periods that are unrelated to how the hedged exposure affects profit or loss.

The Board also discussed whether the proposals could be simplified by removing the differentiation between *transaction related* and *time period related hedged* items. The Board noted that doing so would be inconsistent with other IFRSs and treat unlike situations as alike, hence impairing comparability.

The Board also discussed the concerns of some respondents about whether it is appropriate to defer the time value of options for *transaction related* hedged items. The Board noted that 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-consistent with how other IFRSs treat ancillary costs. The Board also noted that the ED also includes an impairment test to ensure that amounts that are not expected to be recoverable are not deferred.

The Board tentatively confirmed the accounting *outcomes* for the accounting for time value of options as proposed in the ED (ie that to the accounting would depend on the nature of the hedged item). The votes were 13 in favour, 1 against, 1 absent.

The Board also discussed whether further application guidance and clarification should be provided in the final requirements. The Board tentatively decided to expand the application guidance in the ED. The votes were 14 in favour, 0 against, 1 absent.

The Board also considered whether paraphrasing the requirements as a single general principle would clarify the accounting for *transaction* and *time period* related hedged items. The Board noted that a 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 rather to provide further explanation in the basis for conclusions. The votes were 14 in favour, 0 against, 1 absent.

The Board considered whether it should provide an accounting choice to account for the time value of options either as:

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

The Board noted that the treatment in IAS 39 today characterises the time value of an option as a trading gain or loss. This is not a faithful representation of the time value, which is a cost of hedging (the 'insurance premium' view). The Board noted that introducing an accounting choice would impair the comparability of financial statements. As a result, the Board tentatively decided to not introduce an accounting choice. The votes were 13 in favour, 1 against, 1 absent.

Designating combinations of options as the hedging instrument

The Board discussed the restriction on designating a standalone 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 ED 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 Board tentatively decided to amend the requirements such that a combination of a written and a purchased option (regardless of whether the hedging instrument arises from one or several different contracts) can be jointly designated as the hedging instrument provided that the combination is not a net written option. The Board 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. The votes were 13 in favour, 1 against, 1 absent.

Rebalancing

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

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

Mandatory versus voluntary rebalancing

The Board noted that the notion of rebalancing was introduced as a complement of the new hedge effectiveness assessment, mainly to address the requirements for the hedge ratio after designation of the hedging relationship.

Therefore, the Board considered that rebalancing should be aligned with its tentative decision on the hedge effectiveness assessment because the purpose of rebalancing is to maintain compliance with the hedge effectiveness over the life of the hedging relationship following designation.

The Board noted that an entity should therefore rebalance a hedging relationship 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.

In effect that means that if for risk management purposes an entity adjusts the hedge ratio in response to changes in the economic relationship between the hedged item and the hedging instrument the hedging relationship will automatically be adjusted accordingly (provided that it would not result in an imbalance). Hence, the Board noted that the notion of 'proactive' rebalancing would hence be obsolete

Scope of Rebalancing

The feedback on the ED also requested clarification of the scope of the term 'rebalancing'. There was a general request for clarifying the interaction between rebalancing and risk management. Another request was for clarification of 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 (ie changes unrelated to a response to a change in the economic relationship between the hedged item and the hedging instrument).

As a result, the Board tentatively decided to *align* the notion of rebalancing with the Board's tentative decision on the hedge effectiveness assessment as follows:

- 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 (ie the 'hedge ratio is adjusted for risk management purposes'). *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 that 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 (ie an entity must not create an imbalance by omitting to adjust the hedge ratio).
- The notion of proactive rebalancing is eliminated (because it has become obsolete).
- The final requirements would clarify that rebalancing covers *only* adjustments to the quantities of the hedged item or the hedging instrument *for the purpose* of maintaining a hedge ratio that complies with the requirements of the hedge effectiveness assessment.

The votes were 14 in favour, 0 against, 1 absent.

Voluntary discontinuation

The Board considered the feedback and noted that there were mixed views. While some commentators argued that voluntary discontinuation should be allowed given that hedge accounting is optional, others agreed with the proposals but asked the Board to clarify the interaction with the risk management objective and strategy.

As a result the Board 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.

Voluntary discontinuation

The Board noted that the concerns of the commentators in relation to this issue are mainly a disagreement in principle based on the view that if starting hedge accounting by designating a hedging relationship is voluntary then discontinuation of hedge accounting should also be voluntary. However, the Board considered 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.

The Board noted that the ability to voluntarily discontinue hedge accounting would undermine the aspect of consistency over time in accounting for that type of hedging relationship. The Board also noted that the ability to discontinue hedge accounting when an entity still qualifies for hedge accounting and continues to pursue its original risk management objective would result in a misalignment with risk

management and hence be inconsistent with the overall objective of the new hedge accounting model.

Clarification of the interaction between the proposed discontinuation requirements and the risk management objective and strategy.

The Board noted that some of the feedback indicated that the references to the risk management strategy and the risk management objective were not sufficiently clear, particularly their relationship with each other and at what level these notions would apply. The Board also noted that the concerns resulted from two scenarios:

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

The Board 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 (ie 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 Board 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 ED 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.

The votes were 13 in favour, 1 against, 1 absent.

IFRS 9: Financial instruments—hedge accounting: Macro hedging education session

As part of its deliberations on macro hedge accounting the IASB received presentations from Toronto Dominion Bank Group and the European Banking Federation on risk management. No decisions were made.

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