IASB staff day for IFRS Teachers

Tuesday 27 May 2014
London, UK
IASB staff Day for IFRS Teachers  
Tuesday 27 May 2014 in London, United Kingdom

09:30  **Opening remarks**  
Hugh Shields, Executive Technical Director, IASB

09:40  **Introduction to Framework-based Teaching**  
Objective: support IFRS teachers to develop in their students the ability to make the judgements and estimates necessary to apply IFRS.  
Michael Wells, Director, Education Initiative, IASB

10:00  Coffee/tea break

10:15  **Workshop A: Stages 1, 2 and 3—liabilities**  
Target audience: those teaching IFRS to Stage 1 students: 1st IFRS course (e.g., Accounting 101); Stage 2 students: mid-way to qualifying; and Stage 3 students: immediately before final professional qualifying examinations

Format: interactive presentation and case study

Facilitators:  
Michael Wells, Director, Education Initiative, IASB  
Elizabeth Buckley, Project Manager, IASB  
Guillermo Braunbeck, Project Manager, IASB

**Workshop B: Stage 3—general hedge accounting: IAS 39 and IFRS 9**  
Target audience: those teaching IFRS to Stage 3 students: immediately before final professional qualifying examinations

Format: interactive case study

Facilitator:  
Iwona Nowicka, Academic Fellow, Education Initiative, IASB

12:15  Lunch

13:00  **IASB staff update—Conceptual Framework project**  
To update participants on the main concepts being considered in the project to improve the Conceptual Framework  
Presenter:  
Rachel Knubley, Technical Principal, IASB

13:45  **Annual improvements and Interpretations: question and answer session with IFRS Interpretations Committee staff**  
Issues addressed by the IFRS Interpretations Committee staff in the past 12 months.

Panellists:  
Michael Stewart, Director of Implementation Activities, IASB  
Denise Durant, Technical Manager, IASB

14:30  **Revenue recognition: question and answer session with IASB staff**  
Panellists:  
Henry Rees, Technical Director, IASB  
Natasha Dara, Assistant Technical Manager, IASB

15:15  Tea and coffee

15:30  **Financial instruments standards and IASB projects: question and answer session with IASB staff**  
Panellists:  
Kumar Dasgupta, Technical Director, IASB  
Riana Wiesner, Senior Technical Manager, IASB  
Yulia Feygina, Senior Technical Manager, IASB

16:15  **Close**
IASB staff day for IFRS Teachers
Tuesday 27 May 2014
London, UK

Opening remarks

Hugh Shields
Executive Technical Director
IASB
Introduction to Framework-based Teaching

Michael Wells
Director, IFRS Education Initiative
IASB
Framework-based IFRS teaching…

- relates IFRS requirements to underlying concepts
- explains why some requirements do not maximise objective and other concepts (eg cost constraint, inherited requirements)
- develops students’ ability to make IFRS judgements
A quick reminder: concepts underlying IFRS

The Conceptual Framework for Financial Reporting

Objective of IFRS financial reporting

Provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity (buy, sell, hold, provide loan/settle (OB 2))

...who cannot require reporting entities to provide information directly to them (OB 5)

...who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently (QC 32)
Objective of IFRS financial reporting
continued

• Investors’, lenders’ and other creditors’ expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity.

Objective of IFRS financial reporting
continued

• To assess an entity’s prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about:
  – the resources of the entity;
  – claims against the entity; and
  – stewardship—how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources
  – eg protecting the entity’s resources from unfavourable effects of economic factors such as price and technological changes
Qualitative characteristics

• If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent (ie fundamental qualities).
  — Financial information without both relevance and faithful representation is not useful, and it cannot be made useful by being more comparable, verifiable, timely or understandable.

• The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable (ie enhancing qualities—less critical but still highly desirable)
  — Financial information that is relevant and faithfully represented may still be useful even if it does not have any of the enhancing qualitative characteristics.

Fundamental qualitative characteristics

• **Relevance:** capable of making a difference in users’ decisions
  — predictive value (input to process to predict future cash flows)
  — confirmatory value (confirm/disconfirm prior cash flow expectations)
  — materiality (entity-specific—could affect a user’s decision)

• **Faithful representation:** faithfully represents the phenomena it purports to represent
  — completeness (depiction including numbers and words)
  — neutrality (unbiased)
  — free from error (ideally)

Note: faithful representation replaces reliability
Enhancing qualitative characteristics

- **Comparability**: like things look alike; different things look different
- **Verifiability**: knowledgeable and independent observers could reach consensus, but not necessarily complete agreement, that a depiction is a faithful representation—can be direct or indirect—check inputs, recalculate output
- **Timeliness**: having info in time to be capable of influencing decisions—generally older information is less useful
- **Understandability**: classify, characterise, and present information clearly and concisely

Cost constraint

- Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.
- In applying the cost constraint, the IASB assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information.
**Measurement concepts?**

- Conceptual Framework
  - none—a list of measurement conventions (¶4.54–4.56)
  - for a particular asset should depend on how that asset contributes to future cash flows; and
  - for a particular liability should depend on how the entity will settle or fulfil that liability. (¶6.35(d))
  - the number of different measurements used should be the smallest number necessary to provide relevant information. (¶6.35(e))

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**International Financial Reporting Standards**

Framework-based IFRS teaching

*continued...*
**Framework-based approach**

- What is the economics of the phenomenon (e.g., transaction or event)?
- What information about that economic phenomenon would existing and potential investors, lenders find useful in making decisions about providing resources to the entity?
- Then introduce the IFRSs requirement being taught and evaluate it against the objective
  - is the requirement a principle rooted in the Conceptual Framework?
  - if not, explain why the rule does not maximise concepts (e.g., application of the cost constraint, reason often in Basis for Conclusions)
- Focus on IFRS judgements and estimates

**Framework-based teaching provides...**

- a cohesive understanding of IFRSs
  - Framework facilitates consistent and logical formulation of IFRSs
- a basis for judgement in applying IFRSs
  - Framework established the concepts that underlie the estimates, judgements and models on which IFRS financial statements are based
- a basis for continuously updating IFRS knowledge and IFRS competencies
IFRS Foundation support

• We work with others to support Framework-based IFRS teaching
  – create awareness
  – develop material (http://www.ifrs.org/Use-around-the-world/Education/Pages/Framework-based-teaching-material.aspx)
  – hold workshops (eg 2014: Auckland, Jakarta, Johannesburg, London, Mexico City, San Antonio, Tallinn, Tokyo, Warsaw, Yerevan…)
  – encourage those certifying accountants to examine their students’ ability to make the judgements that are necessary to apply IFRS

Framework-based IFRS teaching material language map and workshops
IFRS judgements

<table>
<thead>
<tr>
<th>Stage 1</th>
<th>Stage 2</th>
<th>Stage 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Awareness</td>
<td>Understanding</td>
<td>Competence—ability to make the judgements necessary to apply IFRS</td>
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Does seeing the big picture help answer some vexing questions?

For each example below, choose either (a) reflects the economic reality; or (b) is nonsensical?

- **Ex 1**—financial liabilities: own credit risk downgrade results in recognising income (IFRS 9 solution = recognise change in OCI)
- **Ex 2**—being granted certificates in a cap and trade emission trading scheme = income
- **Ex 3**—equity decreases when controlling interest pays market price to buy out minority interests

Put another way, is it ‘shortcomings’ in recognition and measurement requirements for assets and liabilities that results in ‘counterintuitive’ knock-on effects for the reporting of subsequent transactions or events?
Thank you
IASB staff day for IFRS Teachers
Tuesday 27 May 2014
London, UK

Workshop A:
Stages 1, 2 and 3—liabilities

Michael Wells
Director, IFRS Education Initiative
IASB

Elizabeth Buckley
Project Manager
IASB

Guillermo Braunbeck
Project Manager
IASB
The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

International Financial Reporting Standards

Liabilities
London
May 2014

IFRS judgements

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<td>Awareness</td>
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<td>Competence—ability to make the judgements necessary to apply IFRS</td>
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</table>
Framework-based approach for applying IFRS

- What are the economics of the phenomenon (e.g., transaction or event)?
- What information about that economic phenomenon would existing and potential investors/lenders/creditors that cannot demand information from the entity would find useful in making decisions about providing resources to the entity?
- Then consider the requirements specified in IFRS
- Develop accounting policy
- Make judgments and estimates to apply the requirements with rigor and consistency

Steps in the financial reporting ‘process’

1. Objective (what information about the economic phenomenon could inform decisions by investors and lenders about providing resources to the entity?)
2. Identification (is there an element, e.g., liability?)
3. Classification (if so, which IFRS, e.g., IAS 37?)
4. Recognition (when? what ‘unit of account’?)
5. Measurement at initial recognition (which measurement?)
6. Subsequent measurement (which measurement? If ‘choice’ which alternative?)
7. Derecognition (when?)
8. Presentation and disclosure
Economics and user needs (step 1)

What are the economics? And what information could inform resource allocation decisions?

- **Stage 1**: trade payables, bank loan
- **Stage 2**:
  - potential investor in a business that has assets largely funded through liabilities
  - bank lending officer deciding whether to renew a loan to a business
  - decision whether to sell goods on credit to a business
  - existing shareholder of a company sued by a customer

Elements (step 2)

**Asset**
- resource controlled by the entity...
- expected inflow of economic benefits

**Liability**
- present obligation...
- expected outflow of economic benefits

**Equity** = assets – liabilities

**Income**
- recognised increase in asset/decrease in liability in current reporting period
- that result in increased equity except...

**Expense**
- recognised decrease in asset/increase in liability in current period
- that result in decreased equity except...
Are the following liabilities?

**Stage 1:**
- trade payables
- long–term loan and interest accreted
- lawsuit
- rental income received in advance
- employee benefit

**Stage 2:**
- snow ski-resort operator’s ‘provisions’ in ‘good years’ to reverse in ‘bad years’
- ‘provision’ for doubtful debts
- ‘provision’ for self-insurance
- contracts with suppliers
- environmental rehabilitation
- dividends
- mandatorily redeemable, cumulative preference shares
- convertible bond
- long-service award
- levies
- pledges
- possible retrospective enactment of unforeseen new laws
- economic compulsion
Why classify assets and claims? (step 3)

• Information about the nature and amounts of a reporting entity’s economic resources and claims can help users to identify the reporting entity’s financial strengths and weaknesses.

• That information can help users to:
  – assess the reporting entity’s liquidity and solvency
  – its needs for additional financing and how successful it is likely to be in obtaining that financing. (CF.OB13)

Why classify claims?

• Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the reporting entity (CF.OB13)
Classifying liabilities

Which IFRS applies to the following liabilities?

Stage 1: if any, limit to three classifications of liability:
• financial liabilities;
• provisions; and
• contingent liabilities

Stage 2:
• court case
• restoration of contaminated environment
• lawsuit contaminated environment
• lease—lessee
• sick leave
• loan
• share appreciation rights
• forward contract
Recognition (step 4)

Stage 1: awareness only (ie, discuss only liabilities that obviously satisfy the recognition criteria)

Stage 2:

- Recognise a liability when
  - probable that benefits will flow from the entity
  - has cost or value that can measured reliably

What does probable mean?
The meaning of probable is determined at the standards level.

What does measure reliably mean?
Note: in many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.
Examples: liability recognition

Recognise the liability?
Stage 1:
• trade payable
• bank loan
• lawsuit

Examples: liability recognition

Recognise the liability?
Stage 2:
• warranties
• lease—lessee
• employee benefit
Measurement (steps 5 and 6)

- Measurement is the process of determining the monetary amounts at which the recognised elements are carried
- IFRS measurements are largely based on estimates, judgements and models
- Most IFRS measures require significant estimates and judgements

<table>
<thead>
<tr>
<th>LIABILITY TYPE</th>
<th>MEASUREMENT AT INITIAL RECOGNITION</th>
<th>SUBSEQUENT MEASUREMENT</th>
</tr>
</thead>
</table>
| IAS 12 Income Taxes | Deferred tax:  
  - use enacted/substantively enacted tax rates  
  - reflect the tax consequences that would follow from the manner in which the entity expects to settle the carrying amount  
  - no discounting |  |
| IAS 17 Leases | Operating lease—not recognised  
  Finance lease—lower of fair value of the leased property and PV of the minimum lease payments. | Operating lease—not recognised  
  Finance lease—amortised cost using the interest rate implicit in the lease. |
| IAS 19 Employee Benefits | 4 categories—3 specified measurement conventions | 4 categories—3 specified measurement conventions |
| IAS 37 Provisions, Contingent Liabilities and Contingent Assets | Best estimate of the expenditure required to settle the present obligation at the end of the reporting period. |  |
| IFRS 3 Business Combinations | Fair value | N/A—other IFRSs apply |
| IFRS 9 Financial Instruments | Fair value | It depends. Amortised cost (effective interest method), Fair value for derivatives + other financial liabilities in specified circumstances |
What does ‘best estimate’ mean?

The amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

<table>
<thead>
<tr>
<th>Probability</th>
<th>Cash flow estimate CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>40%</td>
<td>100</td>
</tr>
<tr>
<td>30%</td>
<td>200</td>
</tr>
<tr>
<td>30%</td>
<td>500</td>
</tr>
</tbody>
</table>
What does ‘best estimate’ mean?

Most likely outcome?

But what if:
- > 50% chance of higher cash flows?
- > 50% chance of lower cash flows?

Whatever amount feels ‘best’?

Expected value?
Average (mean) of range

Measuring expected value

Does expected value need accurate data about all outcomes?
Measuring expected value continued

- use any suitable technique for estimating average (mean) of range
- if identifying range of possible outcomes:
  - use same data as would use to identify most likely or median outcome
  - include everything you know
  - but don’t make up what you don’t know...

We have evidence that...
Most likely outcome is 100 currency units (cu)

We have no evidence that...
Distribution is other than normal (bell-shaped)

We would estimate expected value to be...
cu 100
### Measuring expected value continued

<table>
<thead>
<tr>
<th>Outcome</th>
<th>Estimated outflows</th>
<th>Relative likelihood</th>
</tr>
</thead>
<tbody>
<tr>
<td>Best case</td>
<td>cu 100</td>
<td></td>
</tr>
<tr>
<td>Most likely</td>
<td>cu 200</td>
<td>About twice as likely as</td>
</tr>
<tr>
<td>Worst case</td>
<td>cu 1,000</td>
<td>Unlikely, but possible</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Estimate of expected value</th>
</tr>
</thead>
<tbody>
<tr>
<td>cu 100 x 30% cu 30</td>
</tr>
<tr>
<td>cu 200 x 60% cu 120</td>
</tr>
<tr>
<td>cu 1,000 x 10% cu 100</td>
</tr>
<tr>
<td>cu 250</td>
</tr>
</tbody>
</table>

### Risk adjustments?

Do expected values take account of risk?
Expected values may need risk adjustments

- **Liability 1**
  - Probability | Outflows | Probability | Outflows
  - 100%        | CU 500    | 50%          | CU 250
  - 50%         | CU 750    | 50%          | CU 750

- Expected value is CU 500 for each asset
- But risk averse entity would demand more to assume liability 2

Risk adjustments continued

Does risk always increase discount rates?
Risk adjustments for liabilities

- risk aversion typically *increases* transaction prices for uncertain liabilities
- in which case, account for risk by:
  1. increasing estimates of cash outflows, or
  2. adjusting estimates of probabilities, or
  3. *reducing* rates at which cash outflows are discounted to present value, or
  4. adjusting the expected present value

Measuring at initial recognition

Question: what is the amount of the liability when first recognised?

Stage 1:
- trade payables
- lawsuit
- borrowing
Measuring at initial recognition

Question: what is the amount of the liability when first recognised?

Stage 2:
• deferred payment
• clean-up costs
• warranty
• lawsuit

Measuring after initial recognition

Question: what is the amount of the liability after initial recognition?

Stage 2:
• amortised cost—basic borrowing
• amortised cost—including transaction costs
• decommissioning liability
• use of a provision
• remeasurement of provision
• long-service award
Derecognition (step 7)

- Derecognition occurs when a recognised item is removed from the statement of financial position
- There is no explicit concept for derecognition in the *Conceptual Framework*. Consequently derecognition requirements are specified at the Standards level

Presentation (step 8a)

- Presentation: financial statements portray financial effects of transactions and events by:
  - grouping into broad classes (eg liability)
  - sub-classifying liabilities by their nature (eg separate provisions from financial liabilities) and into current and non-current
  - analysing provisions by class
  - **not offsetting** assets and liabilities (or income and expenses)
Disclosure (step 8b)

- Objective of financial reporting
- Notes provide narrative descriptions or disaggregations of items presented in ‘primary’ statements and information about items that do not qualify for recognition in those statements – the failure to recognise an item cannot be rectified by disclosure
- Application of IFRS with additional disclosures when necessary results in a fair presentation (faithful representation of transactions, events and conditions)

Thank you
DEVELOPMENT DRAFT Stage 3—Financial liabilities: TooBigToFail Bank case study
TooBigToFail Bank case study

Michael J C Wells, Director, IFRS Education Initiative, IFRS Foundation

This case study is a ‘work in process’. It will be revised following feedback and comments from people attending a series of workshops on the Framework-based approach to teaching International Financial Reporting Standards (IFRSs) organised by the IFRS Foundation and others. After revisions, the material will be available as an educational resource on the IFRS website.

Background

TooBigToFail Bank (TBTF) has equity and debt listed on the Artican Stock Exchange. Its functional currency is the Artican dollar (ART$).

TBTF’s debt is ART$ denominated. About half the listed debt TBTF issues is, when first recognised, deemed by TBTF to be at fair value through profit or loss. Mr Eden-Bro (Chief Financial Officer, TBTF) justifies this designation—to provide more relevant information to the primary users of TBTF’s financial information by avoiding ‘an accounting mismatch’. The designation is made irrevocably, at initial recognition, for particular financial liabilities issued by TBTF to be measured at fair value through profit or loss. Those debt instruments (financial liabilities measured at fair value), and other similar debt instruments issued by TBTF that are carried by TBTF at their amortised cost, are traded on the Artican Stock Exchange.

Rogue trader

On 29 December 20X1 a rogue trader (Mr P’Ariss) circumvents TBTF’s internal controls and enters TBTF into a number of highly risky derivative transactions. On 15 January 20X2 the unauthorised trades are detected and TBTF immediately closes out the resulting derivative positions at a loss of ART$20 billion.

In its 20X1 statement of comprehensive income TBTF invokes the fair presentation override so as to recognise the ART$20 billion loss in 20X1. On 31 December 20X1 the fair value of the unauthorised derivative instruments is an asset of ART$2 billion. However, Ms Eden-Bro cites the unauthorised actions of the rogue trader in 20X1 as the reason for invoking the fair presentation override to instead recognising a loss of ART$20 billion in its 20X1.

1 The names of individuals, entities and places in this case study are fictitious. Any resemblance to actual people, entities or places is purely coincidental.
Default and credit rating downgrade

The previously unforeseen losses arising from the unauthorised trades caused TBTF to contravene its regulatory capital requirements. In response to this on 20 January 20X2 TBTF’s credit rating was downgraded from AA (‘high credit-quality investment grade’) to BB (‘junk’ bond grade) and other financial institutions stop providing funds to TBTF. Consequently TBTF enters a liquidity crisis as a result of which, on 21 January 20X2, TBTF defaults on the redemption of its stock market traded fixed-rate mandatorily redeemable two-year debentures when they reached maturity.

On 21 January, following the announcement of the downgrade, TBTF market capitalisation fell by ART$50 billion.

In its financial statements for the quarter ended 31 March 20X2 TBTF reported as a result of the downgrading of its credit rating:

- ART$10 billion income—decrease in the fair value of debenture liabilities carried at fair value
- ART$8 billion expense—decrease in the fair value of assets carried at fair value
- ART$12 billion expense—asset impairment loss.

Some in the financial press immediately expressed the view that the recognition of the ART$10 billion gain on its debenture liability is the counterintuitive result of an ‘accounting gimmick’ which effectively halves TBTF’s reported impairment.

Own debt repurchase

On 10 April 20X2 TBTF pays ART$7 billion to repurchase TBTF exchange-listed fixed-rate debt when it carried that debt at its amortised cost—ART$10 billion. In its financial statements for the quarter ending 30 June 20X2 TBTF reports ART3 billion income on repurchasing this debt.

Part nationalisation

In early 2 August 20X2 a financial crisis takes hold in Artican. On 3 August, citing the national interest, the Artican government intervenes in the market to prevent TBTF from being liquidated—TBTF receives ART$100 billion in exchange for ordinary shares that provide the Artican government with a major share of the equity of TBTF.

On 3 August 20X0 the disgraced Mr Eden-Bro is dismissed by TBTF and Ms Fixit is appointed to ‘turn around’ the company.
### Some IFRS issues for class discussion

<table>
<thead>
<tr>
<th>Question</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does measuring debt at amortised cost or fair value provide financial information about TBTF that is more useful to primary users—existing and potential investors, lenders and other creditors—in making decisions about providing resources to TBTF?</td>
</tr>
<tr>
<td>Is it a counterintuitive ‘accounting gimmick’ that the downgrading of TBTF’s credit rating results in TBTF recognising income in the period of the downgrade?</td>
</tr>
<tr>
<td>Does TBTF’s use of the fair presentation override contravene IFRS?</td>
</tr>
</tbody>
</table>
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London, UK

Workshop B:
Stage 3—general hedge accounting IAS 39 and IFRS 9

Iwona Norwicka
Academic Fellow, Education Initiative
IASB
DEVELOPMENT DRAFT Stage 3–
General hedge accounting:
Flymecheaply Case Study
Flymecheaply Case Study

Iwona Nowicka, Academic Fellow, IFRS Education Initiative, IASB
Michael J C Wells, Director, IFRS Education Initiative, IASB

This case study is a ‘work in process’. It will be revised following feedback and comments from people attending a series of workshops on the Framework-based approach to teaching International Financial Reporting Standards (IFRS) organised by the IFRS Foundation and others. After revisions, the material will be available as an educational resource on the IFRS website.

In 20X0 Ms En Trepreneur founded Flymecheaply—a domestic commercial budget airline in Latrica. The company’s meteoric rise is well documented as one of the great successes of the Latrica’s recent economic reforms.

Early in 20X6 Obligit acquired 25 per cent of the equity and voting rights in Flymecheaply. In accordance with the rights its shareholding confers Obligit appointed Mr Big Shot to the Flymecheaply’s Management Board.

Flymecheaply’s functional currency is the Latrican dollar (L$). Its annual reporting period ends 31 December.

Jet fuel

Jet fuel is a significant and volatile cost of operating the airline. From 1 January 20X1 to 31 December 20X5 jet fuel as a proportion of total operating expenses fluctuated between 20–40 per cent—during the five year period jet fuel fluctuated between US$50.4 and US$159.6 per barrel with fluctuations for a 30 day period being as high as 31 per cent.

Before 20X6 Flymecheaply did not hedge its exposure to jet fuel volatility. En Trepreneur believes that hedging cannot save the entity any money in the long-run because “when you hedge all you do is bet against the experts of the oil market and pay the middle man”.

However, Mr Big Shot takes a different view—using a dynamic jet fuel price hedging strategy results in more stable cash flows and that would impact positively on Flymecheaply’s share price.

1 The names of individuals, companies and places in this case study are fictitious. Any resemblance to people or entities is purely coincidental.
2 Through its voting rights and the appointment of Mr Big Shot, Obligit exerts significant influence (but not control) over Flymecheaply.
3 This argument has been put forward by some in the airline industry, eg see AFX News article, *BA says fuel requirement 45% hedging in current year*, May 17, 2004 (as cited by Cobbs and Wolf, Jet Fuel Hedging Strategies: Options Available for Airlines and a Survey of Industry Practice, Finance – Spring 2004, p6)
After much discussion, in mid 20X6, management was persuaded by Mr Big Shot’s arguments and Flymecheaply adopted a hedging strategy to mitigate its exposure to increases in the US$ price of jet fuel. Since September 20X6 Flymecheaply uses forward contracts, futures and options to hedge price risk of jet fuel.

**Issues for class discussion**

What is an economic hedge?

What is hedge accounting? How does cash flow hedge accounting differ from fair value hedge accounting?

Why do some airlines hedge the price risk of jet fuel? What new risks, if any, does hedging the price of jet fuel expose airlines too?

Why do some entities enter into futures contracts?

Why do some entities enter into forward contracts?

Why do some entities enter into options?

What instruments can in accordance with each of IFRS 9 and IAS 39 be designated as hedging instruments? Why are there differences between the hedging instrument requirements of IAS 39 and IFRS 9?

What can (and what cannot) be designated as a hedged item in accordance with each of IFRS 9 and IAS 39? Why are there differences between the hedged item requirements of IAS 39 and IFRS 9?

How is hedge effectiveness assessed in accordance with each of IFRS 9 and IAS 39? Why are there differences between the hedge effectiveness assessments in accordance with IAS 39 and IFRS 9?

In accordance with each of IFRS 9 and IAS 39 can the designated hedge accounting relationship be changed? Why and under which circumstances in IFRS 9 did the IASB allow changes in the designated hedging relationship?

The multiple alternatives set out below describe different hedging strategies that Flymecheaply might consider following in accordance with:

- **IAS 39** *Financial Instruments: Recognition and Measurement*; and
- **IFRS 9** *Financial Instruments*.

Note: in all of the alternatives presented below Flymecheaply uses only collateralised derivatives. The cash flows of a derivative have to be discounted using interest rates that best approximates the fair value of the derivative, for the risk being hedged. In order to achieve it Flymecheaply uses the interest rates based on overnight indexed swap (OIS) rates.

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4 Most derivatives dealers now use interest rates based on overnight indexed swap (OIS) rates when valuing collateralized derivatives. Discounts factors used in the Flymecheaply case study should make the students sensitive to the importance of using a discount factor when calculating the fair value of the derivative.

The views expressed in this article are those of the authors and are not necessarily those of the IFRS Foundation or the IASB. Official positions of the IFRS Foundation and the IASB are determined only after extensive due process and deliberation.
The basics

The risk management strategy

Flymecheaply’s overall risk management strategy is to reduce the volatility in profit or loss. Consistently with this objective Flymecheaply hedges its forecasted jet fuel purchases using different types of contracts depending on market availability of appropriate derivatives.

On 1 October 20X6 Flymecheaply forecasts the purchase of 100,000 barrels of jet fuel that is expected to be contracted for when it is delivered on 31 March 20X7. The purchase price will be the market price (which is denominated in US$) at the date of purchase (31 March 20X6). Consequently, Flymecheaply is exposed to two main risks:

- jet fuel price risk—the risk that the US$ price of jet fuel will change before 31 March 20X7; and
- foreign currency exchange risk—the risk that the L$:US$ exchange rate will change before 31 March 20X7.

Alternative 1

The facts are the same as in the basics above except that in Alternative 1 the L$ is pegged to US$ (perfectly correlated) and therefore Flymecheaply is not exposed to a foreign currency exchange risk in the Alternative 1.

With a view to eliminating its exposure to jet fuel price risk, on 1 October 20X6 Flymecheaply enters into contract to ‘buy’ 100,000 barrels of jet fuel at a price fixed at US$ 60 per barrel (such contracts are commonly referred to as jet fuel commodity forward contracts). The contract expires on 31 March 20X7 and it must be settled net in cash.

The forward jet fuel prices in US$ per barrel on the relevant dates:

<table>
<thead>
<tr>
<th>Contract entered into on</th>
<th>Forward price to 31 March 20X7</th>
<th>Discount factor to 31 March 20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 October 20X6</td>
<td>60</td>
<td>0.985</td>
</tr>
<tr>
<td>31 December 20X6</td>
<td>65</td>
<td>0.991</td>
</tr>
<tr>
<td>31 March 20X7</td>
<td>70</td>
<td>0.994</td>
</tr>
</tbody>
</table>

---

5 The currency of the United States of America
6 In this alternative, essentially the risk is that Flymecheaply would “suffer loss” if the US$ denominated price of jet fuel increases before it purchases the jet fuel that is the subject of the highly probable transaction. Note: this risk also includes the possibility of Flymecheaply “gaining” from favourable US$ jet fuel price movements.

The views expressed in this article are those of the authors and are not necessarily those of the IFRS Foundation or the IASB. Official positions of the IFRS Foundation and the IASB are determined only after extensive due process and deliberation.
The forward price of US$ 60 per barrel is the current forward price for 31 March 20X7 prevailing on 1 October 20X6. Therefore Flymecheaply does not pay any premium for entering into the hedge. In other words, the contract has fair value of zero at the inception of the hedging relationship.

---

**Issues for class discussion**

**What is Flymecheaply’s hedging objective?**

Does the hedging relationship qualify for hedge accounting in accordance with each of IFRS 9 and IAS 39?

What type of hedge is this—a cash flow hedge or a fair value hedge?

Is the hedge likely to be effective? What, if anything, could cause ineffectiveness in the hedging relationship? When assessing effectiveness Flymecheaply compares changes in the hedging instrument to changes in the fair value of the hypothetical derivative.

On 31 December 20X6 and on 31 March 20X7:

- determine the fair value of the hedging instrument—commodity forward contract;
- determine the notional fair value of the hedged item—hypothetical derivative;
- measure the ineffectiveness in the hedging relationship, if any, in accordance with IAS 39 and IFRS 9; and
- prepare the journal entry to illustrate how Flymecheaply would account for the hedging relationship.

Explain differences, if any, between the hedge accounting in accordance with IFRS 9 and IAS 39?

---

**Alternative 2**

......

---

7 The hypothetical derivative approach is a simplification when assessing hedge effectiveness, particularly of cash flow hedges. The hypothetical derivative is a derivative whose changes in fair value offset perfectly the changes in fair value of the hedged item for variations in the risk being hedged. The changes in the fair value of both the hypothetical derivative and the hedging instrument are then used to test the hedge effectiveness and measure ineffectiveness.

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Alternative 3: risk components

The facts are the same as in the basics above except in Alternative 3 the LS is pegged to US$ (perfectly correlated) and therefore Flymecheaply is not exposed to a foreign currency exchange risk in the Alternative 3.

Flymecheaply believes that the price of jet fuel is derived from the prices of the various components that make up jet fuel. Crude oil is one of those components. Crude oil is actively traded and its market price is available. In order to hedge the price risk of the forecasted transaction to purchase 100,000 barrels of jet fuel, on 1 October 20X5, Flymecheaply enters into West Texas Intermediate (WTI) crude oil futures contract. Consequently, the underlyings for the hedged item and the hedging instrument are different. Because WTI crude oil futures contract and the development of the price of jet fuel are not sufficiently strongly correlated Flymecheaply decides to hedge only the crude oil component of jet fuel. The futures contract expires on 15 April 20X7 and it must be settled net in cash.

The futures jet fuel prices in US$ per barrel on the relevant dates:

<table>
<thead>
<tr>
<th>Contract entered into on</th>
<th>Futures price to 15 April 20X7</th>
<th>Discount factor to 15 April 20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 October 20X6</td>
<td>60</td>
<td>0.985</td>
</tr>
<tr>
<td>31 December 20X6</td>
<td>65</td>
<td>0.991</td>
</tr>
<tr>
<td>31 March 20X7</td>
<td>70</td>
<td>0.994</td>
</tr>
</tbody>
</table>

Fair values of the risk exposure being hedged, the highly probable purchase of jet fuel (hedged item), are as follows:

<table>
<thead>
<tr>
<th>Forecasted cash flow fair value</th>
<th>1 Oct 20X6</th>
<th>31 Dec 20X6</th>
<th>31 March 20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Crude oil component price to 31 March 20X7</td>
<td>49</td>
<td>54</td>
<td>59</td>
</tr>
<tr>
<td>Other components of jet fuel to 31 March 20X7</td>
<td>19</td>
<td>22</td>
<td>25</td>
</tr>
<tr>
<td>Entire price risk of jet fuel</td>
<td>68</td>
<td>76</td>
<td>84</td>
</tr>
<tr>
<td>Discount factor to 31 March 20X7</td>
<td>0.990</td>
<td>0.993</td>
<td>1.000</td>
</tr>
</tbody>
</table>

---

8 A commodity futures contract, eg crude oil futures contract, is an agreement to buy (or sell) a specified quantity of a commodity at a future date, at a price agreed upon when entering into the contract – the futures price. A futures contract is a standardized contract that is traded on a futures exchange....
Some questions for class discussion that are designed to foster an understanding of the ‘economics’ of jet fuel hedging.

**Why do airlines use different types of fuel (eg in Alternative 2 - WTI crude oil) derivatives to hedge the price risk of jet fuel?**

**Which risk arises from Flymecheaply using crude oil futures to hedge the price risk of jet fuel?**

**What accounting issues does Flymecheaply encounter when hedging a component of the forecasted purchase of jet fuel in accordance with the hedge accounting models specified in IAS 39 and IFRS 9?**

<table>
<thead>
<tr>
<th>Issues for class discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td>What is Flymecheaply’s hedging objective?</td>
</tr>
<tr>
<td>Does the hedging relationship qualify for hedge accounting in accordance with each of IFRS 9 and IAS 39?</td>
</tr>
<tr>
<td>What type of hedge is this—a cash flow hedge or a fair value hedge?</td>
</tr>
<tr>
<td>Is the hedge likely to be effective? What, if anything, could cause ineffectiveness in the hedging relationship? When assessing effectiveness Flymechply compares changes in the hedging instrument to changes in the fair value of the hypothetical derivative.</td>
</tr>
</tbody>
</table>

On 31 December 20X6 and on 31 March 20X7:

- determine the fair value of the hedging instrument—commodity futures contract;
- determine the notional fair value of the hedged item—hypothetical derivative;
- measure the ineffectiveness in the hedging relationship, if any, in accordance with IAS 39 and IFRS 9; and
- prepare the journal entry to illustrate how Flymecheaply would account for the hedging relationship.

Explain differences, if any, between the hedge accounting in accordance with IFRS 9 and IAS 39?
**Alternative 4: rebalancing**

The facts are the same as in the basics above, except that the L$ is pegged to US$ (perfectly correlated) and therefore *Flymecheaply* is not exposed to a foreign currency exchange risk in the Alternative 4.

*Flymecheaply* believes that the price of jet fuel is derived from the prices of the various components that make up jet fuel. Crude oil is one of those components. Crude oil is actively traded and its market price is available. In order to hedge the price risk of the forecasted transaction to purchase 100,000 barrels of jet fuel, on 1 October 20X5, *Flymecheaply* enters into West Texas Intermediate (WTI) crude oil futures contract.\(^9\) Even though the underlyings for the hedged item and the hedging instrument are different, in contrast to Alternative 3, *Flymecheaply* achieves hedge effectiveness at the inception of the hedge relationship. This because WTI crude oil futures contract and the development of the price of jet fuel sufficiently strongly correlates with each other. Although *Flymecheaply* is optimistic about the correlated development of the both underlyings in the future, it changes its risk management strategy in so far that it requests an adjustment of the hedged item or hedging instrument in cases of unexpected uncorrelated development of the underlyings. The process of adjusting the existing hedge relationship in future periods is known as rebalancing.\(^{10}\) To give effect to the strategy that triggers rebalancing the risk manager decided that such adjustment is necessary when ineffectiveness is outer the limits of 80 to 125 per cent range.

To simplify the case study it is assumed that the WTI crude oil futures contract prices in US$ (hedging instrument are the same as in Alternative 3.

The jet fuel fair value in US$ (hedged item) are as follows:

<table>
<thead>
<tr>
<th>Forecasted cash flow fair value</th>
<th>1 Oct 20X6</th>
<th>31 Dec 20X6</th>
<th>31 March 20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entire price risk of jet fuel</td>
<td>70</td>
<td>76</td>
<td>79</td>
</tr>
<tr>
<td>Discount factor to 31 March 20X7</td>
<td>0.990</td>
<td>0.993</td>
<td>1.000</td>
</tr>
</tbody>
</table>

In March 20X7, the price of jet fuel in Latrica rises unexpectedly to 84 per barrel. The price increase is caused through the punitive tax which the government of Latrica unexpectedly

\(^9\) A commodity futures contract, eg crude oil futures contract, is an agreement to buy (or sell) a specified quantity of a commodity at a future date, at a price agreed upon when entering into the contract – the futures price. A futures contract is a standardized contract that is traded on a futures exchange. For commodity futures the contract specifies the commodity itself, the size of the contract, quality of the assets as well as place and time of delivery.  
\(^{10}\) Rebalancing is a concept under IFRS 9 that allows an entity to adjust the hedged ratio of an existing hedge relationship. In fact, IFRS 9 requires rebalancing when there is a change in the economic relationship between the hedged item and the hedging instrument in case the original risk management objective remains unchanged.
imposes on the jet fuel. However, the prices for WTI crude oil remain stable. After the price increases Flymecheaply decides to increase the volume of the futures contract to 130,000 barrels.

Does the decision, that Flymecheaply made to increase the volume of the futures contract in an existing hedge relationship, meet the IAS 39 and IFRS 9 requirements? Is the decision in line with the Flymecheaply’s risk management strategy?

<table>
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<td>Is the hedge likely to be effective? What, if anything, could cause ineffectiveness in the hedging relationship? When assessing effectiveness Flymecheaply compares changes in the hedging instrument to changes in the fair value of the hypothetical derivative.</td>
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On 31 December 20X6 and on 31 March 20X7:
- determine the fair value of the hedging instrument—commodity futures contract;
- determine the notional fair value of the hedged item—hypothesical derivative;
- measure the ineffectiveness in the hedging relationship, if any, in accordance with IAS 39 and IFRS 9; and
- prepare the journal entry to illustrate how Flymecheaply would account for the hedging relationship.

Explain differences, if any, between the hedge accounting in accordance with IFRS 9 and IAS 39?
IASB staff day for IFRS Teachers

Tuesday 27 May 2014
London, UK

IASB staff update:
Conceptual Framework project

Rachel Knubley
Technical Principal
IASB
The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

Rachel Knubley, Technical Principal

Agenda

• Background on the project
• Measurement
Background

Why?

• Agenda consultation
  – Priority project

• Purpose of Conceptual Framework project
  – Not a fundamental rethink
  – Update, improve and fill in gaps (see next slide)
  – Focus on problems in the real world

• Purpose of the Discussion Paper
  – Starting point for discussion and outreach
  – Seek views on key issues from interested parties
Discussion Paper

Update

- Definitions
- Assets
- Liabilities
- Income
- Expenses
- Equity
- Recognition

Fill in the gaps

- Profit or loss/ other comprehensive income (OCI)
- Disclosure
- Derecognition
- Measurement

Suggested not to reopen chapters covering objective of financial reporting and qualitative characteristics (Chapters 1 & 3) that were finalised in 2010

What we heard: general comments

- Support to update the Conceptual Framework
- Support for many of the IASB’s preliminary views
- Some areas need more work (measurement, OCI)
- Some think that the IASB needs to reconsider some of the conclusions in Chapters 1 & 3:
  - Prudence, reliability, stewardship
- Timetable
  - Some support completion by end 2015
  - Others believe we should take more time, at least for some sections (eg measurement, OCI, liabilities/equity)
Overall strategy for ED

- Complete in a timely manner
  - But some areas (e.g., measurement, OCI) will be less developed than other areas

- Continue with scope
  - Updating, improving, and filling in the gaps
  - Address only financial statements

- Most areas, build on the suggestions in the Discussion Paper modified in the light of responses to the Discussion Paper
  - See next slide for measurement, OCI and liabilities/equity

Strategy for particular areas

**Measurement**
- Build on the proposals in the DP, modified in the light of feedback received, rather than undertaking further research work on measurement.

**Distinction between liabilities and equity**
- Keep the existing binary distinction of liabilities and equity, build on the feedback received on the DP.
- Not provide detailed guidance on how to distinguish liabilities from equity instruments.

**Distinction between profit or loss and OCI**
- Emphasise the role of profit or loss as the primary source of information about an entity's performance
- Provide high level guidance to the IASB on how it could use OCI
Timetable

18 Jul 2013
Issue DP
6-month comment period (14 Jan 2014)

March 2014
Feedback summary to the IASB

Q2-Q3 2014
Analysis of comments

Q4 2014
Issue ED

International Financial Reporting Standards

Measurement
Measurement categories

- Cost (adjusted for depreciation, impairment etc…)
- Current market prices (including fair value)
- Other cash-flow based measures

Cash-flow-based measurements

Factors

- Perspective (entity or market)

- Cash flows
- Variations in amount and timing
- Time value of money
- Risk premium
- Other factors (e.g., liquidity)
- Own credit (for a liability)

Also consider:
- Frequency of update
- Which factors
How to measure assets?

- Depending on how it contributes to future cash flows:
  - Using it in business operations to generate revenues or income
  - Selling it
  - Holding it for collection according to terms
  - Charging others for rights to use it

Examples for discussion

- Traded commodities eg gold or grain
- Finished goods held for sale (inventory)
- Factory building used for manufacturing
- Investment property held for rental income
- Receivable with insignificant variability in cash flows
- Receivable with significant variability in cash flows
- Valuable art work
Questions for those examples

1. How would you measure those assets:
   a) Initially?
   b) Subsequently?

2. If measuring using a cash-flow-based measurement, which factors would you update? Why?

3. Do you think more than one measure should be required for any of these assets?

Thank you
Annual improvements and interpretations:
Question and answer session with IFRS Interpretations
Committee staff

Michael Stewart
Director of Implementation Activities
IASB

Denise Durant
Technical Manager
IASB
The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

International Financial Reporting Standards

IFRS Interpretations Committee:
IASB staff Day for IFRS Teachers

IFRS Interpretations Committee staff
May 27 2014

Agenda

• Provide an overview of some of the work of the IFRS Interpretations Committee (the Committee):
  – Narrow scope amendment: *Clarification of Acceptable methods of Depreciation and Amortisation*
  – Classification of joint arrangements including the assessment of ‘other facts and circumstances’
  – Core inventories
Clarification of Acceptable Methods of Depreciation and Amortisation

Request for clarification

• Can an entity use a revenue-based method as a method of depreciation/amortisation?

What is a revenue-based method?

Revenue generated in an accounting period
Total revenue expected to be generated over the asset's useful life
Clarification of Acceptable Methods of Depreciation and Amortisation

IASB’s decision in IAS 16

• Prohibit a method that uses revenue generated from an activity that includes the use of the asset.

Rationale

• A revenue-based method does not reflect the pattern of consumption of future economic benefits embodied in asset. For example:
  – it includes expected changes in price (i.e. inflation)
  – is affected by other inputs and processes, selling activities and changes in sales volumes and prices.

Have you encountered this issue?
What is your experience?

Clarification of Acceptable Methods of Depreciation and Amortisation

IASB’s decision in IAS 38

• Revenue is presumed to be an inappropriate basis for measuring the consumption of the economic benefits embodied in an intangible asset.

• This presumption can be rebutted when:
  – the rights to the intangible asset is expressed as a measure of revenue; or
  – it can be demonstrated that revenue and the consumption of the economic benefits of the intangible asset are highly correlated.

Have you come across any such examples?
### Project status (Final amendments to IAS 16 and IAS 38)

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>December 2012 Exposure draft ED/2012/5</td>
</tr>
<tr>
<td></td>
<td>Redeliberations Q2 - Q3 2013</td>
</tr>
<tr>
<td>2014</td>
<td>Q2 2014 Final amendments to IAS 16 and IAS 38</td>
</tr>
<tr>
<td></td>
<td>Transition: Prospective</td>
</tr>
<tr>
<td></td>
<td>Effective date: 1 Jan 2016</td>
</tr>
<tr>
<td></td>
<td>Early application permitted</td>
</tr>
</tbody>
</table>

### Classification of joint arrangements

International Financial Reporting Standards
Classification of joint arrangements

Various implementation issues

• Many jurisdictions are in the second year of applying IFRS 11, with EU countries in the process of implementation this year

• Among several issues, the Committee identified and discussed the following priority issue:
  - How to assess ‘other facts and circumstances’ when classifying the joint arrangement
Classification of joint arrangements

IFRS 11 requirements (continued)

• The assessment of ‘other facts and circumstances’ is performed when the parties to the joint arrangement do not have ‘direct’ rights to the assets and ‘obligations’ for the liabilities, relating to the joint arrangement (ie the separate vehicle)

• If ‘other facts and circumstances’ indicate that the parties can be considered, in substance, to have such ‘direct’ rights and ‘direct’ obligations, the joint arrangement is classified as a joint operation

Classification of joint arrangements

Description of the issue

• What should be considered as ‘other facts and circumstances’?:
  − Should the assessment be based only on contractual (and legal) enforceable rights and obligations or should the assessment also take into account design, economic compulsion and business needs?
  − Would only the case in which the joint arrangement (ie the separate vehicle) sells its output to the parties to the joint arrangement result in the classification of a joint operation?
Classification of joint arrangements

Discussions to date

- The Committee took a narrow view of the assessment of ‘other facts and circumstances’: that focuses on contractual (and legal) enforceable rights and obligations

- Informal feedback from some stakeholders who are in the second year of applying IFRS 11 is consistent with the view of the Committee

Future discussions with the Committee

- Consideration of some common joint arrangement structures (so-called ‘project entities’)
  - Some real estate developers and construction companies think that their joint arrangement structures would be classified as a joint operation when applying the assessment of ‘other facts and circumstances’

1) The features of a ‘project entity’ include that: (a) the joint arrangement (ie the separate vehicle) delivers a single bespoke product or service to a single third party customer; and (b) the joint operators guarantee the completion of performance by the separate vehicle
Classification of joint arrangements

An example of ‘project entities’

• A question from a construction company was that:
  − The construction company undertook the same project in two countries, country A and country B. It structured the joint arrangement through a separate legal entity in country B, but not in country A. The joint arrangement was the same in both countries in all other respects.
  − Is it appropriate that the same joint arrangement is classified differently as a joint venture solely on the basis that the JA in Country B has a legal personality?

Questions to you

• Have you encountered this issue?
• What approaches have you observed to the assessment of ‘other facts and circumstances’?
Core inventories

Description of the issue

• Under which Standard (IAS 2 or IAS 16) should ‘core inventories’ be accounted for?

• Core inventories are assets that:
  – are physically identical to ‘ordinary’ inventories and as such qualify for recognition under IAS 2; and
  – are necessary to bring a PP&E item to its required operating condition and as such qualify for recognition as an element of the cost of that PP&E asset under IAS 16.
‘Core inventories’

Description of the issue (continued)

• Examples of core inventories are:
  – ‘base’ gas in a gas storage facility;
  – gas or oil fill in a pipeline;
  – permanent level of metal inventories in metal processing.

• Consequences for the valuation:
  – IAS 2: measured together with ‘ordinary’ inventories using FIFO or a weighted average cost formula; or
  – IAS 16 (cost model): measured at historical cost – results in the accounting treatment similar to that achieved using a LIFO cost formula.
‘Core inventories’

Status
• March 2014: IFRS IC tentatively decided to develop an interpretation on this issue.

Next steps
• IC: Developing and publishing a draft interpretation

Questions to you
• What is your experience of accounting for core inventories?
• What do you think should be the appropriate accounting for core inventories?
• How would you distinguish between what should be accounted for under IAS 2 and what under IAS 16?
Questions or comments?

Over to you...
IASB staff day for IFRS Teachers
Tuesday 27 May 2014
London, UK

Revenue recognition:
Questions and answer session with IASB staff

Henry Rees
Technical Director
IASB

Natasha Dara
Assistant Technical Manager
IASB
The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

International Financial Reporting Standards

Revenue Recognition

At a glance

- IFRS 15 *Revenue from Contracts with Customers*—issued May 2014
  - Joint Standard with FASB
  - Replaces IAS 18, IAS 11 and related Interpretations
- Framework for revenue recognition
- Effective date 1/1/2017, early application permitted
- Transition
  - Retrospective or
  - Cumulative effect at the date of application
- Revenue Transition Resource Group
Extensive due process

- December 2008
  - Discussion Paper
  - Preliminary Views on Revenue Recognition in Contracts with Customers
  - 211 comment letters

- June 2010
  - Exposure Draft
  - Revenue from Contracts with Customers
  - 974 comment letters

- November 2011
  - Revised Exposure Draft
  - Re-exposure of Revenue from Contracts with Customers
  - 358 comment letters

- May 2014
  - Final Standard (IFRS)
  - IFRS 15 Revenue from Contracts with Customers
  - Effective date: 1 Jan 2017

Scope

- All contracts with customers, except
  - Lease contracts
  - Insurance contracts
  - Financial instruments
  - Non-monetary exchanges in the same line of business to facilitate sales to customers
Main steps to apply Standard

1. Identify the contract with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognise revenue when (as) a performance obligation is satisfied

Step 1: Identify the contract

Existence of a contract
- Must meet specified criteria to apply the model, including
  - Probable will collect consideration

Combine contracts
- Negotiated as a package
- Linked consideration
- Goods or services form one performance obligation

Contract modifications
- Separate contract if add distinct goods/services at stand-alone selling price
- Prospective if remaining goods/services distinct
- Otherwise, cumulative catch-up
Step 2: Identify the performance obligations

Promise to transfer a distinct good or service

Customer can benefit from good or service

- On its own
- Together with other readily available goods or services (including goods or services previously acquired from entity)

Promised good or service is separable from other promises

- No significant service of integrating the good or service
- Good or service does not significantly modify or customise another good or service in the contract
- Good or service is not highly dependent on or interrelated with other goods or services

Step 3: Determine the transaction price

Amount of consideration to which entity expects to be entitled in exchange for goods or services

Variable consideration
Estimate using:
- Expected value
- Most likely amount but 'Constrained'

Significant financing
Adjust consideration if timing provides customer or entity with significant benefit of financing

Non-cash consideration
Measure at fair value unless cannot be reasonably estimated

Consideration payable to customer
Reduction of the TP unless in exchange for a distinct good or service
Step 3: Constraining variable consideration

Include estimate of variable consideration in the transaction price to extent it is [highly] probable a significant reversal of revenue will not occur when uncertainty is resolved

• Entity’s expectations of revenue reversal assessed using indicators, eg
  – Factors outside entity’s influence (market, 3rd-party actions)
  – Entity’s level of experience with similar types of contracts
  – Length of time before uncertainty resolved

Step 4: Allocate the transaction price

Allocate to each performance obligation the amount to which entity expects to be entitled in exchange for satisfying that performance obligation

• Relative standalone selling price basis
  – estimate selling prices if not observable
  – residual estimation techniques may be appropriate

• Discounts and contingent amounts allocated entirely to specific performance obligation if specified criteria met
Step 5: Recognise revenue when (as) a performance obligation is satisfied

Performance obligation is satisfied by transferring good or service

<table>
<thead>
<tr>
<th>Performance obligations satisfied over time if specified criteria met</th>
<th>All other performance obligations satisfied at a point in time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue is recognised by measuring progress towards complete satisfaction of the performance obligation</td>
<td></td>
</tr>
<tr>
<td>- Clarified units produced or delivered may be a reasonable proxy in some cases</td>
<td></td>
</tr>
<tr>
<td>- Clarified input methods may need to be adjusted (eg uninstalled materials)</td>
<td></td>
</tr>
<tr>
<td>Revenue is recognised at the point in time when the customer obtains control of the promised asset.</td>
<td></td>
</tr>
<tr>
<td>Indicators of control include:</td>
<td></td>
</tr>
<tr>
<td>- Present right to payment</td>
<td></td>
</tr>
<tr>
<td>- Legal title</td>
<td></td>
</tr>
<tr>
<td>- Physical possession</td>
<td></td>
</tr>
<tr>
<td>- Risks and rewards of ownership</td>
<td></td>
</tr>
<tr>
<td>- Customer acceptance</td>
<td></td>
</tr>
</tbody>
</table>

Step 5: Performance obligations satisfied over time

A performance obligation is satisfied over time (ie revenue recognised over time) if one of three criteria is met:

- The customer receives and consumes the benefits of the entity’s performance as the entity performs – assessed by considering (hypothetically) whether another entity would need to substantially re-perform the work completed to date if that other entity were to fulfil the remaining obligation
- The entity’s performance creates or enhances an asset (eg WIP) that the customer controls as the asset is created or enhanced
- The entity’s performance does not create an asset with an alternative use to the entity and the entity has a right to payment for performance completed to date, and it expects to fulfil the contract as promised
Disclosure requirements

- Disclosure workshops
- User needs
  - Preparer concerns
  - Clarifications and refinements to disclosure requirements

Disclosure requirements (continued)

**Disclosure objective:** To enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers

**Disaggregation of revenue**

- **Disaggregate revenue into categories that depict how revenue and cash flows affected by economic factors**
  - When determining categories, consider: other disclosures, information reviewed by chief operating decision maker and other information used by entity
  - Explain relationship with segment disclosures
### Disclosure requirements (continued)

#### Information about contract balances (formerly a reconciliation)

- *Opening and closing balances*
- *Amount of revenue recognised from contract liabilities*
- *Explanation of significant changes in contract balances*

#### Remaining performance obligations

- Disclose aggregate amount of the transaction price allocated to remaining performance obligations
- Quantitative or qualitative explanation of when amounts will be recognised as revenue

#### Interim requirements

<table>
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<tr>
<th>IASB</th>
<th>Disaggregation of revenue required in annual and interim financial statements; otherwise general principles of interim financial reporting apply</th>
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<td>All quantitative disclosures in annual and interim financial statements required</td>
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### Disclosure requirements (continued)

#### Significant judgements

- Methods used to recognise revenue and an explanation of why the methods used provide a faithful depiction (for performance obligations satisfied over time)
- Evaluating when a customer obtains control of promised goods or services (for performance obligations satisfied at a point in time)
- Methods, inputs and assumptions for
  - Determining the transaction price
  - Assessing whether estimates of variable consideration are constrained
  - Allocating the transaction price
  - Measuring obligations for returns, refunds and similar
Contract costs

Costs of obtaining a contract
Recognised as an asset if:
• Incremental
• Expected to be recovered
For example: Selling commissions

Costs of fulfilling a contract
Recognised as an asset if:
• Relate directly to a contract
• Relate to future performance
• Expected to be recovered
For example: Pre-contract or setup costs

Onerous contracts
Apply IAS 37

Implementation guidance: Licences

Step 2: Identify the performance obligation(s)

Is the licence distinct?

No
Account for bundle of goods and services

Yes
Applying criteria to determine whether nature of entity’s promise in granting licence is to provide:
• a right to access the entity’s intellectual property as it exists throughout the licence period (ie a performance obligation satisfied over time); or
• a right to use the entity’s intellectual property as it exists at the point in time at which the licence is granted (ie a performance obligation satisfied at a point in time)
Transition, effective date and early application

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*contracts not completed in prior years as determined under legacy revenue guidance

- Effective date: annual reporting periods beginning on or after 1 January 2017
- Early application permitted (IFRS only)

Revenue Transition Resource Group

- New, limited life, joint group with FASB
- Public discussion to support transition to new Standard
- Inform IASB and FASB about application issues & help boards determine if/what action required
- Will not issue authoritative guidance
- Likely comprise 11 preparers, 7 auditors, 2 users plus observers (including regulators)
  - Preparers drawn from a variety of regions and industries
  - Auditors mix of IFRS experts and US GAAP experts
- More details to be announced…
IASB staff day for IFRS Teachers
Tuesday 27 May 2014
London, UK

Financial instruments standards and IASB projects:
Questions and answer session with IASB staff

Kumar Dasgupta
Technical Director
IASB

Riana Wiesner
Senior Technical Manager
IASB

Yulia Feygina
Senior Technical Manager
IASB
The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

International Financial Reporting Standards

IFRS 9
Financial Instruments

A unified Standard to improve reliability in accounting for financial instruments

**Classification and measurement**
A logical, single classification approach driven by characteristics of instrument and how it’s managed

**Impairment**
An urgently needed and strongly supported forward-looking ‘expected loss’ model

**Hedge accounting**
An improved and widely welcomed model that aligns accounting with risk management
When will IFRS 9 be effective?

Annual periods beginning on or after 1 January 2018

- A mandatory effective date consistent with stakeholder requests (a 3-year lead time)
- Entities permitted to early apply the completed version of IFRS 9
- Previous versions of IFRS 9 phased out:
  - Not permitted to early apply a previous version if date of initial application is more than 6 months after completed IFRS 9 is issued
- ‘Own credit’ requirements have been available for early application since the publication of IFRS 9 (2013)
The IFRS 9 classification model

Cash flows are solely payments of principal and interest (P&I)

- Business model is held to collect
- Business model is held to collect and sell
- Other business models

Other types of cash flows

- Amortised cost
- FVOCI
- FVPL

Limited Amendments to IFRS 9

- Defined category
- Better reflects how financial assets are actually managed
  - Business model that involves both collecting contractual cash flows and selling financial assets
- Addresses potential accounting mismatches due to interaction with accounting for insurance contract liabilities
- Provides fair value and amortised cost information
- Supported by the majority of respondents, including users
Limited Amendments to IFRS 9

- Clarified the principal and interest concept so that a broader range of instruments are eligible for amortised cost
  - More aligned with what constituents view as ‘simple instruments’
- Exception for instruments with regulated rates to be eligible for amortised cost measurement
  - Particularly important in some jurisdictions, eg France and China
- Simplified the test for assessing a modified economic relationship
  - Now ‘significant’ rather than ‘insignificant’ difference in contractual cash flows compared to benchmark

Financial liabilities – ‘own credit’
designated under fair value option (FVO)

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<th>Financial statements – IFRS 9</th>
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<td><strong>Balance sheet</strong></td>
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<td>Financial liabilities – FVO</td>
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* Not recycled

- Otherwise, **P&L gain when ‘own credit’ deteriorates**, loss when it improves
- **Limited amendments propose** allowing the ‘own credit’ requirements to be applied before the rest of IFRS 9
- **Required by IFRS 9** for liabilities under the FVO
Expected Credit Losses

Objectives of the new impairment model

- Recognise lifetime expected credit losses for all significant increases in credit risk – individual or collective
- Incorporate forward-looking information
- Use reasonable and supportable information that is available without undue cost or effort
- Reflects the economics of expected credit losses in affordable way
- Single model to apply for all financial instruments not measured at FVPL
- Enhanced presentation and disclosures