

Completing our work to reform financial instruments accounting

[Sir David Tweedie](#), Chairman of the International Accounting Standards Board (IASB), provides an update on what has been achieved, as well as the work ahead of the IASB.



The reform of financial instruments accounting is one of the most important and complex projects the Board is undertaking. The project was accelerated at the request of the G20 and others, and good progress has been made in a short period of time.

General approach

The Board is acutely aware of the importance of this project, and the need to work in close co-operation with those responsible for other aspects of the global financial system (such as regulators, policymakers and other interested parties). At each stage, the IASB has sought to consult widely, to consider this input as part of the Board's deliberations, and to feed back to respondents how their views were considered and the rationale for the decisions taken by the Board. The condensed timetable has meant that aspects of the IASB's work have needed to be developed in real time, with levels of consultation far in excess of that required by the Board's formal due process. This more intense form of consultation has been very well received by interested parties – so much so that the IASB is in the process of applying this approach to other important projects.

Project phasing

Responding to requests from the G20 and others to address urgent issues, whilst also undertaking a comprehensive overhaul of the accounting for financial instruments, the IASB split the project to replace [IAS 39 *Financial Instruments: Recognition and Measurement*](#) into three phases. Once completed, each will be incorporated into a new financial instruments accounting standard known as IFRS 9 *Financial Instruments*. IAS 39 will have been replaced in its entirety once the third and final stage of the project has been completed.

[Phase one](#) – classification and measurement, completed

Financial assets: In November 2009 the Board concluded its work related to the classification and measurement of financial assets, reducing the number of measurement methods to two, with principle-based criteria for determining which measurement method to apply. This simplified approach significantly reduces complexity and improves comparability between entities.

Financial liabilities: The Board finalised its work related to the classification and measurement of financial liabilities in October 2010. In response to consistent feedback that the accounting for financial liabilities worked well, except for the so-called 'own credit' issue, the IASB took the pragmatic approach of not changing the existing accounting requirements for financial liabilities (transferring them to IFRS 9). The new requirements address the 'own credit' issue, whereby an entity experiencing financial difficulty is able to book a profit in the income statement on the grounds of its theoretical ability to buy back its own debt at a

reduced level. Own credit gains must now be presented directly in Other Comprehensive Income for liabilities that an entity chooses to measure at fair value. This reduces volatility in the income statement caused by changes in an entity's own credit quality.

Phase two – impairment of financial assets, ongoing

In June 2009 the Board published a Request for Information regarding the feasibility of implementing an expected loss impairment model. This was followed by an exposure draft issued in November 2009, which proposed moving from an incurred loss to a more forward-looking expected loss impairment model. During the financial crisis some felt that under the incurred loss model financial institutions had been too slow to recognise potential impairments. Accordingly, the Board proposed moving to an expected loss model that is designed to better reflect the economics of the way a financial institution manages its loan book and that results in the earlier recognition of impairment.

Recognising the significant operational challenges in moving to an expected loss approach, the Board allowed an eight-month comment period and appointed an Expert Advisory Panel (EAP) comprising risk experts from large financial institutions and other interested parties. The EAP was tasked with providing advice to the Board about the operational implications of the exposure draft.

As a result of information received during the consultation and the input of the EAP, the Board has been discussing modifications to the expected loss model to address operational concerns for open portfolios. The Board expects to obtain further public comment on this revised model for open portfolios, and plans to complete the impairment phase of the project to replace IAS 39 by June 2011.

Phase three – hedge accounting, ongoing

The third and final phase of the project deals with the complex area of hedge accounting. The current requirements under IAS 39 are heavily rule-based and difficult to apply. In many cases, particularly for corporates hedging non-financial exposures, the way hedge accounting is applied is inconsistent with risk management activities, making it very difficult for entities to reflect properly their risk management activities in their financial statements. In turn, this makes it very difficult for investors to understand entities' risk management activities without resorting to information outside the financial statements.

The Board has, therefore, undertaken a fundamental review of the hedge accounting rules and expect to publish an exposure draft for public comment before the end of the year proposing a new general hedge accounting model. This model should enable entities, particularly non-financial companies, to reflect their risk management activities more properly, resulting in a material improvement over the present situation.

The Board is continuing to discuss macro or portfolio hedge accounting. Feedback on the general hedge accounting model will inform the Board as it develops an approach for the more complex area of portfolio hedge accounting.

Convergence with US GAAP

The Board and the US Financial Accounting Standards Board (FASB) continue to work in close co-operation to improve IFRSs and US GAAP, and to achieve their convergence. As part of this work, the two boards are seeking to improve comparability internationally in the accounting for financial instruments.

In May 2010 the FASB published an exposure draft on accounting for financial instruments that addressed classification and measurement of financial assets and financial liabilities, impairment and hedge accounting. The FASB's proposal would have resulted in many more financial instruments being measured at fair value than under IFRS 9. The Board is committed to a mixed measurement model where some financial instruments are measured at amortised cost and some are measured at fair value. Once the FASB has determined how it will classify financial instruments the two boards will consider any remaining differences between their models and decide what steps, if any, should be taken to assist investors and other users of financial statements to reconcile those differences such as through presentation and disclosures.

The boards have begun jointly discussing impairment accounting with an objective of achieving a common solution, if possible.

The boards have also been discussing how to address the way a company reporting under IFRSs can have a significantly larger balance sheet than that reported under US GAAP because of differences in the circumstances when financial assets and liabilities (particularly derivatives) are allowed or required to be offset against one another (known as netting). This is an area that the Financial Stability Board and the Basel Committee have asked the boards to jointly address. The boards hope to determine a common approach to netting that would be jointly exposed for comment, and aim to finish this project by the middle of 2011.

Effective dates

The first phase of IFRS 9 was introduced with an effective date of January 2013 with early application permitted. The Board had always indicated that this date might need to be reviewed (with the potential for a deferral in mandatory application) depending on the timing of its insurance project and the impairment phase of the project to replace IAS 39. In addition, the Board and the FASB are currently seeking views on whether and how to introduce major projects resulting from their convergence programme. The result of this consultation exercise will also inform the boards in determining whether the effective date for IFRS 9 should be changed and the appropriate approach to transition for the impairment and hedge accounting phases.

Conclusion

Financial instruments accounting was ripe for improvement. IAS 39 was inherited from the IASB's predecessor body, and I have often said that if you understand it, you haven't read it properly.

Tinkering with the standard would only have served to increase complexity. Sometimes only a clean sheet of paper will do.

The development of IFRS 9 has been a collaborative effort. The Board and its staff have undertaken an effort of Herculean proportions to ensure that all views are sought and listened to, and the IASB's work has been subject to rigorous public scrutiny and extensive debate.

The decisions the Board has taken may not be universally supported. Many issues that have been considered have no obvious, clear-cut answer. The IASB has sought to weigh up the various arguments, seek input and ultimately apply professional judgement in deciding how to proceed.

On balance, I believe that the development of IFRS 9 has shown how 21st century standard-setting should be done, and the legacy of the project will be a high quality, principle-based standard that provides increased, useful information for investors and other users of financial statements.