

# *IFRS Foundation*

# **Special Interest Session**

## ***IFRSs for Financial Instruments***

28 July 2010— Mandarin Oriental Hotel (Tokyo)

*To provide a comprehensive service for those with a special interest in the accounting and reporting for financial instruments the*

*IFRS Foundation will hold an intensive half-day session immediately before their IFRS conference, on the morning of 28 July 2010.*

*The session will focus on accounting and reporting financial instruments in accordance with IFRS 9 Financial Instruments and on the IASB's current active projects to replace IAS 39 Financial Instruments: Recognition and Measurement.*

### ***Programme***

09:00 ***Registration***

09:30 ***Introduction***

**Warren McGregor**

*Member*

**IASB**

09:35 ***IFRS 9***

An overview of the requirements—Ian Farrar, *Partner, Accounting Consulting Services, PwC*

10:30 ***Replacing IAS 39***

- Impairment of financial assets—Wayne Upton, *Director of International Activities, IASB*
- Hedge accounting—Wayne Upton, *Director of International Activities, IASB*

11:25 ***Round-table Q&A***

- Ian Farrar—*Partner, Accounting Consulting Services, PwC*
- Wayne Upton—*Director of International Activities, IASB*
- Warren McGregor—*Member, IASB*

11:55 ***Concluding comments***

**Warren McGregor**

*Member*

**IASB**





# Financial instruments

Replacing IAS 39

Wayne Upton, Director of International Activities, IASB

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## Timetable

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FASB ED covers all phases	Phases	Due process documents	Finalisation
	1. Classification and measurement	IFRS 9 published on 12 Nov 2009  ED on financial liabilities published on 11 May 2010	In time for year end financial statements 2009 for financial <u>assets</u>  During 2010 for financial <u>liabilities</u>
	2. Impairment methodology	ED published in November 2009 Comments due by 30 June 2010	Expected during 2010
	3. Hedge accounting	ED expected Q3 2010	Expected during H1 2011



# Phase I: Classification and measurement

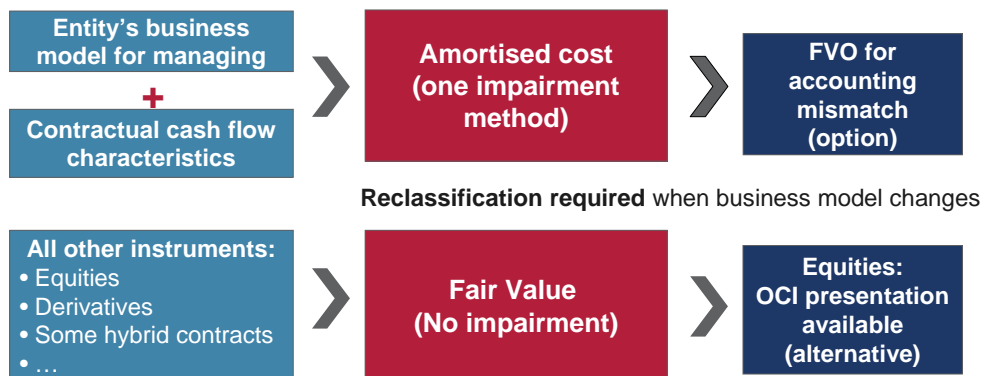
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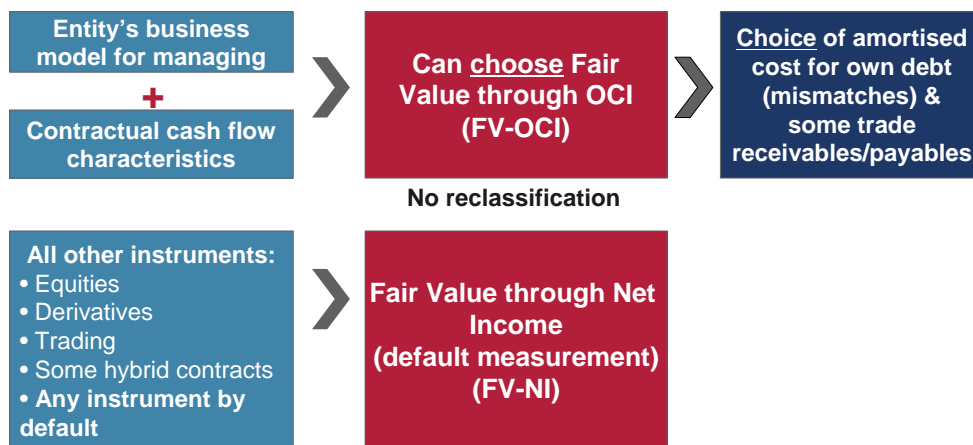
## Overview of classification model - IFRS 9 *for financial assets only*

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## Overview of FASB proposal (financial assets and financial liabilities)

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## Impact of FASB's FV-OCI classification on net income

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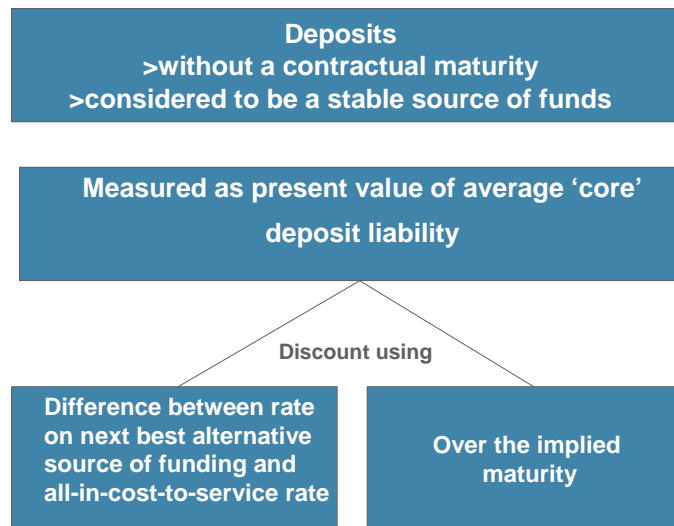
**If an entity meets the business strategy and contractual cash flow criteria they can irrevocably *elect* FV-OCI**



- Any residual change in fair value goes to OCI
- Realised gains/losses are recycled

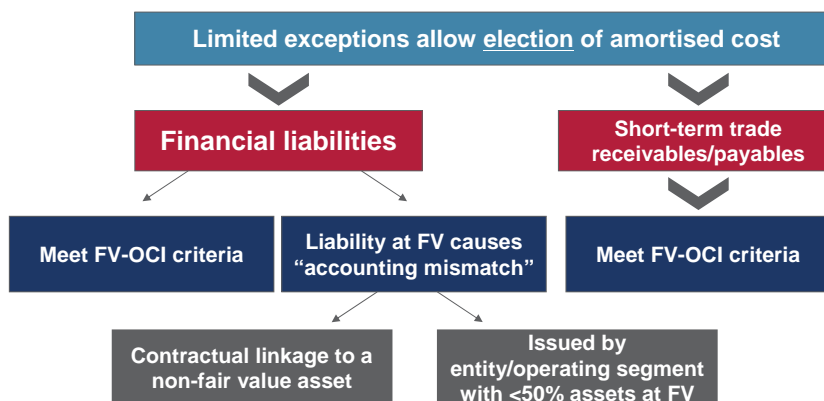
## FASB - Core deposits

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## FASB - Amortised cost

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## FASB - Presentation in Statement of Financial Position

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- FV-OCI and FV-NI items presented separately
- For FV-NI items only present fair value amounts and also amortised cost for own debt
- FV-OCI assets presented as follows:

– Cost/Amortised cost	XXX
– Allowance for credit losses	( XX)
– Residual FV adjustment	<u> X</u>
Fair value	<u>XXX</u>
- FV-OCI liabilities as above but without impairment



## Presentation in Statement of Financial Position - continued

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- Capital could be presented as follows:

Common stock	XXX
Retained earnings	XXX
AOCI, excluding FV changes	<u>XXX</u>
Equity excluding fair value changes	YYY
Fair value changes for instruments	<u>(XX)</u>
Total comprehensive equity	<u>ZZZ</u>



## Key differences between IASB and FASB

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- **FV-NI is the default under the FASB ED**
- **But generally impact on net income/P&L should be similar\* for financial assets under the IFRS model and the FASB proposals**

Topic	FASB ED	IASB Approach
Loans and debt securities (assets) meeting criteria	May elect FV-OCI	Required to be at amortised cost (subject to FVO)
Equity investments	FV-NI	FV but, if not held for trading OCI election available
Financial liabilities	For financial institutions most at FV and <i>many FV-NI</i> (symmetrical model)	Retains IAS 39, except for presentation changes for FVO so <b>most financial liabilities at amortised cost or bifurcated</b>
Core deposits	'Remeasurement value'	Redemption amount

\*Differences will however arise due to differences in impairment proposals



International Financial Reporting Standards

## Phase I: Classification and measurement (financial liabilities)

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## Financial liabilities – background

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### Feedback on ED:

- Financial liabilities 'not broken'
- Financial liabilities less urgent
- Need to address 'own credit'



### Excluded financial liabilities from the scope of IFRS 9 for 2009 year ends

To seek input on best way to address 'own credit'

## Outreach activities

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- Five alternative approaches to the own credit problem explored
- Staff and Board members met with:
  - Regulators
  - Preparers
  - Users (including a user survey)
  - Audit firms
  - Our FIWG
- Focussed on practical issues in separating own credit and which solution would provide the most useful information

## Results of outreach

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Preparers	'Own credit' hard to separate
	Bifurcation of liabilities means don't have to deal with complexity of identifying own credit
Users	Liabilities viewed differently to assets – symmetry not useful
	P&L volatility from own credit not useful
	Do not invent new measurement method: If remeasured prefer full fair value measurement on B/S
	Bifurcation for liabilities helps address own credit concerns
Overall	No consensus

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## Tentative decisions

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### To address 'own credit risk' :

- Retain IAS 39 measurement requirements for financial liabilities:
  - held for trading → fair value through P&L
  - hybrid liabilities → bifurcation requirements in IAS 39
  - 'vanilla' liabilities → amortised cost
  - maintain FVO (with current eligibility conditions)

#### BUT

- Separate out 'own credit risk' for FVO
- 'Own credit risk' portion would be separated in a manner similar to that used in IFRS 7 for disclosure (IFRS 7 B4)

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## FVO proposals

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Profit or Loss (liabilities under FVO)	
Total change in FV	XX
Change in FV due to 'own credit'	(X)
Profit for the year	XXX

Financial liability on balance sheet at (full) fair value

Statement of Comprehensive Income (liabilities under FVO)	
<i>Other Comprehensive Income:</i>	
Change in FV due to 'own credit'*	X

\* Not recycled



## Why this approach?

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- Five alternatives explored during outreach. No consensus as to 'best' approach.
- Minimise disruption
  - Most entities bifurcate and will likely continue
  - Bifurcation method: IAS 39 similar outcomes to IFRS 9
- But addresses 'own credit'
  - Separate 'own credit' only if use FVO
  - Have to do that today for disclosure purposes



## Next steps

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- Exposure draft: May 2010
- Comment Deadline: **16 July 2010**
- Final Standard: 2010

## FASB approach to own credit in ED

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- For *all* financial liabilities at fair value recognise separately in net income (for FV-NI) or in OCI (for FV-OCI)
- Includes gains and losses **only due to changes in credit standing** – not due to the effect of changes in the price of credit.

## Phase II: Impairment

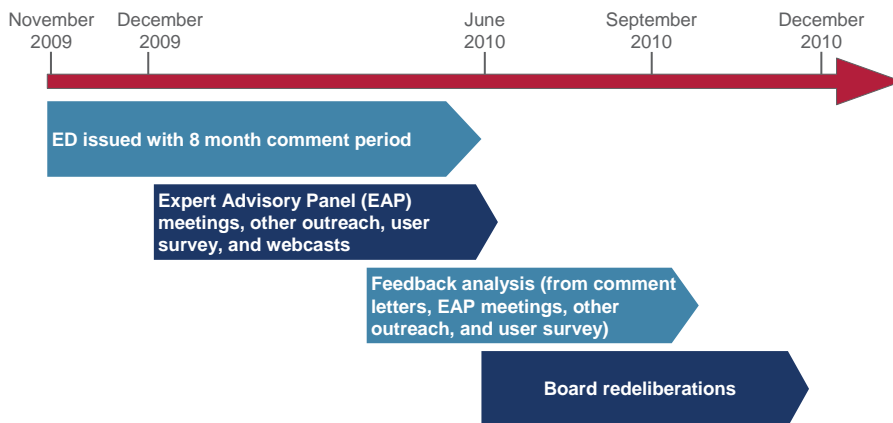
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## Impairment of financial assets

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## Expert Advisory Panel

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- What is it for?
  - To consider how to address operational challenges
- Who is on it?
  - Credit and risk experts from different regions and sectors
- How does it work?
  - Public meetings
  - Formed: Dec 2009 Ended: June 2010
  - EAP subgroups
    - Cash flow estimates
    - Effective interest method



## Major operational issues – decoupling

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### Major operational issue #1:

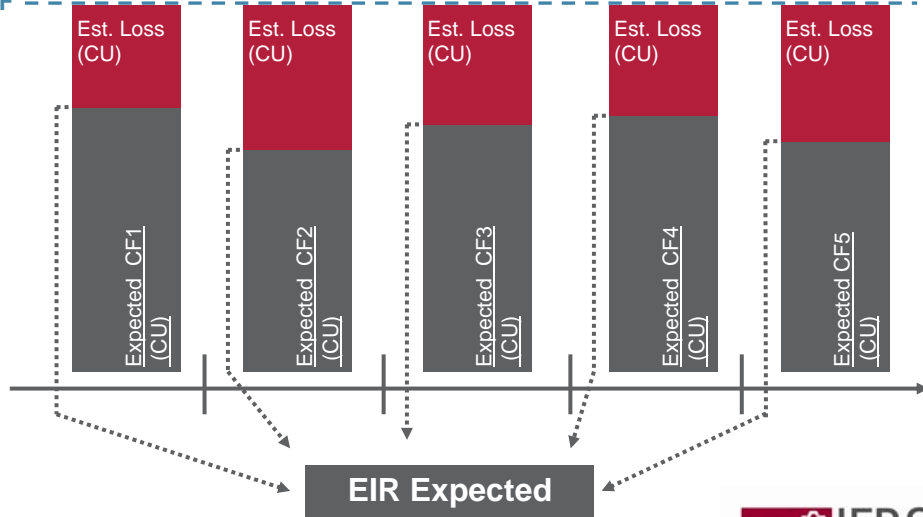
- Allocation of initial expected losses (EL)
  - ED requires allocating the *initial* EL estimate over the expected life of the financial asset
  - Allocation mechanism: the (credit cost adjusted) effective interest rate (EIR)
- Potential simplification: ‘decoupling’ of interest and credit loss calculations



## Deriving expected cash flows

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Contractual  
CF



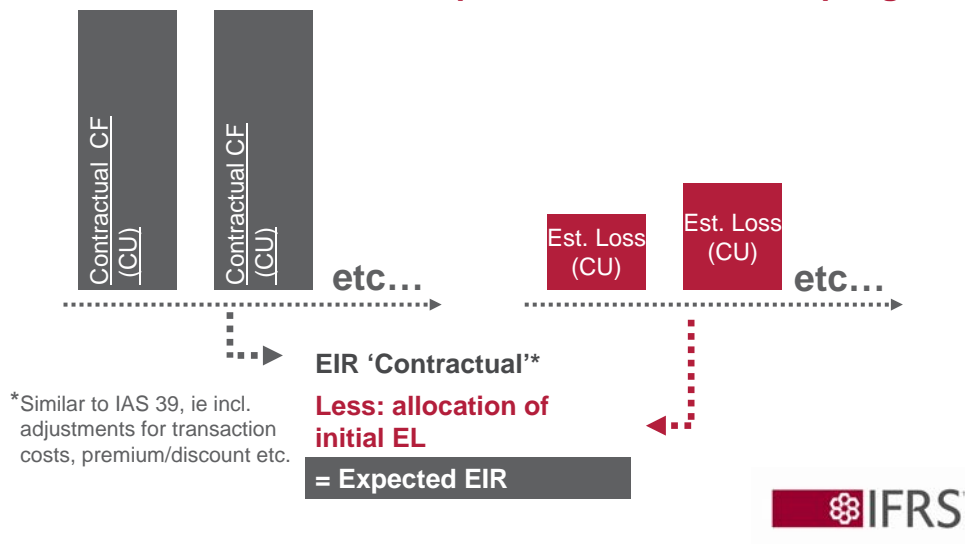
## Organisational and IT structure

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Infrastructure separates accounting (interest rate) systems and credit risk systems



## Allocation of initial expected losses – ‘decoupling’



## Different ways of decoupling

- Use separate DCF calculation for the initial EL that is allocated over the life of the instrument by converting the PV of the EL into an annuity
- Disaggregating the calculation of allowance account into three building blocks:
  - initial expected loss
  - experience adjustment
  - adjustment for changes in expectations for the remaining life of the instrument

## Major operational issues – lifetime EL

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### Major operational issue #2:

- Estimating lifetime expected loss
  - Consider and use best available information
  - Based on historical information adjusted for management expectations of future conditions and likely changes in the portfolio
  - Basel II EL can be used as one possible starting point but would require adjustments
  - Reasonable estimates over 1 to 3 years, then revert to long term average loss rate



## Open portfolios

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### Major operational issue outstanding:

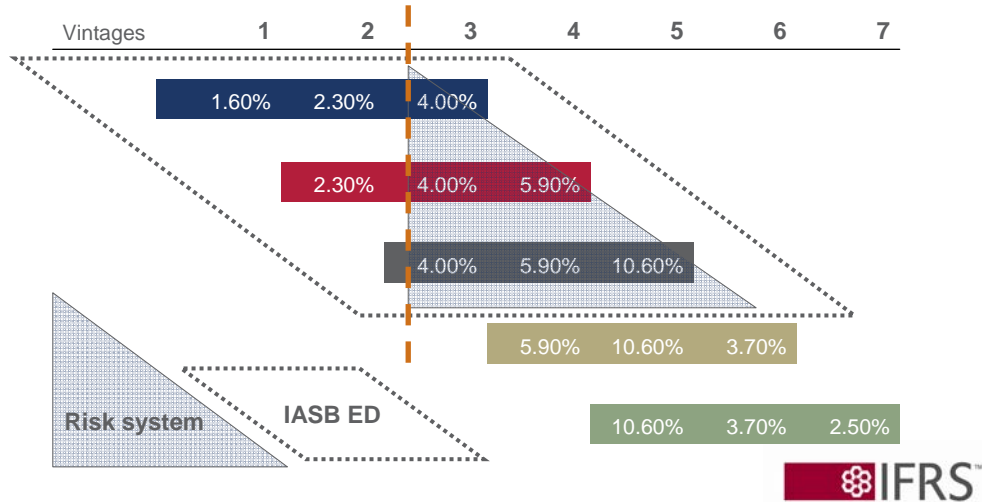
- Application of impairment model to open portfolios
  - Significant operational challenges
  - ED would require carrying forward historical information from date of initial recognition (initial EL or EIR)
  - Most financial institutions only have forward looking information
  - Hard to differentiate whether the revision of expected loss relates to:
    - loans already in the portfolio (→ catch up adjustment)
    - new loans (→ initial EL recognised over life of instrument)



## Open portfolios (cont'd)

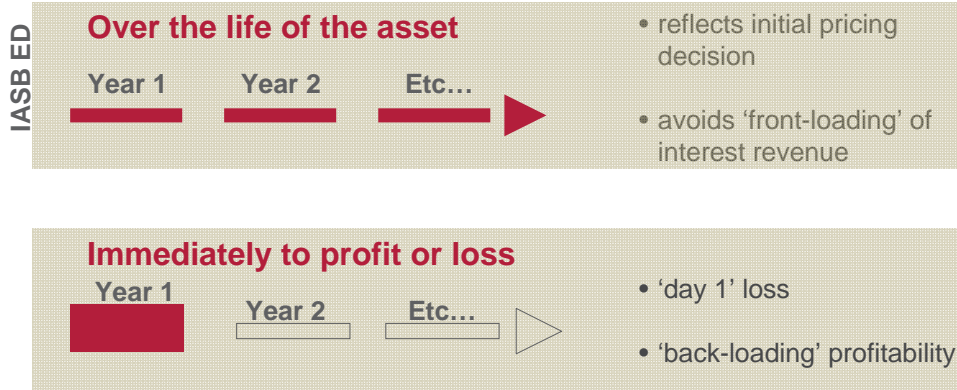
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### Open portfolios vs closed portfolios



## Recognition of the initial expected loss

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## Subsequent changes of estimates

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### Over the life of the asset

Year 1    Year 2    Etc...

- could result in a rate below risk free (even negative)
- counter-intuitive: lower discount rate for a higher risk asset

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### Immediately to profit or loss

Year 1    Year 2    Etc...

- reflects change in credit quality
- carrying amount is always the PV of the current ECF discounted at the (original) effective interest rate
- change in estimates that reflect gains or losses are not allowed to be deferred (other IFRSs)



## FASB ED - Impairment

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- **Applies to FV-OCI and trade receivables at amortised cost**
- Estimate cash flows **based on past and current conditions**
- Losses do not need to be probable to be recognised
- Can evaluate on an individual or pool basis
- Treatment of initial expected future losses different to IASB
- Interest income calculated using effective interest rate *unadjusted for losses* but applied to carrying amount net of allowance for credit losses
- Allowance consists of credit impairments PLUS excess of interest received over interest income accrued



## Phase III: Hedge accounting

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## Introduction

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- The Board is considering hedge accounting **comprehensively**
- **Overall approach:**
  - Use existing architecture
  - Address specific problem areas
  - Use clear and explicit principles
  - Identify any exceptions clearly

## Hedge Accounting – broad direction

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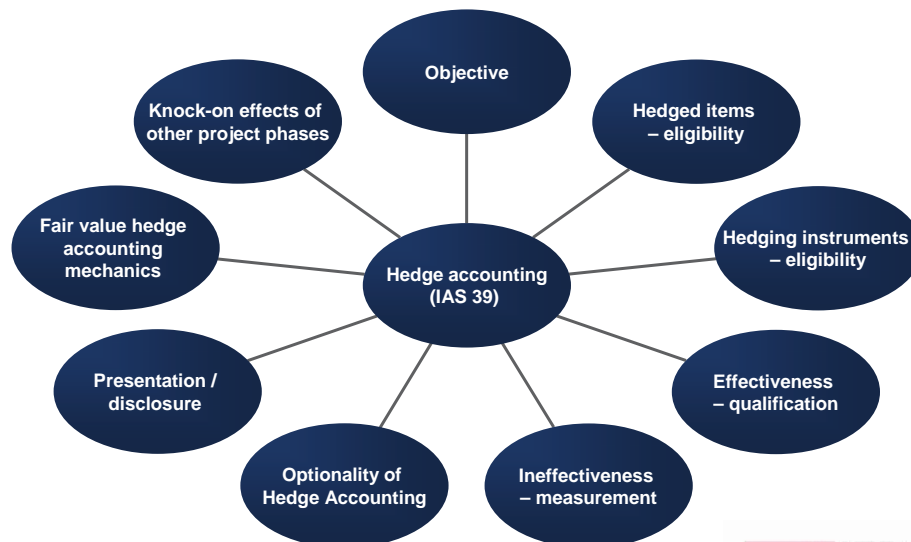
- **Phased approach:**

- general hedge accounting first
  - modification of fair value hedge accounting
  - simplification of cash flow hedge accounting mechanics
- against the background of the general approach consider:
  - portfolio hedge accounting

This project will not look at hedge accounting for hedges of net investments in foreign operations

## Components of the hedge accounting model

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## Tentative approach to hedge accounting

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IAS 39

Fair value hedge accounting

Cash flow hedge accounting

Simplifications to existing  
hedge accounting  
requirements

Fair value hedge

Cash flow hedge

Cash flow hedge accounting mechanics

- Gains/losses on effective portion in OCI
- Any ineffectiveness recognised in P/L
- Hedged item is not remeasured
- Lower of test is not used for fair value hedges
- Items measured at amortised cost eligible as hedged items

## Next steps...

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- Continue deliberations
- Exposure draft expected in Q3 2010
- Continued outreach
- IFRS in Q2 of 2011

## FASB ED - Hedge accounting

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- Qualitative test to demonstrate that the hedging instrument would be *reasonably effective* in offsetting changes in the hedged item or forecasted transaction
- Bifurcation by risk (benchmark interest rate risk, foreign currency and credit risk) allowed for financial items
- All ineffectiveness associated with the hedged risk recognised in net income
- Only reassess if circumstances suggest a change
- Can only discontinue if criteria no longer met or instrument expires, is sold, terminated or exercised



## Questions or comments?

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Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.

