Australian Financial Reporting Council

December 2008 Report to joint IASB/FASB Roundtable on Global Credit Crisis

The Financial Reporting Council of Australia has commissioned this report for the joint IASB/FASB Roundtable on the Global Financial Crisis, to be held in Japan on 3 December 2008. The report identifies accounting issues emerging from the global crisis that are significant for Australian Authorised Deposit-taking Institutions (ADIs), as well as providing potential solutions to the issues, and whether each issue requires urgent action or can be considered over a more normal time frame.

In April 2008, the Financial Stability Forum published a report that made recommendations for enhancing the resilience of markets and financial institutions. Three recommendations related to enhancement to financial reporting, and the IASB has responded to each of these recommendations. The recommendations are summarised as:

- Improvements to the accounting and disclosure standards for off balance sheet vehicles;
- Enhancements to the guidance on valuing financial instruments when markets are no longer active; and
- Strengthen the IASB standards to achieve better disclosures about valuations, methodologies and the uncertainty associated with valuations.

The IASB's progress on each recommendation is available at www.iasb.org

In addition to these responses to the credit crisis, the IASB committed itself to forming an international advisory group jointly with FASB, which will be tasked with considering how improvements in financial reporting could help enhance investor confidence in financial markets, and identifying accounting issues requiring attention.

The IASB also committed to holding three roundtables, jointly with FASB, to gather input on reporting issues arising from the global financial crisis. This report has been prepared for presentation at the third roundtable.

The report seeks to identify and respond to further areas of accounting that have become more significant as the global credit crisis continues (the three issues identified for action by the Financial Stability Forum are not covered in this report). The initial part of the report focuses on accounting issues already raised in the earlier roundtables or recent IASB submissions, and provides comments on alternative accounting approaches that were mentioned for consideration in those papers and discussions. The second part of the report raises further issues that are of significant concern to Australian ADIs, and provides a high level overview of how the credit crisis has impacted financial results and disclosures published with the most recent financial results.

The report is based on a survey commissioned by the Financial Reporting Council (FRC). A total of eight ADIs responded to the survey, either in writing or via an interview. Included in the respondents are the four largest banks in Australia. These banks are four of the eight largest listed entities in Australia (by market capitalisation), and are also the parent entities of the four largest banks in New Zealand.

A copy of the survey is included as an Appendix. To assist the reader, this report lists issues in the same order as in the survey, which does not necessarily reflect the importance of the issue or the urgency that respondents felt attached to potential changes.

Summary

Respondents were familiar with all issues raised in the survey, and in most cases had actively debated the accounting issue and potential solutions or changes to accounting standards within their ADI.

While several respondents called for changes to be made in high priority areas before the end of 2008, on balance the respondents recognised that changes to accounting standards would take several months. No respondents were comfortable with the abolition of due process, however most respondents clearly felt that a faster due process was warranted for high priority issues.

High priority changes

The most pressing need for change that was identified, relates to the difference between the prudential and accounting models for provisioning of loans held at amortised cost. The accounting model is based on incurred loss, while the prudential model focuses on expected loss. Recent increases in provision levels, as the global credit crisis moves into the ‘real’ economy, and the introduction of Basel 2, have resulted in a greater focus on this difference. While respondents recognise that prudential and financial reporting serve different purposes and need not necessarily be aligned, respondents would prefer the IASB to move closer to the expected loss model.

The accounting rules for hedging are a further area of high priority for change. The difficulty of meeting the hedge effectiveness requirements has resulted in entities adopting the fair value option for certain liabilities and, in some cases, certain assets. When an entity’s own debt is fair valued, significant increases in credit spreads have given rise to the recognition of profit from the widening of the entity’s own credit spread. Respondents noted that this profit is backed out by regulators and management and for presentations to investors. Respondents welcomed the review of the hedging requirements that the IASB has commenced.

Respondents also felt strongly that the credit crisis has highlighted the need for changes in the measurement and reversal of impairment of available for sale securities. Respondents requested review of the inability to reverse impairments of available for sale equity securities through profit and loss, and on the measurement of initial and subsequent impairment.

Important issues

Respondents have also raised issues specific to the insurance industry. Insurance liabilities are measured by discounting at the risk free rate. However the assets backing those liabilities, which are fair valued through profit and loss, include counterparty credit quality in the valuation. This has resulted in a significant mismatch as the credit crisis has deepened.

A question was raised about the application of the recent amendments made by the IASB, to allow reclassification of certain securities, to assets backing insurance liabilities.

Impact of credit crisis on recently published results

The second part of the survey asked respondents to identify where their most recently published results had been impacted by the credit crisis. Significant impacts were noted in measurements that incorporate credit spreads (such as the credit valuation adjustment for derivatives, and re-measurement of own debt where designated as at fair value), impairment of available for sale securities, and in consolidation of securitisation assets.

Additional disclosures made as a result of the credit crisis

All respondents felt, and had responded to, the need to provide voluntary disclosure in relation to the specific nature of the impact of the credit crisis on their entity. The range of additional disclosures was wide, reflecting the diversity of transactions undertaken by the ADIs.

Conclusion

The Financial Reporting Council thanks respondents for their willingness to participate in this survey. The FRC is committed to working with Australian entities to ensure that Australian issues are identified and bought to the attention of the IASB, in order to achieve the highest standard possible for financial reporting. The recent G20 communique re-emphasised the importance of key global standard setters working towards single high quality global accounting standards, and the FRC is pleased to support IASB and FASB in this endeavour. The FRC is responsible for providing broad oversight of the process for setting accounting and auditing standards in Australia, as well as monitoring the effectiveness of auditor independence requirements and giving the Australian Government reports and advice on these matters.

Report on survey

Issues identified in survey

Issue 1 Impairment of Available For Sale (AFS) debt securities If AFS debt securities are impaired, the impairment recognised in profit and loss is the difference between carrying value and fair value. If the same security is measured at amortised cost (classified as loans and advances or held to maturity) the amount recognised in profit and loss is the difference between carrying value and present value of expected future cash flows.	**Importance** Moderate **Urgency** Within a year
Solution mentioned at roundtable or in submissions Determine the impairment loss for available for sale debt securities based on present value of expected cash flows, with any difference between fair value changes and impairment losses recognised in equity. Such differences may arise from liquidity risk or credit risk greater than the estimated credit losses.	
Comment on responses Almost all respondents would like to see a change in how impairment loss is determined for AFS debt securities. They supported the approach of determining the impairment loss for available for sale debt securities based on present value of expected cash flows, with any difference between fair value changes and credit losses (determined based on present value of expected cash flows) recognised in equity. Such differences may arise from assessment of liquidity risk or credit risk resulting in reductions of market value that are greater than the estimated credit losses. One respondent noted that management assesses these securities, and bases management decisions and action on the expected underlying future cash flows. Hence a change to the method of calculating impairment would better align with management of AFS debt securities.	

Issues identified in survey.......continued

<table>
<tr><td>Issue 2 Further impairment of AFS debt securities
When further reduction in fair value occurs in an AFS debt security as a result of movements in the risk free rate, it is not clear whether this is impairment or whether further impairment is only incurred if there are further impairment triggers.</td><td>Importance Moderate
Urgency Within a year</td></tr>
<tr><td colspan="2">Solution mentioned at roundtable or in submissions
Fair value movements in impaired AFS debt securities arising from changes in the risk free rate should be recognised in equity.</td></tr>
<tr><td colspan="2">Comment on responses

Respondents noted that where there is a mechanistic recording of all further market movements as impairment once AFS debt securities are impaired, there is no exercise of judgement regarding the likely recoverability of the written down value. The preferred approach would be to recognise fair value movements in impaired AFS debt securities that arise only from changes in the risk free rate, in equity. Under this approach further indicators of impairment would be required before additional losses were taken to profit and loss.</td></tr>
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<table>
<tr><td>Issue 3 Impairment of AFS equity securities
Reversals of impairment of AFS equity securities are not allowed to be reversed through profit and loss.</td><td>Importance High to moderate
Urgency Within a year</td></tr>
<tr><td colspan="2">Solution mentioned at roundtable or in submissions
Align the treatment of reversals of impairment of ASF equity securities with that of debt securities.</td></tr>
<tr><td colspan="2">Comment on responses

In responding to this question, many ADIs also requested that the IFRS test for impairment of ‘significant or prolonged’ be reviewed, with suggestions that the test be ‘significant and prolonged’, and that commentary be provided on what is meant by significant, and by prolonged. In some cases, reference was made to audit firms applying ‘bright line’ rules to determine what is significant, and what is prolonged. All respondents would like the IASB to consider alignment of the treatment of reversals of impairment of AFS equity securities with that of debt securities. In some cases, this issue was the highest priority for the entity. Other respondents noted the difficulty of arguing that equity holdings of soundly capitalised and well managed entities are not impaired, when the share price of the entity has declined, along with general market movements in the jurisdiction, by around 50% from the highest value.</td></tr>
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Issues identified in survey.......continued

<table>
<tr><td>Issue 4 Provisioning for loans held at amortised cost
The incurred loss model for provisioning does not reflect management decision making or performance of the assets. An alternative model is one that is based on expected loss, using internal ratings and methodologies – such a model would include incurred losses in the provision amount.</td><td>Importance High

Urgency Within a year</td></tr>
<tr><td colspan="2">Solution mentioned at roundtable or in submissions
Amend the incurred loss model and align it more closely with the prudential expected loss model.</td></tr>
<tr><td colspan="2">Comment on responses

This was the most important issue for a majority of respondents. They noted the difficulty that Boards and senior management groups had in understanding the need for a significant difference between the prudential and accounting approaches. Recent increases in provision levels, as the global credit crisis moves into the ‘real’ economy, and the introduction of Basel 2, have caused a greater focus on this difference. Several respondents commented that their ADI was managed on the basis of the expected loss model, and that this model was better understood at Board level than the accounting requirements.

Respondents recognised that accounting and prudential standards serve different purposes and would not always align, but regarded provisioning as an area where significant differences between accounting and prudential standards could be avoided. Respondents stated that introduction of the expected loss model would result in increased provisioning at the current time. While recognising that considerable time and effort would be required to change the standard, respondents were keen that the IASB undertake work in this area as a matter of urgency.</td></tr>
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Issues identified in survey.......continued

<table>
<tr><td>Issue 5 Fair value option
Use of the fair value option for certain loans, to overcome an accounting mismatch arising from the use of interest rate hedges for balance sheet management, has resulted in booking significant losses from the widening of credit spreads. The fair value option has been used when the entity has been unable to show hedge effectiveness for its economic hedges.</td><td>Importance High

Urgency Within a year</td></tr>
<tr><td colspan="2">Solution mentioned at roundtable or in submissions
Review restrictions on changing out of the fair value option once adopted, particularly when the conditions that permitted entry to the fair value option have changed.
Alternatively, review the requirements for hedge effectiveness.</td></tr>
<tr><td colspan="2">Comment on responses

Respondents noted that this issue may arise because of the difficulties of meeting the hedge effectiveness requirements, which may result in an entity adopting the fair value option for part of its loan book to offset movements in the value of balance sheet hedging derivatives. Similar comments were made in relation to the use of the fair value option for an entity’s own debt. They noted and commended the commencement of the review of hedge effectiveness requirements with the discussion paper “Reducing complexity in reporting financial instruments”.

There was support for allowing reclassification out of the FVO, provided boundaries were set around the conditions under which reclassification could occur. Some respondents thought that reclassification out of the FVO should be allowed to maintain consistency with the reclassification changes made in October, while others commented that it should only be allowed when the circumstances that caused the fair value option to be chosen initially, had changed.</td></tr>
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Issues identified in survey.......continued

Issue 6 Categories of financial instruments There are too many categories of financial instruments – loans held at amortised cost, trading instruments, available for sale instruments, and held to maturity instruments.	**Importance** Not very **Urgency** Normal due process
Solution mentioned at roundtable or in submissions Reduce the number of categories, by removing either available for sale, or held to maturity categories.	
Comment on responses Respondents noted that the onerous conditions that must be met for assets classified as held to maturity (HTM), meant that this category was rarely, if ever, used. The potential removal of the HTM category had support from some respondents, with others preferring a change to the HTM tainting provisions. Several respondents did not think there were too many categories presently, and would prefer all categories to be retained. The retention of different accounting treatments for trading instruments and AFS instruments was regarded as critical.	

Issue 7 Fair value of own debt The recognition of changes in the fair value of an entity's own debt results in a profit and loss that is confusing for investors, and in many instances this component of the profit and loss is backed out in management presentations that show underlying profit.	**Importance** Moderate **Urgency** Within a year
Solution mentioned at roundtable or in submissions Take the credit spread component of the fair value movement to equity rather than profit and loss	
Comment on responses All respondents (except for one) supported taking the credit spread component of the fair value movement to equity rather than profit and loss. Respondents noted that the impact of movements in the fair value of own debt is backed out for regulatory purposes, and for discussions with analysts which focus on underlying earnings. One respondent was comfortable with the current treatment, providing reclassification out of the FVO was allowed under certain conditions.	

Issues identified in survey.......continued

Issue 8 Disclosure requirements Disclosure requirements on reclassification of financial instruments only apply at year end, thus some analysts found it difficult to analyse Q3 results of entities that had made use of the reclassification change	**Importance** Not very **Urgency** Normal due process
Solution mentioned at roundtable or in submissions Any interim changes to standards should be accompanied by a requirement to make interim disclosures, in addition to year end disclosures	
Comment on responses This issue was not regarded as important. Respondents felt that entities would be making additional voluntary disclosures when and if they make any change that has a significant impact on results. Should entities not make appropriate disclosures, questions from analysts would force the issue.	

Issue 9 Embedded derivatives in CDO When a CDO is reclassified based on the recent amendment to IAS 39 and hence is no longer fair valued through profit and loss, should the entity reassess whether any credit related embedded derivative requires reassessment?	**Importance** Not very **Urgency** Normal due process
Solution mentioned at roundtable or in submissions Clarification from the IASB is expected to confirm that reassessment of the requirement to separate an embedded derivative should occur at the date of reclassification.	
Comment on responses All respondents agreed that reassessment of the requirement to separate an embedded derivative should occur, with a majority supporting the reassessment at the date of reclassification. There was some support for reassessment based on the day of entry to the CDO.	

Impact of credit crisis on recently published results

Respondents were asked to identify the major accounting impacts of the credit crisis on their most recently published results. For each of several potential areas of impact, respondents were asked to indicate whether the issue had no impact, a similar impact to the prior year (that is, the global credit crisis has not changed the extent of impact on financial results), moderately increased impact, or significantly increased impact compared to the prior year. In each case where the issue impacts the entity, reference is made to the prior year impact to assess the extent of change caused by the global credit crisis. Responses are shown below.

Potential area of impact	Response		Potential area of impact	Response
Credit valuation adjustment	Moderate to significant increase		Impairment of available for sale assets	No impact or moderate to significant increase
Bid/offer spread	Moderate increase		Fair value disclosures	Moderate to significant increase
Re-measurement of assets designated as at fair value through profit and loss	No impact or moderate increase (some entities do not use the fair value option)		On balance sheet recognition of previously de-recognised assets as a result of change in circumstance	No impact or significant increase
Re-measurement of own debt where designated at fair value	Moderate to significant increase for those entities that fair value own debt		SPVs consolidated for the first time	No impact or significant increase
Available for sale reserve	No impact or moderate increase(some entities make only minor use of the AFS category)			

Additional Important Issues

Respondents were also asked to identify further accounting issues arising from the global credit crisis.

Assets backing insurance liabilities

Several respondents raised concerns with the impact of the credit crisis on the relationship between insurance liabilities and assets backing those liabilities.

Under Australian accounting standards, insurance liabilities are measured by discounting at the risk free rate. The assets backing these liabilities, which are fair valued through profit and loss, include counterparty credit quality in the valuation. As the credit crisis has further impacted during 2008, this has resulting in a significant mismatch between the valuation of life insurance liabilities, and the valuation of the assets backing those liabilities.

This creates not only an accounting consequence, but also has capital adequacy implications for Australian insurance companies.

Insurance company assets

Assets backing insurance liabilities are measured at fair value, with movements taken to profit and loss. It is unclear whether this fair value measurement results from designation of the assets under the fair value option, or the classification of the assets as trading assets. While the latter would allow use of the recent reclassification amendments, the former would not. Clarification was requested.

Large holdings

One respondent requested review of the prohibition of using judgement in determining the value of large holdings of equities. Given the use of judgement in many other areas of valuation, further consideration could be given to aligning the accounting valuation with the market reality.

IFRS 7 disclosures for parent entities

Australian ADIs must prepare IFRS 7 disclosures for both the consolidated group and for parent entities. The disclosures for the parent entity are not regarded as useful, and are not relevant to the management of the bank. Respondents called for review of the parent entity requirements.

Additional Disclosures

The additional disclosures recommended by the Financial Stability Forum (April 2008) had required all entities to increase the level of disclosure in their most recently reported results. In all instances, these disclosures were located outside the audited financial statements in either unaudited management commentary accompanying the financial statements or in analysts' presentations. Respondents were divided on the preferred long term location of these disclosures, however most were in favour of continuing the disclosures.

As a result of the credit crisis, all respondents had also made additional voluntary disclosures in their most recent reported results. Areas of additional or enhanced disclosure included:

- Reporting the extent of the use of level 1, 2 and 3 measurement of financial instruments
- Methodologies used for measurement of financial instruments in illiquid markets
- Assessment of control of SPVs
- Liquidity and funding disclosures in particular enhanced
- Methodologies used to determine and assess impairment of assets, including individual impairments and where impairment is being observed
- Credit default swaps held and details of transactions underlying these transactions
- Comparison of own levels of gearing with the aggregate/average of benchmarked entities

Reclassification of certain financial assets

Only one of the surveyed entities had availed themselves of the October amendments on reclassification when they reported their most recently published results. No decisions were reported on the use of the amendment in future reporting periods, although the matter was receiving consideration.