October 2009

International Financial Reporting Standards

Analyst Representative Group
Global Preparers Forum
10 November 2009

AGENDA PAPER 4A

IAS 39 Replacement

Proposals and timetable

IASC Foundation

The views expressed in this presentation are those of the presenter, not necessarily those of the IASC Foundation or the IASB

Timetable
One project – three phases

Phases	Exposure Draft	Finalisation
1. Classification and Measurement	**Comment period closed**	**In time for year end financial statements 2009 for financial assets** **During 2010 for financial liabilities**
2. Impairment methodology	October 2009	During 2010
3. Hedge Accounting (Board deliberations ongoing)	December 2009	During 2010

Classification and Measurement - feedback

√	X
Mixed measurement model	Alternative approaches (closer to FASB approach)
Amortised cost criteria	No reclassification
OCI presentation alternative	Restraints around OCI alternative

Overview of classification model
for financial assets only

Basic loan features

+

Managed on a contractual cash flow basis

Amortised cost (one impairment method)

FVO for accounting mismatch (option)

Tentative decision – **reclassification to be required** when business model changes

All other instruments:
- Equities
- Derivatives
- Some hybrid contracts
- …

Fair Value (No impairment)

Equities: OCI presentation available (option)

Amortised cost –Managed on a contractual cash flow basis

Basic loan features
+
Managed on a contractual cash flow basis

- Business model
  - objective of holding instruments to collect or pay contractual cash flows rather than to sell prior to contractual maturity to realise fair value changes
  - <u>not</u> an instrument by instrument approach to classification
- Will only assess contractual terms of instruments within such a business model
- No ‘tainting’ rules for assets at amortised cost
  - gains or losses from derecognising such items to be presented separately with additional disclosures

Amortised cost
- Basic loan features

Basic loan features ❯ **Contractual terms that give rise to payments of**

- **Principal**
- **Interest**

Interest =
Consideration for
•time value of money
•credit risk

•Redeliberated:

- •Structured debt – look through
- •Distressed debt
- •Non-recourse debt

Amendments to embedded derivatives (applicable only to financial assets)

Hybrid contracts

Financial host → **No separation – part of classification**

<u>Non</u>-financial host → **IAS 39 guidance retained**

Equity investments – OCI alternative

Alternative presentation of fair value changes in other comprehensive income (OCI)

- Scope – investments in equity instruments not held for trading
- Features:
  - option available instrument by instrument
  - **dividends recognised in P&L**
  - no recycling, impairment or change in presentation

Fair value option (FVO) for financial assets*

Fair value option available, if…

- Accounting mismatch
- ~~Managed on fair value basis~~
  - Not managed on a contractual yield basis = FV
- ~~Embedded derivative(s)~~
  - Hybrid contracts with financial host classified in entirety

*FVO unchanged for financial liabilities at this stage

Transition and effective date

Transition

- Generally fully retrospective with some exceptions
- Comparatives only required for adopters from 1/1/12

Effective date

- Available for voluntary application in 2009 year end financial statements
- Mandatory adoption –1 January 2013
- Noted mandatory date may require subsequent reconsideration (to later date) depending on impairment and insurance Phase II

Financial liabilities – way forward

- Feedback ≥ financial liabilities less urgent
- Overwhelming response to discussion paper ≥ effects of own credit not decision useful
- Board wants to address the own credit issue
- Tentatively decided during redeliberations to require ‘frozen credit spread’ for some liabilities otherwise at fair value
- Reconsidered and **decided to exclude financial liabilities from scope of new IFRS for 2009 year ends**
- Allows more time to seek input on the best way to address own credit
- Objective ≥ revised classification and measurement for financial liabilities during 2010

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Current state:
Incurred loss impairment

IAS 39 requires an incurred loss approach for financial assets

- What does that mean?

  Impairment loss only recognised when:

  - Trigger (loss) event occurs
  - Impact can be reliably estimated

- Consequence:
  Expected losses not recognised before trigger events

Incurred loss criticisms

Criticisms of the incurred loss approach include:

- Overstates interest revenue before trigger event (front-loading)
- Does not reflect the underlying economics of the transaction
- Triggers inconsistently applied
- Loss recognition too late

Proposed impairment method: Expected cash flow (ECF) approach

Main outcomes of the ECF approach include:

- Earlier recognition of impairment loss
- Eliminates front loading of interest revenue
- Better reflects underlying economics (eg pricing of instruments when lending decision is made)

Expected cash flow approach

- Main features:
  - interest revenue is recognised on the basis of expected cash flows (including initial expected credit losses)
  - impairment results from an *adverse change* in credit loss expectations
  - reversal of impairment loss when expectations change *favourably*
  - re-estimation of expected cash flows each period end

Impairment Presentation

Presentation (face of income statement)

- Contractual interest revenue
  -- Allocation of initial expected credit losses
  = Economic interest revenue (credit cost adjusted)
- Effect of changes in expectations
- Interest expense

Impairment Disclosure

Disclosure

Expected credit losses

- ❑Allowance account
- ❑Estimates and/or changes in estimates
- ❑ Loss triangle
- ❑ Others

Quality of assets

- ❑Reconciliation of changes in non-performing assets
- ❑Vintage information

Operational challenges

The IASB is aware of the operational challenges of the model:

- Request for Information on feasibility in June 2009
- Extensive outreach activities
- Expert advisory panel (EAP)
  - Objectives:
    - Advise the Board on how operational challenges of the ECF approach might be resolved
    - Assist in field testing

Transition and effective date

Transition

- Does not propose fully retrospective or prospective transition
- Adjust the effective interest rate to approximate the rate that would have been determined at inception using the ECF approach

Effective date

- Around 3 years after final standard with early (voluntary) application permitted

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Hedging – Broad direction

- Consider using cash flow hedge accounting mechanics for fair value hedges
  - Gains and losses on effective portion recognised in OCI
  - Hedged item not remeasured
  - ‘Lower of’ test NOT to be used for fair value hedges
- Simplify cashflow hedge accounting methodology
- Phasing:
  - broad hedging model first
  - then consider portfolio hedge accounting and net investment hedging

Project to replace IAS 39
Next steps

October 2009:

IASB publishes ED on **impairment of financial assets**

Q4/2009:

IASB to issue **final IFRS on classification and measurement of financial assets**

IASB to publish ED on **hedge accounting**

During 2010:

IASB to **complete replacement of IAS 39** by issuing final guidance on:

• impairment

• derecognition*

• hedge accounting

• financial liabilities

1 January 2013:

Expected **mandatory effective date** for Phase I

1 January 2014:
Expected **mandatory effective date** for Phase II impairment

*separate project

Questions or comments?

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.