IFRS

World Standard-setters Meeting

Staff Paper

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Project **Project to replace IAS 39**

Topic **Update on phases**

Introduction

1. All three phases of the project to replace IAS 39 are currently active. The classification and measurement of financial liabilities and impairment phases are being redeliberated and the hedge accounting deliberations are ongoing.

2. In addition, the IASB has requested that its constituents provide the FASB with comments on their comprehensive exposure draft on financial instruments –the comment period for that documents ends on 30 September 2010. The IASB and FASB have undertaken to investigate ways to address any differences that ultimately remain between their models to assist the users of financial statements.

3. The staff would like to use the WSS break-out session in the following ways:

   (a) to obtain feedback on possible ways to bridge any remaining gaps between the FASB and IASB models;

   (b) to provide an update on the tentative decisions that have been made in each of the three phases; and

   (c) to obtain feedback on some of the tentative decisions made to date.

Issues to discuss

4. The FASB ED (which can be downloaded from: http://www.fasb.org) proposes a symmetrical model for financial assets and liabilities with most financial

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instruments required to be measured at fair value on the balance sheet. If an entity has a business strategy of holding debt instruments for collection or payment of contractual cash flows and those debt instruments are not bifurcatable under current US GAAP then the entity can *elect* 'FV-OCI' presentation - this means both fair value and amortised cost information is provided on the face of the balance sheet, amortised cost information is reflected in net income and other changes in fair value are recognised in Other Comprehensive Income.

5. This contrasts with IFRS 9 *Financial Instruments* which *requires*[1] financial assets to be measured at amortised cost if an entity has a 'hold to collect' business model and the financial asset has contractual cash flows that only represent the payment of principal and interest. The IASB has proposed that the accounting for financial liabilities be unchanged from IAS 39 except in respect of the treatment of changes in fair value due to own credit.

6. The FASB is yet to finalise its classification and measurement model. It is possible that their final position will be closer to IFRS 9. While the IASB is committed to a mixed measurement model, we are interested in considering how any remaining differences between the models are best addressed such as by providing parenthetical disclosure of fair value information on the face of the balance sheet.

Question 1
Do you have any suggestions for how best to reconcile any differences that may remain between the FASB and IASB financial instrument classification and measurement models in order to assist users of financial statements?

[1] Subject to the fair value option which is available for accounting mismatches.

Impairment

7. The exposure draft *Amortised Cost and Impairment* proposed an expected loss impairment approach for all financial assets measured at amortised cost including short-term trade receivables. However, it was noted that practical expedients could be used for short-term trade receivables (so for example the effect of discounting could be ignored if immaterial and/or a provision matrix of historical loss experience could be used to determine expected credit losses). Application of the proposals would result in revenue being recognised adjusted for expected credit losses. (This is consistent with the exposure draft *Revenue from Contracts with Customers.* However, some respondents felt that recognising revenue related to short-term accounts receivables should only be dealt with in the Revenue Recognition project and not addressed in the Amortised Cost and Impairment project).

8. Many respondents (especially those from non-financial institutions and those with a professional interest in non-financial institutions) to the exposure draft commented on a need for a different approach for non-interest bearing financial instruments (eg short-term trade receivables) and non-financial institutions, in general.

9. Most of the respondents that commented on the treatment of short-term trade receivables in the ED also provided their concerns on the proposed treatment of related revenue (see comment above). They state that allocating the expected losses against revenue when first recording the receivable is inconsistent with the treatment for the other financial assets in the ED which allocate the expected credit losses over the life of the asset. They also state that the losses incurred on trade receivables are a business expense and should be shown separately from revenue.

10. Whilst most respondents that commented on the treatment of non-interest bearing short-term financial assets agree that such instruments should not be treated the same as financial assets created solely as a result of lending

transactions, they provided different suggestions for how to resolve the treatment. Some suggestions received included:

(a) provide more practical expedients (for example related to presentation and disclosure); or

(b) scope out such transactions, and maybe even non-financial institutions in general, from the final standard.

Question 2 – Impairment for short term trade receivables

(a) Do you believe that the initial and subsequent measurement and presentation of non interest bearing short term trade receivables should be as proposed in the exposure draft *Amortised Cost and Impairment*? If not why not and what would you propose instead?

(b) Do you believe that short-term trade receivables and non-financial institutions should remain in the scope of the proposed impairment approach? If not, why and what would you suggest?

Hedge accounting

Fair value hedge accounting mechanics

11. Earlier in the hedge accounting deliberations (September 2009), the IASB tentatively decided to improve hedge accounting requirements by replacing the mechanics used for fair value hedge accounting with an approach that is similar to cash flow hedge accounting (the tentative approach).

12. This decision was made in response to concerns raised by users about the current fair value hedge accounting mechanics which results in hedged items being carried neither at (amortised) cost nor at fair value but rather at an adjusted amount that depends on what risks have been hedged, and how and when that hedging has occurred. This makes the carrying amounts of hedged items difficult to understand.

13. However, during the outreach activities we received feedback that the tentative approach would give rise to OCI volatility that was considered by many to be problematic. As a result of this feedback the Board changed its tentative decision to an approach for fair value hedge accounting that presents the cumulative gain or loss on the hedged item attributable to the hedged risk as a separate line item in the balance sheet. That line item is presented within assets (or liabilities) for those reporting periods for which the hedged item is an asset (or liability). The fair value changes of the hedging instrument and the hedged item attributable to the hedged risk are taken to other comprehensive income, and any ineffectiveness is transferred immediately to profit or loss. (See further Agenda Paper 8A July 2010 which can be downloaded from: http://www.ifrs.org/Meetings/IASB+Board+Meeting+22+July+2010.htm).

Question 3 – Fair value hedge accounting mechanics
Does the proposed change in fair value hedge accounting mechanics improve the decision usefulness of information for users of financial statements? Why or why not?

Hedge accounting – eligibility criteria

14. The Board has discussed the hedge effectiveness testing that should be required to determine whether a relationship qualifies for hedge accounting.

15. The Board has tentatively agreed on a hedge effectiveness testing approach for hedge qualification as follows:

    (a) The objective of the effectiveness assessment is to ensure that the hedging relationship that will produce an unbiased result and minimise expected ineffectiveness. Thus, for accounting purposes hedging relationships should not reflect a deliberate mismatch between the weightings of the hedged item and hedging instrument within the hedging relationship.

(b) In addition to that objective, hedging relationships are expected to achieve other than accidental offsetting of changes between the hedged item and hedging instrument attributable to the hedged risk.

(c) The assessment is forward looking and performed at inception and on an ongoing basis.

(d) The type of assessment (quantitative or qualitative) depends on the relevant characteristics of the hedging relationship and the potential sources of ineffectiveness. Entities' risk management is the main source of information to perform the effectiveness assessment.

(e) No particular methods for assessing hedge effectiveness are prescribed. However, the method used should be robust enough to capture the relevant characteristics of the hedging relationship including the sources of ineffectiveness.

(f) Changes in the method for assessing effectiveness are mandatory if there are unexpected sources of ineffectiveness (ie new sources not initially anticipated) or if upon a rebalancing in the hedging relationship the method used previously is no longer capable of capturing the sources of ineffectiveness and therefore is not capable of demonstrating whether the hedge produces an unbiased result and minimises ineffectiveness.

(See further Agenda Paper 4A 24 August 2010 meeting which can be downloaded from: http://www.ifrs.org/Meetings/IASB+Meeting+24+August+2010.htm).

Question 4 –Hedge accounting effectiveness testing (for hedge accounting qualification)
Will the proposed hedge accounting effectiveness test (for hedge qualification purposes) address the existing issues with hedge qualification criteria? Why or why not?