asian-oceanian standard-setters group

To:	**AOSSG members**	**Date:**	9 November 2012
From:	**Christina Ng**	**Agenda Item:**	12.1
Subject:	**Financial Instruments: project overview and background to presentation slides**	**File:**	

Note

The views presented in this memo are preliminary staff views as a result of informal outreach undertaken by some Working Group (WG) members.

Action

Read this memo for an overview of the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement* with IFRS 9 *Financial Instruments* and for context to the presentation slides (Agenda paper 12.3) that will be discussed at the 4th Annual AOSSG Meeting.

Prepare to participate in the discussions at the 4th Annual AOSSG Meeting with any questions for the IASB or AOSSG Financial Instruments WG. Consider and provide your preliminary views on the discussion points in the presentation slides.

Attachments

Agenda paper 12.2 – Working draft simplified example of debt assets measured at FVOCI

Agenda paper 12.3 – Slides: Financial Instruments

Overview of IASB's project to replace IAS 39 with IFRS 9

1. The IASB is next scheduled to meet on 19-23 November 2012 and will discuss aspects of accounting for financial instruments with the FASB. Due to the timing of the IASB's next scheduled meeting and the Annual AOSSG Meeting (28-29 November 2012), IASB representative will provide a verbal update at the annual meeting of significant outcomes from the IASB's meeting in November 2012.

Limited amendments to classification and measurement of IFRS 9

2. In response to the feedback on the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* (2008), the IASB decided to simplify the accounting for financial instruments by replacing IAS 39 with IFRS 9 in phases. IFRS 9 (2009) requires financial assets that are debt instruments to be classified based on the entity's business model and the financial asset cash flow characteristics. IFRS 9 (2009) requires debt assets to be measured at amortised cost or fair value through profit or loss (FVPL).

3. Since IFRS 9 (2009) was issued, the IASB has been considering feedback from constituents regarding its application, and accordingly, is in the progress of making improvements. One of the proposed amendments is to introduce a third measurement category for debt assets to accommodate entities with a business model which is both to hold financial assets for collection of contractual cash flows and hold for sale. These debt assets would be measured at fair value through other comprehensive income (FVOCI), subject to the contractual cash flows test.

4. The IASB is targeting to issue an exposure draft (ED) on limited amendments to IFRS 9 classification and measurement by the end of Q4 2012. The ED is expected to have a comment period of 120 days. One IASB member has stated an intention to dissent, and two others stated that they are considering dissenting.

5. WG members generally support the IASB's intention of having measurement categories that reflect the economics of transactions. For example, some WG members considered a common scenario: an entity invests in highly liquid bonds that can be easily sold to meet its funding requirements if necessary. These WG members consider that the business model (refer paragraph 3 of this paper) of the IASB's proposed measurement category 'debt assets measured at FVOCI' could potentially be appropriate for such debt assets, rather than amortised cost or FVPL.

6. Having said that, most WG members consider that:

   (a) there is a lack of understanding as to what is the conceptual basis of OCI. Members understand that the IASB aims to resume its project on Conceptual Framework by H1 2013 and accordingly, until that project is complete, these members consider that the IASB should refrain from making any further use of OCI;

   (b) there would be inconsistency in the accounting between equity classified as FVOCI and debt classified as FVOCI. For example:

      (i) recycling of fair value gains/losses of equity instruments at FVOCI is prohibited whereas recycling of fair value gains/losses of debt assets at FVOCI would be required;

      (ii) impairment assessment for equity instruments at FVOCI is not required, whereas it would be required for debt assets at FVOCI [refer paragraph 6(d) below]; and

      (iii) it is an optional designation for equity instruments to be FVOCI, whereas it is not an option for debt assets to be FVOCI—entities with debt assets that meet the business model and characteristics of cash flows would be required to measure those debt assets at FVOCI (unless designated at FVPL);

   (c) the introduction of debt measured as FVOCI introduces a fifth measurement category to IFRS—the existing IFRS 9 (2009) financial asset measurement categories are (i) equity instruments measured at FVPL; (ii) equity instruments measured at FVOCI; (iii) debt assets measured at FVPL; and (iv) debt assets measured at amortised cost—and so WG members are concerned the IASB may not achieve its initial intention of simplifying the accounting for financial instruments; and

   (d) the IASB has tentatively decided that the impairment model for debt assets measured at amortised cost (currently being discussed) would also apply to debt assets measured at FVOCI. It is not yet clear what the impact of this would be.

7. Some WG members are uncertain about the usefulness of the information presented in the Statement of Comprehensive Income from the proposed accounting for debt assets measured at FVOCI (as illustrated in Agenda paper 12.2). That is, the fair value of the debt asset is recognised in the balance sheet with fair value gains or losses recognised in OCI, while interest calculated using the effective interest method, impairment and foreign

exchange gains or losses are recognised in profit or loss. These members are concerned that hybrid measurement models may be less readily understandable by users of financial statements.

Impairment

8. The IASB's original proposal (ED/2009/12) to incorporate expected losses at inception into the effective interest rate calculation received some support for its conceptual approach. The basis of the approach is that credit losses expected at inception of a loan are priced into contractual interest rates and accordingly, those expected credit losses should be recognised over the life of the loan through a credit-adjusted effective interest rate. However, the IASB received feedback from constituents with significant concerns that the impairment model proposed in ED/2009/12 is inoperable. The IASB and FASB responded with a Supplement to ED/2009/12 with a revised model that recognises impairment based on a 'good book' measure (losses are recognised at the the higher of time-proportional loss method and foreseeable future loss method) and a 'bad book' measure (full lifetime losses are recognised). The feedback on the joint impairment model indicated concerns with the conceptual basis and whether the revised model would be operational.

9. The IASB and FASB's reaction to the feedback was a dual-measurement impairment model to recognise some lifetime expected losses on day-one. The dual-measurement being (i) a 12-month expected loss; and (ii) lifetime expected loss.

10. The IASB and FASB then each conducted separate outreach on the dual-measurement model that led to:

    (a) the FASB developing an alternative model that is a single-measurement impairment model to recognise full lifetime expected losses on day-one; and

    (b) the IASB discussing possible clarifications to the criteria for recognition of lifetime expected losses in the dual-measurement model. The IASB will also re-visit the reasons for rejecting the IASB's proposed time-proportionate expected loss method (as part of the Supplement to ED/2009/12) and the original ED/2009/12 expected loss model. The IASB will discuss these at its 19-23 November 2012 meeting.

11. IASB staff are monitoring the FASB deliberations and the FASB has committed to sharing their progress at the IASB's November 2012 meeting. We understand that the IASB still intends to publish a further ED on impairment by the end of 2012.

12. While WG members appreciate the IASB's efforts in developing an impairment model that is both conceptually sound and operational, most WG members consider there is no conceptual basis for recognising day-one losses. That is because an entity does not typically issue a loan if it expects losses at inception or in the first year of issuing the loan. Therefore, these members do not think recognising <u>any</u> day-one loss is conceptually acceptable.

13. Furthermore, WG members received strong feedback from their constituents that there would be significant operational challenges in implementing the dual-measurement model and in explaining what the impairment represents.

Please note the following topics are not planned to be discussed at the 4th Annual AOSSG Meeting.

General Hedge Accounting

14. The IASB published a draft of the forthcoming IFRS on general hedge accounting on their website on 7 September 2012. It will remain available until early December 2012. According to the IASB the draft standard is available for information purposes to enable constituents to familiarise themselves with the new requirements. The IASB had aimed to issue the general hedge accounting requirements by the end of Q4 2012. However, the expectation is now that such timing is highly unlikely—feedback on the IASB's review draft of the general hedge accounting standard is expected to be discussed by the IASB at its January 2013 meeting.

Macro Hedge Accounting

15. The requirements for macro-hedge accounting have been scoped out of the project to replace IAS 39 with IFRS 9. The IASB is expected to issue a discussion paper on macro hedge accounting in H1 2013.

16. The IASB has not made tentative decisions on macro hedge accounting at the date of finalising this memo.