Australian Government
Australian Accounting Standards Board

Memorandum

To:	**AASB members**	**Date:**	5 February 2013
From:	**Sue Lightfoot & Christina Ng**	**Agenda Item:**	8.1 (M129)
Subject:	**Financial Instruments: Project Update**	**File:**	

Action

1. Receive an update on the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement* with IFRS 9 *Financial Instruments* and consider if there are any issues that need to be raised with the IASB at this stage.

2. Consider comments on AASB ED 230 *Classification and Measurement: Limited Amendments to AASB 9 (proposed amendments to AASB 9 (2010)).*

Attachments

Agenda paper 8.2 – IASB Daily Staff Update – 30 January 2013

Agenda paper 8.3 – Further comments received in respect of the IASB Review Draft on General Hedge Accounting

The following papers will be tabled at the February 2013 AASB meeting:

Agenda paper 8.4 – Comment letter analysis (if relevant) and issues paper – ED 230 *Classification and Measurement: Limited Amendments to AASB 9 (proposed amendments to AASB 9 (2010)*

Agenda 8.5 – Any submissions received on ED 230 and (at the time of writing this memo, we have not yet received any submissions, which are due to the AASB by 13 February 2013)

Update on Financial Instruments Project

<u>Hedge Accounting</u>

1 The IASB published a draft of the forthcoming IFRS on general hedge accounting on its website on 7 September 2012 where, as at the date of this memo, it remains.

2 Although the IASB did not specifically ask for comment the IASB did receive comment from a number of constituents. This included a letter from the AASB (Agenda Paper 3.3). Three of the comments letters sent to the IASB were also copied to the AASB. These are Agenda Paper 8.3 (Visual Risk and the Finance and Treasury Association) and Agenda Paper 11.2 of the December AASB meeting papers (ANZ) which can be accessed here: [Agenda Paper 11.2]

[Letter from ANZ to IASB dated 21 November 2012 re IFRS 9 Chapter 6 Hedge Accounting (Review Draft)]

3 In its January 2013 meeting the IASB discussed the feedback it had received on the review draft. In particular the following three issues were discussed:

(a) Cross-currency basis risk and the use of the hypothetical derivative to measure hedge effectiveness.

The issue was set out in Agenda Paper 9.4 of the October 2012 Board meeting.

(b) The transition requirements for designation of 'own-use' contracts as 'at fair value through profit or loss' (FVTPL)

(c) The interaction of the review draft and existing requirements in IAS 39 for applying hedge accounting for macro (portfolio) hedges

Cross-currency basis risk

This issue was identified in the comment letters received by the AASB and was commented upon in the AASB's submission to the IASB. The IASB tentatively decided to expand the 'cost of hedging' approach it had proposed for time value of options and forward points in forward contracts to also apply to cross-currency basis risk. As a result, change in the fair value of cross-currency basis risk would be similarly deferred in other comprehensive income, rather than introducing volatility to profit or loss as ineffectiveness.

Typically cash flow hedging has been designated in preference to fair value hedging due to the common practice of recognising ineffectiveness for each type of hedge. Typically in a cash flow hedge common practice has been to defer change basis risk in the hedging instrument (by also including basis risk in the hypothetical derivative). In contrast in a fair value hedge all changes in the fair value of a hedging instrument, including basis risk, is recognised in profit or loss. Recognising cross-currency basis risk as a 'cost of hedging' would therefore remove the 'arbitrage' between cash flow and fair value hedges.

'Own-Use' Contracts

The review draft permits own use contracts to be designated as at fair value through profit or loss (FVTPL) at the inception of a contract. Since the transition to IFRS 9 is on a prospective basis, existing contracts would be ineligible to be at FVTPL. The IASB tentatively decided to permit the election to be made for all own use contracts for all similar contracts. This would permit entities to avoid a lengthy transition period if they wish to avail themselves of this election on transition.

Macro-hedging

The review draft would permit entities to continue to apply IAS 39 requirements for a fair value hedge of interest rate risk of a portfolio of financial assets or financial liabilities. For a cash flow hedge of interest rate risk of a portfolio of financial assets or financial liabilities the requirements of the review draft would apply.

Some constituents had commented that it was not clear which macro-hedging relationships would be addressed by the separate project on accounting for macro-hedging, and had concerns about the implications of parts of the Implementation Guidance (IG) to IAS 39 on cash flow macro-hedge accounting which was not included in the review draft.

The IASB tentatively decided not to roll the applicable IG paragraphs into IFRS 9, or provide further guidance. However they would confirm that this did not imply that the IG paragraphs (which are not integral to IAS 39, nor authoritative) were rejected. The IASB staff have agreed to further analyse how application of IAS 39 macro-hedging might be achieved and what implications this might have. This analysis would also include the effects on macro-hedging from the 'carve out' from IAS 39 applied by countries in the European Union.

The IASB also tentatively decided to clarify that for hedge relationships that are not identical to risk management practices, hedge accounting is still available if the hedge is 'directionally consistent' with risk management. This would provide relief for entities that currently have in place hedging relationships under IAS 39 which are a proxy to the actual risk management practice. This could be the case where, as mentioned above, cash flow hedging has been applied in preference to fair value hedging to 'optimise' the accounting outcome.

The IASB agreed to continue discussing the issue of macro-hedge accounting in a future meeting.

4 The IASB work plan as at 4 February 2013 indicates that the IASB intends to issue the final requirements for general hedge accounting in Q2 2013. A discussion paper on accounting for macro hedging is targeted for the first half of 2013.

5 AASB staff support the tentative decisions of the IASB in relation to hedge accounting.

Question 1 to Board members:

Does the Board consider there are any issues that need to be raised with the IASB at this stage on hedge accounting?

Impairment

6 The IASB completed discussions on core aspects of its 'three-bucket' credit deterioration impairment model for financial assets in its November 2012 meeting. The FASB published a proposed Accounting Standards Update at the end of December 2012 in relation to its proposed impairment model. Table 1 below provides a high-level summary, and compares key aspects, of the IASB tentative model and the FASB proposed model. Note that the information in this table for the IASB model is subject to ED drafting changes.

Table 1: High-level summary of the IASB tentative model and FASB proposed model

IASB Tentative Model	FASB Proposed Model (published December 2012)
Scope	
Would apply to: • financial assets measured at amortised cost, including: ○ loans; and ○ trade and lease receivables (simplified approach will be made available); • debt instruments measured at FVOCI; • loan commitments; and • financial guarantees that are not measured at FVPL.	Would apply to: • debt instruments measured at amortised cost; ○ FVOCI (practical expedient will be made available); • receivables resulting from revenue transactions; • reinsurance receivables; • lease receivables that are not measured at FVPL; and • loan commitments that are not measured at FVPL.
Measurement objective	
A dual-measurement objective for measuring: • lifetime expected losses that are associated with the probability of default in the next 12 months; and • lifetime expected losses that have experienced significant deterioration in credit quality since initial recognition.	A single measurement objective for measuring expected losses that reflect the current estimate of contractual cash flows that are not expected to be collected.
Recognition and measurement	
Entities would recognise, as an impairment allowance: • lifetime expected losses that are associated with the probability of default in the next 12 months; and • lifetime expected losses if there has been a significant deterioration in credit quality since initial recognition (taking into consideration the term of the asset and the original credit quality). The tentative model would result in recognition of day-one losses that reflect lifetime expected losses associated with the probability of default in the next 12 months.	Entities would recognise, as an impairment allowance, the current estimate of contractual cash flows not expected to be collected. The proposed model would result in recognition of day-one losses that reflect lifetime expected losses.

IASB Tentative Model	FASB Proposed Model (published December 2012)
Expected losses: • would consider all reasonably available external and internal information, including information about past events, current conditions, and reasonable and supportable forecasts of future events and economic conditions; • would reflect a probability-weighted estimate of cash flows associated with a range of possible outcomes; • would reflect time value of money.	Expected losses: • would consider all relevant internal and external information, including information about past events (including historical loss experience with similar assets), current conditions, and reasonable and supportable forecasts; • would reflect at least two possibilities: (i) that a credit loss will occur and (ii) that no credit loss will occur; and • would reflect time value of money.
Subsequent changes to expected losses would be recognised as impairment gain/loss in profit or loss.	Subsequent changes to expected losses would be recognised as provision for impairment loss in profit or loss.
Interest income presentation	
Interest income would be calculated using an effective interest method on the gross carrying amount (that is, based on the contractual cash flows).	Interest income would be calculated using an effective interest method on the gross carrying amount (that is, based on the contractual cash flows).
For financial assets that have incurred losses, interest income would be calculated on the carrying amount net of the impairment allowance. These financial assets would be a subset of financial assets with expected losses.	The proposed Accounting Standards Update does not separately address the presentation of financial assets that have incurred losses.
Entities would continue recognising interest income until the financial asset is written-off.	Entities would stop recognising interest income when it is no longer probable that substantially all of the principal or interest will be received.
Purchased credit-impaired financial assets	
A modified impairment model would apply to both originated and purchased credit-impaired financial assets.	A modified impairment model would apply to purchased credit-impaired financial assets. Originated credit-impaired financial assets would apply the same methodology for estimating expected losses as other financial assets.
At initial recognition, the credit-related discount embedded in the purchase price would be recognised as a day-one impairment allowance.	At purchase date, the credit-related discount embedded in the purchase price would be recognised as day-one impairment allowance. This allowance would be reflected as a gross-up on the balance sheet, rather than as an impairment loss in profit or loss.

IASB Tentative Model	FASB Proposed Model (published December 2012)
Interest income would be calculated using an effective interest method on the net carrying amount (that is, based on the expected cash flows).	Interest income would be calculated using an effective interest method on the net carrying amount (that is, based on the expected cash flows).
Subsequent changes in expected losses (favourable or unfavourable) would be recognised in profit or loss as impairment loss or gain.	Subsequent changes in expected losses (favourable or unfavourable) would be recognised in profit or loss as a provision for expected losses.

7 Based on its work plan dated 4 February 2013, the IASB is targeting issuance of an Exposure Draft on impairment of financial assets in Q1 of 2013, with a comment period of 120 days.

Question 2 to Board members:

Does the Board consider there are any issues that need to be raised with the IASB at this stage on impairment?

Classification and Measurement

8 IASB ED/2012/4 *Classification and Measurement: Limited amendments to IFRS 9* (2010) (Proposed amendments to IFRS 9 (2010)) was published on 28 November 2012 with comments requested by 28 March 2013. The AASB issued ED 230 that incorporated the IASB's proposals in December 2012 with the comment period closing on 13 February 2013. As at the date of this memo no comment letters had been received.

9 The key proposals in ED/2012/4 are:

(a) to introduce a third mandatory measurement category for financial assets that have contractual cash flows that are solely principal and interest and are held within a business model in which the assets are managed in order to both collect the contractual cash flows and held for sale. Such assets would be required to be measured 'at fair value through other comprehensive income' (FVOCI) with amounts being recognised in profit or loss as for financial assets measured at amortised cost and other gains and losses being recognised in OCI;

(b) to amend the application guidance in IFRS 9 to clarify that if contractual cash flows on a financial asset include only payments of principal and interest (interest being consideration for the time value of money and credit risk), but the economic relationship between those components is modified due to an interest rate mismatch feature or leverage, an entity will assess whether the cash flows are solely principal and interest by comparing the instrument to an unmodified benchmark instrument. If the modification could result in contractual cash flows that are more than insignificantly different from the benchmark cash flows, the contractual cash flows would not be solely principal and interest. As a result, the financial asset would be ineligible for measurement at amortised cost (and also ineligible for FVOCI if that measurement category is introduced). The instrument would therefore be required to be measured at fair value through profit or loss;

(c) to permit the 'fair value option' in IFRS 9 to be made available for financial assets that would otherwise mandatorily be measured at FVOCI (ie. where there is an 'accounting mismatch');

(d) to withdraw earlier versions of IFRS 9 six months after the publication of the final version of IFRS 9; and

(e) to permit early application of the 'own credit' provisions of IFRS 9 (such that the amount of change in the fair value of a financial liability that is attributable to changes in the issuer's own credit risk of that liability shall be presented in other comprehensive income (paragraphs 5.7.7-5.7.9 of IFRS 9)) should be permitted without the need to early apply IFRS 9 in its entirety.

10 AASB staff will table comment letters and a comment letter analysis (if relevant); and an issues paper on ED 230 at the February AASB meeting.