Australian Government
Australian Accounting Standards Board

Memorandum

To:	**AASB Members**	**Date:**	19 August 2014
From:	**Sue Lightfoot**	**Agenda Item:**	22.1 (M140)
Subject:	**Financial Instruments**	**File:**	

Action

The purpose of this session is:

1 to provide an overview of IFRS 9 *Financial Instruments* as issued by the IASB on 24 July 2014, including an outline of the events that have shaped IFRS 9;

2 to confirm the Board's views on issuance of AASB 9 concerning:

(a) early application: restriction of earlier versions of AASB 9

(b) transition: date of initial application:

(c) incorporation of information by cross-reference

3 to consider whether consequential amendments need to be made to AASB 1049 *Whole of Government and General Government Sector Financial Reporting* when a revised AASB 9 is issued;

Attachment

Agenda Paper 22.2 IASB Summary of IFRS 9 – July2014

Agenda Paper 22.3 IFRS 9 *Financial Instruments* (2014) [Board Only].

Background

The IASB has been replacing IAS 39 *Financial Instruments: Recognition and Measurement* with IFRS 9 *Financial Instruments* in a phased approach. The phases of the project were as follows:

Phase 1: Classification and Measurement

Phase 2: Impairment

Phase 3: Hedge Accounting

Classification of Assets

The IASB issued a version of IFRS 9 including classification and measurement of financial assets in November 2009. A new version of IFRS 9 including classification and measurement of both financial assets and financial liabilities was issued by the IASB in December 2010.

The mandatory application date of IFRS 9 (and AASB 9) at that time was for annual periods beginning on or after 1 January 2013. Both versions of IFRS 9 were incorporated into versions of AASB 9 *Financial Instruments*. Consistent with IFRS 9, both versions of AASB 9 were available for early adoption.

AASB 9 (as issued in 2009 and 2010) included new criteria for classification of financial assets. A financial asset would be measured at amortised cost if

- its contractual cash flows are solely principal and interest (SPPI); and
- the asset is held in a business model whose objective is to hold asset in order to collect contractual cash flows.

A financial asset that did not meet these two criteria would be at fair value through profit or loss (FVPL). It also provided an election for equity instruments to be at fair value through other comprehensive income (FVOCI) with recognition of dividends in profit or loss. This reduced the number of measurement categories, compared with IAS 39 / AASB 139 *Financial Instruments: Recognition and Measurement* and removed the requirement to separately account for embedded derivatives from financial host contracts.

Classification of Liabilities

Accounting for financial liabilities remained largely consistent with IAS 39, except that the change in fair value due to a change in the entity's own credit risk for financial liabilities designated at FVPL would be presented in OCI ('own credit risk' requirement).

Deferral of Application Date

In December 2011 the IASB deferred the mandatory effective date of IFRS 9 to annual periods beginning or after 1 January 2015 and modified the requirements on transition to IFRS 9. The AASB incorporated the same amendments into AASB 9 through AASB 2012-6.

Hedge Accounting, 'Own Credit' and Withdrawal of Application Date

In its May 2012 Board meeting the IASB scoped 'macro-hedging' out of the IFRS 9 project. The IASB decided to issue a Discussion Paper (DP) on macro hedging rather than an exposure draft.

Although hedge accounting was phase three, the IASB completed its work on hedge accounting (excluding macro-hedging) prior to phase two on impairment. The IASB issued a version of IFRS 9 including classification and measurement and hedge accounting in November 2013. This version of IFRS 9 removed the mandatory application date of IFRS 9 due to the uncertainty over timing of completion of all aspects of IFRS 9, but continued to permit 'early' application. This version also permitted the 'own credit risk' requirement to be early applied in isolation. It also provided an accounting policy choice for an entity to continue to apply the requirements of IAS 39 for hedge accounting, rather than those of IFRS 9. The rationale for allowing a choice for using hedge accounting under either Standard is that the IASB had not yet completed its project on accounting for macro hedge accounting. This choice is not limited to early application.

The AASB incorporated the amendments to AASB 9 in AASB 2013-9, which also deferred the mandatory application date of AASB 9 to annual reporting periods beginning or after 1 January 2017. The rationale for this is given in Agenda Paper 9.1 of the December 2013 AASB meeting.

The AASB also issued AASB 2014-1 which remade consequential amendments arising from AASB 9 (due to an issue with repealed standards). AASB 2014-1 also deferred the mandatory application date of AASB 9 to annual periods beginning on or after 1 January 2018 in anticipation of the IASB issuing IFRS 9 (2014) with that application date.

The IASB issued the DP *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* in May 2014. The DP sets out a new ‘portfolio revaluation approach’ (PRA) for accounting for open portfolios of financial instruments for which ’dynamic risk management’ is used. The DP was incorporated into AASB Invitation to Comment ITC 31 – refer to Agenda Item 11.

IFRS 9 (2014)

Limited Amendments to Classification and Measurement & Impairment

The IASB issued a new version of IFRS 9 in July 2014 which made limited amendments to classification and measurement and added requirements for impairment of financial assets measured at amortised cost and FVOCI (‘IFRS 9 (2014)’). IFRS 9 (2014), attached as agenda paper 22.3.

The key changes introduced by IFRS 9 (2014) are:

- to introduce a new mandatory category for debt instruments to be at FVOCI for financial assets that have contractual cash flows that meet the SPPI criteria and are held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets;
- to revise the application guidance for classification and measurement of financial assets concerning what constitutes SPPI;
- to add a chapter on impairment using an ‘expected loss’ approach;
- to make IFRS 9 mandatorily applicable for annual periods beginning on or after 1 January 2018; and
- to limit early application of previous versions of IFRS 9 such that, for annual periods beginning before 1 January 2018, an entity may only apply earlier versions if the entity’s date of initial application is before 1 February 2015 (ie. six months post issuance of the completed IFRS 9).

Despite the limitation on early application of previous versions of IFRS 9 after 1 February 2018, an entity applying IFRS 9 (2014) may choose to early apply the ‘own credit’ requirements in isolation. An entity may also make an accounting policy choice to apply the hedge accounting requirements of IFRS 9 or continue to apply the hedge accounting requirements of IAS 39. The two options above were previously available in IFRS 9 (as issued in November 2013) and were incorporated into AASB 9 through AASB 2013-9 issued in December 2013.

Limited Amendments to Classification and Measurement

Proposals for amendments to classification and measurement were proposed in the AASB's ED 230 *Classification and Measurement: Limited Amendments to IFRS 9* issued in November 2012 for comment by 28 March 2013. ED 230 incorporated the IASB ED/2012/4 of the same name. ED 230 attracted 8 comment letters. The AASB comment letter to the IASB on ED/2012/4 dated 5 April 2013 can be located on the AASB website here.

In its letter on ED/2012/4, the AASB indicated broad support for the proposals in ED/2012/4 and specifically indicated its support for:

- making amendments for classification and measurement concurrently with the issuance of the impairment requirements in IFRS 9;
- broadening the notion of what constitutes SPPI, however the AASB considered that the IASB should apply a more principle-based approach to the notion of interest, rather than using the comparison to benchmark instrument methodology as proposed;
- introducing a mandatory FVOCI measurement category for financial assets that are held within a business model in which assets are managed both in order to collect contractual cash flows and for sale[1]. The AASB also recommended that robust application guidance on identifying business models is provided. The AASB's support for a mandatory FVOCI category was subject to the fair value option being available for those assets;
- an entity that chooses to early apply IFRS 9 after the completed version of IFRS 9 is issued being required to apply the completed version of IFRS 9. The AASB's view was that the proposed six-month withdrawal period was reasonable; and
- permitting entities to choose to early apply only the 'own credit' provisions in IFRS 9 once the completed version of IFRS 9 is issued.

Staff continuously updated the Board on the IASB's tentative decisions during the IASB's redeliberations on ED/2012/4 and regularly consulted on the issues with key Australian stakeholders. Other than the IASB retaining the SPPI proposal for comparison to a benchmark instrument, the AASB's concerns appear to have been addressed.

No further comment letters were received from constituents on the proposals and the AASB did not write to the IASB to express further concerns during redeliberations.

Impairment

The impairment phase of the IFRS 9 project was initially a joint project with the FASB. The IASB proposals on IFRS 9 impairment were included in three exposure drafts:

1. In November 2009 the AASB issued ED 189 *Financial Instruments: Amortised Cost and Impairment* for comment by 17 May 2010. ED 189 incorporated IASB ED/2009/12 of the same name and was due for comment by 30 June 2010. ED 237 attracted seven comment letters. The AASB comment letter to the IASB on ED/2013/3 dated 30 June 2010 can be located on the AASB website here.

[1] subject to the contractual cash flow characteristics assessment

ED/2009/12 proposed moving from the incurred loss model in IAS 39 to an expected loss model. The AASB did not support the proposals as it was of the view that the expected loss model is not consistent with an amortised cost measurement attribute and lacks a conceptual basis. The AASB also had concerns about the practical operation of the model.

2 In February 2010 the AASB issued ED 210 *Financial Instruments: Impairment* for comment by 16 March 2011. ED 210 incorporated the IASB Supplement to ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* which was due for comment by 1 April 2011. ED 210 attracted two comment letters. The AASB comment letter to the IASB on the Supplement to ED/2009/12 dated 1 April 2014 can be located on the AASB website here.

In the Supplement to ED/2009/12 the IASB proposed modifications to the expected loss model to seek to make it more operational and seek a converged model with the FASB. This included using a time-proportionate approach and using a ‘good-book’ – ‘bad-book’ approach The AASB again did not support the model for conceptual reasons but supported the IASB’s efforts to seek to make the model more operational.

3 In March 2013 the AASB issued ED 237 *Financial Instruments: Expected Credit Losses* for comment by 10 May 2013. ED 237 incorporated the IASB ED/2013/3 of the same name, which was due for comment by 5 July 2013. ED 237 attracted 9 comment letters. The AASB comment letter to the IASB on ED/2013/3 dated 10 July 2013 can be located on the AASB website here.

ED/2013/3 proposed an approach where assets that had suffered significant credit deterioration would have a lifetime expected credit loss recognised. Assets that had not suffered significant credit deterioration would have a ’12 month expected credit loss recognised’. Practical expedients would be available for trade and lease receivables and ‘low credit risk’ assets. The FASB made a separate proposal (Proposed Accounting Standards Update *Financial Instruments—Credit Losses)* which did not include a 12-month ‘bucket’.

Staff continuously updated the Board on the IASB’s tentative decisions during the IASB’s redeliberations on impairment and regularly consulted on the issues with key Australian stakeholders. The AASB continued to have concerns about the proposed model on conceptual and practical grounds – in particular for tracking credit quality of assets from initial recognition. However, it was evident from staff consultation with key Australian stakeholders and our work through the AOSSG Financial Instruments Working Group that the approach the IASB has reached on impairment is expected to be operational. No further comment letters were received from constituents on the proposals and the AASB did not write to the IASB to express further concerns during redeliberations.

Staff recommend that that IFRS 9 (2014) is incorporated into AASB 9 and recommend preparation of a ballot draft of a new version of AASB 9 (‘AASB 9 (2014)’).

1) Question to Board members:

Does the Board agree with the staff recommendation to prepare a ballot draft of AASB 9 (2014)?

2) Question to Board members:

Do any Board members intend to dissent from AASB 9 (2014)? If so, what is the basis for dissent?

Early Application: Restriction of Earlier Versions of AASB 9

Staff note that the phased approach of introducing IFRS 9 and AASB 9 has resulted in a high level of complexity in terms of the number of versions that may be early applied and the accounting policy choices available in the versions.

The table below summarises the various ways in which AASB 9 may currently be early applied[2].

	Version (as amended)	AASB 9 Requirements
1	AASB 9 (2009)	• Classification and measurement of financial assets
2	AASB 9 (2010)	• Classification and measurement of financial assets; and • Classification and measurement of financial liabilities, including 'own credit risk' requirements
3	AASB 9 (2010)	• Classification and measurement of financial assets; and • Classification and measurement of financial liabilities, including 'own credit risk' requirements; and o Accounting policy choice to apply AASB 9 hedge accounting or AASB 139 hedge accounting (including IAS 39 macro hedge accounting)[3]. OR • 'Own credit risk' requirements in isolation

In IFRS 9 (2014) the IASB has restricted early application of earlier versions of IFRS 9 in order to reduce complexity and reduce lack of comparability. If the early application provisions of IFRS 9 (2014) are incorporated in AASB 9, an entity may only apply the versions in the table above if the entity's date of initial application is before 1 February 2015. As an exception the 'own credit risk' requirements may continue to be early applied in isolation until AASB 9 becomes mandatory.

For annual periods with initial application later than 1 February 2015 only the following would be available:

	Version	AASB 9 Requirements
4	'AASB 9 (2014)'	• Classification and measurement of financial assets – <u>including the impairment requirements</u>; and • Classification and measurement of financial liabilities, including 'own credit risk' requirements; and 2. Accounting policy choice to apply AASB 9 hedge accounting or AASB 139 hedge accounting (including IAS 39 macro hedge accounting). OR • 'Own credit risk' requirements in isolation

2 In each case, an entity continues to apply the requirements of AASB 139 for the parts of AASB 9 it has yet to apply.

3 Application of hedge accounting in AASB 9 and AASB 139 is elective and subject to meeting certain specified criteria. Macro hedge accounting in AASB 139 refers to the requirements in that Standard for a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities.

AASB staff are concerned that there is already a potential for diversity given the various ways in which AASB 9 can currently be early applied. Consistent with the AASB's support for the proposal, staff support the IASB's decision to restrict the availability of previous versions of IFRS 9 after February 2015 and recommend that the same restriction is also introduced into AASB 9.

3) Question to Board members: Does the Board wish to issue AASB 9 with the same early application provisions as IFRS 9 2014, including the restriction from 1 February 2015 for earlier versions?

Transition: Date of Initial Application

Paragraph 7.2.2 of IFRS 9 (2014) concerning the date of initial application for transition to IFRS 9 (2014) includes reference to the issue date of IFRS 9 (2014) (bold added for emphasis):

7.2.2 For the purposes of the transition provisions in paragraphs 7.2.1, 7.2.3–7.2.28 and 7.3.2, the date of initial application is the date when an entity first applies those requirements of this Standard and must be the beginning of the first reporting period **after the issue of this Standard**. Depending on the entity's chosen approach to applying IFRS 9, the transition can involve one or several dates of initial application for different requirements.

For the purpose of drafting AASB 9 (2014), staff recommend that 'after 24 July 2014' (the date the IASB issued IFRS 9 (2014)) is inserted in the equivalent paragraph in AASB 9 instead of the words 'after the issue of this Standard'. This would ensure that entities in Australia to have the same availability for early application of AASB 9 as an entity applying IFRS 9 (2014).

4) Question to Board members: Does the Board wish to issue AASB 9 with the words 'after 24 July 2014' inserted as described above in the transition paragraphs of AASB 9, in order for entities in Australia to have the same availability for early application of AASB 9 as an entity applying IFRS 9 (2014)?

Incorporation of information by cross-reference

IFRS 9 (2014) introduces paragraph 35C to IFRS 7 *Financial Instruments: Disclosures*. Paragraph 35C concerns incorporation of information by cross-reference, and, under the heading 'Credit Risk' and 'Scope and Objectives' reads as follows:

35C An entity need not duplicate information that is already presented elsewhere, provided that the information is incorporated by cross-reference from the financial statements to other statements, such as a management commentary or risk report that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

In its February 2014 meeting (refer to Agenda Paper 7.1) the AASB decided to delete paragraph 21B from AASB 7 *Financial Instruments: Disclosures*. Paragraph 21B concerns incorporation of information by cross-reference. The decision was based on the same logic that caused the AASB to delete paragraph B6 of AASB 7 (which was to avoid a situation where there is ambiguity about the status of cross-referenced information particularly in relation to a situation where the financial statements are audited, but the cross-referenced information is not).

However, in its April 2014 meeting the Board noted that the first sentence of paragraph 21B to present disclosures 'in a single note or separate sections in…financial statements' is not repeated in paragraph B6. On this basis, the Board decided to retain the first sentence of paragraph 21B of AASB 7 and only delete the second and third sentences of paragraph 21B from AASB 7. The two sentences were deleted from AASB 7 in AASB 2014-1.

The deleted wording has been shaded to below to illustrate the deleted sentences.

Paragraph B6 of IFRS 7, under the heading Nature and Extent of Risks Arising from Financial Instruments (paragraphs 31-42)' reads as follows:

> B6 The disclosures required by paragraphs 31-42 shall be either given in the financial statements or incorporated by cross-reference from the financial statements to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

Paragraph 21B of AASB 7 (and IFRS 7), under the heading 'Hedge accounting' reads as follows:

> 21B An entity shall present the required disclosures in a single note or separate section in its financial statements. However, an entity need not duplicate information that is already presented elsewhere, provided that the information is incorporated by cross-reference from the financial statements to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

Staff wish to confirm that the Board's wish is to also delete the wording from paragraph 35Cin AASB 7.

5) Question to Board members:

Does the Board wish to delete paragraph 35C from AASB 7?

GAAP/GFS convergence – Consequential amendments to AASB 1049

Staff have analysed the requirements introduced by IFRS 9 (2014) for any implications for GAAP/GFS. Staff note, for example, in paragraphs 31(a)(v) and paragraph 42(a)(i) that AASB 1049 *Whole of Government and General Government Sector Financial Reporting* currently acknowledges that there is a GAAP/GFS difference in accounting for bad debts and doubtful debts:

> 31(a) in both a whole of government and GGS financial reporting context, where GAAP and GFS both recognise the item in the reporting period:
>
> (v) bad debts expense is classified as transactions to the extent it is mutually agreed, otherwise it is classified as other economic flows;…

42(a) in a whole of government and GGS context:

(i) doubtful debts – although the ABS GFS Manual recognises bad debts written off, it does not recognise write-downs of accounts receivable in relation to doubtful debts;…

Although the requirements for determining the amount to be recognised for impairment by IFRS 9 differs from IAS 39/AASB 139, staff do not consider that AASB 1049 needs to be updated on issuance of AASB 9 (2014) since AASB 1049 already identifies a difference in recognition of doubtful debts/impairment losses.

Staff are in the process of confirming this conclusion with staff at the Australian Bureau of Statistics (ABS) and will advise the Board if any ABS staff have a different view.

However staff note that consequential amendments will need to be made to update references in AASB 1049 to AASB 9 instead of AASB 139. Staff also note that paragraph 14(b)(ii) of AASB 1049 refers ‘available-for-sale’ as a classification for financial assets. Staff note that would need to be updated to ‘fair value through other comprehensive income’ as a consequential amendment arising from the issuance of AASB 9 (2014).

Tier 2: Reduced Disclosure Regime

The AASB issued ED Tier 2 Supplement to AASB 237 *Financial Instruments: Expected Credit Losses* in July 2014 proposing reduced disclosures for Reduced Disclosure Regime (RDR) entities.

Staff are currently in the process of considering the final disclosures in IFRS 9 (2014) and will bring recommendations on disclosures for Tier 2 entities to a future AASB meeting.