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IFRS 9 Financial instruments
Status update

Introduction

On 4 August 2011, the International Accounting Standards Board (IASB), issued an exposure draft proposing to postpone the mandatory effective date of the new financial instrument standard, IFRS 9, from 1 January 2013 to 1 January 2015.

In this paper we consider the reasons for the delay, what this means for the IAS 39[1] replacement project as a whole, and take stock of where we are in this deeply complex (and political) financial instrument project.

First we consider the background to the project and reflect on why the IASB are proposing to delay the effective date for IFRS 9. We then consider at a high level, each of the original four phases of the project, noting that each phase is at a different stage:

- **Derecognition** is complete with new IFRS 7 disclosure requirements issued;
- **Classification and Measurement** is (theoretically) complete with the issue of IFRS 9;
- **Hedge Accounting** is in the final stages with a final standard expected soon (although the IASB's thinking on macro hedge accounting is in its infancy); and
- **Impairment** is still on the drawing board with the next milestone being a revised exposure draft of new proposals.

Each phase, even when apparently complete, is subject to political pressure of some kind, whether from the G20, Europe, other standard setters or regulators.

In discussing each phase we also consider where the US Financial Accounting Standards Board (FASB) is with its development of a new financial instruments standard. After all, despite the different timetables and the disparate approach to the project so far, it is a joint project between the IASB and the FASB, with significant pressure for a converged solution. Hence, looking at the FASB's work gives some insight into what may happen to IFRS 9 in the near future.

1 IAS 39 Financial Instruments: Recognition and Measurement

The background

For those who were not there at the start, or have lost track, the background to the project provides useful context against which to assess the future of the IASB's project. The financial crisis was undoubtedly the catalyst for fast tracking the IASB's project to replace IAS 39. A project to reduce the complexity of the financial instrument standard was already underway at inception of the crisis but still far off any concrete plans. It was a request from the G20 and the Financial Stability Board that formalised the replacement project with clear objectives and timelines.

In the midst of the financial crisis, with full year financial reporting looming, there was pressure for a quick fix of the immediate issues. One of the issues was not being able to reclassify out of fair value based measures into cost based measures at a time when markets to sell instruments were drying up, forcing companies to hold on to securities while fair values were plummeting. This immediate pressure on the standard setter gave rise to the IAS 39 Reclassification Amendment, of which many banks took advantage. Few on the IASB were happy with the amendment and the then Chairman, Sir David Tweedie was close to resigning over the matter. However, it was seen as a necessary bandage over a wounded standard, without which the future of IFRS would have been in jeopardy.

Furthermore, since some of the permitted reclassifications were only available in "rare circumstances" and the G20 had set a deadline for a new replacement standard to be available from the end of the following year, 2009, the amendment was seen as temporary.

The IASB worked frantically to meet this deadline which culminated in the issue of IFRS 9 Classification and Measurement in November 2009. This was not the complete replacement to IAS 39. It was the first half of the first phase, prioritised over everything else. It addressed only the classification and measurement rules for financial assets (which would have also made the reclassification amendment redundant). IFRS 9 is a new principles-based standard designed to reflect an entity's business model and hence give more useful information (see below).

There remained tight deadlines for the remaining phases of the project. However, these began to slip as it became apparent that the EU did not plan to endorse the first phase in time for entities to adopt early for 2009 reporting. The EU cited the less urgent need for a new standard, due to a stabilisation in the economic landscape and a need to assess the overall replacement rather than individual phases.

The reluctance of the EU to consider endorsing IFRS 9 until the project is complete has allowed the IASB to take more time on the remaining parts of the project not yet complete, including greater dialogue with the FASB. This prolonged debate has ultimately led to the need for a delay to the mandatory effective date from 2013 to 2015.

Why are the IASB proposing to delay the effective date?

The IASB are proposing to delay the mandatory effective date for IFRS 9 to annual reporting periods starting on or after 1 January 2015. Their proposal is laid out in ED/2011/3 issued on 4 August 2011.

There are a number of factors to consider in deciding whether to defer the effective date. Summarised below are some key considerations.

Reasons to retain the 2013 effective date	Reasons to delay the effective date
Retaining the original date will reduce the potential for non-comparability that could result from having an early adoption option for an extended period.	There is uncertainty over whether IFRS 9 will be endorsed in Europe before the standard is complete (i.e. before impairment and hedge accounting completed). This would give rise to wider divergence in the application of financial instrument accounting.
The mandatory effective date has been known for more than three years before the beginning of the comparative period. As a result some companies have begun to implement the standard on this basis.	If IFRS 9 is not endorsed in Europe in time then a situation could arise where IFRS reporting entities that are also SEC filers would have to prepare two sets of IFRS financial statements prior to EU endorsement – one in full compliance with IFRS for the SEC, and another in compliance with IFRSs as endorsed for use in Europe.
The IASB see IFRS 9 as an improvement to financial instrument accounting and hence should not delay its introduction.	Uncertainty exists with regard to whether IFRS 9 could be subject to change as a result of the convergence project with the FASB which is still debating their proposals (see page four).
	As the impairment and hedge accounting phases have not yet been complete, entities would not be able to concurrently implement all project phases as of 1 January 2013 with comparatives as of 1 January 2012. This is suboptimal as preparers would like to evaluate their classification and measurement decisions in light of the impairment and hedge accounting phases. Hence a single effective date for the complete standard would be beneficial.
	It would be advantageous to have the same effective date for IFRS 9 and other significant new standards being developed (e.g. insurance, revenue recognition and leases).

Considering these factors we think the IASB had little option but to propose a delay to the effective date. The IASB will remain under pressure to complete the remaining phases of the project in order to maximise the time preparers have to implement the new standard, particularly as there will be no exemption from presenting comparative figures.

To put the whole project into context, the rest of this paper summarises where the IASB is in each phase, including a summary of the completed phases on derecognition and classification and measurement. More detailed information about the project can be found using the resources at the end of this paper.

Derecognition

The IASB's project on derecognition was on the IASB's active agenda before the fallout from the financial crisis catapulted the overall replacement project into the limelight. As a result this was one of the first phases of the project to yield an exposure draft issued in March 2009. The document proposed ditching the familiar risk and reward test applied for derecognition of a financial asset. One of the alternatives proposed that got traction with respondents was a test based on who controls the financial asset. Under this regime if an asset is transferred to another entity and control over that asset is also transferred to that entity then derecognition could be achieved. For example, if a transferee borrowed a security that was highly liquid, it would have the ability to sell that security in the market and buy it back in order to return it to the transferor and hence it would be deemed to control it and the transferor would derecognise it.

The control based model represented a significant shift from current accounting. Furthermore, the proposals were being suggested at a time when there was more concern about off-balance sheet arrangements and the control based derecognition model would have resulted in more assets off the balance sheet. As a result the proposals for changing the derecognition model were shelved. However, the detailed disclosures that were proposed to accompany the control based derecognition model were retained and finalised by the issue of an amendment to IFRS 7 (issued in October 2010).

These new disclosure requirements result in significantly more information (compared to IFRS 7) being reported about transferred assets regardless of whether the transfer qualifies for derecognition or fails. The comprehensiveness of the disclosure requirements is in part due to the fact that they were designed to accompany a model where derecognition was easier to achieve. The new disclosure requirements are effective for annual periods beginning on or after 1 July 2011[2]. Although the standard is yet to be endorsed for use in Europe, this is expected to be endorsed later this year.

The objective of the disclosures is to enable users to understand:

- the relationship between transferred assets not derecognised and the associated liabilities; and
- the nature of and risks associated with the entity's continuing involvement[3] with a derecognised asset.

The disclosures required to meet these objectives are detailed and extensive and planning will be required as data gathering may be extensive.

Classification and measurement

IFRS 9 is complete with regards to the classification and measurement rules for financial assets and financial liabilities. We can therefore talk about the new rules with some confidence that they will not be changed. However, they might be subject to some change in the future as a result of responses to the FASB's proposals. The FASB is still working on its project and has not finished deliberating its classification model. It is, however, almost finished and there are some notable differences between their tentative model and the final proposals in IFRS 9 (see below). Hence there is some scope for the two boards to compromise on their respective models to help achieve convergence but this is by no means certain. Given this possibility, we thought it useful to compare the IASB's final model against the FASB's draft model so far (shown below after the IFRS 9 summary). It is not a comprehensive comparison but does give a flavour of the key differences.

IFRS 9: Financial Assets

The IASB's model primarily has two measurement categories for financial instruments on the balance sheet. They are: fair value or amortised cost. For assets measured at fair value, the gains or losses are either recognised in profit or loss (ie fair value through profit or loss) or in other comprehensive income (ie fair value through other comprehensive income). Hence this effectively gives rise to three categories.

Amortised cost is only available for assets that meet two conditions:

- Firstly, they must be held in a business model whose objective is to collect the contractual cash flows (as opposed to an objective of realising fair value through sale).
- Secondly, the contractual cash flow characteristics must represent repayment of principal and interest on principal, where interest is the compensation for the time value of money (in essence this condition requires the instrument's terms to be plain vanilla).

2 Note that comparative information for periods before this date is not required

3 The meaning of the term "continuing involvement" in respect of these IFRS 7 disclosures is not the same as the meaning in IAS 39 where it is used to describe an accounting treatment

The above conditions are principally there because it is considered that only if these conditions are met would it be useful to present a financial asset at amortised cost as opposed to fair value. For example, if an asset is held for trading, a fair value measure is more useful than a cost measure. Also if the terms of a loan have exotic features such as a link to an equity index, a fair value measurement is more useful.

It should be clear that equity investments and derivatives cannot satisfy the "plain vanilla" contractual cash flow test described above and hence these are always measured at fair value. Fair value changes for such items are taken to profit or loss unless an option, available only for equity investments, is elected at initial recognition to take the gains or losses to other comprehensive income permanently with only dividend income recognised in profit or loss (ie the category of "fair value through other comprehensive income").

Given the business model criteria, the IASB decided to require reclassifications between amortised cost and fair value if there was a change in business model (and the "plain vanilla" cash flow test is fulfilled).

The standard acknowledges that even if the conditions are met, it might not be useful to measure certain assets at amortised cost if this gives rise to a measurement mismatch against another instrument that is measured at fair value (e.g. a financial liability or an interest rate swap measured at fair value through profit or loss). Hence there is an option to designate an asset at fair value through profit or loss in such cases.

It is noteworthy that the model for assets does not require an assessment or separation of any embedded derivatives. Instead if there are exotic features, the instrument as a whole is measured at fair value through profit or loss (by virtue of it not qualifying for amortised cost accounting).

IFRS 9: Financial Liabilities

The IASB initially pursued a classification model for financial liabilities that was similar to that described above for assets. However, following negative feedback on this proposal, it opted to keep the model largely unchanged from the IAS 39 requirements except for one change. Many had complained about the requirement to include changes in own credit risk in the measure of fair value changes recognised in profit or loss as it counter intuitively gave rise to gains when credit risk deteriorated and losses when it improved. To address this issue for financial liabilities designated at fair value through profit or loss under the fair value option, IFRS 9 requires fair value changes arising from changes in own credit risk to be permanently recorded in other comprehensive income[4]. For financial liabilities at fair value, but not under the fair value option, IFRS 9 requires the fair value change recognised in profit or loss to include changes in credit risk on the basis that such liabilities will be held for trading and hence such gains/losses could be realised.

As a result of these limited changes, the embedded derivative requirements for financial liabilities and for non-financial hybrid contracts are retained.

One other change that was included at the time when the amendments to own credit risk were made was the removal of the exemption in IAS 39 from fair valuing unquoted equity investments (and derivatives that will result in delivery of such investments) allowing them to be held at cost. IFRS 9 does not have an exemption and therefore all unquoted equity investments (and associated derivatives) must be fair valued.

The FASB's proposals for both financial assets and financial liabilities

A quick comparison to the FASB's proposals highlights some significant differences.

The FASB has retained the embedded derivative requirements for both financial assets and financial liabilities. After any necessary separation of embedded derivatives, a two part test is applied to the instrument to determine its classification. This considers:

• the characteristics of the instrument; and

• the entity's business strategy[5].

If an instrument fails the characteristics test[6] then it must be measured at fair value through profit or loss[7]. If, on the other hand, it passes this first test, then the business strategy test will lead to one of three categories:

• fair value through profit or loss;

• fair value through other comprehensive income; and

• amortised cost.

4 Unless doing so creates a measurement mismatch

5 These descriptions appear similar to those in the IASB's model, however, the supporting wording is markedly different

6 The cash flow characteristics conditions are: It is a debt instrument held or issued that has all of the following characteristics:
(a) It is not a financial derivative instrument subject to the guidance in Topic 815 on derivatives and hedging.
(b) An amount is transferred to the debtor (issuer) at inception that will be returned to the creditor (investor) at maturity or other settlement, which is the principal amount of the contract adjusted by any discount or premium at acquisition.
(c) The debt instrument cannot contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initial investment, other than through its own choice.

7 In the US literature, this is described as "fair value through net income", however for ease of comparison we have used IFRS terminology

This may look similar to the IASB's three classification categories. However, the "fair value through other comprehensive income" category operates very differently under each model and applies to completely different types of instruments. The differences are summarised as follows:

	Fair value through other comprehensive income	
	Under FASB model	Under IASB model
What type of instruments can it be used for?	Only debt instruments held as assets.	Only equity investments.
Is this classification conditional?	Yes. Business model[8] and cash flow characteristics conditions apply.	Cannot be applied to instruments held for trading instruments.
Is this classification mandatory or optional if the conditions above are met?	Mandatory.	Optional.
What gains or losses are recognised in profit or loss?	Interest income is recognised in profit or loss on an effective interest rate method. Any remaining gains or losses retained in other comprehensive income on derecognition are recycled to profit or loss.	Only dividend income is recognised in profit or loss. No accumulated gains or losses are reclassified to profit or loss on derecognition of the investment.
What is a typical example of an instrument under this classification?	A listed debt security.	An equity share holding.

Further aspects of the FASB model include:

- Amortised cost measurement is only permitted for debt instruments (e.g. loans). For loan assets, this classification is only available if all of the following are met:
  - The asset is managed through customer financing or lending activities with a primary focus on collection of substantially all contractual cash flows.
  - The entity has ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss.
  - Sales or settlements are limited to circumstances that would minimise losses due to deteriorating credit.
  - The asset is not held for sale.
- For loan liabilities, amortised cost is the likely measurement category that will apply (after any required separation of embedded derivatives).
- The FASB's model does not permit reclassifications if the business strategy changes from the initial classification of a financial instrument.
- The availability of a fair value option has not yet been fully debated for financial assets but is permitted for financial liabilities only when a hybrid instrument includes a non-closely related embedded derivative.
- All equity investments are measured at fair value through profit or loss, with a limited exception for non-marketable equities held by non-public entities.
- When a financial asset will be used to settle a non-recourse financial liability, an entity is required to measure the financial liability in accordance with the measurement of the associated financial asset. As a consequence, if an asset is recorded at amortised cost and is impaired, the associated liability would also have its value reduced through profit or loss.
- The FASB has not yet discussed the presentation of changes in fair value of financial liabilities arising from changes in own credit risk.

8 The business model conditions for FVTOCI assets are:
1. Financial assets issued or acquired in a business activity for which an entity's business strategy, at origination or acquisition of the assets, is to invest the cash of the entity either to:
   (a) maximize total return by collecting contractual cash flows or selling the asset; or to
   (b) manage the interest rate or liquidity risk of the entity by either holding or selling the asset.
2. Financial assets that are not held for sale at acquisition or issuance.

In summary, some notable differences between the FASB's tentative model and the IASB's IFRS 9 model are:

- Listed debt securities that would satisfy amortised cost measurement criteria under IFRS 9 would likely be measured at fair value through other comprehensive income under the FASB model because the entity is unlikely to be able to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss.

- Equity investments can never be fair value through other comprehensive income under the FASB model but under IFRS 9 there is an option to do this.

- Non-closely related embedded derivatives must be separated from hybrid financial assets under the FASB model but not under IFRS 9.

- The FASB model does not allow reclassifications yet IFRS 9 requires it if the business model has changed.

- IFRS 9 has a fair value option to mitigate a measurement mismatch, but the FASB model does not.

As part of the overall convergence project, the IASB has said that it will expose the FASB's proposals for its constituents to comment. Given the significant differences above and the pressures for convergence, this could eventually lead to some aspects of IFRS 9 on classification and measurement being reconsidered.

Hedge accounting

Background
The financial crisis did not expose specific weaknesses with hedge accounting in the same way as it is claimed for classification, measurement and impairment. Instead the hedge accounting rules have long been regarded as complex and too rules based, giving rise to accounting information that is not always useful or a fair reflection of the risk management activity underlying it.

As a result, the IASB committed to an overhaul of the requirements to develop a model that is more representative of risk management activities. To tackle this project the IASB chose to split the hedge accounting phase into two workstreams:

- The first workstream is described by the IASB as the "general" hedge accounting model. This covers one-to-one hedging relationships and basic, non-dynamic, group hedges.

- The second workstream considers more complex portfolio, or "macro", hedges, including dynamic hedges (ie where the hedged items and hedging instruments change over time). This workstream incorporates the macro fair value interest rate hedging model applied by banks and the subject of the EU carve-out (see boxed text on page eight).

The general hedge accounting model
The IASB has undertaken this phase by systematically working through a series of "problem" hedge accounting scenarios identified during its outreach activities to evaluate whether the accounting outcome under the current standard is reasonable or justified. To the joy of many preparers the IASB has in many cases proposed changes to the model to address many of the problem scenarios.

Despite the model being overhauled in some areas, the basics of hedge accounting remain the same. That is:

- Hedge accounting will remain optional.

- Cash flow, fair value and net investment hedging, and the associated mechanics, are retained.

- Hedge ineffectiveness must still be captured in the income statement.

The following is a snapshot of some key changes proposed in the hedge accounting exposure draft that was issued in December 2010.
Some of these proposals have been redeliberated since the comment period closed in March 2011. The tentative decisions made during these redeliberations should in theory find their way to the final standard and are a good indication of what we can expect. However, we cannot rule out subsequent changes as a result of the FASB's deliberations on the topic (see page eight).

Topic	Proposal in exposure draft	Redeliberations
Hedge effectiveness assessment	In its exposure draft the IASB proposed the removal of the 80% to 125% threshold for testing effectiveness of a hedging relationship. It also proposed no longer requiring a retrospective test of effectiveness. Instead only a prospective test of effectiveness would be required and any resulting ineffectiveness would simply be measured in the income statement. The prospective effectiveness test proposed is a requirement that the hedge be expected to achieve "other than accidental offset" without defining specific parameters.	In the response to the exposure draft there was wide support for the removal of the 80% to 125% threshold and the retrospective effectiveness test. However, some respondents raised concerns that the "other than accidental offset" requirement was not well understood. In its redeliberations the IASB tentatively decided to retain the underlying principle of the proposals but describe it differently. Instead of the "other than accidental offset" requirement the Board tentatively proposed a requirement that requires an "economic relationship" between hedged item and hedging instrument where credit risk is not expected to dominate value changes from the economic relationship.
Hedging with financial options and forward contracts	When an entity designates the intrinsic value of a financial option as a hedging instrument, the IASB proposed deferring some or all of the change in time value in other comprehensive income to be later reclassified to profit or loss. Depending on the hedged item, this reclassification could be direct to profit or loss or via the balance sheet (e.g. by first capitalising as part of the hedged item). Also depending on the hedged item, the reclassification to profit or loss may be through amortisation over time or as one amount.	During its redeliberations the IASB tentatively decided to retain the proposals in the exposure draft but with additional guidance. Respondents also asked the Board to consider a similar accounting treatment for forward points on forward contracts when the spot element is designated in the hedging relationship. In redeliberations the Board discussed this request and tentatively agreed to permit an entity to defer fair value movements of the forward points on a forward contract in other comprehensive income to be reclassified to profit or loss on a rational basis over the term of the hedge.
Hedging risk components of non-financial items	The exposure draft proposed a change in the eligibility of risk components of non-financial items as hedged items. The IASB proposed aligning the eligibility criteria to that which applies to financial items (i.e. the hedged risk component should be "separately identifiable and reliably measurable"). The exposure draft also provided some guidance as to how this could be determined in practice.	The IASB discussed the comment letter feedback which supported the proposal in the exposure draft. The Board tentatively decided to retain the proposal but with the provision of further guidance and examples to help identify eligible risk components. Some respondents to the exposure draft opposed the ineligibility of inflation as a hedgeable risk component when it is not contractually specified in a financial item (this restriction was carried over into the exposure draft from IAS 39). The Board tentatively agreed to remove this specific prohibition, hence allowing an inflation component to be eligible if it is "separately identifiable and reliably measurable". To assist in the application of this principle, the Board agreed to provide an example where the inflation risk component is eligible and an example where it is not eligible.
Derivatives as hedged items	The ED proposed removing the current restriction in IAS 39 that prevents a derivative from being a hedged item. The proposals would allow a derivative to be a hedged item if it is combined with an eligible non-derivative hedged item (ie the hedged item can be an synthetic position).	In its redeliberations, the IASB tentatively agreed to retain this proposal in the final standard. They also agreed to include additional application guidance with regard to how the hedge accounting mechanics would apply.

Redeliberations on the general hedge accounting model are expected to continue for a couple of months with the final standard expected to be issued before the end of the year.

The portfolio hedge accounting model

The hedge accounting exposure draft described above set some of the foundations for a portfolio hedge accounting model (e.g. it allows certain net positions to be eligible for hedge accounting) but did not contain any specific proposals for a portfolio model.

Consistent with the approach with the general model described above, the IASB has focussed its initial efforts in understanding the risk management view point so that it can later be compared to the accounting outcomes. Hence, meetings to date have focussed on discussing the different risk management approaches of various banks. This is seen by many as a good starting point, however, it remains unclear whether this will ultimately lead to the changes that people are seeking. Given the political sensitivity in Europe (see next page) the endorsement of the overall project could ultimately depend on the degree of support in this area.

The EU IAS 39 carve-out

In November 2004, the European Commission endorsed a version of IAS 39 which had certain paragraphs relating to the application of macro fair value hedge accounting for interest rate risk deleted. This is commonly referred to as the IAS 39 'carve-out'. Despite initial expectations that the carve-out would be lifted in time, these paragraphs continue to be excluded from the EU endorsed version of IAS 39. Now the macro hedge accounting requirements are being reviewed as part of the replacement project, there is an expectation by many that new proposals will replace the current model and that a common ground will be reached where the EU would not carve-out any aspect of the new standard.

The carved out rules effectively allow entities applying EU-endorsed IFRS to do the following in respect of portfolio fair value hedging for interest rate risk:

- apply a bottom layer approach to defining the hedged item such that hedge ineffectiveness is not recognised for under-hedges (the full version of IAS 39 requires a proportional approach where hedge ineffectiveness would be recognised for an under hedge);
- hedge items with sub-LIBOR rates for changes in LIBOR (IAS 39 has restrictions on eligibility of sub-LIBOR instruments to be hedged for LIBOR risk); and
- hedge on-demand deposits (sometimes referred to as "core-deposits") for interest rate risk (under IAS 39, on-demand deposits have a deemed fair value of the demandable amount and hence are not eligible for fair value hedge accounting for interest rate risk).

The carved-out version of IAS 39 is applied by a dozen banks in Europe and so its use is not that widespread.[9]

FASB's hedge accounting proposals so far

The FASB has not re-discussed its hedge accounting proposals since it exposed them as part of their Accounting Standards Update (ASU) on financial instrument accounting issued in May 2010. Hence since then the hedge accounting discussions have been IASB-only meetings. Given that the ASU proposed only limited changes to the existing US GAAP requirements (see below), and the IASB has made many changes, the current situation is that the two sets of proposals are more divergent than they were at the outset of the project. The FASB has, however, been keeping a close eye on the IASB developments, often as observers in the board meetings. They also issued a "wrap" around the IASB's hedge accounting exposure draft to ask constituents specific questions on the proposals. The comment period for this ended earlier this year. The FASB will consider responses to both the proposed ASU (summarised below) and the IASB's exposure draft as part of its deliberations on the topic which are expected to commence later this year.

Subject	FASB's proposed ASU	Summary of feedback
Hedgeable risks	The proposed ASU retains the provision under current U.S. GAAP that allows an entity to designate hedges of financial items for certain risks (e.g., benchmark interest rate risk, foreign currency risk, credit risk).	Respondents support bifurcation-by-risk for financial items. Some advocate extending this approach to non-financial items.
Threshold for hedge accounting	The hedging relationship is expected to be "reasonably effective".	Respondents generally support the lower "reasonably effective" threshold for hedge effectiveness. However, many respondents noted a need for additional guidance on what is meant by "reasonably effective" (without setting a bright line).
Means of assessing effectiveness	Typically, only a qualitative assessment is required; however, a quantitative assessment may be necessary if the qualitative assessment is not conclusive.	Respondents generally support simplifications to hedge accounting, including a qualitative assessment of hedge effectiveness.
Frequency of hedge effectiveness assessments	Inception only, unless reassessment is warranted because of a change in circumstances.	Respondents generally support simplifications to hedge accounting.
Determination of amounts recorded in OCI for cash flow hedges	Recorded at the amount necessary to offset the present value of the cumulative change in expected future cash flows on the hedged transaction since hedge inception.	Some respondents do not support the recognition of ineffectiveness in net income on under-hedges in cash flow hedging relationships.
Dedesignating a hedging relationship	An entity cannot remove hedge designation after it has been established; however, the entity may enter into an offsetting derivative to effectively terminate the hedge.	Respondents expressed concern about the changes to the hedge dedesignation requirements.

9 Note that IFRS reporters who are SEC registered file accounts to the SEC based on full IFRS and hence if they apply the carve-out for local reporting purposes in Europe, they must reverse this and apply full IFRS for SEC filings

Impairment

Background

The financial crisis has exposed some inadequacies with IAS 39's impairment rules for loan assets. Some had warned of the "cliff effect" of the current model where provisions can be recognised only when there is objective evidence of a loss (ie an "incurred loss" model) and cannot include future expected losses (ie an "expected loss" model that incorporates future events), however likely.

What was perhaps less obvious for some, prior to the crisis, is the potentially drastic differences in the amount of impairment loss recognised depending on the choice of IAS 39 classification of a loan asset. Loan assets classified as available-for-sale are measured at fair value and when impaired the cumulative fair value loss recognised in other comprehensive income is reclassified to profit or loss. Losses based on fair value are invariably far greater than losses calculated on an amortised cost basis primarily because the fair value implicitly discounts cash flows by a market rate of interest whereas an amortised cost measure of impairment uses the original effective interest rate (EIR). The market rates can be significantly higher than the original EIR because of the increased credit and liquidity spreads that are demanded of a borrower that is in financial difficulty.

For banks, the potential for significant differences in impairment losses for the same loan assets held under different accounting classifications can have damaging effects not only on the reported results but also on regulatory capital. For example, in the current Greek debt crisis banks who hold Greek Government bonds at amortised cost (ie under the "loan and receivable" or "held to maturity" classification) could record significantly lower impairment losses than those who hold them as available for sale. As a result the effect on a bank's capital could also differ significantly. Hence this difference in accounting can make both the accounting results and capital balances less comparable amongst entities with similar assets.

It is noteworthy that the IASB has not included the available for sale category in IFRS 9 (see above) and so the only measure for impairment would be based on amortised cost and not fair value. However, the FASB has included a category where the measurement and recognition basis is similar to the available for sale category in its tentative discussions so far (referred to above as "fair value through other comprehensive income").

Project update

While all assets are not measured at fair value through profit or loss an impairment model is necessary. This is one of the phases of the replacement project where the IASB and FASB have aligned their project timetable and are now having joint deliberations on what the future model should be.

The impairment project has been ongoing for some time with much interaction with constituents. For example:

- In June 2009, the IASB issued a request for views consulting on the workings of amortised cost and impairment recognition models.

- In November 2009, the IASB issued an exposure draft detailing an expected loss impairment model for public comment.

- In the same month the IASB set up an expert advisory panel of accounting and risk experts to consult on the merits and workings of an expected loss impairment model.

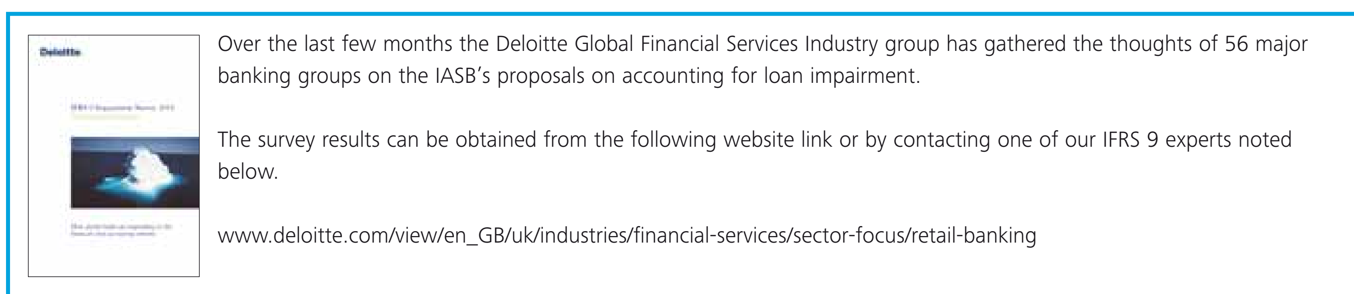
- In January 2011, taking on board comments and feedback received from constituents, the IASB and FASB issued a joint supplementary document proposing a model for the timing of recognition of impairment losses.

The high-level approach has been a move from incurred loss to expected loss. However, exactly how such expected losses should be calculated and when they should be recognised is still subject to much debate. The question of when to recognise the provision is what was most significantly different about the IASB's and FASB's initial proposals. The IASB initially supported a model whose objective was to spread the expected loss over the life of the asset, whereas the FASB supported a model with provisions recognised sooner (e.g. on initial recognition of the loan asset). Working together the two boards reached a compromise in their joint supplementary document where expected losses are spread over the life of the loan except where conditions for earlier loss recognition are fulfilled.

Since the comment period for this document has closed both Boards have met to discuss feedback. Their aim is to re-issue an exposure draft before the end of this year. To reach a consensus and develop their final model, a joint board and staff working group was formed. Below is a brief summary of what this model could look like given Board discussions to date. One of the features of this model is the three-bucket approach (this is in contrast to the two bucket approach of "good book" and "bad book" proposed in the joint supplementary document issued in January 2011). Under these proposals, loans fall into one of three buckets based on the levels of credit deterioration. The categorisation will govern when loss provisions are recognised.

Bucket 1	Bucket 2	Bucket 3
This category includes the portfolio of assets that do not meet the criteria for either of the second two categories. For this category the working group is discussing alternatives for recognising expected credit losses. The latest proposal under consideration is for the loan loss provision to represent expected losses for the next 12 or 24 months from the balance sheet date.	This second category would consist of assets that have been affected by the deterioration in credit risk due to the occurrence of an observable credit event which indicates a possible future default but the specific assets that will default cannot be specifically identified. For this second category, the full lifetime expected credit losses would be recognised as an allowance, but the allowance would be calculated on a portfolio basis. This can be considered to be similar to the notion of "incurred but not reported", but more forward looking.	This third category would consist of individual assets where information is available that specifically identifies that credit losses have, or are expected to occur for individual assets. Similar to the second category, the third category would recognise the full lifetime expected credit losses as an allowance, but the allowance would be calculated on an individual asset basis.

The boards will continue to debate the impairment proposals in the coming months.


Over the last few months the Deloitte Global Financial Services Industry group has gathered the thoughts of 56 major banking groups on the IASB's proposals on accounting for loan impairment.

The survey results can be obtained from the following website link or by contacting one of our IFRS 9 experts noted below.

www.deloitte.com/view/en_GB/uk/industries/financial-services/sector-focus/retail-banking

Closing words

Solving the financial instruments puzzle has taken longer than all would have hoped. With the many Board meetings, resulting exposure drafts, continuous dialogue with both Boards and constituents it is sometimes hard to see where all this is effort is heading. Hopefully this paper has in some way helped to make it clearer.

What the financial crisis has taught us is the influence of the balance sheets of banks and other financial institutions on the functioning of the global economy. As the largest holders of financial instruments it is entirely reasonable that the interest in this project goes beyond the accounting crowd. This wider interest has no doubt slowed the project down, but if it results in a greater understanding and wider acceptance of the standards then the delay is no bad thing.

Will the puzzle ever be solved to everyone's satisfaction? Probably not, but then the objective of accounting standards was never for them to be universally liked. I hope in the not so distant future the focus will move away from lobbying to implementation and the benefit of these reforms will start to accrue.

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Contacts and resources

For up to date detailed information and analysis on the financial instruments accounting project visit www.iasplus.com.

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