IFRS Foundation

Special Interest Session

IFRSs for Financial Instruments

28 July 2010— Mandarin Oriental Hotel (Tokyo)

To provide a comprehensive service for those with a special interest in the accounting and reporting for financial instruments the
IFRS Foundation will hold an intensive half-day session immediately before their IFRS conference, on the morning of 28 July 2010.
The session will focus on accounting and reporting financial instruments in accordance with IFRS 9 Financial Instruments and on the IASB's current active projects to replace IAS 39 Financial Instruments: Recognition and Measurement.

Programme

09:00 ***Registration***

09:30 ***Introduction***
Warren McGregor
Member
IASB

09:35 ***IFRS 9***
An overview of the requirements—Ian Farrar, *Partner, Accounting Consulting Services*, **PwC**

10:30 ***Replacing IAS 39***
- Impairment of financial assets—Wayne Upton, *Director of International Activities*, **IASB**
- Hedge accounting—Wayne Upton, *Director of International Activities*, **IASB**

11:25 ***Round-table Q&A***
- Ian Farrar—*Partner, Accounting Consulting Services*, **PwC**
- Wayne Upton—*Director of International Activities*, **IASB**
- Warren McGregor—*Member*, **IASB**

11:55 ***Concluding comments***
Warren McGregor
Member
IASB

International Financial Reporting Standards

Financial instruments

Replacing IAS 39

Wayne Upton, Director of International Activities, IASB

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

IFRS

Timetable

	Phases	Due process documents	Finalisation
FASB ED covers all phases	1. Classification and measurement	IFRS 9 published on 12 Nov 2009 ED on financial liabilities published on 11 May 2010	In time for year end financial statements 2009 for financial assets During 2010 for financial liabilities
	2. Impairment methodology	ED published in November 2009 Comments due by 30 June 2010	Expected during 2010
	3. Hedge accounting	ED expected Q3 2010	Expected during H1 2011

IFRS

International Financial Reporting Standards

Phase I: Classification and measurement

IFRS Foundation

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or the IFRS Foundation

IFRS

Overview of classification model - IFRS 9 *for financial assets only*

Entity's business model for managing

+

Contractual cash flow characteristics

›

Amortised cost (one impairment method)

›

FVO for accounting mismatch (option)

Reclassification required when business model changes

All other instruments:

- Equities
- Derivatives
- Some hybrid contracts
- …

›

Fair Value (No impairment)

›

Equities: OCI presentation available (alternative)

IFRS

Overview of FASB proposal
(financial assets and financial liabilities)

Entity's business model for managing

+

Contractual cash flow characteristics

›

Can choose Fair Value through OCI (FV-OCI)

›

Choice of amortised cost for own debt (mismatches) & some trade receivables/payables

No reclassification

All other instruments:

- Equities
- Derivatives
- Trading
- Some hybrid contracts
- **Any instrument by default**

›

Fair Value through Net Income (default measurement) (FV-NI)

Impact of FASB's FV-OCI classification on net income

If an entity meets the business strategy and contractual cash flow criteria they can irrevocably *elect* FV-OCI

Net Income	=	**Interest income / expense**	+ / -	**Credit impairment**	+ / -	**FV changes due to hedged risks**

- Any residual change in fair value goes to OCI
- Realised gains/losses are recycled

FASB - Core deposits

7

Deposits
>without a contractual maturity
>considered to be a stable source of funds

Measured as present value of average ‘core’ deposit liability

Discount using

Difference between rate on next best alternative source of funding and all-in-cost-to-service rate

Over the implied maturity

IFRS

FASB - Amortised cost

8

Limited exceptions allow <u>election</u> of amortised cost

Financial liabilities

- Meet FV-OCI criteria
- Liability at FV causes “accounting mismatch”
  - Contractual linkage to a non-fair value asset
  - Issued by entity/operating segment with <50% assets at FV

Short-term trade receivables/payables

- Meet FV-OCI criteria

IFRS

FASB - Presentation in Statement of Financial Position

- FV-OCI and FV-NI items presented separately
- For FV-NI items only present fair value amounts and also amortised cost for own debt
- FV-OCI assets presented as follows:

– Cost/Amortised cost	XXX
– Allowance for credit losses	(XX)
– Residual FV adjustment	X
Fair value	XXX

- FV-OCI liabilities as above but without impairment

Presentation in Statement of Financial Position - continued

- Capital could be presented as follows:

Common stock	XXX
Retained earnings	XXX
AOCI, excluding FV changes	XXX
Equity excluding fair value changes	YYY
Fair value changes for instruments	(XX)
Total comprehensive equity	ZZZ

Key differences between IASB and FASB

- **FV-NI is the default under the FASB ED**
- **But generally impact on net income/P&L should be similar* *for financial assets* under the IFRS model and the FASB proposals**

Topic	FASB ED	IASB Approach
Loans and debt securities (assets) meeting criteria	May elect FV-OCI	Required to be at amortised cost (subject to FVO)
Equity investments	FV-NI	FV but, if not held for trading OCI election available
Financial liabilities	For financial institutions most at FV and *many FV-NI* (symmetrical model)	Retains IAS 39, except for presentation changes for FVO so **most financial liabilities at amortised cost or bifurcated**
Core deposits	'Remeasurement value'	Redemption amount

*Differences will however arise due to differences in impairment proposals

International Financial Reporting Standards

Phase I: Classification and measurement (financial liabilities)

IFRS Foundation

Financial liabilities – background

Feedback on ED:
- Financial liabilities 'not broken'
- Financial liabilities less urgent
- Need to address 'own credit'

Excluded financial liabilities from the scope of IFRS 9 for 2009 year ends

To
seek input on best way to address 'own credit'

Outreach activities

- Five alternative approaches to the own credit problem explored
- Staff and Board members met with:
  - Regulators
  - Preparers
  - Users (including a user survey)
  - Audit firms
  - Our FIWG
- Focussed on practical issues in separating own credit and which solution would provide the most useful information

Results of outreach

Preparers	'Own credit' hard to separate
	Bifurcation of liabilities means don't have to deal with complexity of identifying own credit
Users	Liabilities viewed differently to assets – symmetry not useful
	P&L volatility from own credit not useful
	Do not invent new measurement method: If remeasured prefer full fair value measurement on B/S
	Bifurcation for liabilities helps address own credit concerns
Overall	No consensus

Tentative decisions

To address 'own credit risk' :

- Retain IAS 39 measurement requirements for financial liabilities:
  - held for trading ➔ fair value through P&L
  - hybrid liabilities ➔ bifurcation requirements in IAS 39
  - 'vanilla' liabilities ➔ amortised cost
  - maintain FVO (with current eligibility conditions)

  BUT
- Separate out 'own credit risk' for FVO
- 'Own credit risk' portion would be separated in a manner similar to that used in IFRS 7 for disclosure (IFRS 7 B4)

FVO proposals

Profit or Loss (liabilities under FVO)	
Total change in FV	XX
Change in FV due to 'own credit'	(X)
Profit for the year	XXX

Financial liability on balance sheet at (full) fair value

Statement of Comprehensive Income (liabilities under FVO)	
Other Comprehensive Income:	
Change in FV due to 'own credit'*	X

* Not recycled

Why this approach?

- Five alternatives explored during outreach. No consensus as to 'best' approach.
- Minimise disruption
  - Most entities bifurcate and will likely continue
  - Bifurcation method: IAS 39 similar outcomes to IFRS 9
- But addresses 'own credit'
  - Separate 'own credit' only if use FVO
  - Have to do that today for disclosure purposes

Next steps

- Exposure draft: May 2010
- Comment Deadline: **16 July 2010**
- Final Standard: 2010

FASB approach to own credit in ED

- For *all* financial liabilities at fair value recognise separately in net income (for FV-NI) or in OCI (for FV-OCI)
- Includes gains and losses **only due to changes in credit standing** – not due to the effect of changes in the price of credit.

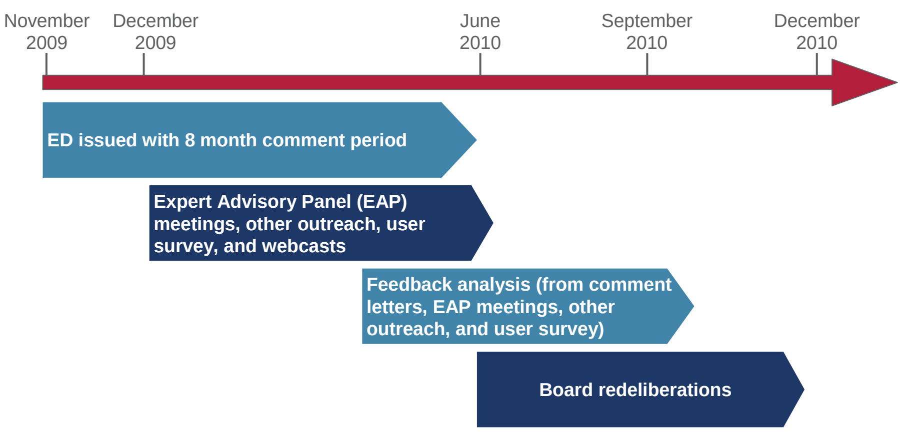
International Financial Reporting Standards

Phase II: Impairment

IFRS Foundation

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or the IFRS Foundation

Impairment of financial assets



Expert Advisory Panel

- What is it for?
  - To consider how to address operational challenges
- Who is on it?
  - Credit and risk experts from different regions and sectors
- How does it work?
  - Public meetings
  - Formed: Dec 2009 Ended: June 2010
  - EAP subgroups
    - Cash flow estimates
    - Effective interest method

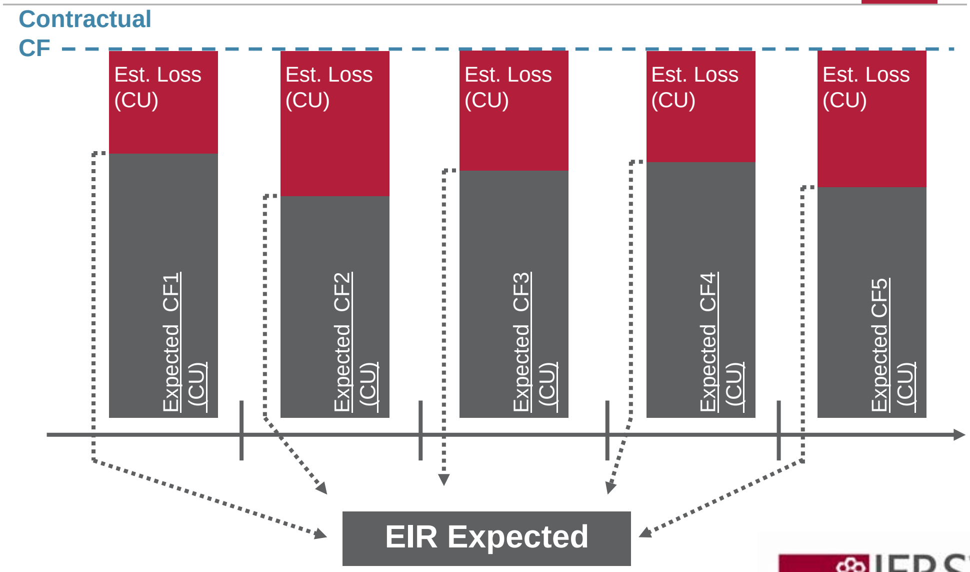
Major operational issues – decoupling

Major operational issue #1:

- Allocation of initial expected losses (EL)
  - ED requires allocating the *initial* EL estimate over the expected life of the financial asset
  - Allocation mechanism: the (credit cost adjusted) effective interest rate (EIR)
- Potential simplification: 'decoupling' of interest and credit loss calculations

Deriving expected cash flows

25



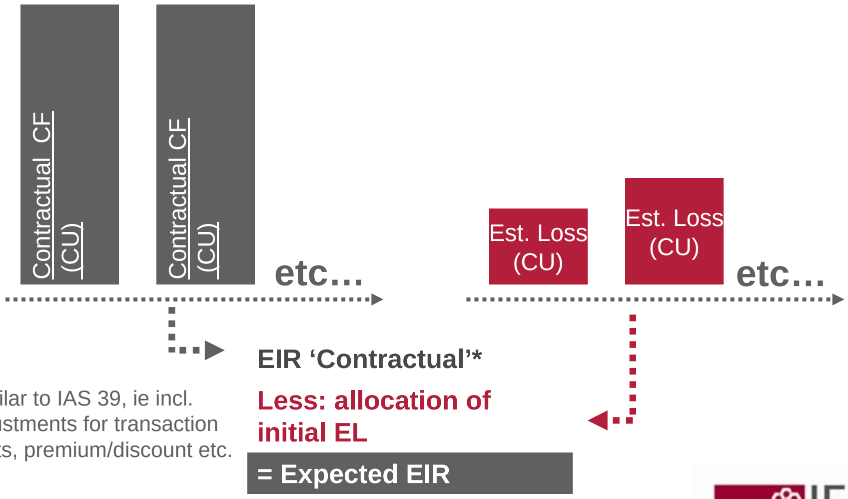
Organisational and IT structure

26

Infrastructure separates accounting (interest rate) systems and credit risk systems

Initial EL

Allocation of initial expected losses – ‘decoupling’



*Similar to IAS 39, ie incl. adjustments for transaction costs, premium/discount etc.

Different ways of decoupling

- Use separate DCF calculation for the initial EL that is allocated over the life of the instrument by converting the PV of the EL into an annuity
- Disaggregating the calculation of allowance account into three building blocks:
  - – initial expected loss
  - – experience adjustment
  - – adjustment for changes in expectations for the remaining life of the instrument

Major operational issues – lifetime EL

Major operational issue #2:

- Estimating lifetime expected loss
  - Consider and use best available information
  - Based on historical information adjusted for management expectations of future conditions and likely changes in the portfolio
  - Basel II EL can be used as one possible starting point but would require adjustments
  - Reasonable estimates over 1 to 3 years, then revert to long term average loss rate

IFRS

Open portfolios

Major operational issue outstanding:

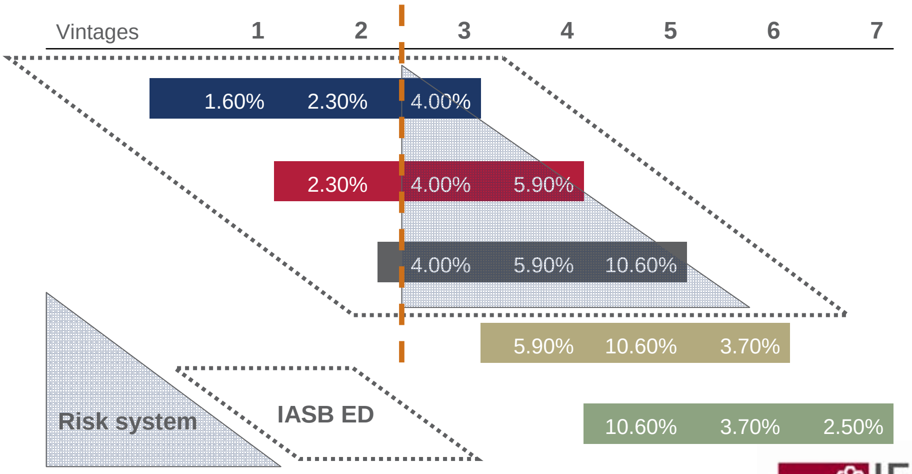
- Application of impairment model to open portfolios
  - Significant operational challenges
  - ED would require carrying forward historical information from date of initial recognition (initial EL or EIR)
  - Most financial institutions only have forward looking information
  - Hard to differentiate whether the revision of expected loss relates to:
    - loans already in the portfolio (→ catch up adjustment)
    - new loans (→ initial EL recognised over life of instrument)

IFRS

Open portfolios (cont'd)

31

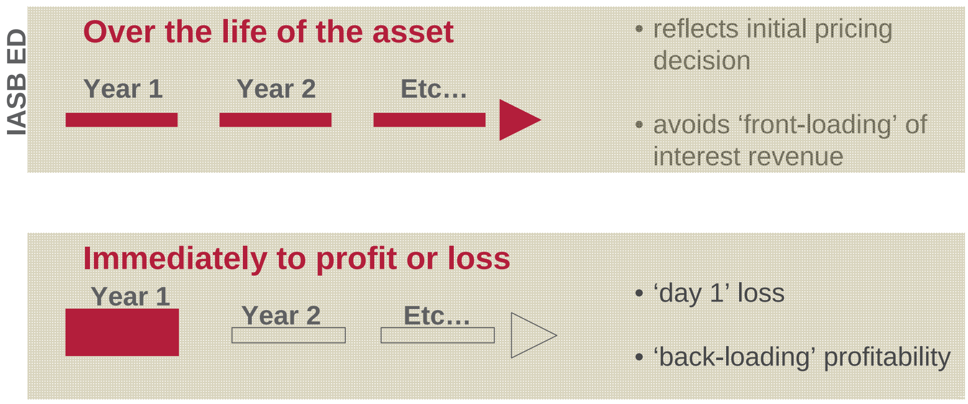
Open portfolios vs closed portfolios



IFRS

Recognition of the initial expected loss

32



IFRS

Subsequent changes of estimates

Over the life of the asset

Year 1 | Year 2 | Etc…

- could result in a rate below risk free (even negative)
- counter-intuitive: lower discount rate for a higher risk asset

IASB ED

Immediately to profit or loss

Year 1 | Year 2 | Etc…

- reflects change in credit quality
- carrying amount is always the PV of the current ECF discounted at the (original) effective interest rate
- change in estimates that reflect gains or losses are not allowed to be deferred (other IFRSs)

FASB ED - Impairment

- **Applies to FV-OCI and trade receivables at amortised cost**
- Estimate cash flows **based on past and current conditions**
- Losses do not need to be probable to be recognised
- Can evaluate on an individual or pool basis
- Treatment of initial expected future losses different to IASB
- Interest income calculated using effective interest rate *unadjusted for losses* but applied to carrying amount net of allowance for credit losses
- Allowance consists of credit impairments PLUS excess of interest received over interest income accrued

International Financial Reporting Standards

Phase III: Hedge accounting

IFRS Foundation

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or the IFRS Foundation

IFRS™

Introduction

- The Board is considering hedge accounting **comprehensively**
- Overall approach:
  - Use existing architecture
  - Address specific problem areas
  - Use clear and explicit principles
  - Identify any exceptions clearly

IFRS™

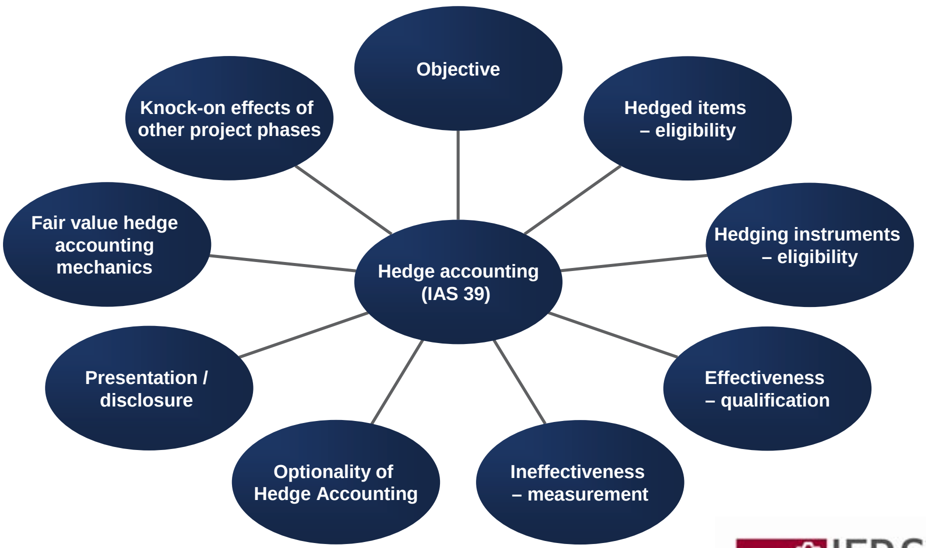
Hedge Accounting – broad direction

- Phased approach:
  - general hedge accounting first
    - modification of fair value hedge accounting
    - simplification of cash flow hedge accounting mechanics
  - against the background of the general approach consider:
    - portfolio hedge accounting

This project will not look at hedge accounting for hedges of net investments in foreign operations

IFRS

Components of the hedge accounting model



IFRS

Tentative approach to hedge accounting

IAS 39

Fair value hedge accounting	Cash flow hedge accounting

Simplifications to existing hedge accounting requirements

Fair value hedge	Cash flow hedge

Cash flow hedge accounting mechanics

- Gains/losses on effective portion in OCI
- Any ineffectiveness recognised in P/L
- Hedged item is not remeasured
- Lower of test is not used for fair value hedges
- Items measured at amortised cost eligible as hedged items

Next steps…

- Continue deliberations
- Exposure draft expected in Q3 2010
- Continued outreach
- IFRS in Q2 of 2011

FASB ED - Hedge accounting

- Qualitative test to demonstrate that the hedging instrument would be *reasonably effective* in offsetting changes in the hedged item or forecasted transaction
- Bifurcation by risk (benchmark interest rate risk, foreign currency and credit risk) allowed for financial items
- All ineffectiveness associated with the hedged risk recognised in net income
- Only reassess if circumstances suggest a change
- Can only discontinue if criteria no longer met or instrument expires, is sold, terminated or exercised

Questions or comments?

Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.