



IASB tentative decisions on IAS 39



Having announced, in April 2009, an accelerated timetable to revise IAS 39, the IASB debated some fundamental, but contentious, topics at its May 2009 meeting. Board members also voted on several Tentative Decisions to enable the IASB Staff come back with focused Agenda Papers and specific decision requests at subsequent Board meetings. These relate to two of the three key topics into which the project has been subdivided, as follows: classification and measurement; and impairment. The third topic, hedge accounting, will be dealt with in an Exposure Draft (ED) to be issued before the end of 2009. Note that the IASB is aiming for the changes in classification and measurement to be available for 2009 annual reports.

Classification and measurement

Proposed criteria

The IASB has adopted a working premise to proceed with a two measurement category approach that would measure financial instruments at either: (a) fair value; or (b) amortised cost. Earlier, in March 2009, the IASB and the US Financial Accounting Standards Board (FASB) decided tentatively to consider three potential measurement methods for financial instruments, with the third measurement category being a discounted cash flow model.

The Board decided tentatively to use as a starting point the classification approach for financial instruments in the forthcoming IFRS for small and medium-sized entities (SMEs). This approach distinguishes between:

- ▶ Basic financial instruments that qualify for amortised cost measurement; and
- ▶ Other financial instruments that are measured at fair value

Basic financial instruments, according to the IFRS for SMEs, would include very simple vanilla debt instruments. Therefore, an instrument that contains an embedded derivative that requires bifurcation under the current requirements of IAS 39, is unlikely to be a 'basic' financial instrument to be recorded at amortised cost. It is possible that the Board will also exclude from the category those financial instruments which are quoted in an active market.

Other proposed changes

Under this working premise, the Board expects to:

- ▶ Retain a fair value option so that entities may elect to measure at fair value financial instruments if, for example, fair value reflects more accurately the entity's business purpose for holding the instrument. It is not yet clear if the use of the option will be constrained and, if so, using what criteria
- ▶ Prohibit reclassifications between the fair value and amortised cost categories



- ▶ Eliminate the existing 'tainting' rules that limit the further use of amortised cost after disposal of other financial instruments measured at amortised cost. Instead, entities would be required to present separately gains and losses on such disposals
- ▶ For certain instruments measured at fair value (probably items not held for trading), allow presentation of fair value changes in other comprehensive income (OCI), but without any subsequent transfers to profit or loss, either on disposal or otherwise. (Such fair value changes would be moved from OCI to retained earnings on the sale or transfer of these instruments). This would eliminate the need to test these instruments for impairment.

The IASB expects to publish for public comment an Exposure Draft on the classification and measurement of financial instruments by July 2009 and a final standard in time for 2009 year-end financial statements.

Impairment of financial assets

IAS 39 *Financial Instruments: Recognition and Measurement* currently requires impairment of financial instruments that are recorded at amortised cost to be determined using an incurred loss model. There have been criticisms of the incurred loss model, chiefly that:

- ▶ The model is internally inconsistent in that expected losses are implicit in the initial measurement of a loan asset (which will usually be issued at fair value, with an interest rate sufficient to absorb future expected credit losses), but the subsequent accounting ignores changes in expected losses until a loss is 'incurred'
- ▶ The model relies on a rather arbitrary distinction between 'incurred credit losses' and 'future credit losses'.

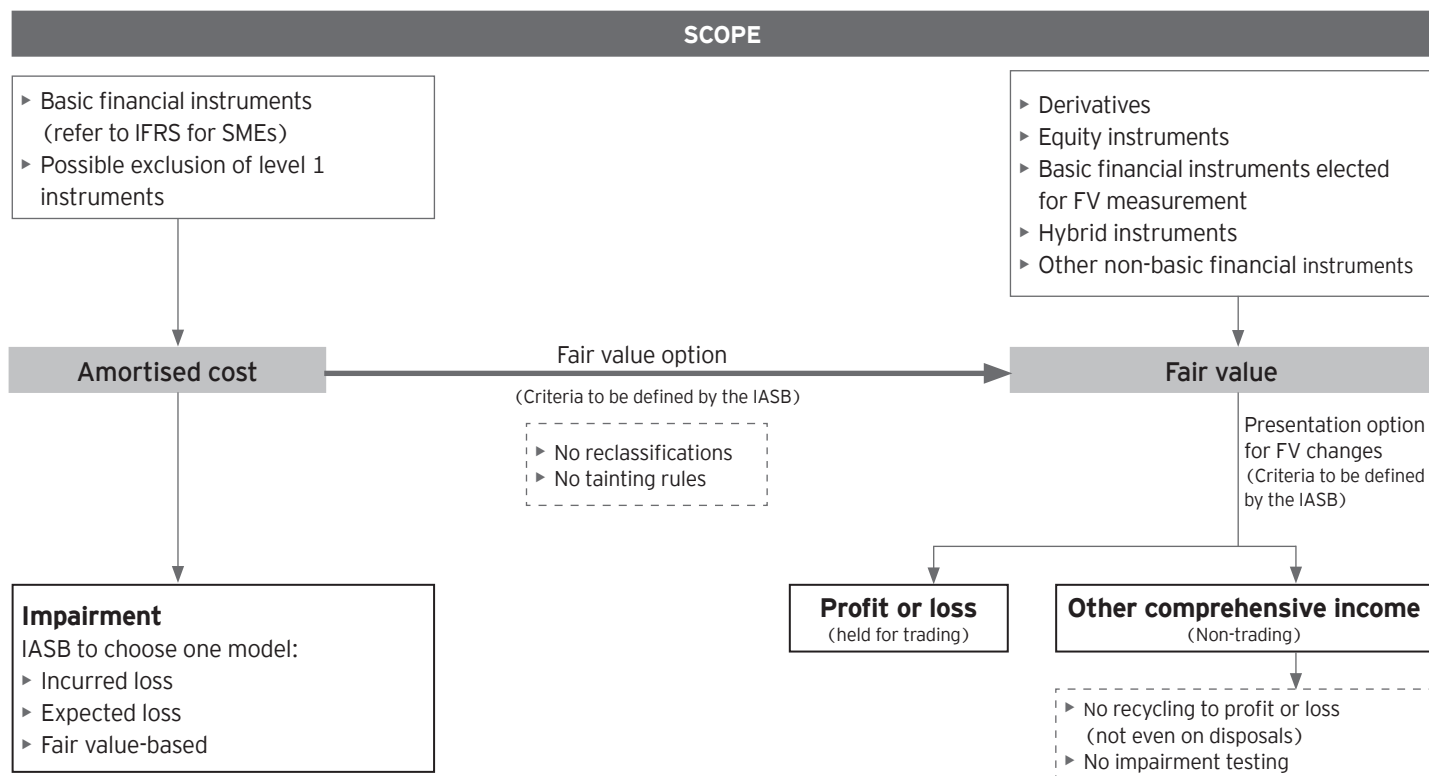
The IASB has been debating two other impairment models, with several members and constituents weighing in favour of the expected loss (or expected cash flow) approach (which would draw on information already required for the Basel II regulatory capital regime), and a fair-value based impairment model.

The use of terms by different bodies, such as standard-setters and regulators, is not always consistent, but the expected loss model proposed by the IASB staff is not the same as 'dynamic provisioning' (or 'through the cycle provisioning') as favoured by some regulators. Whilst both models - expected loss model and 'through the cycle provisioning' - involve recognising credit losses in advance of them being incurred, there is at least one important difference: under 'through the cycle provisioning' for any given loan, greater provisioning would be made in good years to compensate for potential bad years.

In the expected loss model considered by the IASB, expected losses would be computed in the determination of the Effective Interest Rate (EIR) at inception. Therefore, expected losses would accrue over the life of a loan through the EIR method. (So, for instance, if the contractual interest rate is 6% and credit losses of 2% are expected, the net income will be accrued at 4%). Following this approach, if all the future cash flows occur, as originally expected, the interest revenue recognised under the EIR method is all that would be recorded in profit or loss.

However, after initial recognition, any change in expected losses would give rise to an adjustment to income by discounting the revised expected cash flows using the original EIR (as with an AG8 adjustment). There would no longer be any threshold or triggering event for recognising impairment losses and no need to distinguish between an individual and a collective assessment.

Proposed measurement categories



The IASB has obtained feedback from a number of meetings with interested stakeholders to discuss the features and operability of an expected loss approach to impairment. Based on those meetings, the Board believes that wider consultation is necessary before making any formal proposals. After further deliberation at the June 2009 IASB meeting, a request for views from interested stakeholders is expected to be posted on the IASB website. The formal proposal (an Exposure Draft) on impairment of financial assets is expected in October 2009.

Business impact

Classification

The two-category classification and measurement model (fair value or amortised cost), with the option to present fair value changes either in profit or loss or OCI, is fundamentally different from the approach used so far under IAS 39. The ability to recognise gains and losses in OCI means that it is not, strictly, a two category model, and this feature will make the proposal more welcome to preparers than alternative possible models which would require all fair value changes to be recorded in income. However, the suggestion that gains on holding non-trading equities would never be recorded in profit or loss will not be so attractive to some constituents.

Currently, a number of entities hold financial assets classified as 'available for sale' or 'held to maturity', which would need to be reclassified to amortised cost or fair value (presumably through OCI) at the date the entity adopts the new standard. As fair value and amortised cost information will already be available for these instruments, it will not be too difficult or costly to move to this model.

However, it is possible that the Board may require certain debt instruments that can currently be recorded at amortised cost as 'held to maturity' (such as highly liquid government bonds), to be recorded at fair value (either through profit or loss or OCI). Also, some financial assets currently classified as 'loans and receivables' may have to be reclassified in the fair value measurement categories if the Board retains the more stringent criteria set out in the SME project (e.g., hybrid instruments with embedded derivatives).

Since the revised requirements for hedge accounting will not be available for adoption at the same time as the new classification approach, entities will need to carefully consider the implications of revising their hedge accounting arrangements, with the possibility that the method chosen may cease to be available during 2010.

If the IASB publishes the ED in July 2009 with a 60 day comment period, then the final standard would potentially be available in October 2009. This would give companies two months to implement the changes for the 2009 annual report. For European entities, the time frame might even be shorter because the EU would need to endorse the changes before a European entity can apply them.

The transition rules and disclosure requirements under the two-category approach are not yet clear. Will it be possible to adjust categories retrospectively to the beginning of the year or even fully retrospectively? In which case, will it be possible to back-date changes in hedge accounting arrangements?

Users and preparers, corporate entities as well as financial institutions, need to deliberate whether the proposals are workable and provide their inputs to the IASB once the Exposure Draft is issued in July 2009.

Impairment

The expected loss method is the one that best matches the recognition of income and impairment, but is more complex to apply than the incurred loss model. It relies heavily on expected cash flow estimates and may allow more management discretion in the application. The data requirements will be particularly onerous for entities that are not used to estimating future credit losses. There will also need to be assessment of how impairment would be presented and disclosed, to avoid loss of transparency of information on the subject.

Updates on IAS 39

Look for regular updates on the developments on IAS 39 replacement project in our monthly editions of our newsletter, *IFRS Outlook*.

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