



Memorandum

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| To: | AASB members | Date: | 20 January 2010 |
| From: | Christina Ng & Patricia McBride | Agenda Item: | 7.1 |
| Subject: | Update on Financial Instruments (Replacement of IAS 39) Project | File: | |

Action

1. For your information.

Background

Classification and measurement: financial liabilities

2. At its December 2009 meeting, the IASB discussed feedback received during its outreach activities. To address the issue of 'own credit risk' in the remeasurement of financial liabilities, the IASB discussed four possible approaches:
 - (i) fair value measurement with separate presentation of changes related to own credit risk;
 - (ii) adjusted fair value measurement attribute (frozen credit spread);
 - (iii) bifurcation; and
 - (iv) parenthetical presentation of fair value for some liabilities measured at amortised cost.

These approaches were also discussed at the AASB December 2009 meeting.

3. IASB staff will continue outreach work, and will provide more insight to the operational challenges and the mechanics of the four approaches at a forthcoming meeting.

Hedge accounting

4. At the joint December 2009 meeting, the IASB and FASB discussed:
 - feedback received during their outreach activities; and
 - the relationship between risk management and financial reporting, and the interaction between the two in relation to the reporting of hedging activities.

Agenda paper 7.2 summarises their discussion.

5. It appears that the IASB may consider a disclosure principle that looks to an entity's economic picture—i.e., an entity's risks, its risk management strategies, and the linkage between an entity's exposures, risk management activities and the financial instruments (or derivatives) used to manage the different types of risks—as a whole. This principle may add

context to the use of derivatives and improve the understanding of changes in fair value of such derivatives.

6. At the next joint IASB/FASB meeting, on 21 January 2010, the joint-staff will present their views on what might be the objectives for hedge accounting and the goals to be achieved with a hedging model in order for the reporting of hedging activities to better reflect the economics of those activities.

Derecognition

7. The IASB discussed comments received on its Exposure Draft ED/2009/3 *Derecognition* and outreach program at its September 2009 meeting. The ED contained two possible approaches to replacing the current derecognition requirements for financial assets. One approach was a modified version of the current requirements in IAS 39 and the other was an alternative approach mentioned in the ED—i.e. an entity derecognises the entire financial asset when it has given up control over any of the cash flows of the asset, and recognises a new asset/liability for any continuing involvement in the asset retained. As a result of the meeting, the IASB tentatively decided to pursue the alternative approach in the ED and directed staff to further develop the approach.
8. At its December 2009 meeting, the IASB redeliberated derecognition principles and criteria for financial liabilities only, and changes to the requirements proposed in the ED. The IASB also tentatively decided that:
 - a principle-based qualitative assessment might be applied to determine when a financial liability is substantially modified, i.e. in the following circumstances:
 - the timing, amounts or uncertainty of the cash flows under the new or modified contract are substantially different from those under the original contract; or
 - the contract changes the nature of the debtor's obligation or the nature of the investment that the contract represents. Application guidance, including a list of non-exhaustive examples, might be provided to determine when the nature of the investment that the original contract represents is changed;
 - the quantitative assessment under IAS 39 (i.e. the 10% threshold test¹ that is applied to assess when a debt is substantially modified) might be eliminated;
 - the existing accounting requirements under IAS 39 for the modification and extinguishment (including partial extinguishment) of financial liabilities might continue to apply;

¹The terms to a contract are substantially modified if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability. (IAS 39.AG62)

- equity instruments may be used to extinguish financial liabilities, and should be initially measured at fair value when issued to extinguish the financial liabilities (consistent with decisions reached in IFRIC Interpretation 19 *Extinguishing Financial Liabilities with Equity Instruments*). The IASB also clarified that if there is a difference between the fair values of the extinguished liability and equity instruments issued as consideration, the difference should adjust the gain or loss recognised in profit or loss to the extent that the difference qualifies as an asset or liability; and
- derecognition accounting by the borrower and lender should be symmetrical if an amendment to a contract meets the substantial modification criteria.

9. At the next IASB meeting, on 20 January 2010, IASB staff will present an education session on offsetting financial assets and financial liabilities in financial statements. The IASB will also discuss open issues with respect to derecognition of financial assets in a forthcoming meeting.

Financial Crisis Advisory Group

10. The Financial Crisis Advisory Group (FCAG) recently released a document that provides an update of the IASB and FASB progress in addressing the recommendations of the FCAG. Agenda paper 7.3 outlines the progress report.

Next steps

11. Staff will provide a verbal update on any further progress and relevant decisions emerging from the IASB in the lead-up to the AASB February meeting. Agenda Paper 7.4 is also attached for an overview of the IASB project timeline to replace IAS 39.

Attachments

- Agenda Paper 7.2 – IASB December 2009 Agenda Paper: Summary of constituent feedback and discussion of risk management, financial reporting and the interaction between the two in relation to the reporting of hedging activities
- Agenda Paper 7.3 – Financial Crisis Advisory Group letter to G20 on IASB and FASB progress
- Agenda Paper 7.4 – IASB Project Timeline