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Putting the pieces together
An update on the IASB's projects to improve the accounting for financial instruments and other related projects

The past two years has seen a frenzy of activity from standard-setters committed to change, once and for all, the way we account for financial instruments. A continuous stream of proposals and amendments to standards were issued last year with 2011 seeing more of the same. It is expected that the changes will be completed later this year and we will move into a future with a very different set of standards to those with which we are currently familiar. On the heels of the financial crisis, and at the urging of governments and regulators around the world, the International Accounting Standards Board (the "IASB" or the "Board") and the US Financial Accounting Standards Board (the "FASB") (collectively the "Boards") are working fast to improve the accounting for financial instruments. In reality, many of the financial instruments projects predate the financial crisis, but have received increased attention as a result of the global economic turmoil.

The Boards have been working together but have reached different conclusions to date on several key matters. This is due in part to the differences in overall approach that the Boards are taking. The IASB has used a "divide and conquer" strategy, addressing the various components in phases, with separate due process timetables for each, while the FASB started with a "big bang" approach issuing several components together in a single due process document for comment.

This summary of the recent amendments and the status of the various pending projects relating to financial instrument accounting provides insights on issues expected to have the most impact on financial statements and the most significant implementation challenges. Appendix A provides details of key areas in which the Boards have reached different decisions. Appendix B includes a current illustrative timeline of the IASB's project plan for financial instruments and other relevant projects (as at March 2011).

Before looking at the detail of each component of the IASB's "phased" approach, it's useful to outline them. The IASB completed its project on financial asset classification and measurement (IFRS 9) in November 2009. Accounting for financial liabilities (amendments to IFRS 9) and derecognition disclosures relating to off balance sheet activities (amendments to IFRS 7) were issued in October 2010. Live projects include amortised cost and impairment, hedge accounting, and offsetting of financial assets and liabilities with exposure drafts on each of these issued over the last few months. Projects on derecognition accounting and classification of issued financial instruments as either equity or liabilities have been delayed pending completion of higher priority projects. The IASB has also recently completed projects on consolidation and fair value measurement and will issue final standards on these topics shortly. Both standards may also have significant implications for financial instruments accounting.

Issued standards

Financial asset classification and measurement

IFRS 9 *Financial Instruments* will be the standard to replace IAS 39. As various phases of the financial instruments project are completed, IFRS 9 will be amended and eventually IAS 39 *Financial Instruments: Recognition and Measurement* will cease to apply.

IFRS 9 was originally issued in November 2009 and only dealt with the classification and measurement of financial assets, replacing the equivalent requirements in IAS 39. IFRS 9 has since been amended as another phase of the project has been completed (see *Financial Liability Classification and Measurement* below). IFRS 9 is effective for annual periods beginning on or after 1 January 2013, with earlier application permitted.

> **Observation:** The European Financial Reporting Advisory Group (EFRAG) has postponed its endorsement decision on IFRS 9 so that it can also consider the output of the other phases of the financial instruments project. Therefore, banks and other entities domiciled in the European Union are unable, at the date of writing, to early adopt IFRS 9.

IFRS 9 requires financial assets to be classified into one of three categories for measurement and income recognition:

- Amortised cost.
- Fair value through profit or loss ("FVTPL").
- Fair value through other comprehensive income ("FVTOCI").

IFRS 9 requires an entity to consider the following two criteria in determining the classification and measurement attribute for a financial asset (i.e., amortised cost or fair value):

The business model criterion

Is the asset held within a business model whose objective is to hold assets in order to collect contractual cash flows (rather than to divest the financial asset to realise changes in fair value)?

An entity assesses whether its business objective is to collect the contractual cash flows of assets based on the business model as a whole rather than management's intention for individual financial instruments. For example, an entity may have a retail banking unit with an objective of collecting contractual cash flows on originated loans and an investment banking unit with an objective of realising trading gains through the sale of similar assets prior to maturity. Financial instruments held in the retail banking unit that give rise to cash flows that are payments of principal and interest may qualify for amortised cost measurement while similar financial instruments in the investment banking business may not.

The cash flow characteristics criterion

Do the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the outstanding principal?

An entity assesses the contractual cash flow characteristics of a financial asset on an instrument by instrument basis. Instruments that only result in the holder collecting principal and interest would qualify for amortised cost. IFRS 9 describes interest as consideration for the time value of money and credit risk associated with the principal outstanding during a specific period. Therefore, an investment in a convertible debt instrument generally would not qualify because the inclusion of the conversion option (which has value associated with it) does not represent the payment of principal and interest.

The cash flow characteristics criterion is met when the cash flows on a loan are entirely fixed (e.g., a fixed interest rate loan or zero coupon bond), when interest is floating (e.g., when interest is contractually linked to an interest rate index, such as LIBOR) or when interest is a combination of fixed and floating (e.g., LIBOR plus a fixed spread).

The standard also provides specific criteria for when a tranche of a contractually linked instrument (e.g., an asset backed security) meets the contractual cash flow criterion. Those criteria include that (a) the contractual terms of the tranche provide cash flows that are solely payments of principal and interest, (b) the underlying pool of financial instruments also meets the contractual cash flow criterion, and (c) the exposure to credit risk of the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments held by the issuing entity.

Loans, trade receivables, and investments in traditional debt securities like government bonds that meet these criteria would typically be measured at amortised cost.

If the financial asset satisfies the two criteria above, the financial asset should be measured at amortised cost. Loans, trade receivables, and investments in traditional debt securities like government bonds that meet these criteria would typically be measured at amortised cost. However, on initial recognition, an entity may elect irrevocably to designate a financial asset that meets the amortised cost criteria as at FVTPL if that designation eliminates or significantly reduces an accounting mismatch that would have arisen had the financial asset been measured at amortised cost (i.e., an entity can apply the so-called "fair value option").

Financial assets that do not meet the criteria for amortised cost classification are required to be measured at fair value. Hence all equity investments, all derivative assets and assets held for trading are measured at fair value.

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Observation: The contractual cash flow criterion has raised several IFRS 9 application issues, particularly relating to non-recourse loans and debt securities issued by securitisation vehicles. These types of investments may have principal and interest terms, but may not meet the contractual cash flow criterion.

Entities must consider whether a non-recourse loan is for (a) specified assets or (b) gives rise to cash flows from specified assets in such a way that the repayment cannot be considered to be solely repayment of principal and interest (i.e. a "look through" to the specified assets is required). Whether the loan meets the criterion or not will be based on consideration of the linkage between the contractual cash flows of the loan and the performance of the underlying assets.

Regarding debt securities issued by a securitisation vehicle, the 'tranching' of credit risk by the issuance of beneficial interests in the vehicle to investors may result in payments on the securities failing the contractual cash flow criterion from the perspective of the investor. Determining whether this criterion is met will require significant judgement and, in most cases, the use of a quantitative analysis. One possible result is that beneficial interests that are more subordinate (i.e., less senior) than other interests in a securitisation structure are more likely to be measured at fair value rather than amortised cost. Also, investors in structures such as "synthetic" collateralised debt obligations ("CDOs") will be required to measure their beneficial interests at fair value. This is because a CDO structure will typically invest in highly rated debt securities while also writing a credit default swap ("CDS") over a portfolio of assets outside of the vehicle (i.e. insuring a referenced portfolio). As the CDS neither reduces the cash flow variability of the portfolio of assets in the vehicle nor aligns the cash flows from the asset portfolio with those of the issued beneficial interests, the contractual cash flow criterion is not met.

An equity investment is classified as FVTPL unless not held for trading and designated as FVTOCI. Designation as FVTOCI is made irrevocably at initial recognition on an instrument by instrument basis. Gains or losses on equity investments designated as FVTOCI – except for dividend income which is recognised in profit or loss (unless it clearly represents a recovery of the cost of the investment) – are recognised in equity and are not reclassified to profit or loss, even on disposal. Impairment testing of equity investments at FVTOCI is not required since all changes in fair value, other than dividend income, remain permanently in equity.

Observation: The creation of the FVTOCI category for equity investments has led to uncertainty as to whether such investments can be designated in a hedge accounting relationship. Because the amount recognised in OCI is not reclassified to profit or loss, one of the criteria for fair value or cash flow hedging – which is that the hedged exposure impact profit or loss – is not met. In its hedge accounting exposure draft (discussed below), the Board has proposed that hedge accounting for equity investments designated at FVTOCI should not be permitted. However, the Board received several requests by comment letter respondents to also permit items measured at FVTOCI as eligible hedged items. The Board has not yet discussed whether it will reconsider its previous decision.

IFRS 9 does not require separate accounting for non-closely related derivatives embedded in hybrid financial asset contracts within its scope. Embedded derivatives currently accounted for separately at fair value through profit or loss under IAS 39 because they are not closely related to the financial asset host will not be accounted for separately to the host contract under IFRS 9. Instead, the contractual cash flows of the hybrid financial asset in their entirety will be assessed and the hybrid financial asset as a whole classified as FVTPL if any of its cash flows do not represent payment of principal and interest.

IFRS 9 requires the business model criterion to be assessed based on the facts and circumstances at the date of its initial application. The assessment at that date is applied retrospectively, regardless of whether alternative business models may have existed in prior periods.

Financial liability classification and measurement

The second phase of the financial instruments project was completed in October 2010; amendments to IFRS 9 were issued to include requirements for the classification and measurement of financial liabilities. This piece of the project was segregated from that of financial assets due to an acceleration in the timetable for completion of the first phrase of IFRS 9 and disagreement on fair value measurement for some financial liabilities. The revised guidance is very similar to IAS 39 except for two notable exceptions:

- IFRS 9 removed IAS 39's cost exception for unquoted equity instruments and related derivative assets when fair value is not reliably determinable. That exception is also removed for derivative liabilities so that they are no longer eligible for cost measurement hence must be measured at fair value.

- Under IAS 39, all changes in fair value of a liability designated at FVTPL are, as implied, recognised in profit and loss. IFRS 9, on the other hand, generally requires fair value changes attributable to changes in the credit risk of a liability to be recognised in OCI, with any remaining change in fair value recognised in profit and loss. The cumulative amount of fair value changes attributable to credit risk recognised in OCI, if any, is not reclassified to profit and loss on derecognition of the liability.

Observation: One of the primary reasons for this change is the often cited counterintuitive result that arises when liabilities are fair valued through profit or loss; an entity experiencing credit deterioration generates a gain in profit or loss as the liability is reduced (potentially offsetting losses the entity may be incurring that are contributing to the credit deterioration) while an improvement in creditworthiness results in recognition of a loss in profit or loss as the liability is increased (potentially obscuring income the entity is generating that may have led to the improvement in credit quality).

However, if recognising the change in fair value attributable to a liability's credit risk in OCI creates or enlarges an accounting mismatch, IFRS 9 requires the entire fair value change to be recognised in profit and loss. The assessment of whether an accounting mismatch exists is made at initial recognition of the liability and not reassessed.

Observation: During the IASB's discussions on accounting for financial liabilities, an example of a transaction that could result in an accounting mismatch, that was often cited, is that of a Danish mortgage-market contract. In the Danish mortgage market, typically a bank provides a mortgage loan to a customer and funds that loan by issuing a bond with exactly the same ("mirror") terms (e.g., outstanding balance, term, currency, and repayment terms). The terms of the mortgage permit the borrower to prepay the loan by effectively settling the mirror bond specific to their mortgage at fair value. There is a contractual link between the effects of changes in fair value of the bond attributable to credit risk and changes in fair value of the mortgage loan. As such, if the bank recognised the change in fair value of the bond attributable to credit risk in OCI while recognising the change in fair value of the mortgage loan receivable in profit or loss (where the fair value option had been applied to it) this would result in an accounting mismatch.

The amendments provide guidance on differentiating credit risk from asset-specific performance risk and provide examples of the latter. Asset-specific performance risk is the risk that a single asset or a group of assets fails to perform and therefore relieves the issuer of amounts due under an obligation linked to the performance of those assets. One example (IFRS 9.B5.7.15(b)) considers the issue of instruments to investors by a special purpose entity (SPE), the assets of which are legally isolated and restricted to financing the cash flows on the instruments issued to the investors such that amounts are only due if the ring-fenced assets of the SPE generate cash flows. The risk inherent in the notes issued to the investors is regarded as asset-specific performance risk as the return on the assets determines the amount of the obligation.

Observation: The difference between credit risk and asset-specific performance risk is subtle hence consideration of all the terms of a financial liability will be critical. In the example of the SPE above, had the amount owed under the notes not varied with the performance of the assets, the risk would have been regarded as credit risk, not asset-specific performance risk.

The amendments provide guidance on isolating the change in fair value of a liability attributable to credit risk:

1. as either the amount of change in its fair value not attributable to changes in market conditions that give rise to market risk (such as changes in a benchmark interest rate, the price of another entity's financial instruments, a commodity price, foreign exchange rate, or an index of prices or rates); or

2. using an alternative method that more faithfully represents the amount of change in a liability's fair value attributable to credit risk.

With respect to (1) above, if the only significant relevant changes in market conditions are changes in an observed (benchmark) interest rate, the amendments specify how to estimate the amount attributable to credit risk (IFRS 9.B5.7.18).

IFRS 7's requirements for disclosure of the cumulative amount of changes in the fair value of a financial liability attributable to credit risk and any difference between the carrying amount of a financial liability and the amount of the contractual obligation at maturity are retained. Although IFRS 9 prohibits recycling of cumulative credit risk fair value changes out of OCI, an entity is permitted to transfer amounts between reserves in equity, for example, upon extinguishment of the related liability. IFRS 7 is amended to require disclosure of the amount of any transfer of such cumulative gains or losses within equity and the reason for the transfer.

The effective date of the amendments is the same as for the first version of IFRS 9 (i.e. annual periods beginning on or after 1 January 2013 with earlier adoption permitted) provided all other previously issued IFRS 9 requirements are applied simultaneously. The requirements for classification and measurement of financial liabilities apply retrospectively, except that the assessment of whether an accounting mismatch exists is made based on the facts and circumstances that exist at the date of initial application of the amendments.

Derecognition disclosures

The IASB added a project on derecognition to its agenda in July 2008, in response to the financial crisis and the issues it highlighted, particularly the continuing involvement of financial institutions with financial assets they had derecognised from their balance sheets. The project was intended to be a convergence project. However, the FASB was subject to a stricter timetable than the IASB as it was under pressure to amend its own derecognition requirements at the request of the US Securities and Exchange Commission. The FASB finalised amendments to the derecognition guidance in US GAAP in June 2009 while the IASB proceeded with their own discussions leading to the issuance of ED/2009/3 *Derecognition*, proposing a 'preferred' new derecognition model and an alternative model. Both approaches were based on an assessment of whether control of the transferred assets had passed. Responses to the ED were largely unsupportive and in June 2010, when the IASB reprioritised the projects on its workplan, it postponed the project on derecognition accounting. The October 2010 amendments to IFRS 9 carried forward the derecognition guidance in IAS 39 entirely unchanged.

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The IASB's focus switched to the level of transparency and comparability with respect to disclosures around transfers of financial assets. Consequently, in October 2010, the IASB issued amendments to IFRS 7 which introduced additional disclosure requirements for transactions involving transfers of financial assets, with a view to increasing the level of transparency around risk exposures for transactions where the transferor retains some level of continuing involvement with the asset.

Observation: The most notable difference in the disclosure requirements between the amendments to IFRS 7 and US GAAP relates to 'servicing' assets and 'servicing' liabilities. The IASB's exposure draft on derecognition proposed that servicing assets or liabilities did not constitute continuing involvement by the transferor where the transferor 'servicing' the transferred assets was acting in a fiduciary capacity or as an agent for the transferee. Currently IAS 39 does not contain any guidance on these items subsequent to initial recognition. The IASB has agreed to consider disclosures on servicing assets and liabilities as part of its project on derecognition accounting rather than add specific disclosure requirements to IFRS 7.

The amendments to IFRS 7 introduce a specific definition of a transfer for disclosure purposes. Under the new definition, an entity transfers all or part of a financial asset, if, and only if, it either:

(i) transfers contractual rights to receive cash flows of that financial asset; or

(ii) retains contractual rights to receive cash flows of that financial asset, but has assumed a contractual obligation to pay those cash flows to other recipients as part of the arrangement.

An entity has continuing involvement in a transferred financial asset if it retains any of the contractual rights or obligations inherent in the transferred financial asset or obtains any new contractual rights or obligations relating to the transferred financial asset.

Observation: The new derecognition disclosure requirements are much broader than those that preceded them. The amendments introduce definitions of 'transfer' and 'continuing involvement' for disclosure purposes only (i.e., the IFRS 7 definitions are broader than IAS 39's use of these terms). For example, even though an entity may not have met the 'pass-through' tests in IAS 39 to be considered a transfer under IAS 39, the transfer may still be considered a transfer for disclosure purposes. Similarly, under the amendments, 'continuing involvement' for disclosure purposes, is not restricted to those occasions where IAS 39 requires continuing involvement accounting for certain assets not fully derecognised, but captures any transfer where, following the transfer, the transferor retains some exposure to the assets transferred.

The amendments require an entity to disclose information that enables users to:

(a) understand the relationship between transferred financial assets that are not derecognised in their entirety and any associated liabilities; and

(b) evaluate the nature of, and risks associated with, the entity's continuing involvement in derecognised financial assets.

Transferred financial assets that are not derecognised in their entirety

For each class of financial asset, the entity is required to disclose:

(a) the nature of the transferred assets;

(b) the nature of the risks and rewards of ownership to which the entity is exposed;

(c) a description of the nature of the relationship between the transferred assets and any associated liabilities, including any restrictions arising from the transfer on the reporting entity's use of the transferred assets;

(d) when the counterparty to the associated liabilities has recourse only to the transferred assets, a schedule that sets out the fair value of the transferred assets, the fair value of the associated liabilities and the net position;

(e) when the entity continues to recognise all of the transferred assets, the carrying amounts of the transferred assets and of the associated liabilities; and

(f) when the entity continues to recognise the assets to the extent of its continuing involvement, the total carrying amount of the original assets before the transfer, the carrying amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities.

Transferred financial assets that are derecognised in their entirety

Where an entity derecognises transferred financial assets in their entirety but has continuing involvement in them, the entity is required to disclose, as a minimum, for each class of continuing involvement:

(a) the carrying amounts and fair values of the assets and liabilities that represent the entity's continuing involvement and the line items in which any associated assets and liabilities are recognised in the statement of financial position;

(b) the amount that best represents the entity's maximum exposure to loss from continuing involvement and information on how it is determined;

(c) the undiscounted cash flows that would or may be required to repurchase derecognised financial assets along with a maturity analysis of those cash flows;

(d) any gain or loss recognised at the date of transfer of the assets;

(e) any income and expenses recognised in the reporting period and cumulatively from the entity's continuing involvement in the derecognised financial assets; and

(f) qualitative information that explains and supports the quantitative disclosures.

Furthermore, if the total amount of proceeds from transfer activity qualifying for derecognition is not evenly distributed throughout the reporting period, an entity will be required to disclose:

(a) when the greatest transfer activity took place within the period;

(b) the gain or loss recognised from transfer activity in that part of the period; and

(c) the total amount of proceeds from transfer activity in that part of the period.

The amendments to IFRS 7 apply prospectively for annual periods beginning on or after 1 July 2011, with earlier adoption permitted, irrespective of whether an entity applies IAS 39 or IFRS 9 to the classification and measurement of its financial instruments.

Observation: The IASB changed the effective date of these amendments from periods beginning on or after 1 January 2011 to periods beginning on or after 1 July 2011 at the last minute. This was to allow preparers additional implementation time. Some companies may need to make systems modifications in order to capture and retain the necessary information for these disclosures.

Completed projects pending issue of final standards

The financial crisis led to greater focus on both the use and measurement of fair value for financial instruments.

Fair value measurement

The fair value measurement project is not part of the larger financial instruments project but it is very relevant. Currently IAS 39 provides some guidance on how to measure financial instruments at fair value and IFRS 7 provides disclosure requirements for financial instruments measured at fair value. Other IFRSs require or permit fair value measurement for non-financial items. However, nowhere in the IFRS literature today, is there a single source of guidance or standard which defines fair value for all items (i.e., both financial and non-financial).

The financial crisis led to greater focus on both the use and measurement of fair value for financial instruments. At the height of the crisis, an Expert Advisory Panel (EAP) of valuation practitioners, regulators, auditors and investors was set up to address issues around fair value measurement when a market is no longer active. The EAP produced a report that includes non-authoritative educational guidance on measuring fair value in inactive markets.

The IASB recognised the growing need for a comprehensive fair value standard and in May 2009 issued ED 2009/05 *Fair Value Measurement*. The exposure draft proposes a standard definition of, and framework for, fair value measurement as well as disclosure requirements similar to those currently found within US GAAP's ASC 820, *Fair Value Measurements and Disclosures*. Many of the issues raised by the EAP have been addressed in this exposure draft.

The definition of fair value in the exposure draft is based on the notion of an exit price for an orderly transaction between market participants occurring at the measurement date in the 'principal market' (unless the entity does not have access to the 'principal market' and then the most 'advantageous market' would be looked to). This is a market-based measure and, as such, should incorporate assumptions that market participants would use when pricing the asset or liability rather than entity specific information. The exposure draft notes instances when the transaction price might not be representative of fair value such as when the transaction:

- occurs between related parties;
- is a result of a distressed sale; or
- involves a different unit of account or different market (e.g., broker-dealer market vs. the retail market).

Consistent with IFRS 7's existing requirements, the exposure draft would require disclosure of fair value measurements for each category ('level') in the fair value hierarchy (i.e., would retain a three-tier classification of fair value measurements based on the level of market observability of the inputs to the valuation. Level 1 measurements would be based on active market trades, level 2 on trades in inactive markets or transactions for similar items in active markets and level 3 primarily on unobservable (e.g., internal) inputs. A sensitivity analysis for level 3 fair value measurements was also proposed. In June 2010, the IASB published ED 2010/7 *Measurement Uncertainty Analysis Disclosure for Fair value Measurements (Limited re-exposure of proposed disclosure)*, re-exposing the proposed sensitivity analysis to require entities to take into account the effect of correlation between unobservable inputs, where relevant, in their level 3 measurement uncertainty analysis.

Observation: **The proposal to consider the level of correlation between unobservable inputs and the affect that correlation may have on the sensitivity analysis outcomes may be a significant operational challenge for private equity firms and other financial services organisations with significant concentrations of instruments measured at fair value using level 3 inputs.**

The financial crisis highlighted the possibility that entities were exposed to risks of entities they did not consolidate …

The exposure draft includes a "highest and best use" concept similar to that of US GAAP. However, it applies only to non-financial assets and liabilities. As a result, questions have arisen around the appropriate unit of account when the relevant IFRS is not specific. The most notable example of the lack of guidance in this area relates to fair value measurement by investment entities of their 100% ownership interest in an investee to which they have also provided debt financing. Fair value measurement of their interest in the investee as a whole may result in a different fair value measure to the sum of the individual fair values of their equity and debt interests determined separately. The IASB and FASB have tentatively decided to clarify in the fair value measurement standard that although the concept of highest and best use is not relevant for financial instruments, the notion of 'value maximisation' (that market participants would seek to maximise the value of their financial assets) is integral to the fair value measurement of financial instruments. This guidance is intended to provide clarity on the unit of account to apply for fair value measurements.

The Boards have also agreed to require disclosure of all transfers between levels 1 and 2 of the fair value hierarchy; IFRS 7 currently requires disclosure of significant transfers only.

To avoid delay in the issue of the fair value measurement standard, the Boards have agreed to address constituents' concerns around the proposed measurement uncertainty analysis disclosures contained in ED 2010/7 separately to the main project. The target date for publication of the fair value measurement standard is April 2011 with an effective date of 1 January 2013 and early application permitted.

Consolidation

The financial crisis highlighted the possibility that entities were exposed to risks of entities they did not consolidate (i.e., were "off balance sheet"). In the financial services sector, the existence of such "off balance sheet" arrangements is often referred to as the "shadow" banking system. This term is sometimes used to describe various financial structures such as asset-backed securitisation (ABS) trusts, collateralised debt obligations (CDOs), synthetic CDOs, structured investment vehicles (SIVs), commercial paper conduits (CP conduits), and sponsored money market and hedge funds. During the financial crisis, many of these structures were propped up by a financial institution "sponsor", either as a result of contractual requirements (e.g., liquidity facilities) or because of the underlying reputational risk for the sponsor of allowing these structures to fail.

The IASB has debated potential changes to its consolidation model since 2002 but had not issued proposals for comment. As the financial crisis deepened, pressure to reassess its consolidation requirements increased, particularly its guidance on consolidation of structured entities contained in "SIC 12" *(Standards Interpretation Committee No. 12, Consolidation – Special Purpose Entities)*, an interpretation of IAS 27 *Consolidated and Separate Financial Statements*. In April 2008, the Financial Stability Board, an international group established to coordinate the efforts of national financial authorities and international standard setting bodies, in response to the crisis, issued a report to the G7 Ministers and Central Bank Governors recommending that the IASB immediately address the accounting and disclosures of off balance sheet arrangements while working towards global convergence in this area. At their November 2008 meeting, the G20 leaders issued a declaration, which called for, amongst other things, the improvement of accounting and disclosure standards for off balance sheet vehicles. In December 2008, the IASB published ED 10 *Consolidated Financial Statements*.

The Board expects to issue a revised consolidation standard (IFRS 10 *Consolidated Financial Statements*) shortly. The new standard, which will amend IAS 27 and replace SIC 12, will focus on the assessment of control. In a staff draft of the consolidation standard issued in September 2010, control is defined as follows: "an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee".

Control is intended to be the power to direct the activities of another entity whether the reporting entity actively uses that power or not. Potential voting rights such as options and convertible instruments should be considered when assessing whether a reporting entity has the power to direct the activities of an entity.

The use of returns is a deliberate change in terminology; returns are intended to encompass both positive and negative returns for the investor (compared to the use of "benefits" in current IAS 27 which implies only positive returns). The staff draft provides examples of returns such as dividends, other distributions, changes in the value of an investment, remuneration for services, fees and exposure to loss from providing credit or liquidity support, residual interests on liquidation, tax benefits, access to liquidity, and returns not available to other interest holders.

Instances where a reporting entity may have the current ability to direct the activities of another entity include where it has:

- more than half of the voting rights in an entity controlled by voting rights;

- contractual rights within contractual arrangements related to the substantive activities of the entity;

- a combination of contractual rights within contractual arrangements and holding voting rights in the entity; or

- less than half of the voting rights in an entity taking into account other relevant facts and circumstances (e.g. the size of the reporting entity's voting rights relative to the size of voting rights of any other voting right holder).

The exposure draft included an example of a scenario where a reporting entity holding less than half of the voting rights in an entity may control that entity taking into account other facts and circumstances (i.e., where the reporting entity is a dominant shareholder holding less than a majority of the voting rights and all the other shareholders are widely dispersed and are not organised in such a way that they actively cooperate when they exercise their votes). This proposed, additional guidance would address the concept of 'de facto' control, which has led to controversy under IAS 27.

Consolidation exemption for investment entities

The Board has also deliberated the question of consolidation for investment entities. Unlike US GAAP, IFRS does not provide a scope exemption for investment companies from consolidation of investments in entities they control. The Board is expected to issue an exposure draft during the second quarter of 2011 that will propose a consolidation exemption for investment entities that meet certain criteria related to their:

- business purpose;
- investment activity;
- exit strategy;
- unit ownership;
- pooling of funds;
- use of fair value for internal and external reporting purposes; and
- existence as a reporting entity.

Observation: While the investment company exemption from consolidation has been welcomed by the asset management industry, concern remains as to its "upstream" application by asset managers. Based on the tentative decisions to date, the proposed consolidation exemption for an "investment entity" would not be available for a parent of the investment entity, (i.e., fair value accounting would not be retained at the investment manager level, unless the parent is also an investment entity as defined). Hence an investment manager would be required to consolidate all controlled investees, including those held by its investment company subsidiaries. Where, under the proposals, a private equity asset manager is required to consolidate one of its investment funds, it will not only consolidate the fund but also all the underlying businesses controlled by the fund.

In addition to the revised consolidation standard, it is expected that the IASB will also issue requirements for disclosures about interests in subsidiaries, joint ventures, associates and unconsolidated structured entities (IFRS 12 *Disclosure of Interests in Other Entities*).

An entity will be required to provide information about both its involvement with unconsolidated structured entities for which it is the "sponsor" even if it does not have continuing involvement at the reporting date. An entity will also be required to give additional disclosures for subsidiaries with non-controlling interests (NCI), including the name of the subsidiary, its place of incorporation or residence, the method for allocation of profits and losses to the NCI (and, if not on a pro-rata ownership basis, the portion of voting rights held by the NCI) and summarised financial information.

The effective date for both IFRS 10 and IFRS 12 will be 1 January 2013 with early application permitted so long as all other standards issued as part of this project are also early adopted (including IFRS 11 *Joint Arrangements* and revisions to both IAS 27 and IAS 28).

Observation: The IASB hopes to complete the investment company project timely so that it too will have an effective date of 1 January 2013. This would permit entities a single adoption of all related standards rather than a single period of applying the new consolidation standard before the investment company guidance becomes effective.

Projects with proposals outstanding

Impairment

In November 2009, the IASB issued ED 2009/12 *Financial Instruments: Amortised Cost and Impairment*, proposing an expected cash flow model for amortised cost measurement and income/impairment recognition. This would be a significant change from the incurred loss impairment model currently used in practice and the subject of much criticism during the financial crisis. Under the proposals, on initial recognition of a financial instrument to be measured at amortised cost, in its assessment of expected future cash flows, an entity would consider the potential for credit losses (i.e., non-payment by the borrower), using a probability-weighted expected outcome approach. Instead of recognising credit losses if and when incurred (as under the incurred loss model in IAS 39), expected future credit losses would be incorporated in the measurement of the asset on initial recognition and result in a lower effective interest rate (EIR) over the life of the instrument than the contractual effective interest rate. Hence the effective return on the instrument would incorporate any fees, points or transaction costs, any premium or discount on the acquisition, and the initial estimate of expected credit losses. An allowance account would be built up over the life of the instrument, calculated as the periodic portion of expected credit losses included as part of the EIR. If the expectation in timing and/or amount of losses changes from the initial estimate, the carrying amount of the financial asset would be adjusted immediately with the change recognised in profit or loss.

ED 2009/12 also proposes, for the purposes of disclosure, grouping of instruments into classes and information based on the 'vintage' of instruments, including year of origination and scheduled maturity. Proposed disclosures also include a reconciliation of changes in the allowance account, a description of the reporting entity's write-off policy and information about the use of estimates and changes in estimates, including inputs and assumptions used in estimates of expected credit losses and explanations for amounts recognised in profit and loss resulting from changes in those estimates.

The comment letter responses and input from the Expert Advisory Panel identified significant operational challenges relating to implementation and application of the expected cash flow model and compliance with the disclosure requirements. For example, the application of this model to an open portfolio (dynamic portfolios with assets being added and removed throughout each period), would be particularly difficult. Many respondents were concerned that it would not be possible to estimate expected credit losses for open portfolios since it would not be possible to identify those changes in expected future cash flows attributable to the original assets versus those attributable to assets subsequently added to the portfolio. Another concern raised was technology, as the information necessary to determine expectations around future credit losses is typically housed in a credit risk system that is separate to that used for financial reporting.

The IASB and FASB worked together in the second half of 2010 to develop a converged impairment model that is operational and meets each Board's respective but different primary objectives.

The IASB's objective for impairment has focused on credit risk as an inherent component in the pricing of a financial asset.

Observation: **The IASB's objective for impairment has focused on credit risk as an inherent component in the pricing of a financial asset. Its view has been that the amounts recognised in the financial statements should reflect the pricing of the asset (i.e. the interest rate charged), which would consider credit losses (sometimes referred to as "an income statement approach"). The FASB's objective has been to ensure that the allowance balance is sufficient to cover all estimated credit losses for the remaining life of the instrument (sometimes referred to as "a balance sheet approach").**

The IASB and FASB have found sufficient common ground to be able to issue a supplement to ED 2009/12 ("the Supplement"). Published in January 2011, the Supplement proposes to decouple the recognition of expected credit losses from the effective interest rate calculation rather than requiring an integrated EIR. For assets in a 'good book' (i.e., performing loans) expected future credit losses would be recognised (on a portfolio basis) at the higher of (1) the time-proportionate amount (recognising expected losses based on the age and expected life of the portfolio) or (2) those credit losses expected to occur within the foreseeable future period (being a minimum of twelve months after the reporting date). In other words, entities would be required to establish a minimum allowance balance or "floor" of at least those credit losses expected to occur in the foreseeable future.

Observation: **The IASB's re-deliberations have focused on the operational implications of the expected cash flow model for "open" portfolios. The original IASB proposals were criticised for being difficult to apply to open portfolios, which is how many financial institutions manage their assets. The Supplement no longer differentiates between an initial estimate of expected losses and changes in those estimates. As a result, entities would not need to identify what portion of a change in estimate relates to existing assets in the portfolio and what portion relates to those assets that are subsequently added.**

The Supplement also proposes that entities apply an alternative impairment model for 'troubled' assets. Once an entity's objective for an asset has shifted from collection of contractual payments to recovery of the asset, the asset would be transferred to the 'bad book'. For assets in this group, the entire amount of expected credit losses would be recognised immediately. The Supplement does not provide specific parameters on what would constitute a 'troubled' asset, but requires entities to follow their internal credit risk management policies in making that assessment.

In an appendix to the Supplement, the IASB proposes presentation and disclosure requirements. The appendix is not a joint document. The IASB's views on presentation and disclosure were reached at an IASB-only meeting rather than at a joint meeting with the FASB. The FASB has yet to discuss presentation and disclosure requirements for impairment.

The appendix proposes that impairment losses be presented as a separate line item in profit or loss rather than as a reduction of interest revenue as proposed in the IASB's original exposure draft.

Observation: **The inclusion of credit losses as a reduction of interest revenue was criticised by many financial institutions and some analysts in responding to ED 2009/12. They felt doing so would distort a reporting entity's net interest margin ("NIM"), a key operating metric for these entities. The IASB's proposal in the appendix of the Supplement should resolve those concerns.**

The appendix of the Supplement includes many specific disclosure requirements. The proposed disclosures intend to provide financial statement users with information about:

- activity in the allowance account;
- factors that could impact credit losses for the 'good book';
- significant gains or losses from changes in expected loss estimates, particularly arising from specific portfolios or geographic areas;
- the credit risk management process and how the 'good book' and 'bad book' distinction has been made;
- management's assessment of expected losses;
- inputs and assumptions used in estimating credit losses; and
- performance of expected loss estimates compared with actual outcomes (e.g., backtesting).

The appendix proposes that the disclosures related to impairment should be provided at a sufficiently disaggregated level in order to reflect the credit characteristics of the portfolio and also proposes to permit incorporation by cross-reference to other publicly available statements when the required disclosures are already included in other documents.

… the IASB has decided to retain the basic architecture of IAS 39's hedge accounting model and to address significant issues that have made it operationally difficult to apply or resulted in certain risk management strategies not qualifying for hedge accounting.

Observation: The appendix only proposes disclosures specifically related to impairment and does not address other proposed disclosures from ED 2009/12 (e.g., stress testing, vintage information and credit quality of assets) which had not yet been discussed. After issuance of the Supplement, the IASB has tentatively decided to not require disclosure of vintage information or require stress testing. The IASB has also tentatively decided to require a reconciliation of changes in non-performing assets greater than 90 days past due not transferred to the 'bad book'.

Comments on the Supplement and the presentation and disclosure requirements in the appendix are due by 1 April 2011. The IASB intends to issue a final standard before the end of June 2011.

Hedge accounting

IAS 39's hedge accounting model has been criticised for being overly complex and extremely rules-based. Many believe that a future standard should be a more principles-based model for hedge accounting which is rooted in an entity's risk management activities. Many constituents have expressed support for a complete overhaul of hedge accounting rather than a series of repairs to the current model for certain application issues.

During its deliberations, the IASB has decided to retain the basic architecture of IAS 39's hedge accounting model and to address significant issues that have made it operationally difficult to apply or resulted in certain risk management strategies not qualifying for hedge accounting.

The project has been split into two phases: the first focuses on the general hedge accounting model and the second will consider portfolio or macro hedge accounting. Discussions on phase one were ongoing throughout 2010. The IASB issued ED 2010/13 *Hedge Accounting* in December 2010 with the comment period recently closing on 9 March 2011. The discussions on portfolio hedge accounting (the phase likely to have the biggest implication for financial institutions) have not yet commenced.

Scope

The Board has decided to permit hedge accounting for risk components of both financial and non-financial instruments, provided they are separately identifiable and reliably measurable. For example, an entity could apply hedge accounting to the interest rate risk component of a variable rate corporate bond denominated in a foreign currency rather than being required to designate all risks as the hedged item, (i.e., interest rate, credit and foreign exchange risk). This would ensure a greater alignment of the derivative used to hedge the specific risk with the hedge designation for hedge accounting purposes, hence limit the amount of hedge ineffectiveness or "noise" in profit or loss.

> **Observation: Designation of a risk component of a financial instrument as the hedged risk is not new. IAS 39 permits risk component designation for financial items. However, currently it is not possible to designate a component of a non-financial item as the hedged risk. It may now be easier for certain hedges of non-financial entities (e.g., airline companies hedging jet fuel supplies) and those that commodity hedge to qualify for hedge accounting. The current inability to designate risk components of non-financial items as the hedged item and the resulting ineffectiveness from taking all changes in the fair value of the hedged item into account in measuring hedge effectiveness often results in the hedge accounting relationship failing IAS 39's 80-125% effectiveness threshold.**

IFRS 9 has eliminated separate accounting for non-closely related embedded derivatives in hybrid financial assets. The IASB has considered the consequences of this for hedge accounting since such derivatives would no longer be separate financial instruments eligible as hedging instruments. The Board has agreed that these derivatives should not be permitted to be eligible hedging instruments. However, the proposals have expanded the population of eligible hedging instruments to also include financial instruments measured at FVTPL while retaining the ability to designate non-derivative financial instruments for a hedge of foreign currency risk.

Fair value hedge accounting

During the project discussions, the IASB tentatively decided to amend IAS 39's fair value hedge accounting model to propose recognition of gains or losses on hedging instruments in other comprehensive income ("OCI"), similar to cash flow hedge accounting, rather than permit an adjustment to the hedged item. Some constituents raised concerns about the potential for significant volatility within equity as a result, which could significantly distort leverage ratios hence potentially give a negative impression of the reporting entity's net worth. Because of these concerns, the Board reversed their previous tentative decision. The exposure draft instead proposes that both the effective portion of changes in fair value of the hedging instrument and the fair value adjustment for the hedged item are taken to OCI (hence net to zero). Similar to IAS 39, any ineffectiveness would be recognised in profit or loss. Contrary to IAS 39, a separate valuation allowance account would be created, either as an asset or liability as appropriate to reflect the re-measurement of the hedged item for changes in fair value associated with the hedged risk.

… the Board has proposed to replace the 80-125% effectiveness test with a risk objective-based assessment

Hedge effectiveness assessment

The Board proposes to remove the prospective and continuous quantitative hedge effectiveness test. Instead, the Board has proposed to replace the 80-125% effectiveness test with a risk objective-based assessment that a hedging relationship will produce an unbiased result and minimise expected ineffectiveness (i.e., the hedged item is not intentionally over or under hedged) and is expected to achieve offset that is other than accidental. However, the measurement and recognition of ineffectiveness will still be required each reporting period.

> **Observation: IASB outreach with financial statement users has consistently elicited comments that the existing hedge accounting model is not linked, as it should be, to an entity's risk management processes. As a result, a continued theme of the exposure draft is alignment of hedge accounting strategy, criteria and effectiveness with an entity's risk management policies and processes. Entities without formalised processes may need to enhance their level of documentation and controls around risk management in order to apply the proposed hedge accounting model.**

Hedging of groups of items

A net position is eligible for fair value hedge accounting. However, some restrictions are retained for cash flow hedges of net positions for which the offsetting risk positions affect profit or loss in different periods.

Time value of options

IAS 39 currently requires an entity either to designate an option in its entirety as the hedging instrument or to separate the intrinsic and time value components with only the intrinsic value of the option designated as the hedging instrument. Entities will often separate out the time value component of the option to remove it from the designation since otherwise the amount of ineffectiveness is likely to result in the hedging relationship failing the 80-125% effectiveness threshold. In doing so, entities recognise the time value component at fair value through profit or loss, separately from the accounting for the intrinsic value hedge relationship.

The exposure draft proposes an "insurance premium view" of accounting for the time value of options. Under this view, for transaction related hedged items (e.g., forecast purchase or sale of a commodity) the cumulative change in fair value of the option's time value would be recognised in OCI and reclassified in accordance with general requirements, that is, either capitalised into a non-financial asset (a "basis adjustment") or into profit or loss when the hedged purchase or sale affects profit or loss. For time period related hedged items (e.g., hedging existing commodity inventory over a time period) the portion of the cumulative change in fair value of the option's time value in OCI relating to the current period would be reclassified to profit or loss on a rational basis. To avoid accounting issues associated with the term to maturity of the option terms not matching that of the hedged item, the proposed hedge accounting would be based on an "aligned time value", determined using the time value of an option that would have critical terms that perfectly match the hedged item. Hence, if the actual time value were less than that of an option that perfectly matched the hedged item, the amount recognised in OCI would be the lower of the change in fair value of the actual time value on the hedging instrument and the time value of the "perfect" option.

Presentation and disclosure

In addition to the change in presentation for fair value hedges described above, the Board has addressed another presentation issue relating to a lack of comparability regarding "basis adjustments". In a cash flow hedge of a firm commitment or a forecast transaction which results in the recognition of a non-financial item, an entity currently has an accounting policy choice whether or not to adjust the amount of the non-financial item on initial recognition ("basis-adjust") for the cumulative gains and losses on the hedging instrument recognised in OCI. To address the lack of comparability resulting from this accounting policy choice, the Board has proposed requiring basis-adjustment.

The Board has also developed a proposed disclosure framework for hedging activities, which would require disclosure about:

(i) the reporting entity's risk management strategy and how it is applied to manage risk;

(ii) how its hedging activities may affect the amount, timing and uncertainty of its future cash flows; and

(iii) the effect that hedge accounting has had on the statement of financial position, the statement of comprehensive income and statement of changes in equity, by each type of risk exposure and for each hedge type (fair value hedge, cash flow hedge or hedge of a net investment in a foreign operation).

Quantitative information would include the monetary amount or other quantity (e.g, barrels, tonnes, etc.) to which the entity is exposed for each particular risk, the amount or quantity of the risk exposure being hedged and how hedging changes the exposure. Qualitative information such as a description and sources of hedge ineffectiveness would also be required.

The exposure draft acknowledges that some of these disclosures may be presented elsewhere in the annual report (e.g., in the management commentary), in which case the financial statements are only complete if this information is incorporated by cross-reference to the financial statements.

Offsetting

In January 2011, the IASB and FASB issued joint exposure draft ED 2011/1 *Offsetting Financial Assets and Financial Liabilities* addressing offset of financial instruments in the statement of financial position. The proposed amendments are most relevant for determining whether multiple derivative asset and liability positions with the same counterparty qualify for offset although the proposed criteria will also apply in other instances, for example, to determine whether offset of a deposit and a loan with the same counterparty is appropriate.

Under IAS 32 *Financial Instruments: Presentation*, a financial asset and financial liability should only be offset when an entity has a legally enforceable right to set off the recognised amounts of the asset and the liability and intends to settle on a net basis or realise the asset and liability simultaneously. The entity must have the intention to net settle in the normal course of business, not solely in the event of bankruptcy.

During their outreach activities, the Boards found no general consensus amongst financial statement users on the usefulness of presenting gross or net information about financial assets and financial liabilities in the statement of financial position.

During their outreach activities, the Boards found no general consensus amongst financial statement users on the usefulness of presenting gross or net information about financial assets and financial liabilities in the statement of financial position. Credit analysts expressed a preference for disclosure of both the net position (in the statement of financial position) and gross exposure (in the notes) for financial assets and financial liabilities. Equity analysts expressed a preference for recognition of the gross amounts in the statement of financial position.

The Boards' proposals would require offset of a recognised financial asset and financial liability (i.e., presentation as a single net amount in the statement of financial position) when an entity has an unconditional and legally enforceable right of set-off and intends either to net settle or realise the asset and liability simultaneously. Hence, under the Boards' proposals a conditional right of set-off, only exercisable on the occurrence of a future event, for example, default, insolvency or bankruptcy of a counterparty, would not meet the offset criteria. Consistent with this, the proposals clarify that a 'master netting agreement' between two parties, which provides for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract, is a conditional right of set-off hence fails the proposed offset criteria. The proposals are therefore closely aligned with the existing guidance in IAS 32 but require enhanced disclosures.

Observation: Current US GAAP permits an exemption for an entity with derivatives subject to a master netting agreement from the consideration of whether it has the intention to net settle. Similarly, US GAAP also allows for offsetting of repurchase and reverse repurchase agreements under certain criteria (including that they are executed with the same counterparty and subject to a master netting agreement). As a result, under IFRS, generally fewer financial positions qualify for net presentation, as compared to US GAAP. Currently banks reporting under US GAAP are likely to present smaller balances in their statement of financial position than banks reporting under IFRS. The decision to disqualify conditional rights of set-off from net presentation may have significant implications for operating and governing metrics such as regulatory capital and leverage ratios for those reporting under US GAAP.

Comments on the exposure draft are due no later than 28 April 2011. The IASB intends to issue a final standard before the end of June 2011.

Projects delayed pending completion of higher priority projects

Financial instruments with characteristics of equity

The IASB added a project on financial instruments with characteristics of equity to its agenda in 2008. This is a joint convergence project with the FASB. The Boards have tentatively decided on a model where classification is based on how the issued instrument will be settled by an entity, whether in assets (e.g., cash) or in its own equity instruments (i.e., shares). Generally those settled in assets would be classified as liabilities. Instruments settled in an entity's own equity instruments would be classified as liabilities unless the contract specified the exchange of a specific number of shares for a specified amount, in which case equity classification would be permitted.

The Boards' proposed model attracted significant criticism that it lacked an underlying principle and would be difficult to apply to instruments not specifically addressed in the proposals. At their October 2010 joint meeting, the Boards decided to drop this project from their active agenda intending to resume discussions when the Boards have capacity (sometime after June 2011).

In conclusion

The aim of our project updates above is to provide you with an insight into what the future of accounting for financial instruments may look like. With so many projects scheduled for completion and implementation, the next few years will be challenging to say the least. Companies should monitor the IASB's discussion on effective dates for these standards/projects as the Board considers the feedback it has received on its Request for Views – *Effective Date and Transition Methods*. These discussions will determine the timeline for financial statement preparers to implement the new financial instruments and related standards.

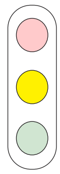
Companies with significant exposures to financial instruments can expect to devote considerable resources over the coming years to the implementation of the new standards. The proposals on amortised cost and impairment have highlighted extensive operational issues (in particular, for entities in the financial services industry); it remains to be seen how challenging application of the final requirements is. The introduction of a new classification and measurement model for financial assets will, in many cases, result in a considerable change to existing accounting under IAS 39. Other projects, such as the proposals for disclosures about transfers and continuing involvement and consolidated and unconsolidated entities, may, at first, appear relatively minor in comparison but significant effort and resources may still be required to gather and process the requisite information.

Staying abreast of the latest IASB developments and having a greater understanding of what the new standards may require will assist you in planning for their implementation. Our Deloitte professionals and our ***IASPlus*** website can help to keep you up to date.

Appendix A: IASB and FASB convergence efforts

Financial asset classification and measurement

Assessment of degree of convergence

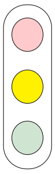


The following table summarises the similarities and differences between the IASB's and the FASB's approaches to classification and measurement of financial assets. The IASB's approach to financial assets is in IFRS 9. The FASB's approach is set out in the proposed ASU *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. Please note that the FASB is currently re-deliberating the proposals in the proposed ASU based on the significant amount of feedback it has received hence it has changed some proposals and others may be subject to change.

Subject	IASB Standard	FASB Proposal
Categories of financial assets	Effectively, three categories of **financial assets**: 1. Fair value through profit or loss (FVTPL). 2. Fair value through other comprehensive income (FVTOCI; an election for equity investments). 3. Amortised cost (required for certain debt instruments).	Effectively, four categories of **financial assets**: 1. Fair value through net income (FVTNI). 2. Fair value through other comprehensive income (FVTOCI; qualifying debt instruments). 3. Amortised cost (required for certain loans). 4. Redemption value (required for certain redeemable investments).
Criteria for measurement at amortised cost	A **financial asset** must be carried at amortised cost if it meets **both** of the following criteria: 1. Business model – the objective of the entity's business model is to hold assets to collect the contractual cash flows. 2. Cash flow characteristics – the asset's contractual cash flows represent payment of principal and interest.	Amortised cost measurement will apply to financial assets for which an entity's business strategy is managing the assets for the collection of the contractual cash flows through a lending or customer financing activity. This is a significant change from the proposed ASU, under which amortised cost was available only to financial assets that are short-term trade receivables. An entity would also need to assess the cash flow characteristics of the instrument; however, this criterion has not yet been deliberated.
Criteria for classification as FVTOCI	On initial recognition, an entity has the option to elect irrevocably to classify an **equity investment** as FVTOCI. Unrealised and realised gains and losses for assets in this category are recorded in OCI, except for dividend income which is recorded in profit or loss unless the dividend clearly represents a recovery of part of the cost of the investment.	FVTOCI measurement will apply to financial assets that are being managed in accordance with an investing activity with a focus on managing risk exposures (interest rate risk and liquidity risk) and maximizing total return. The primary purposes of an entity's investing activities are to manage and invest excess capital and, simultaneously, maximise returns on the related financial assets. An entity would also need to assess the cash flow characteristics of the instrument; however, this criterion has not yet been deliberated. Amounts within OCI would be recycled to profit or loss upon recognition of the financial asset.
Criteria for classification as FVTPL/FVTNI	FVTPL measurement required for items not meeting the business model and cash flow characteristics for amortised cost measurement and for equity instruments where FVTOCI measurement not elected.	FVTNI measurement will encompass an entity's trading or held-for-sale activities (e.g., financial assets that are bought and sold for short-term profit-taking and loans held for sale in the near future). The FVTNI measurement also applies to financial assets that fail the cash flow characteristics criterion; however, this criterion has not yet been deliberated.
Equity investments	Equity investments must be carried at fair value, with changes in fair value recognised in profit or loss, except for those investments that an entity elects irrevocably to classify, on initial recognition, as FVTOCI.	Equity instruments must be carried at fair value, with changes in fair value recognised in earnings, except for certain redeemable investments that are carried at redemption value, with changes in redemption value recognised in earnings. The FASB is deliberating providing a practicality exception for non-markektable equity securities held by non-public entities.

Subject	IASB Standard	FASB Proposal
Embedded derivatives in hybrid financial assets	IAS 39's embedded derivative guidance is eliminated for hybrid **financial assets** (except for those hybrid financial assets outside the scope of IFRS 9 such as a finance lease receivable). Hence such embedded derivatives would not be separated from host financial assets and accounted for as stand-alone derivatives.	Hybrid financial contracts from which embedded derivatives are currently bifurcated and accounted for separately under ASC 815 (formerly FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities) would be measured at FVTNI. However, the requirement to separate out embedded derivatives from hybrid financial instruments outside the scope of the proposed ASU would remain. An entity is permitted to classify hybrid financial contracts that meet the FVTOCI classification criteria and that contain an embedded derivative that does not require bifurcation as FVTOCI. The FASB has not redeliberated this subject.
Fair value option ("FVO")	The FVO is retained for **financial assets** but only available when designation at fair value eliminates or significantly reduces an accounting mismatch; the option is an irrevocable election at initial recognition.	No explicit fair value option provided for in the proposed ASU. The FASB has not redeliberated this subject.
Reclassification	This is required for a **financial asset** if the business model relating to the assets changes. Changes in the business model are expected to be infrequent.	Not permitted.

Financial liability classification and measurement



Assessment of degree of convergence

The following table summarises similarities and differences between the IASB's and the FASB's approaches to classification and measurement of financial liabilities. The IASB's approach is described in the amendments to IFRS 9 published in October 2010. The FASB's approach is set out in the proposed ASU *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. As mentioned above, the FASB proposals are subject to change as it re-deliberates its financial instruments project.

Subject	IASB Standard	FASB Proposal
Categories of financial liabilities	Effectively, three categories of **financial liabilities**: 1. FVTPL (required for trading and derivative liabilities). 2. Fair value, with changes attributable to credit risk recognised in other comprehensive income and other changes recognised in profit or loss (required for financial liabilities elected to be measured at fair value under the fair value option). 3. Amortised cost (required for certain debt instruments).	Effectively, two categories of **financial liabilities**: 1. Fair value through net income (FVTNI), a default category. 2. Amortised cost (an election for qualifying liabilities and short-term payables and receivables).
Criteria for measurement at amortised cost	A **financial liability** must be carried at amortised cost if it is not held for trading and the entity has not elected to use the fair value option.	Primary measurement attribute for financial liabilities. Generally, the same classification criteria apply to financial assets and financial liabilities. The FASB has yet to determine how those criteria woulld apply to financial liabilities.
Criteria for measurement at FVTOCI	No FVTOCI category for financial liabilities. Use of the fair value option would require the changes in fair value attributable to credit risk to be recognised in OCI rather than profit and loss unless doing so creates or enlarges an accounting mismatch.	No FVTOCI category for financial liabilities. The same classification criteria apply to financial assets and financial liabilities. However, since FVTOCI is limited to investing activities, financial liabilities would not qualify for this classification.
Embedded derivatives in hybrid financial liabilities	IAS 39's embedded derivative guidance is retained for hybrid **financial liabilities**. Hence non-closely related embedded derivatives should be separated out from host financial liabilities and accounted for as stand-alone derivatives.	Hybrid financial contracts from which embedded derivatives are currently bifurcated and accounted for separately under ASC 815 (formerly FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities)* would be measured in their entirety at fair value, with changes in fair value recognised in earnings. However the requirement to separate out embedded derivatives from hybrid instruments outside the scope of the proposed ASU would remain. The FASB has not yet redeliberated this subject.
Fair value option	Retained for **financial liabilities** and available when: • designation at fair value eliminates or significantly reduces an accounting mismatch; • an entity manages and evaluates a group of instruments on a fair value basis; or • the liability contains certain types of embedded derivatives. Changes in fair value, except for changes attributable to an entity's own credit risk, are recognised in profit or loss. Recycling of amounts recognised in OCI is prohibited.	No explicit fair value option provided for in the proposed ASU. The FASB has not yet redeliberated tis subject.

Derecognition disclosures

Assessment of degree of convergence

During 2010, the IASB decided that their near-term focus should be on improvement and convergence of the disclosure requirements for off balance sheet arrangements and therefore decided to delay its project on derecognition accounting. The IASB's recently issued disclosure requirements on derecognition are very similar to those required under ASC 860 with one significant exception – the IASB's requirements do not include disclosures about servicing assets and servicing liabilities which are required under US GAAP.

Fair value measurements

Assessment of degree of convergence

The IASB and FASB have worked jointly to develop a converged fair value measurement standard. The final standard should be virtually identical except for one notable difference: US GAAP includes, as a practical expedient, the use of net asset value (NAV) as a measure of fair value for interests in alternative investment funds. The IASB was concerned that such an expedient would not work due to the lack of specific accounting guidance for investment companies in IFRS. Such guidance exists in US GAAP and includes guidance on the determination of NAV.

Consolidation

Assessment of degree of convergence

The IASB is expected to issue its revised consolidation standard in early 2011 with an exposure draft on consolidation for investment companies following in the second quarter of 2011. The FASB participated in the IASB's deliberations on this project and is expected to issue its own exposure draft. The FASB has tentatively decided to diverge in certain areas from the IASB's pending standard. US GAAP currently distinguishes between 'voting interest entities' and 'variable interest entities' (variable interest entities may either not be sufficiently capitalised to support their ongoing activities or their investors' economic interests may be disproportionate to their voting rights). The FASB has tentatively decided to continue to retain separate consolidation models for each. The FASB does not plan to amend its existing guidance for voting interest entities and therefore does not intend to incorporate the possibility – which will be introduced in IFRS 10 – that an entity can have 'de facto' control over another when it does not have majority ownership of voting interests. In other words, under IFRS 10, an entity holding less than 50% of the voting rights, but its interest relative to other shareholders' voting interest could, considering other factors, be an indicator of power to control. However, in respect of variable interest entities, the FASB plans to propose guidance, similar to the IASB's pending standard, for assessing when a decision-maker is a principal or an agent.

The FASB intends to propose investment company criteria similar to the IASB's planned exposure draft. However, the FASB has reached one tentative decision that differs from the IASB. The FASB intends to propose that a non-investment company parent entity consolidating an investment company would be permitted to retain fair value accounting for the investment company's investments. The IASB does not intend to provide a similar exception.

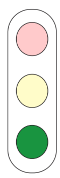
The table below compares highlights of the decisions made in the IASB's pending standard to the current consolidation guidance in US GAAP for the financial services industry.

Subject	IASB Proposal	US GAAP current requirements
Consolidation decision criteria	A comprehensive consolidation standard applicable for all entities based on control (defined as the power to direct the activities of another entity to generate returns for the reporting entity).	Separate consolidation models for (i) voting interest entities based on control of voting rights/decision-making and (ii) variable interest entities based on control together with a potentially significant economic interest.
Kick-out/Removal rights	Removal rights may indicate that the decision-maker is an agent (see below). Removal rights held by a single party would be indicative of an agency relationship while removal rights held by multiple parties, in isolation, would not, hence an assessment of other factors would be required.	For voting interest entities, the ability of a simple majority of interest holders to exercise kick-out rights can rebut the presumption of control by the decision-maker. For variable interest entities, kick-out rights must be exercisable by a single party (and their related parties and de facto agents) to overcome the presumption of control.

Subject	IASB Proposal	US GAAP current requirements
Agency relationship	The assessment of whether an entity is an agent or a principal focuses on the nature and design of the relationship including: • the entity's decision-making authority, • the rights held by other parties, • remuneration of the decision-maker, and • the decision-maker's exposure to variability of returns because of other interests that it has in the entity. Variability of returns associated with the remuneration paid to the entity does not necessarily result in the entity being considered a principal.	For voting rights entities, the ability of the equity holders to replace the "agent" by a simple majority vote would overcome the presumption of control by the "agent". For variable interest entities, the fees paid to an "agent" are not considered variable interests when all of the following conditions are met: • the fees are commensurate with the level of effort required to perform the service, • the fees are at the same level of seniority of the other operating liabilities of the entity, • the "agent" and its related parties do not have other interests in the entity which expose it to more than an insignificant amount of expected losses or expected residual returns, • the arrangement is on customary terms negotiated on an arm's length basis, • the fees are insignificant relative to the entity's economic performance, • the fees are expected to absorb an insignificant amount of the variability associated with the entity's economic performance.
Investment company criteria	Criteria for qualification as an investment company include: • Business purpose • Investment activity • Exit strategy • Unit ownership • Pooling of funds • Use of fair value for internal and external reporting The proposed consolidation exemption for an investment entity would not be available for a parent of the investment entity (e.g., the investment manager) unless the parent also meets the criteria for qualification as an investment entity. Hence an investment manager that does not meet the criteria will consolidate both its funds and any underlying businesses controlled by its funds.	Criteria for qualification as an investment company include: • Investment activity • Unit ownership • Pooling of funds • Reporting entity Parent companies required to consolidate an investment company may retain the fair value accounting applied by the investment company at the parent company level.

Impairment

Assessment of degree of convergence



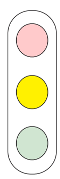
The IASB's proposals on impairment, included in its November 2009 exposure draft *Amortised Cost and Impairment*, were very different from the FASB's proposals. Differences included fundamental items such as scope and primary objective.

The IASB's primary objective for impairment has been to consider estimated expected credit losses as a component of the effective interest rate on the asset, based on its view that credit risk is an inherent component in the pricing of a financial instrument. The FASB's primary objective for impairment has been to ensure a sufficient reserve for future expected losses is maintained.

The two Boards reconciled their respective differences in their proposals contained in the joint Supplement published in January 2011 (see detailed section on impairment above). However, the FASB has not yet voted on the IASB's presentation and disclosure proposals contained in the IASB-only appendix to the Supplement.

Hedge accounting

Assessment of degree of convergence



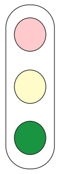
The following table summarises similarities and differences between the IASB's and the FASB's proposed approaches to hedge accounting.

The following table reflects the IASB's exposure draft and the FASB's approach as described in the proposed ASU. It is also worth noting that in February the FASB issued a Discussion Paper – *Invitation to Comment – Selected Issues about Hedge Accounting* requesting US constituent feedback on the IASB's proposals on hedge accounting.

Subject	IASB Proposal	FASB Proposal
Hedgeable risks	The IASB proposes to permit hedge accounting for risk components of both financial items (e.g., benchmark interest rate risk, foreign currency risk, credit risk) and non-financial items provided the risk component is separately identifiable and reliably measurable.	The proposed ASU retains the provision under current US GAAP (ASC 815) that allows an entity to designate hedges of financial items for certain risks (e.g., benchmark interest rate risk, foreign currency risk, credit risk).
Hedge effectiveness threshold	The hedge relationship is required to produce an unbiased result and minimise expected ineffectiveness and achieve offset that is other than accidental.	Reasonably effective.
Means of assessing effectiveness	The type of assessment (quantitative or qualitative) will depend on the specific hedging relationship and the potential sources of ineffectiveness. As the entity's risk management objective for a hedge must be linked to its risk management strategy, the assessment of effectiveness will be based heavily on its internal risk management processes and documentation.	Typically, only a qualitative assessment is required; however, a quantitative assessment may be necessary if the qualitative assessment is not conclusive.
Frequency of hedge effectiveness assessments	At inception and ongoing.	At inception only, unless reassessment is warranted because of a change in circumstances.
Hedge assessments with no assumed ineffectiveness	IFRS will not permit such a technique. Effectiveness assessment and measurement would still be required.	Neither the "shortcut method" nor the "critical-terms-match method" will be permitted. *US GAAP currently allows an entity to assume no ineffectiveness for certain hedge relationships when all of the critical terms of the hedging instrument and hedged item align. Additionally, for certain hedges of interest rate risk when a variety of conditions are met, an entity may assume no hedge ineffectiveness (this technique is commonly referred to as the "shortcut method").
Fair value hedge accounting model	Changes in fair value of the hedged risk would be recognised in a separate line item in the statement of financial position rather than adjusting the hedged item. The effective portion of the hedging relationship will be recognised in OCI (netting to nil).	Retention of ASC 815 requirements for the hedged item to be remeasured for changes in value of the hedged risk recognised through earnings.
Time value of options	Fair value changes in the time value of an option, where the intrinsic value of the option is designated as a hedging instrument, would be deferred in OCI and reclassified to profit or loss as follows: • For transaction related hedged items, it would be reclassified in accordance with general requirements, (e.g., capitalised into a non-financial asset (a "basis adjustment") or into profit or loss when the hedged transaction affects profit or loss). • For time period related hedged items, the current period portion, determined on a rational basis, would be transferred to profit or loss.	Retention of existing US GAAP requirements. If intrinsic value is designated as a hedge, the time value is recognised in earnings; if option time value is included in the hedge relationship, an entity can defer time value in OCI when certain criteria are met. Certain cash flow hedge designations where the hedging instrument is an option, qualify for the shortcut method of hedge effectiveness assessment. In these cases, all changes in fair value of the option (including time value) are recognised in OCI and reclassified into profit or loss in the periods in which the hedged forecast transaction affects profit or loss.
De-designation of a hedging relationship	De-designation would not be permitted when the qualifying criteria continue to be met. Rebalancing of the hedge relationship (changing the weightings of the hedged item and the hedging instrument) would be permitted so long as the risk management objective of the hedge has not changed.	An entity cannot de-designate a hedging relationship once it has been established; however, the entity may enter into an offsetting derivative, effectively to terminate the hedge.

Offsetting

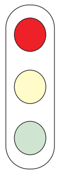
Assessment of degree of convergence



The IASB and FASB held joint deliberations on offsetting of financial assets and financial liabilities in the statement of financial position hence the proposals in the recently issued IASB exposure draft reflect joint decisions. The aim is to eliminate the primary difference between US GAAP and IFRS in this area, which is that US GAAP permits derivative positions subject to a conditional right of set-off (e.g., under an ISDA master netting agreement) to be offset whereas IFRS does not.

Financial instruments with characteristics of equity

Assessment of degree of convergence



Both Boards have agreed to defer discussing this project until later in 2011. Hence the existing differences between the requirements in IAS 32 and ASC 480 will remain for the time being. The US GAAP requirements are considerably more complex than the IFRS requirements.

Subject	IASB current requirements	US GAAP current requirements
Convertible debt – ***separation of the conversion option***	Separation of the conversion option is always required (either as equity or as a derivative liability).	A conversion option is only separated in certain circumstances.
Convertible debt – ***conversion into equity pursuant to original terms***	Conversion of convertible debt in accordance with the original terms under which the conversion option was recognised in equity does not result in a gain or loss.	Conversion of convertible debt in accordance with the original terms sometimes results in a gain or loss.
Convertible debt – ***early redemption (extinguishment)***	Entities allocate the consideration paid upon redemption or repurchase between the liability and equity components using the same method used to make the original allocation of the proceeds of the issue of the instrument between the liability and equity components upon initial recognition (i.e., the fair value of consideration paid is first allocated to the liability component with the residual assigned to the repurchase of the equity component).	US GAAP does not generally require separation of an equity component, with certain exceptions. Accordingly, on early redemption, entities do not generally allocate proceeds between the debt and equity components. Instead, entities generally derecognise the instrument and recognise a gain or loss in earnings between current carrying amount and the redemption proceeds.
Convertible debt – ***multiple settlement alternatives upon conversion***	Separation of the conversion option is always required. Generally an issuer is precluded from classifying the conversion option as equity and accounts for the conversion option as a non-closely-related embedded derivative.	Separation out of the conversion option as an embedded derivative is required unless the issuer cannot be forced to settle for cash.
Obligations to issue a variable number of equity shares	Accounted for as liabilities.	Accounted for as equity, unless at inception, the monetary value of the obligation is based solely or predominantly on any of the following: a) A fixed monetary amount known at inception; b) Variations in something other than the fair value of the issuer's equity shares; or c) Variations inversely related to changes in the fair value of the issuer's equity shares.
Derivatives indexed to, and potentially settled in, the entity's own equity instruments that it has the ability to net-share settle	Accounted for as assets or liabilities.	Except for written put options and forward repurchase contracts, classified as equity unless the issuer could be forced to settle in cash.

Appendix B: IASB Financial Instruments and other related projects timeline

<table>
<tr><th>Project</th><th>Q4 2010</th><th>Q1 2011</th><th>Q2 2011</th></tr>
<tr><td>Financial liability classification and measurement</td><td>IFRS</td><td></td><td></td></tr>
<tr><td>Amortised cost and impairment</td><td></td><td>Supplement to the Exposure Draft</td><td rowspan="3">IFRS</td></tr>
<tr><td>Hedge accounting</td><td>Exposure Draft</td><td></td></tr>
<tr><td>Offsetting</td><td></td><td>Exposure Draft</td></tr>
<tr><td>Derecognition disclosures</td><td>IFRS</td><td></td><td></td></tr>
<tr><td>Fair value measurement</td><td></td><td></td><td>IFRS</td></tr>
<tr><td>Consolidation</td><td></td><td></td><td></td></tr>
<tr><td>• Consolidation IFRS</td><td></td><td></td><td>IFRS</td></tr>
<tr><td>• Investment Company ED</td><td></td><td></td><td>Exposure Draft</td></tr>
</table>

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