

HKFRSs / IFRSs UPDATE 2011/01

LATEST DEVELOPMENTS ON THE IAS 39 (HKAS 39) FINANCIAL INSTRUMENTS REPLACEMENT PROJECT – HEDGING, IMPAIRMENT AND OFFSETTING



IASB's project plan to replace IAS 39 consists of three main phases:

(a) Completion of Phase 1: Classification and measurement of financial assets and financial liabilities.

- ▶ In November 2009 the IASB issued the chapters of IFRS 9 *Financial Instruments* setting out the requirements for the classification and measurement of financial assets (for more details, please read [BDO HKFRSs/IFRSs Update](#)).
- ▶ In October 2010 the IASB added to IFRS 9 the requirements for the classification and measurement of financial liabilities (for more details, please read [BDO HKFRSs/IFRSs Update](#)).

(b) Phase 2: Impairment methodology.

- ▶ In June 2009 the IASB published a *Request for Information* on the feasibility of an expected loss model for the impairment of financial assets.
- ▶ This formed the basis of an *exposure draft Financial Instruments: Amortised Cost and Impairment*, published in November 2009.
- ▶ In seeking a common solution on the accounting for impairment of financial assets, the IASB and the US FASB (the boards) published jointly in January 2011 a [Supplement to the Exposure Draft Financial Instruments: Amortised Cost and Impairment](#) (Supplementary Document).

(c) Phase 3: Hedge accounting.

- ▶ In December 2010 the IASB published an [exposure draft Hedge Accounting](#) proposing a comprehensive re-examination of hedge accounting, covering hedging of both financial and non-financial exposures.
- ▶ Differences exist between IFRSs and US GAAP relating to hedge accounting. The revisions proposed by the IASB in the exposure draft would result in more differences compared with the FASB's current and proposed (May 2010) hedge accounting guidance. In response, the FASB issued on 9 February 2011 a Discussion Paper seeking reaction to the IASB's proposals.

Revised Hedge Accounting

Common Impairment Model for Financial Assets Measured at Amortised Cost and Managed in Open Portfolio

Common Approach in Offsetting of Financial Assets and Financial Liabilities

In addition, in seeking a common solution on the offsetting of financial assets and financial liabilities, the boards published jointly in January 2011 an **exposure draft** *Offsetting of Financial Assets and Financial Liabilities*.

The following sections provide a high-level summary of the recent IASB's consultation documents in revising financial instruments accounting.

Revised Hedge Accounting

Need for change

The exposure draft proposes significant changes to the general hedge accounting requirements in IAS 39 in order to provide more useful hedge accounting information. Many users and preparers of financial statements describe hedge accounting today as complex and criticise it for not reflecting an entity's risk management activities nor to what extent those activities are successful in meeting the entity's risk management objectives. Many also find the requirements in IAS 39 excessively rule-based, resulting in arbitrary outcomes.

The proposals

The proposals in the exposure draft amount to a comprehensive review of hedge accounting requirements (apart from some portfolio hedge accounting requirements), and the proposals in the exposure draft, if confirmed, would:

- (a) align hedge accounting more closely with risk management and hence result in more useful information
- (b) establish a more objective-based approach to hedge accounting
- (c) address inconsistencies and weaknesses in the existing hedge accounting model.

The exposure draft proposes requirements in the following areas:

- (a) what financial instruments qualify for designation as hedging instruments
(for example, the exposure draft would expand the types of financial instruments eligible to be designated as hedging instruments to include non-derivative financial

assets and non-derivative financial liabilities measured at fair value through profit or loss)

- (b) what items (existing or expected) qualify for designation as hedged items
(for example, the exposure draft would expand the types of items that may be designated as a hedged item
 - ▶ *An aggregated exposure that is a combination of an exposure and a derivative may be designated as a hedged item*
 - ▶ *An entity is permitted to designate a "nil net position" (when the hedged items in a group fully offset among themselves the risk that is being managed on a group basis) as the hedged item in a hedging relationship that does not include a hedging instrument if specific requirements are met)*
- (c) an objective-based hedge effectiveness assessment
(for example, the exposure draft would amend the criteria to qualify for hedge accounting by replacing the current requirement for a hedge to be "highly effective" (defined as a bright line quantitative test of 80-125%) with the requirements that the hedging relationship (i) meets the objective of the hedge effectiveness assessment (that is, to ensure that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness) and (ii) is expected to achieve "other-than-accidental offset")
- (d) how an entity should account for a hedging relationship (fair value hedge, cash flow hedge or hedge of a net investment in a foreign operation)
(for example, the exposure draft would permit and sometimes require an entity to adjust an existing hedging relationship (referred to as a "rebalancing" of the hedging relationship) and account for the revised hedging relationship as a continuation of an existing hedge rather than as a discontinuation. In some cases, rebalancing (that is, adjusting the hedge ratio) can ensure that a hedging relationship continues to meet the objective of the hedge effectiveness assessment)

- (e) hedge accounting presentation
(for example, the exposure draft would change the presentation of fair value hedges in the financial statements. The hedged items in such hedges would no longer be adjusted for changes in fair value attributable to the hedged risk. Instead, those fair value changes would be presented as a separate line item in the statement of financial position. The separate line item would be presented next to the line item that includes the hedged asset or liability. Additionally, the gain or loss on the hedging instrument and the hedged item (for changes in the hedged risk) would be recognised in other comprehensive income rather than through profit or loss, which is similar to the current cash flow hedge model. Any ineffective portion of the gain or loss would be transferred from other comprehensive income to profit or loss)

- (f) hedge accounting disclosures
(for example, the exposure draft would require disclosures about the risks that an entity decides to hedge and for which hedge accounting is applied, including information about the following:
- a. An entity's risk management strategy and how it is applied to manage risk*
 - b. How the entity's hedging activities may affect the amount, timing, and uncertainty of its future cash flows*
 - c. The effect that hedge accounting has on the entity's primary financial statements.*
- The exposure draft also would require quantitative disclosures of risk exposures and amounts hedged related to items designated as hedging instruments. This information would be disclosed separately by category of risk and for each type of hedge)*

Comment deadline

The exposure draft is open for public comment until 9 March 2011 and the deadline for submission of comments to the HKICPA is 16 February 2011.

The exposure draft includes an alternative view on certain proposed changes, which is presented in the Alternative View section provided at the end of the Basis for Conclusions in the exposure draft.

The IASB decided not to address open portfolios or macro hedging as part of the exposure draft. The IASB is continuing to discuss proposals for hedge accounting for open portfolios.

Common Impairment Model for Financial Assets Measured at Amortised Cost and Managed in Open Portfolio

Background

At present, IFRSs and US GAAP account for credit losses using an incurred loss model, which requires evidence of a loss (known as a trigger event) before financial assets can be written down. The boards have proposed moving to an expected loss model that provides a more forward-looking approach to how credit losses are accounted for, which they believe better reflects the economics of lending decisions. The proposals are included in an exposure draft published by the IASB in November 2009, and in a separate FASB exposure draft published in May 2010. Those exposure drafts outlined different methods to account for credit impairment. Since then, the boards have worked to align their approaches.

Proposed common impairment model

As a result, the boards jointly published the Supplementary Document incorporating elements of the separate models that the boards were developing by proposing a common impairment model for open portfolios of financial assets measured at amortised cost, excluding short-term trade receivables as follows:

"Good book" – "bad book"

Many financial institutions have two broad groups of financial assets that are monitored differently: loans that are considered problematic (the "bad book") and those that are not (the "good book"). Financial assets in the "good book" are generally monitored on a portfolio basis, while those in the "bad book" are managed more closely and, often, on an individual basis. The Supplementary Document proposes separate methods to recognise expected losses for these groups:

- ▶ For the "good book", expected losses are recognised over time, using a time-proportional approach.
- ▶ For the "bad book", expected losses are recognised immediately.

Time-proportional approach

Under the time-proportional approach, an allowance is calculated as a portion of the remaining lifetime expected losses on the portfolio. The portion is determined on the basis of the age of the portfolio using a straight-line approach or an annuity approach:

- (a) straight-line approach using either a discounted or undiscounted estimate: multiplying the entire amount of credit losses expected for the remaining life of the portfolio by the ratio of the portfolio's age to its expected life
- (b) annuity approach, which by definition, uses a discounted estimate: converting the entire amount of the credit losses expected for the remaining life of the portfolio into annuities on the basis of the expected life of the portfolio and accumulating these annuities for the portfolio's age (which includes accruing notional interest on the balance of the allowance account).

Minimum "good book" allowance

In some cases, recognising a time-proportional amount for the "good book" may result in actual losses occurring that exceed the allowance balance at the time of the loss. For example, this might occur if a portfolio has a concentration of loans that are expected to default early in their life. To address this concern, it is considered necessary to set a minimum allowance balance (a floor). The allowance balance for the "good book" will be the greater of:

- (a) the time-proportional amount, and;
- (b) the floor, being the expected losses for the foreseeable future which is the period for which an entity can develop specific projections of events and conditions to estimate expected losses for the portfolio (no less than 12 months).

Comment deadline

The Supplementary Document is open for public comment until 1 April 2011 and the deadline for submission of comments to the HKICPA is 9 March 2011.

Common Approach in Offsetting of Financial Assets and Financial Liabilities

Need for change

This project is being undertaken jointly by the boards. At present, the circumstances when financial assets and financial liabilities may be presented in an entity's statement of financial position as a single net amount, or as two gross amounts, differs depending on whether the entity reports using IFRSs or US GAAP. This reduces the comparability of financial statements, and is especially prominent in the presentation of derivative assets and derivative liabilities by financial institutions. As a result, users and preparers of financial statements have asked the boards to find a common solution for offsetting those items.

Proposed offsetting criteria

In responding to the comments received, the boards are proposing that offsetting should apply only when the right of set-off is enforceable at all times, including in default and bankruptcy, and the ability to exercise this right is unconditional, that is, it does not depend on a future event. The entities involved must intend to settle the amounts due with a single payment or simultaneously. Provided all of these requirements are met, offsetting would be required (not an accounting choice).

The existing IFRSs offsetting requirements are set out in IAS 32.42-50, in particular IAS 32.42 which requires that "a financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:

- (a) currently has a legally enforceable right to set off the recognised amounts; and
- (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously."

Impact of the proposals

Companies that have financial assets and financial liabilities and especially those with large derivative activities may be affected by the proposals. Large financial institutions that report in accordance with US GAAP will especially be affected. However, generally, IFRSs preparers should not be significantly affected by the proposals.

Comment deadline

The exposure draft is open for public comment until 28 April 2011 and the deadline for submission of comments to the HKICPA is 7 April 2011.

BDO's support and assistance on HKFRSs

For any support and assistance on HKFRSs, please talk to your usual BDO contact or Stephen Chan, Partner and Head of Technical & Training at +852 2853 5820 or email StephenChan@bdo.com.hk

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