



Australian Government

Australian Accounting Standards Board

"Key Issues in Financial Reporting for Banking & Finance Professionals"

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Overview

1. GFC has been a positive wakeup call for standard setting
2. Financial Crisis Advisory Group Report
3. Report of IASCF Trustees to G20
4. Key current issues and projects



Preliminary Observations:

Distinguishing users' and stakeholders' interests

- Uproar re fair value and provisioning
- Standard setting must remain user focussed
- Other stakeholders are not primary parties
- All noise potentially contains true messages, even if not well articulated



Preliminary Observations:

Distinguishing users' and stakeholders' interests

- Existing biases?
 - ∅ Governments/politicians
 - ∅ Banking and other regulators
 - ∅ Preparers/management/auditors
 - ∅ Standard-setters



Preliminary Observations:

Understanding the economic environment and changing risks

- The GFC's effects on financial reporting of both financial and non-financial services entities
- When should existing standards have signalled risk in the financial reporting environment? Were they deficient?
- What should standard setters do, systematically, to detect the risks of:
 - ∅ inadequacies in reporting generally?
 - ∅ circumstances requiring flexible responses?



Preliminary Observations:

Detecting the technical areas under stress / fixing what is broken

- What have we learned so far from the GFC?
 - ∅ Fair value: not well articulated, understood conceptually or well accepted
 - ∅ Methodological guidance found wanting when markets are less active or inactive
 - ∅ Uncertainty exists around credit valuation adjustments



Preliminary Observations:

Detecting the technical areas under stress/fixing what is broken

- Existing categorisation of FI is complex, arbitrary and inadequate
- Mixed measurement models accommodate confusing debates
- Existing impairment models are numerous and inadequate
- De-recognition remains a problem
- Lease accounting still accommodates off balance sheet treatment
- Consolidation needs global agreement



Preliminary Observations:

Detecting the technical areas under stress/fixing what is broken

- Reduce complexity in standards by:
 - ∅ concentrating on principles
 - ∅ minimising exceptions
 - ∅ keeping anti-abuse measures to a minimum



Preliminary Observations:

Detecting the technical areas under stress/fixing what is broken

- Disclosure to be more purposeful and reduced
- The presentation of financial statements needs to be structured in a more meaningful way
- Professional judgement is the result of principles-based requirements and needs to be depended upon
- Differential reporting's time has come



2. Financial Crisis Advisory Group Report (*July 2009*)

- Membership of FCAG
- FCAG's Brief
- Main findings



FCAG Members (22)

- Co-Chair: Former SEC Commissioner
- Co-Chair: Chairman of Netherlands Authority for the Financial markets
- Various Financial Institutional Chairmen/Executives
- Former IFAC president
- Former President of New York Federal Reserve Bank
- Senior Pension Fund Executive
- Insurance Industry Executives
- Former Controller of Currency for US
- Central and Reserve bank board members
- Former Finance Minister
- Other Senior Securities Commission Officers
- Various observers including Basel Committee, Financial Stability Board



FCAG Brief

- To advise the IASB and FASB about the standard-setting implications of the GFC and potential regulatory changes
- Independent review
- Focus on financial institutions



FCAG Main Findings

- Pointed to four guiding principles
 - ∅ Effective financial reporting is critical
 - ∅ The limitations of financial reporting need to be kept in mind
 - ∅ High-quality, global standards are needed
 - ∅ The independence of standard setters is vital, as is the need for them to be accountable



FCAG Main Findings cont'd

- Accounting standards were **not** the root cause of the financial crisis
- However, weaknesses were exposed in;
 - ∅ determining fair value in illiquid markets
 - ∅ delayed recognition of losses on loans and structured products
 - ∅ off-balance sheet financing
 - ∅ complexity in financial instruments standards, including multiple impairment models



FCAG Main Findings cont'd

- Criticisms of pro cyclicity arising from fair value:
 - ∅ “It is important to recognise that, in most countries, a majority of bank assets are still valued at historic cost...By now it seems clear that the overall value of these assets has not been understated – but overstated. The incurred loss model...has delayed recognition of losses on loan portfolios.”



FCAG Main Findings cont'd

- Recommendations:
 - ∅ Simplify and improve standards, especially on financial instruments
 - ∅ Converge US GAAP and IFRS; extend IFRS to other countries
 - ∅ Explore expected-loss model
 - ∅ Be wary of earnings management in changing impairment models
 - ∅ Reconsider marking own debt for changes in own creditworthiness
 - ∅ Consult with prudential regulators on consolidation, de-recognition and risk disclosure
 - ∅ Maintain the integrity of due process
 - ∅ Document the limitations of financial reports in conceptual framework



FCAG Main Findings cont'd

- Non-accounting recommendations
 - ∅ Tighter control of OTC markets for derivatives and structured products
 - ∅ Improved valuation and verification processes in companies
 - ∅ Ensure enforcement of standards doesn't cause divergence
 - ∅ Policy makers to refrain from trying to influence specific standards
 - ∅ Strengthen the independence of the IASB
 - ∅ Include regulators from more countries on IASB Monitoring Board



3. Report of Trustees to G20 (September 2009)

- What has been achieved so far?
 - ∅ Importance of globally converged standards acknowledged
 - ∅ Engagement increased with stakeholders and with banking and securities regulators
 - ∅ Proposals being developed to revise IAS 39 on financial instruments
 - ∅ Work under way on impairments and fair value
 - ∅ Governance improvements made



3. Report of Trustees to G20 cont'd

Specific publications/events so far:

- IASB Advisory Panel Report (Oct 2008) Fair Value Measurement in Illiquid Markets
- IAS 39 Reclassification amendments (Oct 2008)
- IASB ED (April 2009) Derecognition
- IASB ED (May 2009) Fair Value Measurement
- IASB DP (June 2009) Expected Loss Model
- IASB staff paper (June 2009) Own Credit Risk in Liability Measurement
- IASB ED (July 2009) Financial Instrument Classification and Measurement
- IASB/FASB Financial Instrument roundtables (Sept 2009)



3. Report of Trustees to G20 cont'd

Relevant projects underway prior to GFC

- IASB ED (Dec 2008) Consolidated Financial Statements
- IASB/FASB DP (April 2009) Leases



3. Report of Trustees to G20 cont'd

'Non-technical' responses

- IASB meets regularly with Basel Banking Supervision Committee
- IASCF Monitoring Board created
- IASCF membership widened
- Standards Advisory Council restructured



4.- Key Current Projects

- Classification and measurement
- Derecognition
- Own credit risk
- Impairment
- Hedging



Classification and Measurement

- Basic loan features; &
- Managed on a contractual yield basis
- No tainting and no need to consider intention and ability to hold to maturity

Amortised
cost

Fair Value

- All other instruments
- Irrevocable option to present changes in fair value in OCI for equity investments not held for trading
- Fair value option for accounting mismatches



Classification and Measurement:

Embedded Derivatives

- Embedded derivatives with financial hosts
 - Bifurcation of embedded derivatives will be eliminated
 - use of classification approach (excluding hybrids with non-financial hosts)
- Embedded derivatives with non-financial hosts
 - not addressed at this stage



Classification and Measurement:

Presentation of Fair Value Changes

- Presentation in OCI
 - available for all equity instruments that are not held for trading
- Characteristics:
 - irrevocable option
 - instrument by instrument (not principle based)
 - no recycling or impairment
 - dividends recognised in OCI



Classification and Measurement:

Fair value option (FVO)

- FVO for accounting mismatches only
- Makes two of the existing FVO criteria irrelevant

Current IAS 39	Why irrelevant?
When a group of financial assets or liabilities is managed and evaluated on a fair value basis (in accordance with a documented risk management or investment strategy)	Proposal is now to consider instruments that have basic loan features and managed on a contractual yield basis measured at amortised cost
When a hybrid contains an embedded derivative, unless that embedded derivative does not significantly affect the cash flows of the hybrid contract or it is clear that it is closely related to the host contract	Proposal is now to eliminate embedded derivative accounting for hybrid contracts with financial hosts



Derecognition: Proposed Approach

Derecognise a financial asset (or a specified part thereof) if...

Contractual rights to the cash flows expire

OR

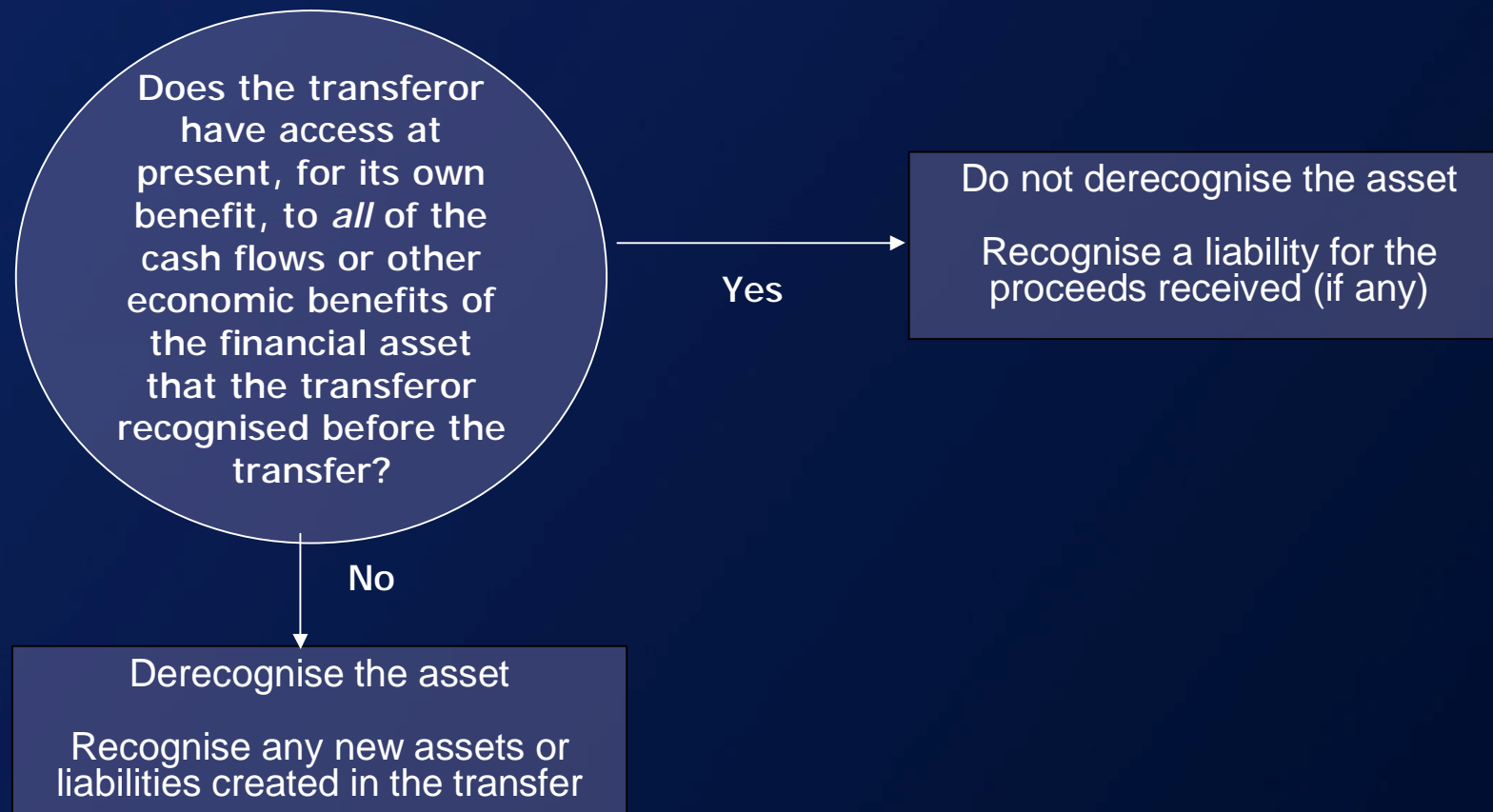
Transfer + no continuing involvement

OR

Transfer + no continuing involvement, but transferee has practical ability to transfer the asset (or part) for its own benefit



De-recognition: An alternative approach





Own credit risk

IASB staff paper seeks views on whether credit should be :

- included in initial liability measurement
- included in subsequent liability measurement



Impairment

- Focus on loan loss provisioning
- IAS 39 has an 'incurred loss model'
- IASB DP seeks views on viability of an expected loss model but does not explain what it is



Hedging

- IAS 39 permits hedge accounting in particular circumstances
- IAS 39 hedge effectiveness testing can be complex
- Proposals to simplify hedge accounting:
 - ∅ One category – like cash flow hedges
 - ∅ Ineffectiveness – simplified/less anti-abuse



5 - Conclusion

- Frenetic pace of change
- Meeting the challenges posed by G20 and FCAG
- Still facing political pressures from Europe
- Australia caught in global change
- Comments needed on proposals
- Opportunity to learn or re-learn financial instruments and other related major topics



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