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14 September 2009

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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UNITED KINGDOM

Dear David

AASB comments on IASB Exposure Draft ED/2009/7
Financial Instruments: Classification and Measurement

The Australian Accounting Standards Board (AASB) is pleased to provide comments on Exposure Draft ED/2009/7 *Financial Instruments: Classification and Measurement*. In formulating its views, the AASB sought the views of Australian constituents.

The AASB agrees that the global financial crisis has highlighted that users of general purpose financial statements require better information to understand the reporting of financial instruments and that the proposals in this ED respond to these concerns.

The AASB is supportive of the IASB's objective to improve and simplify the accounting requirements for the reporting of financial instruments. However, the AASB is concerned that the IASB's short project timeframe has not provided constituents with sufficient time to properly assess the impact of the classification and measurement proposals on financial statements. The AASB believes that this may have contributed to some constituents placing an inappropriate focus on the possible change in the incidence of the use of fair value, rather than giving proper consideration to the merits of the proposals.

In addition, the AASB is concerned that the accelerated due process and the staged approach to this project are likely to result in the subsequent identification of unintended accounting consequences that may require further consideration by the IASB and its constituents and subsequent amendments.

The AASB notes the objective of this project, as stated on the FASB project page is to "...replace the FASB's and IASB's respective financial instruments standards with a *common* standard." [Emphasis added.]

However, the AASB notes that the FASB decisions-to-date regarding classification and measurement differ from the proposals in the IASB's ED in certain key respects. In addition, the FASB is not undertaking a staged approach to the project, because it believes that these issues are interrelated and that a comprehensive approach will result in requirements that are more coherent, making it easier for constituents to react to and understand. Therefore, it expects to issue an exposure draft at the end of this year, or early in 2010, that considers classification and measurement, as well as impairment and hedging

requirements. We would be concerned if the IASB finalises the classification and measurement decisions in December, without the benefit of seeing the outcomes of the FASB exposure process. Despite the views of some in Europe, we consider the focus on December year ends to be inappropriate and to be creating a sense of urgency that is unhelpful. The FASB is facing no less important issues than the IASB, but is employing a more reasonable timetable.

The AASB strongly encourages the IASB to work closely with the FASB on this project, in the same timeframe, in order to progress towards the development of a high quality principle-based global standard that deals with the accounting for financial instruments.

Noting the above concerns, the AASB believes that the IASB proposals are a substantial improvement to the existing financial instruments requirements. The AASB supports the simplification of the classification categories and the elimination of the 'tainting rules' in existing IAS 39 for held-to-maturity investments. In addition, the proposal to only require impairment of instruments carried at amortised cost is a significant improvement to reporting requirements for financial instruments and will help ensure consistent treatment of instrument classifications.

If you have any queries regarding any matters in this submission, please contact me or Natalie Batsakis (nbatsakis@aasb.gov.au).

Yours sincerely

Kevin M. Stevenson
Chairman

AASB comments on IASB Exposure Draft ED/2009/7
Financial Instruments: Classification and Measurement

Specific matters for comment

The AASB provides the following responses to the IASB's Exposure Draft ED/2009/7 *Financial Instruments: Classification and Measurement.*

Issue 1: Classification approach (paragraphs 3–5)

> **Question 1**
>
> Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

Consistent with our response to the IASB's Discussion Paper *Reducing Complexity in Reporting Financial Instruments*, the AASB supports the retention of an amortised cost classification until due consideration is given to the *Conceptual Framework* and *Fair Value Measurements* projects. These projects will provide a basis for determining the suitability of measuring more financial instruments at fair value than already prescribed by the Standards. In the meantime, and pragmatically, we support retention of amortised cost in the circumstances identified.

Certainly some would see the taking of fair value changes for basic borrowings to the income statement as showing variability that does not represent the contractual arrangements involved or the entity's approach to managing its cashflows or risks.

The AASB believes that an amortised cost classification is a practical way of distinguishing between those financial assets/liabilities whose cash flows are intended to be recovered via basic interest and principal repayments in accordance with the contract and those that are managed for their fair value movements.

> **Question 2**
>
> Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a contractual yield basis'? If not, why? What additional guidance would you propose and why?

The AASB considers that the guidance provided in paragraphs B1 to B13 of Appendix B of the ED proposes sufficient, operational guidance for the application of the classification criteria to straight forward debt instruments that have basic loan features and are managed on a contractual yield basis. However, there are concerns about the application of the classification criteria to instruments other than simple debt instruments. For example, there is no specific guidance on the treatment of simple receivables and payables which do not have basic loan features.

In addition, there are concerns that the 'basic loan features' criterion is too narrow and would inappropriately result in the reclassification of some instruments, that are currently managed on a contractual yield basis (that is, held to maturity to recoup interest and principle payments), from amortised cost to being classified and measured at fair value.

This concern arises in relation to the financial liability component of a compound financial instrument that is bifurcated into its debt and equity components under IAS 32 *Financial Instruments: Presentation*, and will not be able to be classified and measured at amortised cost under the current proposals because the equity conversion option would not meet the definition of a 'basic loan feature'. Therefore, despite the business model being such that the liability is managed on a contractual yield basis, fair value movements would be recognised in the income statement.

Some of our constituents have expressed concern with regard to the application of the 'basic loan features' criterion to entities that are bound by applying the rules relating to Islamic contracts. Banks issuing loans in accordance with Islamic contracts are not allowed to earn passive income (that is, by way of interest) and therefore, repayments of borrowings are made in accordance with a profit sharing arrangement between the bank and the entity. The profit sharing arrangement is in substance the repayment of interest on the loan. However, it cannot be described as such, or even be linked to interest under the requirements of Islamic contracts. These loans are becoming more prevalent in many jurisdictions. The AASB does not have a solution to the issue, but does wonder whether some bridging guidance might be developed for those who are concerned. It would seem strange if amortised cost is precluded on what may turn out to be terminological grounds.

The AASB considers that the criteria (both the notion of 'basic loan features' and 'contractual yield basis') should be expressed in a generic manner to remove the emphasis on financial institution loans in order to help ensure consistent accounting treatment for transactions by all types of entities (and not just financial institutions) that are 'in substance' the same.

The AASB also believes that both criteria should be retained, even though we are aware that some have suggested that the business model criterion is either sufficient or should in some way be given primacy.

The AASB also believes that the IASB should consider how it expects an entity to deal with the possible accounting impacts of changes to its business model. Whilst the AASB agrees that changes to an entity's business model should be infrequent and that there will be circumstances where the instrument is not treated consistently with the entity's business model, it is conceivable that the business model could change (for example, after a major business combination) and it would be appropriate for there to be transitional arrangements in any resulting standard.

The AASB believes that the use of a 'business model overlay' is a pervasive issue because it affects many of IFRSs. The AASB believes that this concept has been better articulated in the proposals (in particular at paragraphs BC32 and BC33) than elsewhere in the IASB literature. Furthermore, the AASB considers that it would be appropriate to further develop this notion, about the difference between management intent and looking to the entity's business model, more generally for application across other IFRSs.

Question 3

Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost? If so,

(a) what alternative conditions would you propose? Why are those conditions more appropriate?

(b) if additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in information that is more decision useful than measurement at fair value?

(c) if financial assets or financial liabilities that the exposure draft would measure at amortised cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?

As discussed above, the AASB believes that unless the 'basic loan features' criterion is refined in relation to compound financial statements, it would result in the inconsistent treatment of like transactions.

Issue 2: Embedded derivatives (paragraphs 6–8)

Question 4

(a) Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

(b) Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (ie tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision usefulness of information about contractually subordinated interests?

(a) The elimination of the embedded derivative requirements for a hybrid contract with a financial host is intended to be a simplification of the existing requirements which are perceived to be complex and to have resulted in diversity in practice and interpretation.

However, there are concerns that the proposed requirements may result in the same embedded derivatives being accounted for differently because:

(i) one is embedded in a host contract and another is standalone; or

(ii) there are similar/identical derivatives embedded in different host contracts which are accounted for differently because of the classification criteria or the significance of the embedded derivative relative to its host.

Given these concerns, the AASB is supportive of allowing an option to bifurcate instruments for those who wish to split out any embedded derivatives from their financial hosts in accordance with their risk management strategy. This would be

consistent with considering a business' objective in determining the classification of a financial instrument.

In addition, the AASB believes that these requirements may be impacted by any amendments to the hedging requirements, because often these components are split and hedged in accordance with a business' risk management strategy. Therefore, the AASB encourages the IASB to consider the impact of any proposed hedging requirements on the embedded derivative classification and measurement requirements prior to finalising Phase I of its project to replace IAS 39.

In finalising the requirements, the AASB believes that it may be useful to provide examples that illustrate the impact of embedded derivatives on the effective interest rate calculation (that is, the impact of prepayment or cap/collar/floor options).

The AASB is sympathetic to the IASB's view that securitisation vehicles can involve interests in financial instruments with more than basic loan features. Indeed sponsoring and other participants can, in effect, be the providers of embedded credit default swaps or guarantees for others involved.

The dilemma the IASB has faced is whether to require these embedded derivatives to be bifurcated (to allow the underlying instruments to be accounted for at amortised cost) or, for simplification, to remove the concept of bifurcation and require the host and derivative to be marked to fair value.

The AASB suggests that if the choice is between marking interests at fair value en toto or in bi-furcation, entities may well elect to bifurcate. We consider that marking the embedded derivative to market, carrying the underlying loans and receivables at amortised cost and improving impairment may provide reasonable answers.

Constituents have not found the identification of the problems in securitisation to be clear. Some have had difficulty reconciling the fact patterns to those with which they are familiar or in understanding why the differing risk levels of different tranches should lead to different measurement bases. Some have been concerned that the IASB's solutions encourage structuring to avoid the proposed treatments. The AASB thinks that these difficulties can be overcome by better description of the problem and circumstances, together with the provision of an option to mark the embedded derivatives.

Issue 3: Fair value option (paragraph 9)

Question 5

Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?

The AASB supports the proposed fair value option where such designation eliminates or significantly reduces an accounting mismatch.

Question 6

Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

Consistent with the response to Question 4, the AASB supports the retention of an option to bifurcate hybrid instruments.

The AASB believes that it would be appropriate to retain a fair value option at initial recognition for hybrid instruments (host contracts with embedded derivatives) that enables the classification and measurement of the instrument in its entirety at fair value through profit or loss.

In addition, the AASB believes that it would be a positive step to encourage the use of fair value by having a one way, irrevocable election to use fair value that could be exercised at any time (that is, subsequent to initial recognition). Over time entities may become more comfortable with using fair value, particularly in relation to instruments that the entity has held for some time – and where the entity has become more familiar with the features of the instrument and relevant markets for the instrument have become more active.

Issue 4: Reclassification (paragraph 10)

Question 7

Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

The AASB agrees that reclassification (other than advocated in the response to Question 6) should be prohibited. The second leg of the classification criteria is not based on management expectations or assessments – it is a business model overlay. Therefore, the classification of a financial asset or financial liability is a question of fact and should be accounted for as such. However, as discussed in the response to Question 1, the AASB believes that the IASB should provide guidance on what would constitute a change in business model and the transitional provisions for existing and newly-acquired instruments.

Issue 5: Investments in equity instruments that do not have a quoted market price and whose fair value cannot be reliably measured

Question 8

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

The AASB agrees with the proposal to remove the cost exemption for equity instruments that do not have a market price and whose fair value cannot be reliably measured. Consistent with the IASB's project *Fair Value Measurement*, the AASB considers that a Level 3 fair value measurement should be attainable, and that measuring equity instruments using a fair value measurement will provide more decision-useful information than using a cost basis.

Question 9

Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

No. The AASB is not aware of any other circumstances in which the costs of obtaining a fair value measure would outweigh the benefits of improved decision-useful information.

Issue 6: Investments in equity instruments that are measured at fair value through other comprehensive income (paragraphs 21 and 22)

Question 10

Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

The AASB believes that the requirement to report dividends in OCI will be controversial, especially for those entities whose primary business is to hold instruments for the longer term to generate yield (for example, Listed Investment Companies in Australia). The business objective of such entities is to invest in dividend paying companies for the longer term (not for trading purposes), collect dividends from investments and pay out dividends to unit holders.

The investments are held at fair value in the balance sheet which allows users to determine net asset backing per share and the net income is understood to represent amounts that are available for distribution to shareholders (recurring dividend yield). Therefore, there are concerns that the presentation of dividends with gains and losses on equity instruments (whether realised or unrealised) in OCI will result in financial statements that present practical problems. The payment of dividends in some jurisdictions may be limited where the only income an entity receives is recognised in OCI (being the dividend income received from investments) and all expenses incurred for the year are recognised in the income statement, because, for example, under the Australian Corporations Law, dividends can only be paid out of profits. This could also result from an all fair value presentation, where unrealised losses in any particular year (which are currently

recognised within equity) exceed dividend income – thus preventing the payment of dividends to unit holders.

Whilst the AASB would, on balance, prefers the proposals to be retained in their existing form, it would not be opposed to a final decision by the IASB to allow the presentation of dividends in the income statement and fair value movements in OCI where the investments are held as part of the entity's normal business operations – that is, for the longer term to generate yield for unit holders. To quite some degree, we see a need to be more purposeful in using the OCI and profit or loss parts of comprehensive income. If this could be achieved, we would not see the need for recycling or the motivation to place gains and losses in the same place as operating returns. However, if the proposals are retained in their existing form, the AASB believes that the option to present one statement of comprehensive income in paragraph 81 of IAS 1 *Presentation of Financial Statements* should alleviate some of the concerns identified above of not presenting dividends received from equity investments held for long-term yield in net profit, and the AASB accepts that jurisdiction specific issues on payment of dividends cannot be addressed by global generic standards issued by the IASB.

As a corollary, the AASB believes that changes to the presentation of dividend income will require amendment to IAS 33 *Earnings per Share* which currently requires earnings per share to be calculated based on earnings (the income statement). If dividend income is to be recognised in OCI, the impact on certain organisations, such as Listed Investment Companies, whose earnings in the income statement will be reduced to marginal amounts, will be that an earnings per share calculation under the existing requirements will be meaningless. Therefore, the IASB should consider how IAS 33 should be amended to provide meaningful information on earnings per share amounts.

Question 11

Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not,

(a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?

(b) should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

Yes. The AASB agrees that the decision to present fair value changes (and dividends) in OCI should be an election allowed only on initial recognition of the investment because the decision should reflect the business objective behind the investment. However, consistent with our response to Question 6, the AASB considers that the instrument should be able to be reclassified from FVTOCI to FVTPL where it no longer meets the criteria for classification as FVTOCI.

Issue 7: Effective date and transition (paragraphs 23–33)

Question 12

Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

Yes. The AASB supports the additional disclosures for financial assets and financial liabilities that are proposed in paragraph 44H of IFRS 7, such as:

(i) the original measurement category and carrying amount determined in accordance with existing IAS 39 requirements;

(ii) the new measurement category and carrying amount determined in accordance the proposals in the ED;

(iii) the amount of any financial assets or financial liabilities designated as at fair value through profit or loss that have been reclassified in accordance with the new fair value option requirement;

(iv) the amount of any financial assets or financial liabilities that were previously designated as at fair value through profit or loss (FVTPL) that are no longer so designated, distinguishing between those that the proposals require to be reclassified and those that an entity elects to reclassify out of FVTPL.

The AASB considers that entities should have the information available on transition to the new requirements at little cost.

Question 13

Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

The AASB supports the effective date and transition requirements detailed in paragraphs 24 – 33 of the ED. However, the AASB believes that, if the IASB is going to persist with its accelerated programme, there should be scope, for early adopters of the classification and measurement requirements, to reassess the decisions made in light of the completion of other phases of the IASB's project to replace IAS 39. For example, an entity's decision to bifurcate an embedded derivative from its financial host (should such an option be allowed per the AASB response to Question 4 above) may depend on the decisions made with regard to the hedging requirements.

Issue 8: An alternative approach

Question 14

Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortised cost, specifically:

(a) in the statement of financial position?

(b) in the statement of comprehensive income?

If so, why?

The AASB is aware that the FASB is concerned that the carrying amount of loans and receivables at amortised cost has been common to various eras of calamity – for example, the savings and loan crisis, the Japanese banking crisis and the global financial crisis. However, the AASB is of the view that better impairment requirements and practices, rather than more marking to fair value, may have much reduced the accounting problems of those eras. The AASB would also like to preserve the measurement attributes used for any one item and to consistently use those attributes between the balance sheet and the income statement. Bifurcating value changes runs the risk of confusion and lack of meaning for the parts.

Question 15

Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

No. The AASB would not support any of the possible variants of the alternative approach provided on page 14 of the exposure draft.