Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Not-for-Profit Private Sector Financial Reporting Framework**	**Meeting:**	M188
Topic:	**Tier 3 – Financial Instruments**	**Agenda Item:**	12.2.1
		Date:	6 June 2022
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		Decision-Making:	High
		Project Status:	Initial deliberations

Objective of this paper

1 The objective of Agenda Papers 12.2.1 – 12.2.4 is for the Board to **decide** its preliminary views on Tier 3 reporting requirements for a not-for-profit (NFP) private sector entity's financial instruments for inclusion as part of a discussion paper (DP)[1].

2 This Agenda Paper:

(a) sets out the background and reasons for bringing this topic to the Board;

(b) lists the financial instrument topics for which staff recommend possible simplification from Tier 1 reporting requirements and summarises the Board decisions regarding the financial instrument topics to date; and

(c) analyses and seeks Board members' views on the financial instruments for which specific Tier 3 reporting requirements will be developed.

Background and reasons for bringing this paper to the Board

3 At its 4 August 2021 meeting, the Board decided to consider the accounting for financial instruments for NFP private sector entities at a future meeting. Addressing financial instruments as part of a DP recognises:

(a) the complexity of the accounting requirements in the suite of Tier 1 financial instrument-related standards (AASB 9 *Financial Instruments*, AASB 132 *Financial Instruments: Presentation*, AASB 139 *Financial Instruments: Recognition and Measurement* and AASB 7 *Financial Instruments: Disclosures*); and

(b) that a smaller NFP private sector entity will hold at least some 'basic' financial instruments.

Developing preliminary views in this regard will help the Board obtain feedback on whether its proposed views should be further developed as part of a future Exposure Draft.

4 The Board commenced discussing the accounting for financial instruments for NFP private sector entities at its May 2022 meeting. The topics discussed, and the tentative Board decisions made, are reflected in Table 1 below. Agenda Papers 12.2.2 – 12.2.4 address the

1 For succinctness, in general, references to 'AASB 9' in this paper are to the suite of Tier 1 financial instrument-related standards, rather than to AASB *9 Financial Instruments* in particular.

classification, recognition, and measurement of the remaining financial instruments topics identified at the May 2022 meeting, similar to the approach taken to other topics to date.

5 A disclosure approach applying to Tier 3 financial instruments is discussed as part of Agenda Paper 12.3.1.

Options for Tier 3 requirements

6 At its May 2022 meeting, staff identified 10 topics for possible simplification of the accounting for financial instruments. These topics are summarised in Table 1 below. Topics 1 – 4 were discussed by the Board at its May 2022 meeting, and the Board's decision for the purposes of the DP on these aspects has been reflected in the Table. The staff analysis of the remaining simplification topics identified in Table 1 is set out in Agenda Papers 12.2.2 – 12.2.4.

7 Board members raised two other matters for discussion: the scope of the Board's simplified Tier 3 financial instrument requirements and the need to provide clarity for preparers as to the classification of units issued by trusts as liability or equity. The staff analysis of these matters is discussed later in this staff paper.

Table 1: Proposed departures from AASB 9

Topic	Reasons for proposing a departure from AASB 9	Identified potential simplification[2] [Note to Board: Column has been updated since the May 2022 meeting]
Discussed at the AASB May 2022 meeting		
1. Extent of requirements and guidance	• The extent of requirements and guidance is not proportionate to the needs and limitations of a smaller NFP private sector entity	Board decision, May 2022 meeting The Board decided to develop requirements for some, but not all, financial instruments within a Tier 3 Standard. The Tier 3 reporting requirements should direct an entity to apply AASB 9 requirements for other (more complex) financial instruments. **Staff Note 1:** A Board member observed that it is important that the financial instruments specifically addressed by Tier 3 requirements be clearly identifiable to users of the Tier 3 Standard. Refer paragraphs 8 – 18 below. **Staff Note 2:** Staff have assumed that other Board decisions regarding financial instruments are made in the context of this Board decision; i.e. the Board decision applies to only those financial instruments for which the Board determines the accounting

2 The simplification aspect may be explanation, recognition or measurement criteria, interpretation or understandability.

Topic	Reasons for proposing a departure from AASB 9	Identified potential simplification[2] **[Note to Board: Column has been updated since the May 2022 meeting]**
		should be specified 'within' a Tier 3 Standard.
2. Initial measurement of financial assets and financial liabilities	• A different initial measurement basis to AASB 9 may be easier for preparers to understand and less subject to interpretation and explanation. In many cases, the result is likely to be the same as the item's fair value	<u>Board decisions, May 2022 meeting</u> The Board decided to seek feedback as part of the DP as to whether requiring financial assets and financial liabilities to be measured at transaction price would be a useful simplification. In addition, the Board decided to require transaction costs that are directly attributable to the acquisition or issue of a financial asset or financial liability to be expensed in the period incurred. **Staff Note 3:** Several Board members observed that examples will need to be included in a Tier 3 Standard to explain a 'buy now' cash price/ present value measurement basis, if the Board decides to adopt such measurement basis in its redeliberations following the Discussion Paper consultation.
3. Approach to subsequent measurement – accounting policy options	• The AASB 9 measurement criteria for different instruments are overly complex for smaller entities as there are too many different measurement models • Limiting the subsequent measurement accounting policies, or not permitting any choice of subsequent measurement basis, provides clarity to preparers and eliminates an aspect of management judgement. Doing so also facilitates consistency in the reporting of similar financial assets and financial liabilities between Tier 3 entities	<u>Board decision, May 2022 meeting</u> The Board decided to specify overall simpler subsequent measurement requirements for financial assets and financial liabilities. The Board has decided to require the following subsequent measurement bases: • financial assets that are held to generate both income and capital return for the entity – fair value through other comprehensive income (FVTOCI); • derivative financial instruments – fair value through profit or loss (FVTPL); • other financial assets and financial liabilities – cost (less impairment). **Staff Note 4:** In the May 2022 agenda paper, staff proposed that there would be no 'recycling' of gains and losses if the financial asset were measured at FVTOCI. Staff will draft the Discussion Paper on this basis as Board members did not comment on this point when
4. Approach to subsequent measurement – simpler accounting policies	• It is not clear whether AASB 9 accounting policies provide users of the financial statements of a Tier 3 entity with better information about investments of different natures. The staff review of the requirements in other jurisdictions (NZ, UK, HK, IFRS for SMEs) suggest that simpler accounting policies might be an appropriate proportionate response. This may	

Topic	Reasons for proposing a departure from AASB 9	Identified potential simplification[2] **[Note to Board: Column has been updated since the May 2022 meeting]**
	be a different measurement basis to AASB 9 • Feedback from stakeholders has identified the different AASB 9 accounting policies for investments in managed investment schemes compared to equity instruments as a source of consternation for preparers • Developing simpler accounting policies will remove an element of management judgement and could reduce preparation costs	discussing FVTOCI as a measurement basis. **Staff Note 5:** Several Board members noted that the Board has not yet discussed whether to specifically address the accounting for derivative financial instruments within a Tier 3 Standard. Staff acknowledge that the subsequent measurement basis noted above will not be relevant should the Board decide to require derivative instruments to be treated in accordance with AASB 9 (discussed in Table 3 of this agenda paper).
For discussion at the AASB June 2022 meeting (this meeting)		
5. Measurement of interest income and interest expense – effective interest method [Agenda Paper 12.2.2]	• The effective interest method can be complex to apply, including being more challenging to identify the effective interest rate • The extent of explanation necessary to understand and apply the effective interest method is arguably not proportionate when considering the types of financial instruments that a smaller entity might normally hold	• Require interest income and interest expense to be calculated by reference to the instrument's contractual interest rate • Require any initial premium or discount on acquisition to be amortised on a systematic basis over the expected life of the financial instrument
6. Impairment of financial assets[3] [Agenda Paper 12.2.2]	• The expected credit loss requirements are complex to understand and apply. The costs involved with determining a probability-weighted estimate of credit losses are unlikely to be a proportionate response when considering the types of financial instruments that a smaller entity might normally hold and the resources available to that entity	Either: • Require an impairment loss to be recognised when it is probable that the amount owed will not be collectible, measured at the expected uncollectible amount • Require an impairment loss to be recognised for all lifetime expected credit losses
7. Hedge accounting [Agenda Paper 12.2.3]	• The AASB 9 hedge accounting qualifying requirements are complex to apply. Without amendment, it is likely a too onerous imposition for a smaller	Either: • Do not permit hedge accounting

3 Staff have updated the topic description and reasons for proposing departure from that included in the May 2022 agenda paper, so as to better reflect the scope of the proposed impairment provisions. The topic was previously described as "Impairment of financial assets that are debt instruments"; however, the staff analysis extended also to other financial assets, consistent with the staff proposal that some financial assets other than debt instruments be subsequently measured at cost.

Topic	Reasons for proposing a departure from AASB 9	Identified potential simplification[2] [Note to Board: Column has been updated since the May 2022 meeting]
	entity to take advantage of such optional accounting	• Develop simpler hedge accounting requirements; e.g. fewer/no qualifying conditions
8. Embedded derivatives [Agenda Paper 12.2.3]	• The AASB 9 embedded derivative requirements are complex to apply and involve judgement that may be more challenging for smaller NFP private sector entities to evaluate	• Do not require an embedded derivative to be separated from its host contract
9. Derecognition of financial assets and financial liabilities [Agenda Paper 12.2.4][4]	• Some of the transfer of a financial asset provisions of AASB 9 are complex to apply, requiring significant judgement of whether substantially all (or only some) of the risks and rewards of ownership of the financial asset have been transferred, and assessment of the entity's "continuing involvement" • Judgement as to whether the terms of a financial liability have changed "substantially" to qualify for derecognition may be more challenging for smaller NFP private sector entities to evaluate	• Develop simpler criteria for derecognition that eliminates aspects of management judgement complexity
10. Estimating fair value [Agenda Paper 12.2.2]	• AASB 13 can be complex to understand and apply	• Develop a simpler expression of the fair value hierarchy that mirrors the AASB 13 principles for inclusion as part of a Tier 3 Standard

Financial instruments for which specific Tier 3 reporting requirements should be developed

8 At its May 2022 meeting, the Board decided to specify 'simpler' financial reporting requirements for some, but not all, financial instruments. This decision takes the view that an entity holding more complex financial instruments should be able, and required, to apply the more complex accounting specified by AASB 9 (unless otherwise specifically addressed by topic-based requirements). Also, clearly identifying within a Tier 3 Standard the accounting associated with a financial asset and financial liability that a smaller NFP private sector entity might typically hold provides better clarity to smaller NFP private sector preparers of the relevant accounting for each financial asset and financial liability held.[5]

4 Agenda Paper 12.2.4 will be included as part of the second mail out to the Board.

5 Staff think that clarification for preparers as to what are "debtors" or "cash equivalents" or "investments", or other descriptive classes, can be provided as part of the drafting of the Standard, in the same manner as how the NZ Tier 3 reporting requirements explain each category used. For example, the NZ Tier 3 reporting requirements clarify that "Investments are shares, term deposits, bonds, units in unit trusts, or similar instruments held by the entity" and "Debtors (sometimes called accounts receivable) comprise amounts owed to the entity by customers or others. This includes any GST receivable from Inland Revenue."

9 In response to the Board decision, staff considered the financial instruments to be addressed by simplified 'general' financial instrument accounting requirements rather than AASB 9. In forming their recommendations, staff had regard to the:

(a) scope of AASB 9;

(b) typical financial instruments held by smaller NFP private sector entities (as suggested by the staff review of the sample set of financial statements);

(c) topics already discussed by the Board;

(d) the Board's objective in developing Tier 3 reporting requirements; and

(e) the scope of the financial instrument requirements, and approach taken by, selected other jurisdictions.[6]

Financial instruments that are not complex or measurement already considered by the Board

10 Staff think the following financial assets and financial liabilities represent typical simple financial instruments that should be subject to simplified 'general' Tier 3 financial instrument requirements (the subsequent measurement basis decided by the Board at its May 2022 meeting applying to each instrument is shown in brackets):

(a) cash and cash equivalents (cost);

(b) trade and other receivables (cost);

(c) debt instruments such as amounts provided as a security bond (cost);

(d) term deposits (cost);

(e) investments in managed investment schemes and unit trusts (FVTOCI);

(f) investments in listed shares (FVTOCI);

(g) trade and other payables (cost); and

(h) loans (cost).

Question for Board members

Q1 Do Board members agree that the financial assets and financial liabilities listed in paragraph 10 above should be addressed by the 'general' Tier 3 simplified financial instrument requirements?

11 The following financial assets and financial liabilities are not subject to the proposed simplified 'general' financial instruments recognition and measurement requirements other than impairment, as their measurement (shown in brackets) has been considered – directly or indirectly – by the Board at a previous meeting:

(a) employee benefit obligations (undiscounted amount of the future cash flows expected to be required to settle the obligation);

6 The selected other jurisdictions/pronouncements considered were the *IFRS for SMEs*, United Kingdom FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, United Kingdom FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, Hong Kong *Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard* (HK SME-FRF & FRS), New Zealand *Public Benefit Entity Simple Format Reporting – Accrual (Not-For-Profit)* (NZ Tier 3 reporting requirements) and CPA Canada Handbook Section 3856 *Financial Instruments*. Staff did not consider the applicable USA requirements given their expected complexity.

(b) lease receivables and lease payables (consistent with lease rental payments recognised on a straight-line basis[7] over the expected lease term); and

(c) income received in advance that meets the definition of a financial liability (e.g. refundable prepaid membership fees or school fees).

Question for Board members	
Q2	Do Board members agree that the financial assets and financial liabilities listed in paragraph 11 above should not be addressed by the 'general' Tier 3 simplified financial instrument requirements?

Financial instruments that are possible complex financial instruments

Financial instruments that are excluded from the scope of AASB 9

12 The Board decided at its September 2021 meeting that Tier 3 entities should apply the requirements of a higher tier of Australian Accounting Standards in full for transactions not covered by the Tier 3 reporting requirements. Therefore, a Tier 3 preparer would apply AASB 141 *Agriculture* to biological assets held consistent with the accounting hierarchy agreed by the Board.[8] This is because Tier 3 reporting requirements are not expected to include specification of accounting for such assets as they are not expected to be typically held.[9] However, unlike 'property, plant and equipment' or 'inventory', 'financial instruments' is a general topic.

13 Resultantly, the same conclusion does not necessarily apply to financial instruments acquired or assumed in contracts or arrangements that are expected to be less common to the smaller NFP private sector, for example, obligations arising under an insurance contract. Consequently, staff think the Board should specifically consider its intentions for the accounting to apply to the remaining financial assets and financial liabilities excluded from the scope of AASB 9 as otherwise such financial assets or financial liabilities may inadvertently be subject to the 'general' simplified Tier 3 financial instrument requirements.

14 Table 2 lists scope exclusions from AASB 9, per Chapter 2 of the Standard and provides the staff recommendation for treatment of the financial instrument.

Table 2: AASB 9 scope exclusions

Financial asset/ financial liability	Staff comment	Staff recommended action
Interests in a subsidiary, associate or joint venture	The Board has decided to permit an entity the choice of whether or not to prepare consolidated financial statements. Without further Board regard, based on the decisions at the May 2022 meeting, such interests will be recognised at FVTOCI in the	Staff recommend that Tier 3 reporting requirements should require an entity to account for its interests in a subsidiary, associate or joint venture in its separate financial statements at cost (less impairment). Specifying a single accounting policy for the subsequent measurement of such interests provides clarity to preparers. Accounting for the investment at cost (less impairment) is simple, and so imposes lower cost to preparers. Staff also expect this to be

7 Or another systematic basis, if appropriate

8 In AP 4.1, presented at the August 2021 meeting, example topics to be omitted include specialised topics such as agriculture, insurance, exploration, superannuation and service concession arrangements. There are also example topics that are not applicable to NFP Tier 3 entities such as earnings per share, share-based payments, and interim and segment reporting.

9 Except if there is prescribed Tier 3 accounting for 'other assets', similar to the approach taken by the New Zealand *Public Benefit Entity Simple Format Reporting – Accrual (Not-For-Profit)* (NZ Tier 3 reporting requirements). This is not the approach suggested by the Board's discussions to date.

Financial asset/ financial liability	Staff comment	Staff recommended action
	entity's separate financial statements. This is likely to impose greater costs on the entity than the accounting permitted by AASB 127 *Separate Financial* Statements. AASB 127 permits an entity's interests in a subsidiary, associate or joint venture to be measured at cost, in accordance with IFRS 9 (FVTPL or FVTOCI), or using the equity method of accounting.	the measurement basis most commonly applied. Measurement at cost is consistent with the measurement basis specified by some other jurisdictions (UK FRS 105, HK).[10] Staff observe that there may be a concern that users are not served by unconsolidated financial statements without the group interest being measured at fair value. However, staff think that measurement at cost is consistent with the Board decision to require disclosures in the unconsolidated financial statements that will help users understand the accounting for the economic entity, including summarised financial information of each unconsolidated controlled entity.
Forward contracts to buy or sell an acquiree in a business combination, or contingent consideration recognised by an acquirer in a business combination	Staff are not intending to bring the accounting for business combinations to a Board meeting, as staff are not proposing any simplification from the accounting prescribed by AASB 3. Without further Board regard, such forward contracts and contingent consideration will be recognised as derivatives measured at FVTPL.	Staff think that instances of forward contracts to acquire an entity in a business combination or contingent consideration are unlikely to be common for smaller NFP private sector entities. Consequently, staff recommend not specifically excluding or proposing a different treatment for such derivatives or contingent consideration, as measurement at FVTPL provides users of the financial statements with useful information that is unlikely to be materially different from the result that might have otherwise been determined had the Board specifically considered the topic.[11]
Share-based payment obligations that meet the definition of a financial liability or equity instrument	Share-based payment arrangements are not expected to be common to Tier 3 NFP private sector entities.	Because share-based payment arrangements are not expected to be a typical transaction of the sector, staff recommend that Tier 3 reporting requirements should be silent with regards to the accounting for share-based payment arrangements, subject to feedback on the discussion paper as to whether there is a need for the Board to develop specific requirements in this regard. However, staff think the effect of 'silence' is that any share-based payment obligation settled in cash is recognised as a financial liability only once the obligation becomes due and payable (a provision may be recognisable before that time). (If the Board determines to specifically exclude share-based payment arrangements from the scope of its Tier 3 financial instrument requirements, the Tier 3 requirements do not require the recognition or

10 Some other jurisdictions allow entities an accounting policy choice in addition to measurement at cost. The *IFRS for SMEs* permits the parent to measure the investment in accordance with IFRS 9 or the equity method while UK FRS 102 permits the investment to be measured either at FVTOCI or FVTPL.

11 Staff note that the *IFRS for SMEs* and UK FRS 102 require the cost of the combination be adjusted for contingent consideration when the adjustment becomes probable and can be measured reliably.

Financial asset/ financial liability	Staff comment	Staff recommended action
		measurement of a financial liability or equity instrument resulting from a share-based payment arrangement in accordance with Tier 3 financial instrument requirements. However, AASB 2 applies instead.)
Rights and obligations arising under an insurance contract or contract with a discretionary participation feature	Staff considered that a smaller Tier 3 NFP private sector entity is unlikely to issue insurance contracts or contract with a discretionary participation feature.	Because smaller Tier 3 NFP private sector entities are not expected to typically issue insurance contract or contract with a discretionary participation feature, staff recommend that Tier 3 reporting requirements should be silent with regards to the accounting for these contracts, subject to feedback on the discussion paper as to whether there is a need for the Board to develop specific requirements in this regard. In the absence of a direction on the accounting in this regard, staff think the effect is that any obligation arising as a result of an insurance contract issued is recognised as a financial liability only once the obligation becomes due and payable (a provision may be recognisable before that time). (If the Board determines to specifically exclude issued insurance contracts from the scope of its Tier 3 financial instrument requirements, the Tier 3 requirements do not require the recognition or measurement of a financial liability for the insurance contract in accordance with Tier 3 financial instrument requirements. However, AASB 4 applies instead.)
Rights to payments to reimburse the entity for expenditure that it is required to make to settle a provision	At the August 2021 meeting, staff proposed that Tier 3 reporting requirements for provisions, contingent liabilities and contingent assets should be primarily based on the NZ Tier 3 reporting requirements.	Staff think that reimbursement assets should be addressed as part of the accounting requirements for provisions, contingent liabilities and contingent assets. Consequently, staff recommend specifically excluding reimbursement assets from the scope of the general Tier 3 financial instrument requirements, similar to the scope exclusions for employee benefits and leases.

Question for Board members

Q3 Do Board members agree with the staff recommended action for each financial asset and financial liability identified in Table 2?

Financial instruments that are included in the scope of AASB 9

15 Staff think the following financial assets and financial liabilities within the scope of AASB 9 and listed in Table 3 represent more complex financial instruments. Staff have further analysed these financial assets and financial liabilities to recommend whether the financial instrument should be directed to apply simplified Tier 3 financial instrument requirements or accounting specified by AASB 9.

Table 3: AASB 9 scope inclusions

Financial asset/ financial liability	Staff analysis	Staff recommended action
Debt instruments other than trade receivables, security bonds, term deposits, and similar financial assets (e.g. convertible bond) Equity instruments other than ordinary shares	As suggested by the review of the small sample of financial statements, staff expect that a smaller NFP private sector entity would not typically hold debt instruments that are leveraged or otherwise more complex than a simple receivable. Similarly, staff do not expect a smaller NFP private sector entity to typically hold equity instruments that are not ordinary shares. Consequently, as Tier 3 reporting requirements are meant to be geared to the common transactions and balances of such entities, staff's initial thinking for the purposes of the DP was that the Tier 3 reporting requirements would not specifically address such debt or equity instruments. Under the 'general' simplified financial instrument proposals, the financial asset will be measured at cost (less impairment) unless it is an 'investment asset', in which case it is measured at FVTOCI. Staff considered this to be appropriate, as it minimises profit or loss volatility and as staff do not anticipate users of the Tier 3 financial statements to 'judge' the financial instrument as part of the performance of the entity. Measurement at cost is also consistent with the measurement basis adopted by several other jurisdictions, including NZ. However, staff note that the *IFRS for SMEs* requires more complex debt instruments to be measured at FVTPL.	Staff do not recommend that Tier 3 reporting requirements direct an entity to apply AASB 9 to account for debt instruments other than trade receivables, security bonds and similar financial assets. Staff also do not recommend that Tier 3 reporting requirements direct an entity to apply AASB 9 to account for equity instruments other than ordinary shares. This is because under AASB 9, the financial asset might be measured at amortised cost, at FVTPL or at FVTOCI (recycling) or FVTOCI (no recycling). As there will be more accounting policies available to a Tier 3 entity, it does not assist with improving comparability. It is also not obvious whether users of the Tier 3 financial statements will proportionately benefit from the more principle-based, but complex accounting.
Financial guarantee contracts	Under AASB 9, a financial guarantee contract would normally be measured at the higher of: • the amount of the AASB 9 loss allowance; and • the amount initially recognised, less, when appropriate, the cumulative amount of income recognised in accordance with the principles of AASB 15. Staff do not anticipate financial guarantee contracts to be a contract commonly entered into by a smaller NFP private sector entity, and did not identify any financial guarantee contracts from the sample of financial statements reviewed. Consequently, as Tier 3 reporting requirements are meant to be geared to the common transactions and balances of such entities, staff's initial thinking for the purposes of the DP was that the Tier 3 reporting requirements would not specifically address such contracts. The contract might be measured as a financial liability (at cost) or, if eventually scoped out, as a provision. There is a risk that the financial statements will not be a faithful representation of the financial position of an entity that has provided a financial guarantee to another entity if the financial	Staff do not recommend that Tier 3 reporting requirements direct an entity to apply AASB 9 to account for a financial guarantee contract. This is because staff think that requiring a financial guarantee contract to be measured as a provision is easier for preparers to understand. Further, the result may not materially differ from the result under the accounting specified by AASB 9, when the loss allowance is calculated with regard to lifetime expected credit losses. Consequently, staff recommend instead that Tier 3 reporting requirements require a financial guarantee contract be measured as a provision, rather than subject to the 'general' financial liability requirements.

Financial asset/ financial liability	Staff analysis	Staff recommended action
	guarantee contract were subsequently measured at cost. Measuring a financial guarantee contract at other than cost is also consistent with accounting treatment applied by some other jurisdictions, for example UK FRS 102 and NZ Tier 3 reporting requirements require a provision be recognised in respect of the guarantee. In addition, staff note that the IASB is intending to develop financial guarantee contract accounting proposals as part of its current review of the *IFRS for SMEs*.	
Derivative financial instruments	An entity that acquires derivative financial instruments would normally do so as part of a more considered financial risk management strategy. As such, staff do not expect it to be an instrument typically held by smaller NFP private sector entities. At the May 2022 AASB meeting, the Board formed a preliminary view that its Tier 3 reporting requirements should require derivative financial instruments to be measured at FVTPL, consistent with AASB 9 – staff did not suggest any simplification in this regard.	Staff do not recommend that Tier 3 reporting requirements direct an entity to apply AASB 9 to account for a derivative financial instrument. This is because staff think that there is little additional benefit to preparers (or other stakeholders) from a direction in this regard, compared to including the requirement as part of a Tier 3 pronouncement, as the proposed measurement for a derivative instrument (except if hedge accounting applies) is the same.
Embedded derivative instruments	The complexity in accounting for an embedded instrument arises from: • identification of the embedded derivative; • determination of whether it needs to be separately recognised; and • measurement of any separately recognised embedded derivative. Staff also note that the AASB 9 requirements for embedded derivatives were developed having regard to the measurement that applies to the host contract. The Board has not necessarily made the same measurement decisions in respect of the host contract. For example, AASB 9 does not require the separate recognition of an embedded derivative from a financial asset host. However, while that hybrid contract with a non-closely related embedded derivative may be measured at fair value under AASB 9, under the Board's decisions at its May 2022 meeting, the hybrid contract is likely to be measured at cost. Directing an entity to account for the embedded derivative in accordance with AASB 9 may have some unintended results.	Staff do not recommend that Tier 3 reporting requirements direct an entity to apply AASB 9 to account for an embedded derivative financial instrument. This is consistent with the staff proposal in Agenda Paper 12.2.3 not to require the separate recognition of an embedded derivative in Tier 3 financial statements.

Financial asset/ financial liability	Staff analysis	Staff recommended action
Contracts to buy or sell a non-financial item that can be net settled, as if the contracts were financial instruments[12] Loan commitments that can be settled net in cash	Staff do not expect that a smaller NFP private sector entity would typically enter into such arrangements. Consequently, as Tier 3 reporting requirements are meant to be geared to the common transactions and balances of such entities, staff's initial thinking for the purposes of the DP was that the Tier 3 reporting requirements would not specifically address such contracts. However, in the absence of a Board direction, staff think the contracts might be regarded independently, rather than as a derivative. As such, it is possible that no gain or loss is recognised during the period before contract performance.	Staff do not recommend that Tier 3 reporting requirements direct an entity to apply AASB 9 to account for contracts to buy or sell a non-financial item that can be net settled, as if the contracts were financial instruments. Staff do not recommend that Tier 3 reporting requirements direct an entity to apply AASB 9 to account for loan commitments that can be settled net in cash. This is because staff think that there is little additional benefit to preparers from a direction in this regard, compared to including the requirement as part of a Tier 3 pronouncement, as the proposed measurement for a derivative instrument is the same. However, for clarity, staff recommend that the Tier 3 pronouncement clearly identify such contracts as being treated as a derivative financial instrument.
Commitments to provide a loan at a below-market interest rate	Staff think it is possible that some smaller NFP private sector entities might provide a loan to another NFP entity at a below-market interest rate. While staff's initial thinking for the purposes of the DP was that the Tier 3 reporting requirements would not specifically address such commitments, staff now think that it might provide clarity to do so.	Staff do not recommend that Tier 3 reporting requirements direct an entity to apply AASB 9 to account for a commitment to provide a loan at a below-market interest rate. This is because staff think that there is little additional benefit to preparers from a direction in this regard, compared to including the requirement as part of a Tier 3 pronouncement, as the proposed measurement for a derivative instrument is the same. However, for clarity, staff recommend that the Tier 3 pronouncement clearly identify

12 Such contracts are within the scope of AASB 9, other than if the 'own use' exemption in the Standard applies. The financial instrument provisions of the *IFRS for SMEs* similarly applies to such contracts (and, additionally, to contracts that impose risks on the buyer or seller that are not typical of contracts to buy or sell non-financial items, for example, contracts that could result in a loss to the buyer or seller as a result of contractual terms that are unrelated to changes in the price of the non-financial item, changes in foreign exchange rates or a default by one of the counterparties). Under the *IFRS for SMEs*, a non-financial contract that includes an embedded derivative with economic characteristics not closely related to the host contract is accounted for in its entirety at FVTPL.

Financial asset/ financial liability	Staff analysis	Staff recommended action
		such contracts as being treated as a derivative financial instrument.
Issued compound financial instruments and puttable financial instruments	The guidance in AASB 132 provides useful direction to preparers to identifying the classification and measurement of puttable financial instruments and compound financial instruments. Staff do not anticipate smaller NFP private sector entities to typically have share capital or issue compound or puttable financial instruments. Consequently, as Tier 3 reporting requirements are meant to be geared to the common transactions and balances of such entities, staff's initial thinking for the purposes of the DP was that the Tier 3 reporting requirements would not specifically address such instruments.	Staff recommend that Tier 3 reporting requirements direct an entity to consider the requirements of AASB 132 for classifying such financial instruments, including for guidance on the classification of units issued by trusts as liability or equity. This eliminates content that might otherwise be necessary in a Tier 3 pronouncement. Staff note that AASB 132 may not be specific to the circumstances of the smaller NFP private sector. However, on balance, staff consider this direction to be appropriate given it is not expected to be a common transaction. As such, resources should not be invested into crafting guidance in this regard.

Question for Board members

Q4 Do Board members agree, for the purposes of the Discussion Paper, with the staff views included in Table 3?

If not, which financial assets or financial liabilities do Board members consider should be treated in a different manner?

Effecting a Board decision to require AASB 9 accounting for complex financial instruments

16 This section is only relevant if the Board determines that there are complex financial instruments that should be accounted for in accordance with AASB 9.

17 There are two ways of drafting a Tier 3 pronouncement to effect a Board decision to direct an entity to apply AASB 9 to account for more complex financial instruments; either:

(a) by scoping out of a Tier 3 Standard specified financial assets and financial liabilities. Under the accounting hierarchy agreed by the Board, a preparer will be required to consult the accounting in Tier 2 Australian Accounting Standards; or

(b) by scoping into a Tier 3 Standard these 'complex' financial assets and financial liabilities, but requiring that the entity apply the accounting specified by Tier 2 Australian Accounting Standards to any such assets and liabilities held, through cross-reference within the Tier 3 pronouncement to an Accounting Standard.

Both approaches will require preparers to have regard to the guidance and requirements in AASB 9 to account for the specified financial instrument.

18 Staff think the Board does not need to form a view as to how to operationalise its decision in this regard at this stage of the project (i.e. for inclusion in a Discussion Paper). However, staff

note that the IASB considered incorporating, as part of the *IFRS for SMES*, certain requirements by cross-reference to other IFRSs, but decided not to do so following feedback received on its exposure draft. Consequently, staff recommend the Board include a question in its Discussion Paper seeking feedback on the operationalisation of this Board decision.

Question for Board members

Q5 Do Board members agree, for the purposes of the Discussion Paper, to specifically seek feedback on the operationalisation of the Board decision to direct an entity to apply AASB 9 to account for more complex financial instruments?