Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Not-for-Profit Private Sector Financial Reporting Framework**	**Meeting:**	M187
Topic:	**Tier 3 – Financial Instruments**	**Agenda Item:**	5.2.1
		Date:	2 May 2022
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		Decision-Making:	High
		Project Status:	Initial deliberations

Objective of this paper

1 The objective of Agenda Paper 5.2.1 and Agenda Paper 5.2.2 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) describes the current accounting requirements for financial instruments;

(c) summarises stakeholder feedback and findings from research and other literature;

(d) presents the topics for which staff propose simplification from Tier 1 reporting requirements; and

(e) seeks Board members' views on the completeness of the areas of the simplifications considered.

3 The staff analysis of some of the topics for which staff propose simplification from Tier 1 reporting requirements is the subject of Agenda Paper 5.2.2. The remaining topics for which staff propose simplification from Tier 1 reporting requirements will be brought to the June 2022 Board meeting.

Background and reasons for bringing this paper to the Board

4 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

1 For succinctness, in general, references to 'AASB 9' in this paper and in Agenda Paper 5.2.2 are to the suite of Tier 1 financial instrument-related standards, rather than to AASB 9 in particular.

(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.

5 This staff paper addresses the classification, recognition, and measurement of financial instruments, similar to the approach taken to other topics to date. Related financial instrument disclosures, or a disclosure approach, will be addressed at a future meeting.

6 This scope of the analysis in this staff paper does not consider financial obligations relating to employee benefits and contract liabilities. These are topics addressed by other staff papers.[2]

Current requirements under Australian Accounting Standards

AASB 9 Financial Instruments

7 The following table provides a high-level summary of the AASB 9 recognition, classification and measurement requirements for financial assets and financial liabilities:

Table 1: Summary of AASB 9 requirements

Classification	Condition(s)	Initial measurement	Subsequent measurement
Financial assets (reclassification possible, where conditions are met)			
Amortised cost	Financial asset meets both: • business model test – collect contractual cash flows; and • solely payments of principal and interest ('SPPI') test	Fair value, plus transaction costs. Trade receivables without a financing component – at transaction price	Amortised cost using the effective interest method, subject to impairment. Changes in the carrying amount are recognised in profit or loss.

Fair value through other comprehensive income (FVTOCI)	Financial asset either:
	• meets both:
	  • business model test – collect contractual cash flows and sell financial assets; and
	  • solely payments of principal and interest ('SPPI') test; or
	• is an equity instrument with elected OCI option that is neither held for trading nor contingent consideration in a business combination
		Fair value, plus transaction costs	Fair value, with changes in fair value generally recognised in other comprehensive income (OCI).
			Dividends, and interest calculated using the effective interest method, are recognised in profit or loss.
			Impairment losses and foreign exchange gains and losses relating to a debt instrument are recognised in profit or loss.
			The cumulative gain or loss presented in OCI is:
			• 'recycled' to profit or loss on derecognition of a debt instrument; but
			• not recycled on derecognition of an equity instrument.

2 Tier 3 reporting requirements for employee benefits were discussed in Agenda Paper 11.3 of the AASB February 2022 meeting. Tier 3 reporting requirements for revenue were partly analysed in Agenda Paper 11.4 of the AASB February 2022 meeting, and continued in Agenda Paper 5.1 of this meeting. The minutes from the AASB February 2022 meeting are available here: https://www.aasb.gov.au/media/oaelu4dc/aasbapprovedminutesm185feb22.pdf

Classification	Condition(s)	Initial measurement	Subsequent measurement
Fair value through profit or loss (FVTPL)	The financial asset either: • fails condition(s) to be classified as FVTOCI or at amortised cost; or • is designated as measured at FVTPL in order to manage an accounting mismatch; or • is a derivative financial instrument	Fair value	Fair value, with changes in fair value recognised in profit or loss. Interest and dividends are recognised in profit or loss.
Financial liabilities			
Amortised cost	The financial liabilities not classified as FVTPL or addressed by a topic-based Standard (e.g. provisions, employee benefits)	Fair value, less transaction costs	Amortised cost using the effective interest method. Changes in carrying amount recognised in profit or loss.
Fair value through profit or loss (FVTPL)	Either: • meets the definition of held for trading (including derivatives); or • is designated by the entity as at fair value through profit or loss (particular instruments only).	Fair value	Fair value, with most changes in fair value recognised in profit or loss. For a financial liability designated as at FVTPL, the portion of the change in fair value relating to a change in the entity's own credit risk is recognised in OCI except if this creates or enlarges an accounting mismatch in profit or loss. Interest and dividends are recognised in profit or loss.
Other	• financial guarantee contract • below-market loan commitment • liability arising on a partial transfer of a financial asset • contingent consideration in a business combination	Fair value	Special requirements apply. Financial guarantee contracts and below-market loan commitments are measured at the higher of the expected credit loss allowance and the instrument's fair value at initial recognition, less any income subsequently recognised

8 A financial instrument is recognised when the entity becomes party to the contractual provisions of the instrument. For regular way sales and purchases, this may be the trade date or settlement date.

9 A financial asset is derecognised when:

(a) the contractual rights to the cash flows from the financial asset expire; or

(b) the entity has (legally or in substance) transferred its contractual rights to cash flows of the financial asset and has also transferred substantially all the risks and rewards of ownership of the financial asset.

Where the entity neither transfers nor retains substantially all the risks and rewards of ownership of a financial asset, a financial asset is derecognised only when control of the asset has been transferred to another party such that the other party has the practical ability to unilaterally sell the asset without needing to impose additional restrictions on the transfer.

Otherwise, the asset remains recognised to the extent of the entity's continuing involvement in the asset.

10 A financial liability is derecognised when the obligation specified in the contract is discharged or cancelled or expires. A financial liability is derecognised if its terms have been substantially modified, or if it has been exchanged for another financial liability with substantially different terms. AASB 9.B3.3.6 explains that the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability.

AASB 132 Financial Instruments – Presentation

11 AASB 132 specifies the defined terms and provides direction on:

(a) classification of a financial instrument as a financial liability or equity instrument, including compound financial instruments and puttable instruments. It requires a compound financial instrument to be separated into its component parts, with the financial liability measured in accordance with AASB 9 and the residual attributed to the equity instrument;

(b) the accounting for treasury shares, requiring these to be treated as an equity transaction;

(c) the accounting for transaction costs of an equity transaction, requiring these to treated as a deduction from equity; and

(d) offsetting.

AASB 139 Financial Instruments – Recognition and Measurement

12 In the main, AASB 139 specifies the grandfathered hedge accounting requirements available to entities on the adoption of AASB 9.

Summary of approaches taken by selected other jurisdictions

13 Appendix A provides a high-level overview of the requirements of selected other jurisdictions. From the staff review, staff make the following general observations:

(a) entities are not accorded an option to choose between different accounting policies to apply to a particular financial asset or financial liability;

(b) there is a default to cost/amortised cost measurement for many financial assets and financial liabilities, including some investments and derivative financial instruments;

(c) transaction costs and the premium/discount on acquisition are often deferred and amortised over the life of the instrument. Jurisdictions vary as to whether the accounting is described as part of an effective interest method of allocating interest, or whether interest and the amortisation of these amounts are regarded separately;

(d) there is less direction on estimating fair value;

(e) hedge accounting is generally not contemplated for smaller entities; and

(f) impairment and derecognition provisions are simplified.

14 Staff note that the IASB is currently undertaking its second comprehensive review of the *IFRS for SMEs* Standard. It has tentatively decided to propose amendments to the IFRS for SMEs to better align those financial instrument requirements to full IFRSs. These amendments are described in Appendix A.

15 Additionally, staff understand that the NZASB expects to propose introducing, within its Tier 3 accounting standard, an accounting policy choice to measure publicly traded financial investments. A forthcoming Exposure Draft is expected to propose that these investments be permitted to be measured at current market value with changes in market value recognised in profit or loss (i.e. in effect, FVTPL).

Feedback from Australian stakeholders

2020 Targeted outreach

16 As part of the targeted outreach conducted by staff in 2020, staff received feedback that stakeholders supported the Board developing 'a simpler balance sheet'. Amongst other aspects, staff understood this to extend to stakeholder support for simpler recognition and measurement requirements.

AASB NFP Project Advisory Panel

17 Staff sought feedback from the AASB NFP Project Advisory Panel on AASB 9 areas of complexity for smaller entities at its meetings on 18 May 2021 and 18 October 2021. From these meetings, staff note:

(a) the AASB 9 limitation on use of the fair value through other comprehensive income (FVTOCI) category appears to be one of the primary areas of consternation to at least some preparers. Staff heard that some smaller entities had previously classified investment-type financial assets, including investments in managed investment schemes, as "available-for-sale" financial assets and recognised changes in the fair value of those assets in OCI, as previously permitted under a former version of AASB 9. Where such entities complied with AASB 9, such investments would have been reclassified as FVTPL on the adoption of the revised AASB 9 requirements;

(b) staff received feedback from a few Panel members that some stakeholders considered that an entity's general inability to measure investments in managed schemes/unit trusts at FVTOCI did not result in useful financial information. Several Panel members opined that preparers have a preference to keep fair value changes on investment financial assets "outside" profit or loss, similar to revaluations of property, plant and equipment.

(c) staff also heard anecdotally that such accounting requirement was reason sufficient for at least one NFP private sector entity deciding to prepare special purpose financial statements; and

(d) understanding and applying the effective interest method and AASB 9 impairment requirements is challenging for some Tier 3 NFP preparers. Staff note however that feedback in this regard was limited, compared to the FVTOCI concern described above.

18 The AASB NFP Project Advisory Panel discussed approaches to the accounting for investments held by smaller entities in more detail at its 8 March 2022 meeting. Staff presented a staff preliminary view that Tier 3 reporting requirements would require all investments to be accounted for in the same way. Not all Panel members shared their views, but from the seven members (auditors/accounting advisors/preparers) who shared views, staff understand:

(a) there continues to be a desire for FVTOCI accounting for "investments". Some members indicated they would like to see the AASB 9 accounting 'divide' for investments in managed schemes and equity instruments be eliminated for smaller entities and for these forms of investments to be accounted for consistently at either FVTPL or FVTOCI;

(b) there is support for different debt investment forms (e.g. term deposits vs. units in a managed scheme or listed shares) to be accounted for differently. However, members

indicated a preference for most investments to be measured at fair value. Most members supported a FVTOCI policy over a FVTPL approach.[3] The reason given for supporting a FVTOCI policy over a FVTPL approach appears to be so that the entity can provide its users with insight into the stewardship of its long-term investments while not 'muddying' the profit or loss;

(c) some members considered the accounting for different investments should be an unrestricted accounting policy choice from AASB Board-identified acceptable policies. These members indicated this would allow an entity to select the accounting policy approach that presents the more useful information to its users or that better leverages the work required to determine the entity's taxes; and

(d) there is support for no 'recycling' of any amounts previously recognised in OCI under a FVTOCI accounting policy when the asset is sold or disposed (i.e. similar to the accounting for equity investments measured at FVTOCI in accordance with AASB 9).[4]

19 A member indicated that common investment forms held by entities in the NFP sector were term deposits, units in managed schemes, equity portfolios, and also possibly commercial bills and bonds. An observation was made that smaller entities are unlikely to invest in non-tradable investments, so measuring the fair value may be straightforward.

ITC 47 Request for Comment on IASB Request for Information on Post-implementation Review of IFRS 9 Financial Instruments – Classification and Measurement

20 At the Board's February 2022 meeting, the Board received Agenda Paper 15.1 *Staff analysis of the feedback received on ITC 47*. The agenda paper summarised Australian stakeholder feedback received on the classification and measurement provisions of IFRS 9.[5,6]

21 While the feedback received was not particular to NFP entities nor entities of the Tier 3 size contemplated by the Board, staff think the following feedback themes are relevant for this project:

(a) the classification and measurement requirements of IFRS 9 provide more useful information than IAS 39 *Financial Instruments: Recognition and Measurement*. The business model requirements work well most of the time and provide useful information about the amount, timing and uncertainty of future cash flows. In straightforward cases, amortised cost and the effective interest rate method are easy to apply and provide users with useful information;

(b) implementing IFRS 9 can be challenging. Some stakeholders noted that, sometimes, applying IFRS 9 seems unnecessarily complex or the degree of judgement required may result in a diversity of application. Several stakeholders found the level of detail that must be considered in evaluating the terms and conditions of some instruments can be significant and result in counterintuitive outcomes. Application challenges include the:

(i) interpretation of terminology such as "origination", "infrequent", "short term", "near term", "solely repayments of interest and principal" (SPPI) and "substantial";

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3 Recounting their experience in applying AASB 9, for reasons of complexity, a member supported development of a FVTPL accounting policy in preference to a FVTOCI approach.

4 Staff did not check to confirm that Panel members understood what was meant by "recycling" having regard to expectations of Panel members.

5 Link to M185 Agenda Paper 15.1: https://www.aasb.gov.au/media/q1mb3vev/15-1-0_sp_ict47_ifrs9_cm_pir-feedbackanalysis_m185_pp.pdf.

6 The AASB submission to the IASB on its Request for Information can be downloaded from: https://www.aasb.gov.au/admin/file/content106/c2/AASBLetterToIASB-IFRS9_20220131_1643606807036.pdf

(ii) impact of non-market interest rates and flexible repayment terms on the SPPI test;

(iii) application of amortised cost and the effective interest method when there has been a change in the contractual cash flows of the financial instrument; and

(iv) while OCI seems relevant to understanding an entity's financial performance, there is a lack of clarity on a principle underlying the classification category (or conceptual support for the requirements). Consistent with this, staff received mixed feedback on whether the 'recycling' of the fair value gains and losses recognised in OCI should be permitted. Further standard-setting work is necessary regarding presenting fair value changes on investments in equity instruments in OCI and the issue of OCI and recycling more broadly; and

(c) derecognition is difficult, and pass-through and continuing involvement are very difficult. Stakeholders said that with increased risk-sharing transactions, avoiding continuing involvement is much more prevalent, increasing complexity of applying the standard.

22 The following feedback about investments was received:

(a) stakeholders agreed that the FVTOCI election is usually made for investments when entities do not think that the fair value movements in the profit and loss would provide useful information to the users of the financial statements;

(b) some stakeholders questioned the rationale for the FVTOCI election not being available for unit trust investments, and one stakeholder said some people thought investments in unit trusts should qualify for the FVTOCI designation; and

(c) one stakeholder commented that many entities may still measure their unlisted equity instruments at cost (as a proxy for fair value, as permitted by AASB 9.B5.2.3). They noted that reasons commonly cited are a lack of sufficient and reliable information and the possible wide range of fair value estimates. A significant level of judgement is required to assess the indicators listed in AASB 9.B5.2.4 that cost might not be representative of fair value.

Findings from academic research and other literature

23 In 2020, CAANZ conducted a survey gauging members' views on the impact of recently implemented accounting standards, including IFRS 9 *Financial Instruments*. The survey findings suggest that a majority of the respondents (59%) found complexity in preparing IFRS 9-compliant financial statements to be of the greatest impact to them on adopting the Standard, when compared to the impact of the Standard on their business model, KPIs or IT systems and processes. However, the complexity of IFRS 9 was viewed by 47% of respondents to be compensated by improved information quality.[7] Complexity was judged by reference to effort in making estimates and judgements, and preparing disclosures. The survey was not specific to NFP entities.

24 This is not to say that IFRS 9 did not affect business models, KPIs or require updates to IT systems and processes. For example, a recent Chinese research study[8] has found a significant rise in selling available-for-sale equity investments and increased audit fee premiums coincided with the implementation of IFRS 9. Similarly, in 2022, the Swinburne University of Technology-CPA Australia publication *Annual reports of Australian Not-for-profit Organisations: Insights*

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7 See the 2020 Chartered Accountants IFRS Survey, available on the CAANZ website. Respondents' responses to the revised approach to accounting for expected credit losses serves as a proxy for information quality.

8 *Implementation costs of IFRS 9 for non-financial firms: evidence from China*, Xingtong Fang, Yuanyuan Guo, Beilei Mei, Jianfang Ye (published 1 December 2021, Accounting & Finance)

from internal and external stakeholders reported a research participant as noting that investigating the technical requirements of AASB 9 had helped the board and management team of an NFP entity operating under the NDIS model with their focus when making some important operational decisions.[9]

25 Staff have not identified any further academic research, AASB research or other literature that provides useful input to the staff analysis, including findings specifically providing support or otherwise for maintaining AASB 9 reporting requirements or fair value measurement for a NFP private sector entity's financial instruments.[10]

Findings from staff review of a sample of financial statements

26 Staff reviewed a random non-representative sample (20) of the 2020 financial statements of entities with reported revenues between $500,000 – $3 million to understand the prevalence of different types of financial instruments by entities of this size.[11] The reviewed financial statements included general purpose financial statements and those described as special purpose financial statements.

27 The staff findings are summarised below. These findings should be interpreted with caution due to the limited sample size:

(a) in general, the sampled entities applied the accounting policies specified by AASB 9. However:

(i) several did not describe their accounting policies for financial instruments (3);

(ii) some included disclosure suggesting that their financial assets and financial liabilities were held at historical cost (7).[12] An entity indicated that, as such, any deferred consideration is not discounted. In general, it was not evident whether the carrying amount of the financial assets was subject to impairment;

(b) the extent of the financial instruments accounting policy disclosure sometimes appeared disproportionate to the complexity of the financial instruments held. Four entities had financial instrument accounting policy disclosures ranging from 2.5 – 4 pages in length. The accounting policy disclosure of several other entities ranged from 1-2 pages;

(c) cash, receivables and payables, and loan liabilities are common financial assets and financial liabilities:[13]

(d) besides trade receivables and trade payables, separately identified receivables and payables commonly included GST recoverable and GST payables;

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9 *Annual reports of Australian Not-for-profit Organisations: Insights from internal and external stakeholders* (February 2022) is accessible on the CPA Australia website at https://www.cpaaustralia.com.au/-/media/project/cpa/corporate/documents/tools-and-resources/financial-reporting/annual-reports-of-australian-nfps.pdf?rev=f580afc1610142189097a36934171bc9&download=true.

10 Staff note that the accounting for financial instruments in general, other than with regards to financial assets resulting from concessionary loans, was not identified as an NFP-specific financial reporting issue in the International Financial Reporting for Non-Profit Organisations (IFR4NPO) Consultation Paper 2021.

11 The sample set is the same as that considered in the September 2021 staff paper on Tier 3 reporting requirements for changes in accounting policies, accounting estimates and errors.

12 None of these entities held investments.

13 One entity appeared to have prepared its financial statements using a cash basis of accounting, and as such reported only cash. The remaining entities in the sample all held cash, receivables, and payables.

the sample reviewed included six entities with outstanding credit card debt/ bank overdraft at the reporting date and six entities currently holding (or indicated they previously held) bank loans. Little, if any, disclosure was made about these borrowings;[14]

(e) some (6) entities hold funds in short-term term deposits. Several (3) other entities held financial assets described as “investments”. Of these:

(i) two entities measured the investment (including units in managed funds) as at FVTPL;

(ii) an entity measured the financial asset (units in managed funds) at FVTOCI.

In the statement of comprehensive income, two (2) entities distinguished the fair value gain or loss from their “operating surplus”; presenting it below this subtotal.

(f) two entities indicated their bankers held bank guarantees over their lease arrangements. For context, 13 of the sampled entities were lessees in a non-concessionary lease;

(g) other identified financial assets were rental bonds (1), and a loan receivable (1). Other identified financial liabilities were security bonds held (1) and income tax payable (1);

(h) none of the sampled entities appears to hold derivative financial instruments or engage in hedging activity; and

(i) the financial statements include little, if any, comment on the entity’s financial risk management strategy or its financial risk exposures.

Options for Tier 3 requirements

28 With reference to the flowchart in Appendix B on approaches to simplification, staff have identified the following aspects for simplification for Tier 3 reporting requirements. This analysis takes into consideration of current practices in Australia and international jurisdictions, and research findings summarised in paragraphs 16 – 27 above.

29 Aspects 1-6 and the simplification options thereto are analysed in Agenda Paper 5.2.2. Aspects 7-10 will be brought to the June 2022 Board meeting.

Table 2: Proposed departures from AASB 9

Topic	**Reasons for proposing departure from AASB 9**	**Identified potential simplification (explanation, recognition or measurement criteria, interpretation or understandability)**
1. Extent of requirements and guidance [Agenda Paper 5.2.2]	• The extent of requirements and guidance is not proportionate to the needs and limitations of a smaller NFP private sector entity	Either: • Limit requirements and guidance to that contained fully within a Tier 3 Standard • Incorporate specified guidance or requirements by cross-reference to AASB 9
2. Initial measurement of financial assets	• A different initial measurement basis to AASB 9 may be easier for preparers to understand and less	• Require financial assets and financial liabilities to be initially measured at cost, being the

14 Several entities indicated that their loans were secured. One entity explained some of its loan repayment terms (e.g. interest-only for an initial period). None provided information about interest rates on the borrowings.

Topic	Reasons for proposing departure from AASB 9	Identified potential simplification (explanation, recognition or measurement criteria, interpretation or understandability)
and financial liabilities [Agenda Paper 5.2.2]	subject to interpretation and explanation. In many cases, the result is likely to be the same as the item's fair value	transaction price. The transaction price should be discounted to the cash price if the transaction includes a financing element • Require transaction costs incurred to acquire a financial asset or assume a financial liability to be expensed as incurred, rather than increasing (reducing) the initial carrying amount of a financial asset (financial liability).[15]
3. Approach to subsequent measurement – accounting policy options [Agenda Paper 5.2.2]	• The AASB 9 measurement criteria for different instruments is 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	Either: • Specify a single measurement basis for each class of financial asset and financial liability • Reduce the available accounting policies from those allowed by AASB 9
4. Approach to subsequent measurement – simpler accounting policies [Agenda Paper 5.2.2]	• 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 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	• Require the same accounting treatment for equity instruments and debt instruments other than term deposits • Require measurement at cost (less impairment) rather than amortised cost

15 No simplification amendment is proposed in relation to the AASB 132 requirement for the costs of issuing equity instruments to be deducted from equity.

Topic	Reasons for proposing departure from AASB 9	Identified potential simplification (explanation, recognition or measurement criteria, interpretation or understandability)
	a source of consternation for preparers • Developing simpler accounting policies will remove an element of management judgement and could reduce preparation costs	
5. Measurement of interest income and interest expense – effective interest method [Agenda Paper 5.2.2]	• 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 • If the proposed initial measurement simplification for transaction costs is not supported by the Board, require any deferred transaction costs to be amortised on a systematic basis over the expected life of the financial instrument
6. Impairment of financial assets that are debt instruments [Agenda Paper 5.2.2]	• 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 [June 2022 meeting]	• The AASB 9 hedge accounting qualifying requirements are complex to apply. Without amendment, it is likely a too onerous imposition for a smaller entity to take advantage of such optional accounting	Either: • Do not permit hedge accounting • Develop simpler hedge accounting requirements; e.g. fewer/no qualifying conditions
8. Embedded derivatives [June 2022 meeting]	• 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	Either: • Be silent on the accounting for an embedded derivative • Explicitly do not require an embedded derivative to be separated from its host contract but require the host contract to be accounted for in its entirety at the measurement basis specified by the Board for the host contract

Topic	Reasons for proposing departure from AASB 9	Identified potential simplification (explanation, recognition or measurement criteria, interpretation or understandability)
9. Derecognition of financial assets and financial liabilities [June 2022 meeting]	• 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	• For financial assets, develop criteria that specifies possibly later derecognition of financial assets compared to AASB 9 • For financial liabilities, develop criteria that specifies earlier derecognition of a financial liability, where the original financial instrument is modified or replaced by another financial instrument
10. Estimating fair value [June 2022 meeting]	• AASB 13 can be complex to understand and apply	• Develop a simpler hierarchy that mirrors the AASB 13 principles for inclusion as part of a Tier 3 Standard

Question for Board members

Q1 Besides the topics listed in Table 2, are there any other possible aspects of simplifying the accounting for financial instruments that Board members think should be considered for inclusion in a Discussion Paper? (If so, staff will bring an analysis of such topic(s) to the June Board meeting.)

APPENDIX A: High level summary of financial instrument requirements of other jurisdictions pertinent to smaller NFP private sector entities

1 Table 1 below provides a high level summary of financial instrument requirements of selected other jurisdictions pertinent to smaller NFP private sector entities. The Accounting Standards considered were:

(a) the IFRS for SMEs;

(b) United Kingdom FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*;

(c) United Kingdom FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*;

(d) Hong Kong *Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard* (HK SME-FRF & FRS);

(e) New Zealand *Public Benefit Entity Simple Format Reporting – Accrual (Not-For-Profit)* (NZ Tier 3 reporting requirements); and

(f) CPA Canada Handbook Section 3856 *Financial Instruments*.[16]

2 Forthcoming amendments that impact the requirements summarised in Table 1 are described in the paragraphs following the Table.

Table 1: *High level summary of financial instrument requirements of other jurisdictions pertinent to smaller NFP private sector entities*

	IFRS for SMEs / UK FRS 102	UK FRS 105	Hong Kong	New Zealand	Canada
Opt up	• IFRS for SME – to IAS 39 in entirety • UK FRS 102 – to IFRS 9 or IAS 39 in entirety	• Opt up not permitted	• Opt up not permitted	• Opt up to a higher tier financial instrument accounting policy permitted	• N/a – the same provisions apply to NFP entities of all sizes
Classification	• Debt instruments – by features; Other instruments – by nature	• By nature	• By nature	• By nature	• By nature

16 Staff did not consider the applicable USA requirements given their expected complexity.

	IFRS for SMEs / UK FRS 102	UK FRS 105	Hong Kong	New Zealand	Canada
Initial measurement	• 'Basic' instruments[17] – transaction price plus transaction costs. Exception for financing transactions, which are measured at present value rather than at transaction price. • Other instruments – fair value	• Cost + material transaction costs	• Cost, including acquisition charges	• Transaction price (note: not necessarily described as such)	• Fair value, including transaction costs and financing fees[18]
Accounting policy choice	• Opt up permitted to IAS 39 in its entirety (UK: IAS 39 or IFRS 9)	• No accounting policy choice	• No accounting policy choice	• Opt up to a higher tier financial instrument accounting policy permitted	• Entity can elect to subsequently measure a financial asset/ financial liability at fair value (exceptions apply)

17 'Basic' financial instruments are (a) cash; (b) certain debt instrument; (c) a commitment to receive a loan that cannot be settled net in cash and when the commitment is executed, is expected to be a 'basic' debt instrument; (d) investments in non-convertible preference shares and non-puttable ordinary shares or preference shares. A debt instrument must satisfy all of the following conditions to qualify as a 'basic' financial instrument:

(a) returns to the holder assessed in the currency in which the debt instrument is denominated are either:

(i) a fixed amount;

(ii) a fixed rate of return over the life of the instrument;

(iii) a variable return that, throughout the life of the instrument, is equal to a single referenced quoted or observable interest rate; or

(iv) some combination of such fixed and variable rates, provided that both the fixed and variable rates are positive.

(b) there is no contractual provision that could, by its terms, result in the holder losing the principal amount or any interest attributable to the current period or prior periods.

(c) contractual provisions that permit or require the issuer to prepay a debt instrument, or permit or require the holder to put it back to the issuer before maturity, are not contingent on future events other than to protect (i) the holder against a change in the credit risk of the issuer or the instrument or a change in control of the issuer; or (ii) the holder or issuer against changes in relevant taxation or law.

(d) there are no conditional returns or repayment provisions except for the variable rate return and prepayment provisions described above. (reference: IFRS for SMEs, paras 11.8-11.9)

18 Some related party transactions are initially measured at cost. The cost of an instrument with repayment terms is determined with reference to undiscounted cash flows.

	IFRS for SMEs / UK FRS 102	UK FRS 105	Hong Kong	New Zealand	Canada
Subsequent measurement – trade and other receivables	• Amortised cost using the effective interest method, subject to impairment • Impairment loss – excess of the carrying amount over the present value of estimated cash flows discounted at the asset's original effective interest rate	• Transaction price + deferred transaction costs + interest, less repayments and impairment • Impairment loss – excess of carrying amount over present value of the estimated net cash flows that can be generated from the asset	• Estimated realisable value	• Original carrying amount, less impairment • Impairment loss recognised when it is likely that the amount owed will not be collected	• Amortised cost, subject to impairment
Subsequent measurement of financial assets – equity instruments / shares	• FVTPL if the shares are publicly traded or their fair value can otherwise be measured reliably without undue cost or effort • Otherwise – cost, less impairment. Cost may be the fair value at the last reliable measurement date • Impairment loss – excess of the carrying amount over the best estimate of the amount receivable for the asset if it were to be sold at the reporting date	• Cost, less impairment • Impairment loss – excess of the carrying amount over the best estimate of the asset's selling price at the reporting date	• Current investments – lower of cost and net realisable value[19] • Long term investments – cost, less impairment[20] • Impairment loss – excess of the carrying amount over the recoverable amount (higher of net selling price and the future net cash flows expected from the continued use of the asset)	• Original carrying amount, less impairment • Written down to current market price if it appears that carrying amount will not be recovered	• FVTPL if instrument is quoted in an active market • Otherwise – cost, less impairment
Subsequent measurement of financial assets – debt instruments	• 'Basic' debt instruments – amortised cost using the effective interest method • Otherwise – FVTPL	• Transaction price + deferred transaction costs + interest, less repayments and impairment	• Investments – cost based, as per equity investments • Other debt instruments – consistent with historical cost convention	• Original carrying amount, less impairment • Written down to current market price if it appears	• Amortised cost

19 Different requirements apply to investments held by an investment company and to retractable or mandatorily redeemable preference shares.

	IFRS for SMEs / UK FRS 102	UK FRS 105	Hong Kong	New Zealand	Canada
			• The difference between the acquisition cost and redemption value of a held to maturity debt security is amortised over the period to maturity on a straight-line or constant yield basis, as though it were interest	that carrying amount will not be recovered	
Subsequent measurement of financial liabilities (other than derivatives)	• 'Basic' financial liabilities – amortised cost. (Loan commitments – cost) • Other financial liabilities - FVTPL	• Transaction price + deferred transaction costs + interest, less repayments and impairment	• Not specifically addressed. Measurement consistent with historical cost convention	• Bank overdraft – at the drawn amount • Creditors – at initial amount owing less part that has been paid or is no longer owed • Loans – outstanding principal + unpaid interest	• Amortised cost
Interest income/ interest expense	• Calculated in accordance with the effective interest method	• The difference between the initial transaction price and the total subsequent contractual receipts or payments, excluding transaction costs, is recognised as interest income/expense • Financing transactions – interest is recognised on a straight line basis • Other – interest is recognised at a constant rate on the carrying amount excluding any deferred transaction costs	• Interest income is recognised on a time proportion basis	• Interest income/expense is recognised as it is earnt/ incurred • interest is measured in accordance with the terms of the contract	• Interest is calculated using the stated interest rate, plus or minus the amortisation of any initial premium or discount

	IFRS for SMEs / UK FRS 102	UK FRS 105	Hong Kong	New Zealand	Canada
Impairment testing	• Assess whether there is objective evidence of impairment. If present, calculate impairment loss[20]	• Test for impairment	• Test for impairment	• Test for impairment	• An assessment is made at the end of the reporting period whether there is an indication that financial assets are impaired. Impairment is charged where the entity has identified that there has been a significant adverse change in the expected timing of future cash flows from the financial asset. • In general, the extent of impairment is limited to the highest amount recoverable of the future cash flows from: • holding the asset (excluding cash flows from interest and dividends); • selling the asset at the reporting date; or • securing any collateral over the asset.
Derivative financial instrument	• FVTPL	• Transaction price, less impairment. Transaction price is recognised in profit or loss on a straight-line (or other appropriate) basis	• Consistent with historical cost convention	• Not specifically addressed (but expected to be original carrying amount less impairment)	• FVTPL

20 Not explicitly stated in the text, but impairment is based on an incurred loss model.

	IFRS for SMEs / UK FRS 102	UK FRS 105	Hong Kong	New Zealand	Canada
		• Amounts receivable/ payable during the derivative life are recognised as the amount accrues • Impairment loss – excess of carrying amount over fair value less costs to sell			
Embedded derivatives	• Not addressed	• Not addressed	• Not addressed	• Not addressed	• Does not require separation from a non-financial host contract
Hedge accounting	• Permitted only for certain risks and provided a derivative is involved • Some hedging gains and losses are recognised in OCI until the hedged item is recognised • Conditions to qualify for hedge accounting are simpler than those specified by IFRS 9 and IAS 39	• Not permitted	• Not permitted	• Not permitted (unless the entity opts up)	• Permitted for specified hedging relationships • Some hedging gains and losses recognised in equity until the hedged item is recognised
Compound financial instruments	• As per IAS 32	• As per IAS 32	• Not specifically addressed	• Not specifically addressed	• Either (1) assign the entire amount to the financial liability, or (2) measure the more easily measurable component and assign the residual to the other component
Derecognition of a financial asset	• A financial asset is derecognised on expiry of contractual cash flows, or	• A financial asset is derecognised only when:	• Not specifically addressed	• Debtors – when amount is collected or written off	• Receivables transferred to another enterprise are derecognised only if

	IFRS for SMEs / UK FRS 102	UK FRS 105	Hong Kong	New Zealand	Canada
	the transfer of substantially all the risk and rewards of ownership, or where the entity has transferred control of the financial asset even though it retains some significant risks and rewards of ownership. • The Standard does not include the "continuing involvement" provisions of IFRS 9	(a) the contractual rights to the cash flows from the financial asset expire or are settled; (b) the micro-entity transfers to another party substantially all of the risks and rewards of ownership; or (c) when no future economic benefits are expected from holding it or its disposal.		• Investments – when sold, otherwise disposed of, or written off	control of the financial instrument has been surrendered
Derecognition of a financial liability	• As per IFRS 9	• As per IFRS 9, but there is no guidance about the treatment in instances of exchanged instruments or modifications to the terms of the original instrument	• Not specifically addressed	• Creditors – when settled • Loans – when all principal and interest has been paid	• As per IFRS 9
Fair value	• Limited guidance on estimating fair value – a simplified hierarchy • Fair value is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction	• Limited guidance on estimating fair value – a simplified hierarchy • Fair value is defined as the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction	• No guidance on estimating fair value • Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction	• No guidance on estimating fair value • Fair value is defined as the amount for an arm's length transaction if it takes place between two willing parties in the market	• Limited guidance on estimating fair value • Fair value is defined as the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

Forthcoming changes – IASB Review of the IFRS for SMEs Standard

3 The IASB is currently undertaking its second comprehensive review of the *IFRS for SMEs* Standard. As part of its this project, with regards to financial instruments, the IASB has tentatively decided to:

(a) supplement the examples in Section 11 *Basic Financial Instruments* with a principle for classifying financial assets based on their contractual cash flow characteristics;

(b) no longer provide entities the option of applying 'full IFRS' accounting for financial instruments;

(c) retain existing IFRS for SME hedge accounting requirements;

(d) align 'fair value' definition with IFRS 13 and to include the IFRS 13 principles of the fair value hierarchy and illustrative examples;

(e) not to allow discounted loans to directors to be initially measured at transaction price rather than at present value;

(f) to add a definition of a 'financial guarantee contract' from IFRS 9, and introduce measurement requirements;

(g) retain the existing impairment requirements for equity instruments measured at cost; and

(h) retain the incurred loss model for trade receivables and contract assets, but to develop an expected credit loss model for all other financial assets measured at amortised cost.

Forthcoming changes – NZ Post-implementation review of Tier 3 and Tier 4 reporting requirements

4 Following the Post-implementation Review of its Tier 3 reporting requirements, the NZASB is expected to propose in a forthcoming Exposure Draft to allow, as an accounting policy choice, publicly traded financial investments to be measured at current market value with changes in market value recognised in profit or loss (i.e. in effect, FVTPL).

APPENDIX B: Approach to simplification agreed by the Board at its 4 August 2021 Board meeting