Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Not-for-Profit Framework Project**	**Meeting:**	200
Topic:	**Tier 3 Exposure Draft Proposals – financial instruments, employee benefits, changes in accounting policies and estimates, and correction of prior period accounting errors**	**Agenda Item:**	5.3
		Date:	13 November 2023
Contact(s):	Maggie Man mman@aasb.gov.au Fridrich Housa fhousa@aasb.gov.au	**Project Priority:** **Decision-Making:** **Project Status:**	High High Developing Exposure Draft

Objective of this paper

1 The objective of this paper is for the Board, in relation to the feedback received on the Discussion Paper *Development of Simplified Accounting Requirements (Tier 3 Not-for-Profit Private Sector Entities)*:

(a) **to consider** staff analysis of the feedback on the Board's preliminary views about the Tier 3 requirements on:

(i) financial instruments;

(ii) employee benefits; and

(iii) changes in accounting policies and estimates and correction of prior period accounting errors; and

(b) **decide** on the staff recommendations of the abovementioned matters for the purpose of drafting the Tier 3 Exposure Draft (ED).

Structure of this paper

2 This paper is structured as follows:

(a) Summary of staff recommendations (paragraph 3);

(b) Background and reasons for bringing this paper to the Board (paragraphs 4 – 7);

(c) Additional feedback from NFP PAP members on matters in this Staff Paper (paragraph 8)

(d) Staff analysis and recommendations regarding the following matters arising from the consideration of stakeholder feedback on the Discussion Paper (DP) proposals:

(i) **Issue 1**: The Tier 3 requirements for financial instruments:

(A) Background (paragraphs 9 – 13);

(B) Summary of feedback from DP and further outreach (paragraphs 14 – 17);

(C) Matter 1: The distinction between basic and complex financial instruments (paragraphs 18 – 25);

(D) Matter 2: Specifying items of basic and complex financial instruments for Tier 3 entities (paragraphs 26 – 35);

(E) Matter 3: The accounting for basic financial instruments (paragraphs 36 – 59);

(ii) **Issue 2**: Tier 3 accounting requirements for employee benefits:

(A) Background (paragraphs 60 – 63);

(B) Summary of feedback on DP and further stakeholder outreach (paragraphs 64 – 69);

(C) Matter 1: Recognition of personal leave provisions (paragraphs 70 – 76);

(D) Matter 2: Requirement to consider future outflow expected to be required in calculating provisions for employee benefits (paragraphs 77 – 80);

(E) Matter 3: Development of guidance on (i) the probability assessment in calculating long service leave provisions, (ii) portable long service leave, and (iii) accounting of on-cost (paragraphs 81 – 89);

(iii) **Issue 3**: Tier 3 accounting requirements for changes in accounting policies and accounting estimates, and correction of prior period accounting errors:

(A) Background (paragraphs 90 – 92);

(B) Summary of feedback on DP and further stakeholder outreach (paragraphs 93 – 97);

(C) Staff analysis and recommendation (paragraphs 98 – 101); and

(e) **Appendix A**: Extract of May 2023 Agenda Paper 3.1.1, staff preliminary analysis of the feedback on the DP and suggested next steps.

Summary of staff recommendations

3 Staff recommend that the Tier 3 requirements for the purpose of drafting the ED should*:*

(a) distinguish basic financial instruments by the specific financial instruments that are commonly held by smaller NFP private sector entities;

(b) identify the following basic financial instruments within the Tier 3 Standard to be subject to the Tier 3 simplified accounting requirements:

(i) cash and cash equivalents;

(ii) trade and other receivables;

(iii) security bonds (e.g. residential bonds);

(iv) term deposits;

(v) government and listed corporate bonds;

(vi) units held in managed investment schemes, unit trusts and similar other investment vehicles;

(vii) non-convertible preference and ordinary shares held in listed and non-listed entities including instruments redeemable for known amount of cash or the amount of cash equivalent to their share of the net asset of the entity;

(viii) trade and other payables; and

(ix) loans (being either interest-bearing at fixed or variable amount, interest free, or including terms that create leverage).

(c) identify the following financial instruments as complex within the Tier 3 Standard and not reference them as examples:

(i) purchased debt instruments such as unlisted corporate bonds and convertible notes;

(ii) acquired equity instruments other than non-convertible preference and ordinary shares;

(iii) financial guarantee contracts;

(iv) derivatives such as interest rate swaps and forward exchange contracts; and

(v) commitments to provide a loan at a below-market interest rate.

(d) allow an accounting policy choice for financial assets held for capital return and income to be subsequently measured at:

(i) fair value through profit or loss; or

(ii) fair value through other comprehensive income;

(e) require transaction costs of a financial asset and financial liability to be expensed immediately in the period the costs are incurred;

(f) not to permit hedge accounting in the Tier 3 Standard, including for entities that are required to apply AASB 9 for complex financial instruments;

(g) not require entities to recognise any provision of any non-vesting accumulating employee benefits unless amounts are due and unpaid to an employee;

(h) not require an entity to consider any future pay increases when determining a provision for employee benefit measured at the undiscounted future outflow expected to be required to settle the present obligation;

(i) not to develop guidance on probability assessment for long service leave provisions, portable long service leave and employee on-cost; and

(j) require a full retrospective approach to correction of prior period accounting errors.

Background and reasons for bringing this paper to the Board

4 The Board decided at its May 2023 meeting to proceed with the development of an ED on a Tier 3 Accounting Standard with simplified recognition, measurement and disclosure requirements for smaller NFP private sector entities.

5 The Board considered the summarised feedback on the DP, and staff preliminary analysis and suggested actions for the next steps in Agenda Paper 3.1.1 of the May 2023 Board meeting. At that meeting, the Board noted the categorisation to distinguish the suggested action for the next steps presented in Agenda Paper 3.1 of the May 2023 Board meeting on the topics that staff will need to bring back for further discussions and incorporate changes to the Board's preliminary views for consideration in future meetings.[1]

6 The Board also decided on the approach to drafting the Tier 3 ED, as presented in Appendix B in Agenda Paper 5.1 for this meeting to the extent consistent with the project objective to develop

1 Agenda Paper 3.1 of the May 2023 Board meeting presented three main categories to distinguish the suggested action for next steps based on the feedback on the DP. The three categories were:
(1) Category A (ED drafting based on DP proposals with minor issues to be resolved);
(2) Category B (ED drafting based largely on DP proposals with some potential changes); and
(3) Category C (further analysis and direction required).

simplified and proportionate requirements for smaller NFP private sector entities and in line with the principles the Board applies in this regard.

7 In this paper, staff are bringing staff analysis of the feedback on the DP and seeking the Board's direction on the matters below according to the project timeline presented in Agenda Paper 3.1 at the August 2023 Board meeting, on the Tier 3 requirements for:

(a) **Issue 1**: financial instruments;

(b) **Issue 2**: employee benefits; and

(c) **Issue 3**: changes in accounting policies and estimates, and correction of accounting errors.

Summary of additional feedback from NFP PAP members on matters in this Staff Paper

8 Staff gathered further feedback from the NFP PAP meeting held on 31 October 2023.[2] One PAP member also provided comment outside the PAP meeting. The following views were provided at that meeting:

(a) all members agreed with the proposal in the DP to distinguish basic financial instruments from complex financial instruments by specifying financial instruments that are commonly held by smaller NFP private sector entities subject to the list including preference shares without conversion features. They also agreed not to permit hedge accounting for entities applying the Tier 3 Standard;

(b) many members agreed with the proposed list of basic financial instruments except a few members also considered:

(i) listed corporate bonds are quite common and should also be treated similarly to listed ordinary shares and included as basic financial instruments;

(ii) whether the reference of non-convertible preference and ordinary shares should be referred to as non-redeemable instead.

(c) a few members noted the need to ensure Tier 3 entities are not inadvertently required to apply the Tier 2 requirements if a financial instrument is not contained in either the basic or complex financial instrument list;

(d) a majority of members supported an accounting policy choice to be provided for Tier 3 entities to account for changes in fair value through either profit or loss or other comprehensive income because it caters to entities that prefer one method over another. One member also noted whether financial assets held to generate both income and capital return should be referred to as held for trading instead;

(e) all members supported the DP proposal for transactions and fees, on initial measurement, to be expensed in the period incurred and not to permit hedge accounting in the Tier 3 Standard;

(f) all members supported not to require a provision of any non-vesting accumulating personal leave and not to require the consideration of future pay increases to settle the present obligation as a form of further simplification; and

(g) all members agreed not to develop guidance on:

(i) the probability assessment such as rebuttable presumption or practical expedient in calculating long service leave because it may become outdated and may not factor in changes in the workforce;

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2 Refer to Agenda Paper 5.5 NFP PAP minutes from 31 October 2023 for this meeting.

(ii) portable long service leave, even though they noted there is diversity in practice. However, members acknowledge that the lack of understanding is not confined to Tier 3-sized NFP entities and no Tier 3 simplification should be developed specifically for smaller NFP entities; and

(iii) on-cost since it is not specific only to smaller NFP entities but noted that many smaller NFP entities would lack the knowledge to consider on-cost when accounting for employee benefits. As such, members consider an illustrative example would be helpful to at least raise awareness that entities would need to think about on-cost when considering employee benefits.

Matters to be addressed based on feedback on the DP proposals

Issue 1: The Tier 3 requirements for financial instruments

Background

9 As detailed in paragraph 5.64 of the DP, the Board's preliminary view is that a Tier 3 Standard will identify the basic financial instruments that a smaller NFP private sector entity might typically hold, for which simpler requirements will apply.

10 Paragraphs 5.69 and 5.70 of the DP proposed a list of basic financial assets and financial liabilities that are typically held by smaller NFP private sector entities that will apply the simpler reporting requirements in the Tier 3 Standard being:

(a) cash and cash equivalents;

(b) trade and other receivables;

(c) security bonds and similar debt instruments;

(d) term deposits and government bonds;

(e) units held in managed investment schemes, unit trusts and similar other investment vehicles;

(f) ordinary shares held in listed and non-listed entities;

(g) trade and other payables; and

(h) loans (being either interest-bearing at fixed or variable amount, interest free, or including terms that create leverage).

11 Paragraph 5.74 of the DP provides for the Board's preliminary view and subsequently decided at its 13-14 September 2023 meeting that an entity will be directed for certain 'more complex' financial instruments to be accounted for in accordance with AASB 9 *Financial Instruments*.[3] Examples of these complex financial instruments provided in the DP may include:

(a) purchase debt instruments such as listed corporate bonds and convertible notes;

(b) acquired equity instruments such as preference shares;

(c) financial guarantee contracts;

(d) interest rate swaps and forward exchange contracts; and

(e) commitments to provide a loan at a below-market interest rate.

12 The Board also proposed for Tier 3 reporting requirements not to specifically highlight or address particular financial instruments or transactions considered in AASB 9 *Financial Instruments*, AASB 132 *Financial Instruments: Presentation* and AASB 139: *Financial Instruments: Recognition and Measurement*, because these items and transactions are not common to NFP private sector entities.

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3 Refer to the minutes of the September 2023 Board meeting.

An entity would need to develop an accounting policy based on the hierarchy approach to account for these unaddressed financial instruments. Examples of unaddressed financial instruments included: issued compound financial instruments, puttable financial instruments, treasury shares, loan commitments and contracts to buy or sell a non-financial instrument item that can be settled net of cash, and transfers of financial assets.

13 To gather feedback on the Board's proposal, the DP included the following question:

> ***Question 21***
>
> ***Paragraphs 5.62 to 5.76 discuss the Board's preliminary view with respect to the accounting for financial instruments, in particular to develop simpler reporting requirements only for the identified 'basic' financial instruments.***
>
> ***The Board intends to require certain 'more complex' financial instruments to be accounted for in accordance with AASB 9 (or other Australian Accounting Standards, as appropriate) if the financial instrument is not otherwise addressed by a topic-based Tier 3 requirement. In addition, the Board intends not to specifically highlight or address particular financial instruments or transactions considered in AASB 9, AASB 132 and AASB 139 where these items and transactions are not common to not-for-profit private sector entities.***
>
> ***Do you agree with the Board's approach to the identified 'basic' financial instruments? Why or why not? If you disagree with the Board's view, do you prefer other alternatives? Please specify and explain why.***

Summary of feedback from DP and further outreach

14 As noted in Agenda Paper 3.1.1 at the May 2023 Board meeting, almost all stakeholders (92%) including most of those that provided a written response (6 written responses out of 10 that commented on this question) agree that the current requirements to account for financial instruments are too complex for smaller NFP private sector entities and that the proposal would standardise the reporting. A few of those stakeholders that agree also consider that financial instruments other than term deposits would be uncommon, and the need to define the boundary between a 'basic' or 'complex' financial instruments to be clear and simple for smaller NFP entities to apply.

15 However, a few stakeholders (2%) including several written responses (4 written responses) disagree because:

(a) requiring Tier 3 entities to apply AASB 9, AASB 132 and AASB 139 for complex financial instruments is challenging for smaller NFP entities and would lead to the Tier 3 Standard being less self-contained. The AASB should consider a similar approach to the International Financial Reporting Standard for Small and Medium-Sized Entities (IFRS for SMEs) ED which proposed to remove the option to opt up to IAS 39 *Financial Instruments* to develop Tier 3 accounting requirements to account for all financial instruments; and

(b) the use of 'blunt instruments' proposed in the DP for basic and complex financial instruments is unclear. For example, certain units held in managed investment schemes, unit trusts and similar other investment vehicles may contain embedded derivatives and therefore, AASB 9 may be more appropriate. An alternative approach to distinguish between a basic or complex financial instruments could be based on whether a financial instrument contains complex features, such as conversion features or derivatives, to avoid a risk of entities acquiring (or, less likely, issuing) instruments with 'basic names' to be able to apply basic accounting, even if the features indicate the instrument is of a complex nature.

16 Almost all stakeholders (92%) agreed with the proposed listed of common financial instruments. However, there were a few stakeholders (including two that provided written response) that did not agree with some of the financial instruments proposed to be complex, including:

(a) unconditional bank guarantees (such as residential bonds), commitments to provide concessional loans and preference shares may be a common instrument;

(b) listed corporate bonds are simple to account for and hybrid securities with equity risks could be dealt with similarly to ordinary shares, hence these instruments could be accounted in the Tier 3 Standard; and

(c) interest rate swaps are used to manage interest rate risk that is held by a few NFP entities, and it may be difficult for members or the NFP boards to understand why these instruments, which are required to be fair valued in accordance with AASB 9, would be complex.

17 Further feedback was sought from the NFP PAP members where:

(a) all members agreed with the proposal in the DP to distinguish basic financial instruments from complex financial instruments by specifying financial instruments that are commonly held by smaller NFP private sector entities (i.e. Option 1 in Table 1 below) because:

(i) the proposed list of basic financial instruments (further discussion on the specific basic financial instruments is included in Matter 2 in paragraph 26) has been revised to address their initial concern that some of the financial instruments in the basic list may contain complex features and embedded derivatives may not always be separated; and

(ii) distinguishing basic financial instruments that do not contain complex features such as derivatives or conversion features (i.e. Option 2 in Table 1 below) is principles-based and caters specifically for Tier 3 requirements. However, the requirements may take longer to develop. Therefore, Option 1 would be a more practical approach going forward to achieve the objective of simplifying the accounting requirements for financial instruments in accounting and allowing for consistency amongst Tier 3 entities.

(b) one member considered another approach to distinguish basic and complex financial instruments is to define what complex financial instruments would be in the Tier 3 Standard. Any financial instruments that would not be considered complex would apply the simplified accounting requirements developed for basic financial instruments.

Matters to be addressed

18 Based on the feedback on the DP summarised in paragraphs 14 – 17 above, staff consider that there are three accounting matters that the Board will need to consider in relation to the Tier 3 requirements for financial instruments, that is:

(a) **Matter 1:** The distinction between basic and complex financial instruments in paragraphs 19 – 25;

(b) **Matter 2**: What are basic and complex financial instruments for Tier 3 entities (paragraphs 26 – 35); and

(c) **Matter 3**: The Tier 3 accounting for basic financial instruments in (paragraphs 36– 59).

Matter 1: The distinction between basic and complex financial instruments

19 When developing the DP proposals on Tier 3 accounting for financial instruments, the Board decided to specify 'simpler' financial reporting requirements for some, but not all, financial instruments.[4] As specified in paragraph 5.72 of the DP, the Board's view is that an entity that holds 'more complex' financial instruments will not usually be the type of entity preparing financial statements that comply

4 Refer to Agenda Paper 12.2.1 at the June 2021 Board meeting.

with Tier 3 reporting requirements. The Board expects these entities should be able to apply the more complex accounting specified by AASB 9 *Financial Instruments.*

20 The Board also decided to clearly identify 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, to provide better clarity to smaller NFP private sector preparers of the relevant accounting for each financial asset and financial liability.[5]

Staff analysis and recommendation

21 Staff noted the feedback from the few stakeholders suggesting the AASB to consider the IFRS for SMEs approach[6] and to develop accounting requirements for all financial instruments has been addressed because the Board decided at its September 2023 meeting to continue to direct entities to apply Tier 2 requirements for complex financial instruments. The Board consider financial instruments that are highly specialised and complex would warrant the application of the more complex accounting specified by Tier 1 or Tier 2 Australian Accounting Standards. As such, staff analysis and recommendation relate to the distinction between basic and complex financial instruments. Consideration of what are basic financial instruments will be addressed in Matter 2.

22 Considering the approach to simplification applied by the Board in Appendix A of Agenda Paper 5.1, for this meeting staff incorporated the summary of feedback from DP and further outreach summarised in paragraphs 14 –17, and considered there are two possible options to address the feedback in Table 1 below.

Table 1 Options to determine the distinction between basic and complex financial instruments

Option 1 – Proceed with the Board's proposal to distinguish basic financial instruments based on financial instruments that are not complex and are commonly held by smaller NFP entities	Option 2 – Distinguish basic financial instruments that do not contain complex features such as derivatives or conversion features.
Arguments for this approach	
1) Almost all stakeholders (92%) supported the Board's proposed approach that financial instruments identified to be common to smaller NFP entities should apply the simplified accounting proposed for 'basic financial instruments'. **2)** As discussed in Agenda Paper 12.2.1 at the June 2021 Board meeting, the Board considered that clearly	**1)** As the Research Report 19 findings did not identify many derivative financial instruments held by charities, the risk of potentially not identifying common types of financial instruments referred to in Option 1 is contained. **2)** This Option would likely capture more financial instruments that would be eligible to apply the basic

5 As specified in Agenda Paper 12.2.1 at the June 2021 Board meeting, in forming the proposed list of financial instruments that would be subject to the Tier 3 accounting requirements, staff had regard to:
(a) the scope of AASB 9;
(b) typical financial instruments held by smaller NFP private sector entities (as suggested by a staff review of the sample set of financial instruments);
(c) topics already discussed by the Board;
(d) the Board's objective in developing Tier 3 reporting requirements; and
(e) the scope of financial instrument requirements, and approach taken by selected other jurisdictions.

6 The IFRS for SMEs ED proposes to supplement the list of examples of basic financial instruments and the conditions a debt instrument is required to satisfy to be classified as a basic financial instrument, with a principle based on the contractual cash flow characteristics of the financial asset. In addition, the IASB proposed to remove the option to apply the recognition and measurement requirements in full IFRS Accounting Standards for financial instruments in IAS 39. BC 94 outlines the reasons to remove the option to apply IFRS 39, mainly because the IASB did not identify good reasons for indefinitely maintaining a single exception in the Standard (i.e. IAS 39 was the only topic an entity was permitted to opt up for) and intends the Standard to be self-contained and to align Sections 11 and 12 with IFRS 9. Feedback on the ED also did not indicate entities are applying IAS 39.

Option 1 – Proceed with the Board's proposal to distinguish basic financial instruments based on financial instruments that are not complex and are commonly held by smaller NFP entities	Option 2 – Distinguish basic financial instruments that do not contain complex features such as derivatives or conversion features.
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 assets and financial liability held. **3)** This approach is similar to IFRS for SMEs ED which lists examples of basic and complex financial instruments, however, accompanied by characteristics of a debt instruments that would normally be considered as basic instruments, noting that non-convertible preference shares and non-puttable ordinary shares are directly listed as basic financial instruments.	financial instrument requirements without requiring entities to apply Tier 2 requirements.
Arguments against this approach	
1) As noted in paragraph 5.76 of the DP, the Board's proposal could result in financial instruments of a similar nature to the entity being treated differently, (e.g. government bonds that pay variable market interest rate), may apply the basic financial instruments requirements but convertible bonds would be considered a complex financial instrument and would be required to apply Tier 1/Tier 2 requirements. **2)** As noted in the feedback on the DP, judgement would need to applied to ensure the names of the financial instruments are in line with their intended characteristics.	**1)** This Option is more complex as smaller entities may not have the necessary financial knowledge to distinguish or identify complex features or conversion features to begin with. Research Report 19 did not identify smaller charities were holders of financial instruments outside the common financial instruments identified in paragraph 10 (refer to paragraph 29 for more information). As such, requiring entities to identify whether derivatives or complex features proposed in Option 2 would increase complexity. **2)** The Board’s preliminary decision was that Tier 3 entities are not required to separately recognise certain derivatives when they are not readily identifiable and measurable, including any embedded derivatives as per paragraph 5.79 of the DP. As such, Option 2 would contradict the Board's preliminary view to require entities to identify whether their holdings of financial instruments, such as various loan commitments, may meet the definition of derivatives, or financial instruments that contain embedded derivatives which increases complexity for Tier 3 entities.

Staff recommendation

23 Staff recommend Option 1, the Board's proposal in the DP, based on the arguments presented in Table 1 and after considering the assessment against the Tier 3 development principles in Appendix B of Agenda Paper 5.1 for this meeting. Staff continue to think Option 1 will keep the Tier 3 Standard simple and, as acknowledged in the DP in paragraph 5.76, the Board considered it more important that a Tier 3 direction is provided to preparers regarding the requirements applicable to specific financial instruments.

24 Staff note there are other alternative approaches to determining the distinction between basic and complex financial instruments such as:

(a) a combination of the features, conditions or characteristics constituting a complex financial instrument together the with the list of examples of basic and complex instruments (i.e. an approach similar to the one adopted by IFRS for SMEs); or

(b) other or additional features to those highlighted in Option 2 above (i.e. embedded derivative and conversion features) such as characteristics of the cash-flows or returns, repayment profiles and similar.

25 However, staff did not consider these approaches further because:

(a) The approach in paragraph 24(a) would be unlikely to be more helpful to the Tier 3 entities as it may create confusion whether the listed instruments or the underlying criteria take precedence, especially noting the proposed list is a combination of the simplicity consideration together with an assessment about whether the instruments are expected to be common for Tier 3 entities. Staff note that this would be similar to the approach taken in IFRS for SMEs where criteria listed in paragraphs 11.8 and 11.9 in IFRS for SMEs ED are a combination of characteristics (e.g. relating to debt instruments) and a direct specification of the instrument (e.g. certain types of ordinary and preference shares). Staff also note that the list of basic and complex instruments will allow for application of judgement and Tier 3 subsequent measurement requirements would reflect the different characteristics in payoff profile – such as shares would be measured at fair value and debt instruments normally at cost.

(b) Although there would be various additional and more detailed characteristics that could be considered, most of them would be already captured by the derivative characteristic or through the subsequent measurement requirements of the Tier 3 standard. Staff also considers that more detailed characteristics would unnecessarily increase complexity of the assessment whether a financial instrument is simple or complex for Tier 3 entities, whilst at the same time Research Report 19 findings suggest that there is not a significant variety of the instruments held by these entities and the most commonly held instruments are simple as noted in Agenda Paper 3.1 for September 2023 Board meeting (paragraph 54) and in paragraph 28 below.

Question 1a: Do Board members agree with the staff recommendation in paragraph 23, for the purpose of drafting the Tier 3 ED, to proceed with Option 1. That is, to proceed with the Board's proposal to distinguish basic financial instruments by specific financial instruments that are commonly held by smaller NFP private sector entities.

If not, what does the Board suggest?

Matter 2: Specifying items of basic and complex financial instruments for Tier 3 entities

26 Only if the Board agrees with staff recommendation with Option 1 to distinguish basic financial instruments by specific financial instruments, then the Board needs to consider what are the financial instruments that are commonly held by smaller NFP entities.

27 When developing the list of basic financial instruments that are commonly held by smaller NFP private sector entities as stated in paragraph 10, the Board had regard to staff's analysis of a random sample of financial statements and feedback from NFP panel members.[7] This analysis was further supplemented by Research Report 19 summarised in paragraph 29 below.

28 As noted in paragraph 16, a few stakeholders did not agree with some of the financial instruments proposed to be complex, including:

(a) unconditional bank guarantees;

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7 Refer to Agenda Paper 12.2.1.1 at the June 2022 Board meeting.

(b) listed corporate bonds;

(c) interest rate swaps; and

(d) commitment to provide concessionary loans.

29 Findings from Research Report 19 showed that the common types of financial instruments held by medium-sized charities were cash and cash equivalents, trade and other receivables (including accrued revenue), loan receivables (debt/bond) and term deposits. The less common financial instruments were equity investments, managed funds, financial assets held either at cost, fair value through either profit or loss or other comprehensive income. However, the research noted that it may be difficult to draw any definitive conclusion that financial instruments at fair value through other comprehensive income or held at amortised cost are less common, or the type of financial instruments, since these assets may be aggregated with equity investments or loan receivables categories.

30 Further feedback sought from the NFP Project Advisory Panel members indicated that members were supportive of the proposed list identified as basic and complex financial instruments in paragraphs 10 – 11 above:

(a) except for the following:

(i) Preferences shares that are non-convertible should be included as basic financial instruments, similar to ordinary shares that are non-convertible. However, one member noted whether the reference to non-convertible should be referred to as non-redeemable instead. It is rare to see non-convertible preference shares and they would only convert to ordinary shares.

(ii) Listed corporate bonds are quite common for smaller NFP entities and should be treated similar to listed ordinary shares as their fair value would be simple to obtain. A member also questioned the difference between government bonds being treated as basic but not listed corporate bonds given their similarities.

(iii) The reference to security bonds and similar debt instruments in paragraph 10(c) may add confusion given it is not clear what similar debt instruments may be if they were not purchased instruments.

(b) and noted the following:

(i) Commitments to provide a loan at below market interest rate could be common for NFP entities but more often than not, it would be larger NFP entities that are providing the commitment to provide concessionary loans and smaller NFP entities being the recipient of concessionary loans.

(ii) Forward contracts may not be uncommon for at least some NFP entities but members agree that entities should continue to refer to AASB 9 for the accounting of forward contracts.

(iii) It is important to ensure Tier 3 entities should not be inadvertently required to apply Tier 2 requirements if a financial instrument is not contained in either the basic or complex financial instruments list. As such, some members consider the complex financial instrument list as proposed in the DP should not be referred to as examples (see paragraph 11). This would allow entities to apply the hierarchy approach to consider the Tier 3 requirements first for any financial instruments that are not identified as complex.

Staff analysis and recommendation

31 Staff think the findings in Research Report 19 support that the proposed list of financial instruments listed in paragraph 10 would be those that are commonly held by smaller NFP entities because the findings did not identify any other financial instruments not contained in paragraph 10.

32 Feedback from the DP indicated that there may be some financial instruments that a few stakeholders consider should be included in the list of basic financial instruments and subject to the simplified accounting requirements. Staff reflected on the feedback as follows:

(a) **unconditional bank guarantees (such as provided as part of a residential bond)** – a few stakeholders indicated that as part of their lease agreement, they often have unconditional bank guarantees included in their contracts. Staff noted that residential bonds would already be captured by security bonds and similar debt instruments as payments held as security for the leasing agreement. In relation to the unconditional bank guarantees, staff understanding of this instrument is that as part of the lease agreement, an entity has arranged an unconditional bank guarantee to the lessor, which is a promise by the tenant's financial institution to pay the landlord an amount up to an agreed limit if the tenant breaks any of the terms and conditions of the lease. Staff note that the tenant usually has to give the bank some form of security to obtain a bank guarantee which would be captured by respective presentation and disclosure Tier 3 requirements such as collateral for contingent liabilities. Staff also note that this is different to an issued financial guarantee contract (i.e. an entity providing a financial guarantee to another entity) that the IASB proposed to include as a basic financial instrument in the IFRS for SMEs ED. Staff do not expect Tier 3 entities to be commonly issuing or holding financial guarantees. However, noting the feedback from panel members in paragraph 30(a)(iii) above and considering that the list of basic instruments contains several references to various types of debt instruments and some of them are quite broad such as receivables, loans and bonds, staff recommend removing the reference to similar debt instruments from security bonds to remove the confusion;

(b) **preference shares** – a few stakeholders consider these instruments should be included in the list of basic financial instruments as they consider it may be common for smaller NFP entities to hold these types of financial instruments. Staff noted the stakeholder feedback that preference shares would be commonly held by smaller entities, and that INPAG and IFRS for SMEs ED allows preference shares that are publicly traded or whose fair value can otherwise be measured reliably without undue cost or effort to be subject to basic financial instruments requirements. Therefore, staff agree that preference shares should also be included as part of the basic financial instruments. However, staff suggest clarifying that only preference shares that are non-convertible should be considered as a basic financial instrument, otherwise these features will make the financial instrument complex. Staff also noted the comment from a panel member whether to refer to preferences shares as redeemable rather than non-convertible or puttable as per paragraph 30(a)(i) above. In staff opinion:

  (i) it is not uncommon for preference shares to be convertible (noting that especially bank issuers more recently fund through capital notes). Because a conversion feature would link their value to an external variable, the valuation (assuming these preference shares would be carried at the fair value) is expected to be too complex for NFP Tier 3 entities. Staff also note that the 'non-convertible' limitation is applied to preference shares in the IFRS for SMEs list of basic financial instruments; and

  (ii) preference shares are typically redeemable (either at the option of the issuer or holder). In relation to this, staff noted that the Board's preliminary view was to include investments in managed investment schemes (MIS) and unit trusts in the list of the simple financial instruments covered by Tier 3 requirements and these are commonly puttable, that is, they give the holder right to redeem the unit for cash (e.g. for open ended management investment schemes). On the other hand, staff noted IFRS for SMEs excludes puttable preference and ordinary shares from the list of basic financial instruments. Therefore, staff also considered whether puttable ordinary and preference shares should not be basic financial instruments. Staff think that valuation of the redemption/put feature is not as complex as a conversion feature and, from the shareholder perspective, the Tier 3 subsequent measurement will not require assessment of whether the

instrument is debt or equity, and therefore recommend not to exclude puttable instruments from the list of simple financial instruments. However, staff recommend to include a condition for such instruments to be redeemable/puttable for a known amount of cash or the amount of the cash equivalent to their share of the net assets of the entity.

(c) **listed corporate bonds** – a stakeholder considered listed corporate bonds were simple and should be accounted for similarly to ordinary shares. Based on the additional feedback from panel members noted in paragraph 30(a)(ii), staff recommend that listed corporate bonds should be included as basic financial instruments because:

(i) listed corporate bonds are expected to be straightforward instruments to account for from the measurement perspective under the assumption of liquid corporate bond market. In other words, the valuation complexity of non-listed corporate bonds including the one in relation to the credit risk and associated margin would not be applicable,

(ii) it will be similarly accounted for as listed ordinary shares which are included as basic financial instruments; and

(iii) it appears it may be not uncommon for smaller NFP entities to hold listed corporate bonds.

(d) **hybrid securities** – a stakeholder considered that hybrid securities usually have equity risk and should be accounted for similarly to ordinary shares. As such, they should also be included in the basic financial instruments list. However, staff disagree and therefore do not recommend that these financial instruments should be accounted for as basic financial instruments (other than preference shares noted above) because hybrid securities may contain a derivative and may be convertible, noting the Board decided for derivatives to be considered as complex financial instruments. In addition, hybrid securities are not expected to be commonly held by smaller NFP entities;

(e) **interest rate swaps** – a stakeholder considered that NFP entities hold interest rate swaps to manage interest rate risk, and it may be difficult for members or the NFP boards to understand why these instruments are required to be fair valued in accordance with AASB 9. However, based on findings in paragraph 31, staff do not consider interest rate swaps as commonly held by smaller NFP private sector entities. Furthermore, the Board proposed interest rate swaps and forward exchange contracts being derivatives as complex financial instruments as referenced in paragraph 5.74 of the DP. Therefore, staff do not agree that interest rate swaps or other derivatives should be included in the list of basic financial instruments as it would not be faithful representation to measure any outright and easily identifiable derivatives other than at fair value through profit or loss (being the default accounting unless hedge accounting would apply); and

(f) **commitment to provide concessionary loans** – based on feedback from panel members in paragraph 30(b)(i), it would likely be larger NFP entities providing commitments to provide concessionary loans and smaller NFP entities being the recipient of concessionary loans. Staff also note that the commitments to provide a loan at a below-market rate would be in scope of AASB 9 and, unless measured at fair value through profit or loss, such commitment would be initially measured at fair value and subsequently at the higher of impairment loss allowance and the amount initially recognised less cumulative income. Due to the expectations these are not common and their relative measurement complexity, staff do not agree that commitments to provide concessionary loans should be included as basic financial instruments within the Tier 3 Standard.

Staff recommendation

33 Therefore, staff recommend the following financial instruments should be:

(a) identified as basic financial instruments within the Tier 3 Standard to be subject to the Tier 3 simplified accounting requirements:

(i) cash and cash equivalents;

(ii) trade and other receivables;

(iii) security bonds (e.g. residential bonds);

(iv) term deposits;

(v) government and listed corporate bonds;

(vi) units held in managed investment schemes, unit trust and similar other investment vehicles;

(vii) non-convertible preference and ordinary shares held in listed and non-listed entities including instruments redeemable for known amount of cash or the amount of cash equivalent to their share of the net asset of the entity;

(viii) trade and other payables; and

(ix) loans (being either interest-bearing at fixed or variable amount, interest free, or include terms that create leverage).

(b) identified as complex financial instruments within the Tier 3 Standard and not expected to be commonly held by Tier 3 sized entities, to require entities to apply AASB 9 for:

(i) purchased debt instruments such as unlisted corporate bonds and convertible notes;

(ii) acquired equity instruments other than non-convertible preference and ordinary shares;

(iii) financial guarantee contracts;

(iv) derivatives such as interest rate swaps and forward exchange contracts; and

(v) commitments to provide loans at a below-market interest rates.

34 Staff acknowledge that the identified list of complex financial instruments in paragraph 33(b) above would not include all the possible financial instruments that may be considered complex. However, staff suggest not to reference them as examples of complex financial instruments, but rather, to identify them as those financial instruments that must be accounted for under AASB 9 because:

(a) this approach would align with paragraph 5.74 of the DP, that is:

(i) to develop requirements for certain 'more complex' financial instruments to be accounted for consistently with AASB 9 (or other Australian Accounting Standard, as appropriate); and

(ii) for Tier 3 entities reporting requirements not to address particular financial instruments or transactions considered in AASB 9, AASB 132 and AASB 139 because those items are not common to NFP private sector entities;

(b) It provides a clear direction for smaller entities which financial instruments that would be considered complex;

(c) It allows an entity to develop an accounting policy based on the Tier 3 principles and reporting requirements dealing with similar and related issues for any financial instruments applying the

accounting policy hierarchy approach decided by the Board at its September 2023 Board meeting;[8] and

(d) It aligns with a panel member's feedback in paragraph 30(b)(iii) to determine what are complex financial instruments and enables Tier 3 entities to apply the accounting requirements for basic financial instruments to all other financial instruments.

35 Staff note that an alternative approach is to reference the complex financial instrument list in paragraph 33(b) as being examples. This approach means that any financial instrument that is not identified as a basic financial instrument in paragraph 33(a) may be considered a complex financial instrument, since the listed complex financial instruments are examples only, in which case an entity would be required to apply Tier 2 requirements. This approach aligns with the IFRS for SMEs ED. However, staff had not considered this approach further because it would not align with paragraph 5.74 of the DP, and due to the reasons noted in paragraph 33(b) above. In any case , it would not result in Tier 3 Standard being more self-contained without the need for entities to look to higher tier requirements as noted in Agenda Paper 3.1 at the September 2023 Board meeting.

Question 1b: Do Board members agree with the staff recommendation, for the purpose of drafting the Tier 3 ED,

(i) that basic financial instruments within the Tier 3 Standard to be subject to the Tier 3 simplified accounting requirements are those identified in paragraph 33(a) and complex financial instruments are those identified in paragraph 33(b); and

(ii) that the list of complex financial instruments would not be referenced as an example as per paragraph 34.

If not, what does the Board suggest?

Matter 3: The accounting for basic financial instruments

36 Paragraph 5.64 of the DP proposed that the Board's preliminary view for the accounting for financial instruments in a Tier 3 Standard is specified in Table 2 below.

Table 2 Proposed accounting for financial instruments in the DP

Topic	Summary of the proposed accounting for financial instruments
Scope	Simpler reporting requirements will be developed for identified basic or simple financial instruments that the Board considers to be most commonly held by Tier 3 NFP private sector entities as identified in paragraph 5.69 of the DP. The Board intends to require other financial instruments that are more 'complex', as noted in paragraph 5.74(a) of the DP, to be accounted for in accordance with AASB 9, AASB 132 or AASB 139, as appropriate, without specific NFP private sector entity guidance. However, hedge accounting will not be permitted. More 'complex' financial instruments are those that the Board would not expect to be held by a Tier 3 NFP private sector. Other financial instruments that are not specifically addressed as noted in paragraph 5.74(b) of the DP are to be accounted for consistent with the Tier 3 financial instrument requirements.
Initial recognition of basic financial assets and basic financial liabilities	Consistent with AASB 9, a basic financial asset and financial liability is recognised when the entity becomes party to the contractual provisions of the financial instrument.

8 Refer to meeting minutes of the September 2023 Board meeting.

Topic	Summary of the proposed accounting for financial instruments
Initial measurement of basic financial assets and basic financial liabilities	A basic financial asset (including donated assets) and financial liability is initially measured at its fair value. Transaction costs and fees incurred by the entity are expensed immediately.
Classification of basic financial assets and basic financial liabilities	An entity will not be required to classify basic financial assets and financial liabilities in the manner specified by AASB 9.
Accounting policy choices	An entity will not be able to choose how a basic financial asset or financial liability is subsequently measured. The accounting policy for financial assets and financial liabilities will be dictated by their nature.
Subsequent measurement of basic financial assets	Basic financial assets are subsequently measured as follows: • financial assets that are held to generate both income and capital return for the entity – at fair value through other comprehensive income; and • all other basic financial assets – at cost, less any accumulated impairment. Any initial premium or discount on acquisition of the asset is amortised over the expected life of the financial asset. Interest on a basic financial asset is recognised as income when the entity is entitled to the interest. Interest is measured by reference to the instrument's contractual interest rate.
Subsequent measurement of basic financial liabilities	Basic financial liabilities are subsequently measured at cost. Any initial premium or discount is amortised over the expected life of the financial liability. Interest on the financial liability is recognised as an expense when incurred. Interest is measured by reference to the instrument's contractual interest rate.
Impairment	A basic financial asset is impaired when it is probable that the full carrying amount will not be collectible. (That is, impairment is assessed by reference to an 'incurred loss' model.)
Derecognition of a basic financial asset	A basic financial asset is derecognised when either: • the contractual rights to the cash flows from the financial asset expire or are settled; or • the entity otherwise loses control of the financial asset.
Derecognition of a basic financial liability	A basic financial liability is derecognised when the obligation is discharged, cancelled or expires. An entity treats a modification of the terms of a financial liability or an exchange of a debt instrument for a different debt instrument as an extinguishment of the original financial liability.

37 To gather feedback on the Board's proposal, the DP included questions 22 to 27 on each of the accounting requirements for basic financial instruments proposed in Table 2.

Summary of feedback from DP and further outreach

38 As presented in Agenda Paper 3.1.1 at the May 2023 Board meeting, most stakeholders (85%) including most of those that provided a written response (9 written responses) agree with the proposed accounting of basic financial instruments listed in paragraph 10 above.

39 However, some stakeholders (15%) disagree including several written responses (5 written responses that disagreed with some aspects of the proposals) with the proposed accounting for basic financial instruments, particularly:

(a) most stakeholders that disagreed prefer the subsequent measurement of financial assets held for capital return and income recognising changes of fair value through profit or loss instead of through other comprehensive income because they consider it a simpler option for preparers and users who lack understanding of what other comprehensive income is. A stakeholder also

noted the change as fair value through other comprehensive income would require isolating the accrued interest from net change in the fair value and result in unnecessary complexity;

(b) a few stakeholders that disagree with expensing transaction costs and fees on initial recognition because it may result in significant capital gains tax issues reported to the ATO, and may negatively impact the net results of the year of acquisition of the financial instrument. Staff understand this may relate to instances where the tax base of the financial instrument may be lower due to transactions costs being expensed immediately rather than included in the financial instrument measurement and amortised over the life. This may result in a larger difference between the tax and accounting value on sale of the instrument as the related transaction cost would have been considered earlier (i.e. timing difference); and

(c) not permitting hedge accounting may disadvantage smaller NFPs entities from applying the accounting policy choice compared to Tier 1/Tier 2 entities and, while uncommon, some smaller NFP entities operating overseas utilise forward contracts concerning future cash outflows and should be allowed hedge accounting policy. In addition, a few stakeholders that disagree questioned whether an entity that is required to apply Tier 2 requirements where hedge accounting would be available for complex financial instruments contradicts the Board's proposal not to permit hedge accounting.

40 As per paragraph 29 above, findings from Research Report 19 showed financial instruments less commonly held by Tier 3 sized charities were financial assets through profit and loss (1.54%), financial assets at fair value through other comprehensive income (1.54%) and financial assets held at amortised cost (1.92%). This may indicate that smaller NFP entities are equally likely to subsequently measure changes in fair value through profit or loss and other comprehensive income. The research findings did not indicate that any reviewed charities applied hedge accounting. Also, the research did not review accounting policies nor the effect of materiality when identifying common financial statement items and, therefore, staff cannot make any assessment whether transaction costs would be significant or common for the reviewed charities.

41 Further feedback was sought from the NFP PAP members. They provided the following feedback:

(a) A majority of members supported an accounting policy choice to be provided to Tier 3 entities to account for the changes in fair value through either fair value or other comprehensive income because:

(i) many NFP entities may already be applying AASB 9 and measuring changes in fair value via profit or loss, and mandating fair value through other comprehensive income may unintentionally put more weight in requiring the statement of changes in equity for Tier 3 entities;

(ii) accounting policy choice would cater to those members that supported for changes in fair value through profit or loss and those members that supported changes through other comprehensive income;

(iii) while accounting policy choice may impact comparability, the Tier 3 proposals already allow an accounting policy choice in many other requirements; and

(iv) the proposal not to allow recycling of other comprehensive income to profit or loss (if changes in fair value must go through other comprehensive income) would not be preferred by entities with significant investment balances that forms a significant portion of their income.

(b) The IASB's *Primary Financial Statements* project may address the concern of those stakeholders that prefer changes via other comprehensive income to separate the presentation from the entity's operating profits. Otherwise, another option relating to the presentation of other comprehensive income is to allow Tier 3 entities to present a separate

section below the statement of profit or loss to present information about other comprehensive income.

(c) One member queried whether financial assets held to generate both income and capital return should be referred to as held for trading instead. Their concern stems from the accounting of unlisted equities that would be subject to fair value measurement and many smaller NFP entities may default to measuring unlisted equity at cost (given the DP states that cost may be an appropriate estimate of fair value for unlisted equity instruments in some circumstances).

(d) A member noted that while there was strong support from the survey results that agreed with the DP proposals, in many of those cases, the matter may not be relevant to the stakeholder completing the survey. Caution needs to be exercised when considering the stakeholder feedback.

(e) Only one member did not support allowing an accounting policy choice as it would impede comparability amongst Tier 3 entities.

Staff analysis and recommendation

42 After staff have considered the approach to simplification applied by the Board in Appendix A of Agenda Paper 5.1 for this meeting, the stakeholder feedback from the DP, findings from Research Report 19 summarised in paragraphs 38 – 40 above, and further feedback from NFP PAP members, the following matters need to be considered further:

(a) subsequent measurement of financial assets held for capital return and income (paragraphs 43 – 48);

(b) accounting for transaction costs and fees on initial recognition (paragraphs 49 – 52); and

(c) application of hedge accounting (paragraphs 53 – 59).

<u>Subsequent measurement of financial assets held for capital return and income</u>

43 As per paragraph 5.92 of the DP, the Board decided to require basic financial assets that are held to generate both income and capital return to be measured at fair value through other comprehensive income because:

(a) it acknowledged that the entity's primary interest in holding these financial assets is to obtain a periodic return to fund the entity's NFP activities rather than to generate capital gains; and

(b) keeping the fair value gains and losses on financial assets outside the profit or loss separates the entity's 'non-operating' activity gains and losses from its operating activities. This distinction may provide less sophisticated users with more understandable information.

Other than dividends and interest return, all gains and losses on the financial asset are recognised outside the profit or loss. This includes crystalised gains and losses on the sale or disposal of the financial asset (i.e. amounts recognised in other comprehensive income are not ‘recycled’ on sale of the financial asset).

44 In addressing the comment from one panel member whether the subsequent measurement at fair value should apply to instruments held for trading (instead held for capital and income return) to avoid abuse of the cost as measurement basis for shares, units and other investments, staff note the following:

(a) the feedback informing the Board in developing the DP (such as on ITC 47) or on the DP itself did not identify concern with existence of the fair value subsequent measurement category (paragraph 5.87 of the DP);

(b) the Board noted in the DP that this category aims to capture the instruments for which the principal is or may be subject to loss (paragraph 5.91 of the DP);

(c) the Board determined its preliminary views on the subsequent measurement approach also with the aim to remove the degree of judgement required to assess the business model, and observed that smaller NFP private sector entities are less likely to hold financial assets for trading purposes (par. 5.95 of the DP); and

(d) the Board expressed its preliminary view in the DP that it expects that entity's unlisted share investments would be measured at fair value and that it does not intend to extend the instances for which the cost of a financial instrument provides an appropriate estimate of its fair value beyond those currently available in Tier 1, as doing so may misrepresent the item to users of the financial statements.

Therefore, whilst acknowledging that Tier 3 will allow for judgement applied, for example, to determine whether government bond or corporate bond are held for capital return, in staff opinion, it is not necessary to change the preliminary views in the DP in respect of subsequent measurement at fair value and linking to trading intent to avoid abuse of the measurement at cost as approximation of fair value.

45 Considering the approach to simplification applied by the Board in Appendix A of Agenda Paper 5.1 for this meeting, feedback on the DP and panel member comments in paragraph 41 , staff think an alternative approach to the proposals in the DP is to allow Tier 3 entities an accounting policy choice to elect to subsequently measure financial assets held for capital and income at fair value either through profit or loss or other comprehensive income.

(a) Arguments supporting this approach are:

(i) it addresses the concerns of few stakeholders who prefer fair value through profit or loss for those preparers and users who lack understanding of what other comprehensive income is;

(ii) it allows flexibility for management to present the gains or losses with the information management uses;

(iii) entities would not be required to isolate the accrued interest from net change in the fair value for entities that elect for fair value through profit or loss;

(iv) the comparability with Tier 2 requirements could be maintained to some extent given many Tier 2 entities would measure the changes in fair value through profit or loss;

(v) reconciling the reserve on fair value through other comprehensive income is an area where NFP entities commonly make an error;

(vi) NFP entities that have managed investment schemes are required to measure changes in fair value through profit or loss based on AASB 9. As such, it appears some entities would rather measure changes in fair value for their whole investment portfolio through profit or loss as it would be more complex to separate the investments that would be measured through other comprehensive income from those through profit or loss.

(vii) many Tier 3 entities would lack the understanding of what is other comprehensive income;

(viii) while accounting policy choice may impact comparability, the Tier 3 proposals already allow an accounting policy choice in many other requirements; and

(ix) the proposal not to allow recycling of other comprehensive income to profit or loss (if changes in fair value must go through other comprehensive income) would not be preferred by entities with significant investment balances that forms a significant portion of their income.

(b) Arguments against this approach are:

(i) this approach would reduce comparability by allowing an accounting policy choice and no other selected other jurisdictions allow for the choice;

(ii) as noted in paragraph 5.89 of the DP, under AASB 9, debt instruments such as government bonds (but not units in a unit trust) may be measured at fair value through other comprehensive income, rather than at amortised cost, provided certain conditions are met. Similarly, equity instruments such as shares may qualify to be measured at fair value through other comprehensive income and entities would generally make this irrevocable election. Also, the Board noted in par. 5.95 in the DP that smaller NFP private sector entities are less likely to hold financial assets for trading purposes. Rather, these assets are more likely to be primarily held to create a stable passive income stream to help fund the ongoing activities of the entity, which would not imply the recognition of the fair value changes in the profit or loss as the most appropriate for these entities;

(iii) whether the fair value is accounted for through profit or loss or other comprehensive income is more related to the location where the information is presented within the financial outcomes. Therefore, requiring fair value through other comprehensive income may provide, as noted in paragraph 43(b), less sophisticated users with more understandable information; and

(iv) as outlined in Agenda Paper 5.2.2 at the May 2022 meeting, in addition to the arguments noted in paragraph 43, the Board decided to required financial assets held to generate both income and capital investment return to be measured at fair value through other comprehensive income because a majority of stakeholders during preliminary outreach have indicated preference for being able to recognise all financial investments gains and loss in other comprehensive income rather than as part of the profit or loss.

46 On balance, staff recommend allowing an accounting policy choice for financial assets held for capital and income to be subsequently measure at:

(a) fair value through profit or loss; or

(b) fair value through other comprehensive income

based on the arguments presented in paragraph 45. Staff think this approach would address most stakeholders concerns and be the simplest approach for Tier 3 entities.

47 Staff noted that a sub-option is to align with the Tier 2 requirements to only allow an entity to make an irrevocable election to present in other comprehensive income changes in the fair value of an investment in an equity instrument rather than for all financial instruments.[9] This would limit the accounting policy choice provided to Tier 3 entities to only those financial assets held for capital and income that are not equity instruments and may reduce inconsistency. However, this sub-option may add another layer of complexity to require an entity to separate equity instruments from other financial assets held for capital return and income.

48 In relation to panel members' feedback that the IASB's Primary Financial Statement project may address the presentation concerns to separate changes in fair value from the entity's operating

9 Paragraph B5.7.1 of AAAB 9 permits an entity to make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the scope of AASB 9 that is neither held for trading nor contingent consideration recognised by an acquirer in a business combination in which AASB 3 *Business Combination* applies.

profits, staff's initial thinking is not to incorporate any presentation changes that may be introduced in the IASB's Primary Financial Statements project to apply in the Tier 3 Standard because:

(a) it may introduce more complexity for Tier 3 entities when the Board has not yet considered whether any changes should be introduced for Tier 1 or Tier 2 entities; and

(b) based on DP feedback presented in Agenda Paper 3.1.1 at the May 2023 Board meeting, most stakeholders supported for consistency with AASB 1060 *General Purpose Financial Statements – Simplified Disclosures for For-Profit and Not-for-Profit Tier 2 Entities* for presentation of financial statements. As noted in DP paragraph 5.23, adopting the existing Tier 2 requirements would limit the need for preparer to change its existing practice.

Staff will consider the presentation requirement when discussing the Tier 3 requirements of primary financial statements at a future Board meeting.

Question 1c: Do Board members agree with the staff recommendation in paragraph 46, for the purpose of drafting the Tier 3 ED, to allow an accounting policy choice for financial assets held for capital return and income to be subsequently measured at:

(i) fair value through profit or loss; or

(ii) fair value through other comprehensive income.

If not, what does the Board suggest?

Accounting for transaction costs and fees on initial recognition

49 As per paragraph 5.85 of the DP, the Board has formed a preliminary view to require the entity's directly attributable transaction costs and fees to acquire a financial asset or assume a financial liability to be immediately expensed. The Board made this decision considering that the relative amount of transaction costs would generally be insignificant to the financial statements. Requiring these costs to be immediately expensed eliminates costs of identifying, monitoring and amortising the costs while being unlikely to result in any material misrepresentation of the financial instruments.

50 Based on feedback from the DP noted in paragraph 39(b), there are a few stakeholders that prefer the current requirements to require any directly attributable transaction costs to be included as part of the initial measurement of a financial asset or financial liability using the effective interest method to be amortised as interest income/expense over the life of the instrument, similar to the requirements in IFRS 9 for the assets measured at amortised cost and at fair value through other comprehensive income.

51 Further feedback from PAP members indicated that, even though one member considered including transaction cost as part of the financial instruments (i.e. capitalising the cost) would be simple, they agreed with all other panel members with the arguments supporting the DP proposal to require transaction cost to be expensed immediately.

52 The Board considered immediately expensing transaction costs of a financial asset and financial liability in the period the costs are incurred would reduce preparer costs without any significant loss of useful information to users of Tier 3 financial statements or material misrepresentation of financial statements over the life of the related financial instrument. As such, staff recommend continuing to require entities to immediately expense attributable transaction costs and fees. Staff noted that the view of stakeholders that did not support expensing transaction costs and fees on initial recognition should not result in a change of the preliminary Board's view because:

(a) for the few stakeholders that consider there would be significant capital gains tax issues reported to the ATO – as mentioned in Agenda Paper 3.1.1 at the May 2023 Board meeting, staff do not expect widespread and common significant capital gain tax issues would arise from expensing transaction costs, unless a smaller entity acquires significant quantities of

financial instruments giving rise to significant transaction costs. Findings from Research Report 19 did not indicate capital gain tax as a common material issue for smaller NFP entities, and tax expenses were not identified as a common transaction as it would be expected that the majority, if not all, of NFP operations would not be subject to income tax. Staff also consider financial statements are prepared for different purposes to tax information; and

(b) It may negatively impact the net results of the year of acquisition of the financial instrument – as noted in paragraph 52(a), staff do not expect smaller NFP entities would acquire significant quantities of financial instruments giving rise to significant transaction costs, especially based on findings from Research Report 19 where the most common financial instruments for Tier 3-sized charities are cash and cash equivalents, trade and other receivables and term deposits, etc. As such, as outlined in Agenda Paper 5.2.2 at the May 2022 Board meeting and feedback from a written responses on the DP, staff consider that it may be the case that the practice of at least some Tier 3 entities is already consistent with immediately expensing transaction costs and might be accepted on the basis for materiality by auditors.

Question 1d: Do Board members agree with the staff recommendations in paragraph 52, for the purpose of drafting the Tier 3 ED, to proceed with the Board's proposal in the DP to requiring transaction costs of a financial asset and financial liability to be expensed immediately in the period the costs are incurred?

If not, what does the Board suggest?

Application of hedge accounting

53 As per paragraph 5.81 of the DP, the Board has formed a preliminary view not to allow hedge accounting as an accounting policy choice as part of its Tier 3 reporting requirements because:

(a) retaining the hedge accounting requirements from AASB 9 and AASB 139 would not be consistent with its objectives in developing Tier 3 reporting requirements as a proportionate response for smaller NFP private sector entities; and

(b) hedge accounting is unlikely to be a practice adopted by many smaller NFP private sector entities. Consequently, the Board thinks it is unnecessary to direct its resources to developing simpler conditions for hedge accounting, as it is unlikely to have widespread use.

54 Based on the Board's preliminary views, derivative financial instruments would be measured at fair value while gains and losses on the instrument would be recognised as they arise in profit or loss over the life of the instrument.

55 Further feedback sought from panel members indicated that they all supported for hedge accounting not to be permitted for entities applying the Tier 3 Standard.

56 Based on the feedback, staff recommend that hedge accounting should not be permitted within the Tier 3 Standard because most stakeholders, including those that disagree, consider hedge accounting would be uncommon for smaller NFP entities. This approach would keep the Tier 3 Standard simple and aligns with the Board's view that NFP entities with complex financial instruments would be required to apply Tier 1/Tier 2 requirements.

57 Staff noted the feedback in paragraph 39(c) whether requiring NFP entities with complex financial instruments such as interest rate swaps and other derivatives to apply AASB 9 could make hedge accounting applicable, given Tier 2 requirements allow an entity the accounting policy choice to apply hedge accounting. Such a decision may contradict the Board's preliminary view not to permit entities to apply hedge accounting within the Tier 3 Standard. To address this concern, staff recommend clarifying that hedge accounting would not be permitted for Tier 3 entities including when applying requirements in AASB 9 for any complex financial instruments. Staff are of the view that a Tier 3 entity can choose to apply the Tier 2 requirement in its entirety if it wishes to apply

hedge accounting. Staff will also consider whether any transitional requirements, such as grandfathering if an entity is already applying AASB 9, at a future meeting.[10]

58 Staff noted other alternative approaches, such as:

(a) permitting hedge accounting and requiring hedged items, even if they fall within the list of basic financial instruments, to be accounted for in accordance with AASB 9; or

(b) to require all financial instruments to be accounted for in accordance with AASB 9.

However, staff recommend the Board not to consider these approaches further because staff think that including a hedge accounting requirement would not add value compared to simply allowing accounting policy choice to apply hedge accounting, they would increase complexity of the Standard and staff do not expect many Tier 3 entities to apply hedge accounting. The Board also decided at its September 2023 meeting to refer entities to apply Tier 2 requirements for complex financial instruments.

59 Staff also noted other feedback from the DP requesting more guidance, such as:

(a) the disclosures that would be useful for basic and complex financial instruments, especially where financial assets that are donated rather than acquired and the transaction price may not equal fair value, to ensure relevant information is made available to users;

(b) factors to determine whether or not an NFP controls a bank account held in trust;

(c) definitions of terms including simplification of terminology such as:

(i) on practical evidence of 'debtor's inability to pay' to enhance assurability of the proposals such as assessment of what is probable regarding collectability of the amount owed;

(ii) 'financial asset held to generate both income and capital return' as some instruments may initially be held to earn income only with the view to a capital return in the distant future or not at all (subject to the investment strategy);

(iii) 'otherwise loses control of the asset' in the context of when an entity derecognises a financial asset needed to avoid the risk of default interpretation using Tier 1 and Tier 2 requirements;[11]

(iv) 'initial premium or discount on acquisition' of basic financial instruments measured at cost that is required to be amortised over the expected life of the financial asset; and

(v) 'derecognition of financial instruments when the obligations specified in the contract either expired or were cancelled (forgiven)'.

Staff will address definitions and additional guidance as part of the drafting of the Tier 3 ED.

Question 1e: Do Board members agree with the staff recommendations in paragraph 56, for the purpose of drafting the Tier 3 ED, to proceed with the Board's proposal in the DP not to permit hedge accounting in the Tier 3 Standard, including for entities that are required to apply AASB 9 for complex financial instruments.

If not, what does the Board suggest?

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10 Refer to Agenda Paper 3.1 Project update and timeline for developing Tier 3 ED presented at the August 2023 Board meeting.

11 As noted in Agenda Paper 12.2.4 at the June 2022 Board meeting, the proposed derecognition principle broadly aligns with how NZ Tier 3 reporting requirements approach this topic. However, NZ Tier 3 reporting requirements describe the derecognition event (e.g. "the amount is collected or written off", "when sold, otherwise disposed of, or written off") rather than using the word "control".

Issue 2: Tier 3 requirements for employee benefits

Background

60 As detailed in paragraph 5.193 of the DP, the Board's preliminary view for Tier 3 reporting of employee benefits is for:

(a) non-accumulating paid absences and termination benefits to be recognised when the event occurs; and

(b) all other employee benefits, regardless of whether the entitlement is vesting or non-vesting, to be recognised when an employee has rendered the services which entitles the employee to consideration; where:

(i) an expense (unless capitalised) is measured at the undiscounted amount of the obligation to the employee; and

(ii) a liability is:

(A) recognised at the reporting date for the outstanding obligation owed, including reflection of the changes in the entity's expectations of future amounts payable, as part of the employee benefit expenses in the period of the change;

(B) measured at the undiscounted future outflow expected to be required to settle the present obligation; and

(C) presented as current or non-current depending on whether the service conditions are met or expected to be wholly met before twelve months after the end of the annual reporting period in which the employees render the related service.

61 The Board decided to gather feedback on whether guidance or support could be developed for preparers representing deemed likelihood of employees becoming entitled to an employee benefit (e.g. long service leave) based on any industry-specific probability guidance.

62 Paragraph 5.200 of the DP outlines the Board's view not to develop any other special requirements for accounting for termination benefits and defined benefit plans.

63 To gather feedback on the Board's proposal, the DP included the following questions:

Question 43
Paragraphs 5.189 to 5.199 discuss the Board's preliminary view that employee benefits expenses are measured at the undiscounted amount of the obligation to the employee for:
(a) non-accumulation paid absence and termination benefits when the event occurs; and

(b) all other employee benefits when an employee has rendered the services that entitles the employee to consideration.

A provision for employee benefit is measured at the undiscounted future outflow expected to be required (including consideration of future pay increases) to settle the present obligation.

The Board has not yet determined the form of guidance to be developed to support preparers in determining the likelihood that an outflow of economic benefits will be required to settle these obligations.

Do you agree? Why or why not? If you disagree with the Board's view, do you prefer other alternatives, for example, Tier 3 requirements should require future outflows of employee benefit expenses to be discounted? Please specify and explain why.

Are you aware of any industry-specific probability guidance that relates to employee benefits such as a long service leave? Please specify the source of that guidance.

Question 44

Paragraph 5.200 discusses that the Board has not developed any other special requirements for accounting for termination benefits and defined benefit plans.

Do you agree? Why or why not? If you disagree with the Board's view, do you prefer other alternatives? Please specify and explain why.

Summary of feedback on DP and further stakeholder outreach

64 As presented in Agenda Paper 3.1.1 at the May 2023 Board meeting, almost all stakeholders (91%) including most of those that provided a written response (8 written responses) agree with the Board's preliminary views and support that guidance on determining the probability of long service leave should be included in Tier 3 requirements. While stakeholders did not identify any industry-specific guidelines they currently follow, a few stakeholders consider that probability calculation could be simplified for smaller NFP entities by reflecting 100% probability:

(a) in year one; or

(b) after an employee is 50% on the way to vesting.

65 Almost all these stakeholders also supported not including accounting for termination benefits and defined benefit plans, given these are uncommon for smaller NFP entities. However, one stakeholder noted that recent legislative changes in the *Fair Work Act 2009* have converted some eligible casual employment to permanent part-time and full-time status, which could increase the likelihood of termination benefits being recognised in the future.

66 However, a few stakeholders (7%) including a few written responses (2 comment letters) disagree with some aspects of the DP proposal including:

(a) for non-vesting personal leave, such as sick leave, the few stakeholders consider the current practice is not to record personal leave as entitlement increases year on year on a group basis. Therefore, AASB should consider the default of not recording such leave other than in certain circumstances (e.g. where the above fact pattern does not occur);

(b) not using future outflow expected to be required in calculating the provision of employee benefits because it may increase the complexity of the requirements; and

(c) a stakeholder considers all NFP entities should apply the same accounting requirements consistent with other entities while another stakeholder considers entitlement would be better dealt via a 'sinking fund' provision.

67 Additionally, some stakeholders highlighted the need for further guidance on:

(a) portable long service leave schemes provided in Victoria and Queensland amongst the health sector may need further consideration;

(b) the accounting for on-cost as it is an ongoing issue; and

(c) whether future outflow expected is an inflation-adjusted value and whether an adjustment is required for such inflation.

68 Findings from Research Report 19 showed that long service leave provisions (52.69%) and annual leave provisions (including holiday leave) (51.92%) were identified as common liabilities amongst Tier 3-sized charities. The research findings also identified other types of employee benefits provisions that were less common such as personal leave provisions including sick leave provisions (5.77%) and other various types of leave (6.51%).[12]

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12 Various other types of employee benefit provisions are made up of time in lieu (1.92%), staff bonuses (0.38%), enterprise bargaining agreements (0.38%), redundancy entitlements (0.77%), exempt fringe benefit accounts (0.38%); overtime accrued (0.38%), termination (0.38%) and other types of provisions of employee benefits without details (1.92%).

69 Further feedback was sought from the NFP PAP members. They provided the following feedback:

(a) All members supported not to require entities to recognise any provision of any non-vesting accumulating employee benefits with one member noting it was confusing to require a provision for personal leave where it is rare for these types of leave to be paid out.

(b) All members agreed for a provision for employee benefits to be measured at the undiscounted future outflow expected to be required without considering any future pay increases, to settle the present obligation.

(c) All members agreed not to include guidance within the Tier 3 Standard on the following specific areas:

(i) Probability assessment guidance such as rebuttable presumption or practical expedient could become outdated and may not factor in changes in the workforce. Long service leave that is not portable, will reduce over time as the workforce changes. As such, setting a probability assessment within the standard that is not based on the entity's facts and circumstances can create unintended consequences (e.g. disagreements with auditors) and may result in inflated provisions over time.

(ii) There may be diversity in practice for the accounting of portable long service leave but this is not confined to Tier 3-sized entities and would be also relevant to larger NFP entities. In addition, the diversity in practice stems from different requirements in legislation between states. As such, members appreciate that no specific guidance should be included within the Tier 3 Standard given there is no simplification applicable to smaller NFP entities. However, they suggested whether the AASB could explore developing an FAQ or similar educational material, to address the accounting for portable long service leave.

(iii) While on-cost is not specific to smaller NFP entities, members noted that there is a lack of understanding for smaller NFP entities when on-cost should be included as part of employee benefits. An example provided was whether annual leave provisions should include superannuation or Workcover, and there may be disagreements between the auditor and management on how this is accounted for. Members consider an illustrative example would be helpful for smaller NFP Entities to at least raise awareness that entities need to consider on-cost when considering employee benefits, rather than developing specific guidance on the accounting for on-cost within the Tier 3 Standard.

Matters to be addressed

70 Based on the feedback in paragraphs 64 – 69, staff noted stakeholders generally agree with the Board's preliminary views to require employee benefits provision to reflect the probability of future outflow expected to be required to settle the present obligation and are consistent with the feedback that entitlement is better dealt with via a sinking fund provision to ensure entities have sufficient funds to meet these expected employee benefit payments.

71 Only a few stakeholders expressed concerns that staff summarised in the three accounting matters below that the Board may need to consider in relation to the Tier 3 requirements for employee benefits:

(a) **Matter 1:** recognition of personal leave provisions (paragraphs 72 – 76);

(b) **Matter 2**: requirement to consider future outflow expected to be required in calculating provisions of employee benefits (paragraphs 77 – 80); and

(c) **Matter 3**: development of guidance on (paragraphs 81 – 89):

(i) the probability assessment in calculating long service leave provisions;

(ii) portable long service leave; and

(iii) accounting of on-cost.

Matter 1: Recognition of personal leave provisions

72 When developing its proposals for the DP in Agenda Paper 11.3 at the February 2022 meeting, the Board decided to maintain the current recognition requirement for short-term paid absences, with a simplified measurement of treating all short-term paid absence obligations without discounting for the time value of money. For non-vesting accumulated entitlement such as sick leave, an entity would be required to measure the expected cost of accumulating paid absences as the additional amount that the entity expects to pay as a result of the unused entitlement that has accumulated.

73 Staff also noted in footnote 4 in Agenda Paper 11.3 at the February 2022 meeting that in Australia, there's an understanding that most employees are entitled to accumulating and non-vesting sick leave and generally do not exceed their sick leave entitlements in any one reporting period. As a result, sick leave entitlements are generally not recognised as a liability but recognised as an expense when taken by the employee.

74 As such, an alternative approach to the DP proposals and further simplification is not to require an entity to recognise at the reporting date for the entity's expectations of future amounts payable for any non-vesting accumulating employee benefits (e.g. sick leave), except for any amounts that are due (i.e. the employee has taken sick leave) and unpaid to an employee at the end of the reporting period. This approach would:

(a) address the few stakeholders' concern noted in paragraph 66(a) that sick leave provisions are not recorded, which aligns with the staff understanding in paragraph 73 that it may be not uncommon not to record provisions for personal leave entitlements;

(b) further simplify the requirements to not require the consideration of the expected cost of accumulating paid absences if it is generally expected that employees do not exceed their sick leave entitlements in any one period, that is, the expectation would be 0% resulting in the same outcome as not recording personal leave entitlements; and

(c) is supported by all panel members as noted in paragraph 69(a) above.

75 However, such an approach may result in understating liability in scenarios where employees may be expected to take additional sick leave in excess of their sick leave entitlements in a reporting period. This scenario may not be as uncommon, as indicated in Agenda Paper 11.3 at the February 2022 meeting where an academic study noted the impacts of COVID-19 on sick leave and annual leave are increasingly cumulative and constitute material amounts.[13] In addition, entities will need to differentiate employee benefits that are non-vesting compared to the DP proposals which require all other accumulating employee benefits to be accounted for in the same way as outlined in paragraph 60(b).

76 On balance, staff recommend that the Tier 3 requirement should not require entities to recognise any provision/liability of any non-vesting accumulating employee benefits unless amounts are due and unpaid to an employee. Staff think this approach would be a proportionate approach for Tier 3 entities and provides clear direction to these entities without altering their existing common practice of not recording sick leave provisions.

Question 2a: Do Board members agree with the staff recommendations in paragraph 76, for the purpose of drafting the Tier 3 ED, to not require entities to recognise any provision of any non-vesting accumulating employee benefits unless amounts are due and unpaid to an employee?

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13 Gilchrist, J.D., West, A., and Zhang, Y. (2021), *Decision Usefulness: A re-examination of the information needs of non-profit GPFR users*, working paper, presented at the AASB 2021 Research Forum, https://aasb.gov.au/media/5oelznke/rf2021-gilchrist_et_al_decisionusefulnesspaper.pdf

If not, what does the Board suggest?

Matter 2: Requirement to consider future outflow expected to be required in calculating provisions for employee benefits

77 As per paragraph 5.196 of the DP, the Board decided that the proposed liability measurement requires an entity to consider future pay increases and the likelihood that an outflow would be required to settle the obligation. The Board considered it would not be a faithful representation of measuring employee obligations if the liability ignores the uncertainty of achieving the entitling event. As such, staff do not think it would be unreasonable to require an entity to consider future pay increases.

78 However, in light of the feedback that some NFP entities may consider it difficult to reflect salary increases when estimating future cash outflows, an alternative approach is not to require the consideration of future pay increases for provision of employee benefits. Staff also noted that the IASB staff recommended to the IASB in staff paper 30B for November 2023 meeting, albeit specifically in relation to defined benefit plans, to retain the simplification in IFRS for SMEs not to include estimated future salary increases and to clarify that the obligation is not discounted.. This approach:

(a) would be simplest to apply with no interpretation ambiguity and not require staff and Board time to provide the clarification of an expected salary increase when estimating future cash outflows noted in paragraph 66(b);

(b) would largely negate any future pay rises such that the present value of the obligation and its undiscounted amount are not significantly different as noted in paragraph 5.194 of the DP. This would ensure the provisions are not, to a certain extent, inflated by factoring in future pay increases without requiring discounting of those provisions to present values; and

(c) is supported by all panel members as noted in paragraph 69(b) above.

79 Arguments against this alternative approach are:

(a) it is not expected to be overly complex to determine future pay increases especially if they are set out in formal terms of a plan or legislation; and

(b) reflecting an estimate of future pay increases takes account of inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market as per paragraph 90 of AASB 119. Not requiring expected future outflow may not address a stakeholder concern whether future outflow expected is an inflation-adjusted value.

80 On balance, staff recommend the Tier 3 requirements for a provision for employee benefits to continue to be measured at the undiscounted future outflow expected to be required but not require the consideration of future pay increases to settle the present obligation based on the reasons highlighted in paragraph 78.

Question 2b: Do Board members agree with the staff recommendation in paragraph 80, for the purpose of drafting the Tier 3 ED, for a provision for employee benefits to continue to be measured at the expected undiscounted future outflow but not require the consideration of future pay increases to settle the present obligation?

If not, what does the Board suggest?

Matter 3: Development of guidance on (i) the probability assessment in calculating long service leave provisions, (ii) portable long service leave, and (iii) accounting of on-cost

(i) Probability assessment in calculating long service leave provisions

81 As highlighted in paragraph 64, almost all stakeholders supported the development of guidance for calculating probability assessment of the entitling events, particularly for long service leave. However, there was no industry-specific probability assessment identified from the feedback on the DP.

82 Given there were no industry-specific probability identified, staff do not recommend the Board to consider including a rebuttable presumption or practical expedient within the Tier 3 requirements because:

(a) there are different state/territory laws or industrial instruments (such as an award or agreement), that entitle an employee to long service leave after a period of continuous service ranging from 7 to 15 years.[14] As such, it would be difficult to enable a common probability assessment to apply to meet the different circumstances of the entity;

(b) determining probability assessments is subjective and determined based on facts and circumstances with reference to prior experiences and future expectations within the organisation and industry;

(c) no framework or pronouncement of the selected other jurisdictions provides a rebuttable presumption or similar in assessing employee benefit provisions;

(d) a few stakeholders suggested a few examples of a probability assessment being applied currently by some NFP entities (e.g. probability at 100% on year 1 or when an employee is 50% on the way to long service leave being vested). Staff suggest these scenarios be included as illustrative examples instead given these scenarios would not be expected to meet every NFP entity's needs and circumstances;

(e) while there may be some long service leave probability assessments published publicly, they are generally applicable for universities or the public sector.[15] Staff do not think it would be an appropriate resource for NFP private sector entities. Staff expect the employee retention level would generally be higher resulting in different probability assessment; and

(f) as indicated by panel members in paragraph 69(c)(i) above, setting a probability assessment within the standard that is not based on the entity's facts and circumstances can create unintended consequences (e.g. disagreements with auditors) and may result in inflated provisions over time.

83 However, staff acknowledge that many stakeholders supported developing some form of guidance that would be useful to preparers. Therefore, as per staff suggested actions for next steps outlined in Agenda Paper 3.1.1 in Appendix A at the May 2023 Board meeting, staff consider developing illustrative examples of how an entity can factor in a probability assessment (without providing any actuarial calculations) for long service leave calculations would be useful.

(ii) Portable long service leave

84 Portable long service leave is provided to employees in some Australian states and territories in the security, community services, building and construction, coal mining and contract cleaning industries. Where portable long service is available, an employee is able to keep their long service leave entitlements if they work on different projects for one or more employers.[16] Employers of the

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14 Refer to Fair Work Ombudsman website: https://www.fairwork.gov.au/tools-and-resources/fact-sheets/minimum-workplace-entitlements/long-service-leave#minimum-entitlements

15 Refer to Fact Sheet 30 June 2022 providing standard parameters to be used by Commonwealth entities, published by the Department of Finance. Business Queensland website provides a table to calculate long service leave entitlements and pro-rata long service leave payable on termination of employment.

16 Refer to Fair Work Ombudsman website: https://www.fairwork.gov.au/leave/long-service-leave#portable-long-service-leave

departed employee may still be required to pay long service leave to its departed employee who can access portable long service leave but they may be able to recover some of the costs from the relevant portable long service leave authority.

85 A few stakeholders highlighted that portable accounting for long service leave is often an issue in the NFP sector and requested that the Tier 3 Standard include guidance in this area. However, staff do not recommend including guidance specifically in the Tier 3 Standard on portable long service leave because:

(a) portable long service leave is not unique to smaller NFP entities and would impact larger NFP entities and even for-profit entities as noted by panel members in paragraph 69(c)(ii). Staff do not consider portable long service leave arrangements would be common especially amongst smaller NFP entities given it is only applicable in certain states and territories and industries. Adding guidance would make the Tier 3 Standard longer and may detract/confuse entities that would not need to consider these arrangements;

(b) there is already some industry guidance accessible freely that entities could refer to; and

(c) the feedback request for guidance on portable long service leave does not appear to relate to the application of the accounting standards, but rather the need to consider the legislative requirement when accounting for these leave arrangements. As such, staff do not think it should be addressed by the accounting standards.

(iii) On-cost

86 The Board previously discussed whether to include on-cost[17] as part to the Tier 3 requirements in Agenda Paper 3.2.2 at its August 2022 Board meeting and decided not to develop guidance for on-cost as part of a Tier 3 accounting standard because providing guidance could contradict the Board's policy of not interpreting IFRS, as there is no proposed difference between Tier 2 and Tier 3 reporting requirements on the definition of employee benefits.

87 A few stakeholders provided feedback on the DP that accounting for on-cost is an ongoing issue, however, no further details were provided on what the specific issue is. However, based on initial outreach when developing the DP, staff have heard that the issue relating to on-cost stems from whether the on-cost should be accrued as part of long-service leave provisions given some on-cost is payable and some is not upon an employee resigning. There is also a need to determine the probability of employee resignation to determine the provision for employee on-cost.

88 Considering the feedback, staff noted alternative approaches the Board could consider include:

(a) whether to develop simplification for a Tier 3 requirement not to require the consideration of any on-cost, or accrue 100% of all on-cost, regardless of whether on-cost is payable upon an employee resigning or taking leave, as part of the provision of long-service leave; and

(b) to include guidance that was previously included in AAS 30 noted in footnote 17 to provide specific example for on-cost in the context of long service leave.

89 However, similar to staff not recommending the development of guidance for calculating probability assessment for long service leave provisions, staff continue to recommend not developing any specific guidance specifically for on-cost, based on similar reasons outlined in paragraph 82. Nevertheless, staff think application guidance or illustrative examples could be included in the Tier 3

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17 On-cost can include superannuation, payroll tax, worker's compensation premium, etc. Pre-IFRS, both AAS 30 *Accounting for employee Entitlements* (paragraph 12) and AASB 1028 (paragraph 4.1.3) provided a specific example for on-cost in the context of LSL that:
"*where the settlement of employee benefit liabilities, such as long service leave, gives rise to the payment of employment on-costs, such as payroll tax and workers' compensation insurance, a liability is recognised for those on-costs as well as for the employee benefits.*"

Standard to specifically mention on-cost to be considered when calculating employee benefit provisions as supported by panel members in paragraph 69(c)(iii) above.

Question 2c: Do Board members agree with the staff recommendations in paragraphs 82, 85 and 89, for the purpose of drafting the Tier 3 ED, not to develop any guidance on:

(a) probability assessment for long service leave provisions;

(b) portable long service leave; and

(c) employee on-cost provisions?

If not, what does the Board suggest?

Issue 3: Tier 3 accounting requirements for changes in accounting policies and accounting estimates and correction of prior period accounting errors

Background

90 As detailed in paragraphs 5.57, 5.60 and 5.61 of the DP, the Board's preliminary view is that the Tier 3 requirements for:

(a) voluntary changes to accounting policies and correction of prior period accounting errors to apply a modified retrospective approach, that is, not to require restating comparative information and making corresponding adjustment to the opening balance of each affected component of equity that period; and

(b) changes in accounting estimates to be accounted for prospectively.

91 The DP also provided an illustrative example in paragraphs 5.58 and 6.14 on the application of the disclosure approach to the changes in accounting policies and correction of errors to adopt the applicable disclosure requirements in NZ Tier 3 Standard and adjust for Australian Tier 3-specific circumstances. In particular, an entity shall disclose the following about prior period errors:

(a) a description of the error, including how the error occurred, and how it was corrected; and

(b) the line items and amounts that have been corrected.

92 To gather feedback on the Board's proposal, the DP included the following questions:

Question 19

Paragraphs 5.55 to 5.60 discuss the Board's preliminary view to develop a requirement for a modified retrospective approach to apply to changes in accounting policies and correction of accounting errors.

Do you agree? Why or why not? If you disagree with the Board's view, do you prefer other alternative requirements for changes in accounting policies and correction of accounting errors; for example, should Tier 3 accounting requirements continue to require the accounting treatment specified by AAB 108 to retrospectively reflect voluntary changes in accounting policies and correction of accounting errors? Please specify and explain why.

Question 44

Paragraph 5.61 discusses the Board's proposal to develop a requirement for changes in accounting estimates to be accounted for prospectively, consistent with AASB 108.

Do you agree? Why or why not? If you disagree with the Board's view, do you prefer other alternatives? Please specify and explain why.

Question 49

Paragraph 6.14 discusses the Board's preliminary view on the disclosure requirements for changes in accounting policies and correction of errors would be for:

(a) changes in accounting policies – develop fit-for-purpose disclosures based on AASB 1060 and removing non-applicable disclosures; and

(b) correction of errors – adopt New Zealand Public Benefit Entity* Simple Format Reporting – Accrual Not-for-Profit*.

Do you agree with the Board's preliminary view? Why or why not? If you disagree, do you prefer alternative disclosure requirements? Please specify and explain why.

Summary of feedback on DP and further stakeholder outreach

93 As presented in Agenda Paper 3.1.1 at the May 2023 Board meeting, most stakeholders (84%) agreed with the Board's preliminary proposals for:

(a) changes in accounting policies including most of those that provided a written response (11 written responses) agree with a modified retrospective approach;

(b) changes in accounting estimates including most of those that provided a written response (9 written responses) agree with a prospective approach; and

(c) correction of prior period errors but only minority of stakeholders that provided a written response (4 written responses) agreed with a modified retrospective approach; and

(d) welcomed the simplification not requiring adjusting prior period comparatives which would be clearer with adequate disclosures of how the accounting error occurred, would increase transparency and improve user understanding.

94 However, some stakeholders (13%) who were mostly auditors disagree mainly in relation to the accounting for correction of prior period errors including many stakeholders that provided a written response (6 written responses) because:

(a) adjusting the opening balance approach could produce misleading comparatives and obscure the current year operations in some situations, and correcting comparatives provides useful information to users that outweigh the associate cost, especially if the error is significant;

(b) there may be opportunities for management to manipulate financial reporting; and

(c) it may impact audit sign-off if a known error was not adjusted retrospectively and cause concern about whether the financial statements could provide a true view if the comparative information is known to be materially incorrect.

95 Almost all stakeholders (97%) including almost all written submissions (9 written submissions) supported the proposed disclosures for changes in accounting policies and correction of prior period accounting errors, except one written submission disagreed with the proposed modified retrospective approach, and therefore disagreed with the proposed disclosure. While one other written submission that supported the proposed accounting for correction of prior period accounting errors considered that the nature of the error should also be disclosed.

96 Research Report 19 showed that only two of the sampled charities presented prior period adjustments where one charity corrected the error by adjusting the opening balance of retained earnings and the reason for the area was disclosed in the notes to the financial statements. The other charity only presented "prior period adjustments" to adjust the specific line item in the current period and did not provide any details of the adjustment, or whether the comparative information was corrected. While ACNC charities' regulations require compliance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* as one of the six mandatory Australian Accounting Standards in the preparation of special purpose financial statements, the research

findings may suggest that charities may be applying a modified retrospective approach to correcting accounting errors.

97 Further feedback was sought from NFP PAP members. All members agreed with the proposal in the DP for the accounting of changes in accounting policies and estimates but disagreed with applying a modified retrospective approach to the correction of errors because:

(a) the DP proposals require users to refer to the notes to understand the error, and many users may not read the notes to the financial statements;

(b) not correcting a known error would be misleading to users;

(c) the nature of changes in accounting policy and correction of errors is different and warrants different accounting requirements. A known error should be corrected;

(d) it would be equally if not more efficient to correct the error rather than requiring entities to provide disclosures about the error in the notes to the financial statements; and

(e) even though the framework may allow an entity to apply a modified retrospective approach, there may be legislation that references a true and fair view, and it may be difficult for auditors to sign off that the financial statements meet a true and fair view if there is a known error not corrected.

Staff analysis and recommendation

98 Based on the feedback in paragraphs 93 – 97, staff noted that stakeholders generally agree with the Board's preliminary views to apply a modified retrospective approach for changes in accounting policies and a prospective approach for changes in accounting estimates. As such, staff analysis will only focus on the proposed accounting for correction of prior period errors.

99 When the Board was developing its proposals for the DP, the Board considered whether to align the existing Tier 2 requirements for the correction of prior period accounting errors, that is, apply full retrospective approach.[18] The Board noted that this approach aligns with the accounting requirements of the selected other jurisdictions and aligns with the feedback from those stakeholders that disagree with the DP proposal. As indicated by panel members in paragraph 97 above, other arguments supporting the application of the full retrospective approach to the correction of prior period errors include:

(a) it would provide faithful information to users who are likely to refer to the information on the face of the financial statements rather than the notes;

(b) it may not be as simple to require the proposed disclosures, and may be more efficient for preparers to correct the error and comparatives instead; and

(c) all panel members supported this approach.

100 Arguments to continue to apply the Board's proposal of a modified retrospective approach to correction of prior period errors, as detailed in paragraphs 5.56 – 5.58 of the DP, are because the approach strikes an appropriate cost-benefit balance for smaller entities and:

(a) while some feedback considers not correcting comparatives can obscure the current year operations in some situations and correcting comparatives provides useful information to users noted in paragraph 94(a), staff think the proposed disclosures should provide users with sufficient information that may be more useful to users. The proposal continues to distinguish the cumulative effects of transactions and events about a prior period from the impact of

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18 AASB 108 requires the retrospective approach to be applied for correction of errors, except to the extent that it is impracticable to determine the period-specific effects or the cumulative effect of the error.

transactions and events occurring in the current period so not to mislead users who may not regard such restatement as crucial;

(b) although there was feedback that it may provide opportunities for management to manipulate financial reporting noted in paragraph 94(b), previous stakeholder feedback suggests that incentivising wrong behaviour would most likely be attributable to Tier 1/Tier 2 entities than smaller NFP entities;[19]

(c) in relation to the possible impact on audit sign-off if a known error was not adjusted retrospectively as noted in paragraph 94(c), staff consider that if the applicable Financial Reporting Framework allows comparative information not to be restated, an auditor would provide assurance against the information presented in accordance with the applicable Framework, including assuring that comparatives are not required to be restated. Staff are also aware that a similar audit consideration already existing, as outlined in the AUASB Bulletin on the removal of special purpose financial statements for certain for-profit private sector entities. Paragraph 7 of the AUASB Bulletin discusses the auditor's responsibilities in relation to comparative information on the year of transition from SPFS to GPFS. Whilst it's relating to SPFS and transition requirements, the same can apply directly for not restating comparative amounts if such treatment is available under future Tier 3 requirements. That is, the objective is to obtain sufficient appropriate audit evidence about whether the comparative information has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable Financial Reporting Framework. Therefore, the auditor's objective is to assess whether the comparative information has been prepared and presented in accordance with the requirements (i.e. if there is a requirement to disclose the impact of not correcting comparatives for prior period errors); and

(d) in New Zealand's post-implementation review of its Tier 3 requirements, no feedback was received in relation to applying the existing modified retrospective approach on the correction of prior year accounting errors which is the same as proposed for the Tier 3 requirements.

101 On balance, staff recommend the Tier 3 requirements for the accounting for prior period accounting errors should require entities to apply a full retrospective approach, for reasons outlined in paragraph 99.

Question 3: Do Board members agree with the staff recommendations in paragraph 101, for the purpose of drafting the Tier 3 ED, to require a full retrospective approach to correction of prior period accounting errors.

If not, what does the Board suggest?

19 See NFP PAP minutes of meeting held on 20 September 2023.

Appendix A – Extract of the summary of detailed feedback presented in Agenda Paper 3.1.1 at the May 2023 Board meeting

Q21) Tier 3 Standard to develop simplified accounting for financial instruments that are common for smaller NFP entities and financial instruments that are more complex or uncommon to refer to AASB 9* Total response = 301	
Yes = 277 (92%) consisting of: • 53 preparers (18%) • 101 auditors (34%) • 5 users (2%) • 6 others (2%) • 106 virtual sessions (35%) • 6 written responses (2%) (PP, SD, IPA, UWA, Deloitte, ACNC) Not applicable = 14 (5%) consisting of: • 2 preparers (1%) • 1 auditor (0%) • 11 virtual sessions (4%)	Almost all stakeholders agree that the current requirements are too complex for smaller entities and that the proposals would standardise the reporting. A few stakeholders also noted: • it is rare to see financial instruments other than term deposits; • unearned income should be specifically disclosed (e.g. grant or service program funding received in advance); and • guidance on disclosures would be useful for the basic and more complex financial instruments. Other comments noted: • the boundary between 'basic' and 'complex' financial instruments will need to be clear to make it simple for smaller NFP entities to apply. All fair values should be recorded through OCI even for complex financial instruments where AASB 9 may require FVTPL to eliminate the need to consider the nature and purpose of the financial instruments (PP); and • guidance will need to be provided on the factors to consider in determining whether or not an NFP controls a bank account held in trust (MA).
No = 10 (2%) consisting of: • 1 preparer (0%) • 1 auditor (0%) • 4 virtual sessions (1%) • 4 written responses (1%) (MA, CPA/CA ANZ, DH, BDO) 38 (13%) respondents did not agree with the list and highlighted the following items they disagree with:	A few stakeholders disagree because: • directing entities to refer to Tier 1/Tier 2 requirements for complex financial instruments contradicts objective of the Tier 3 requirements to be a stand-alone standard and may lead to potential issue where AASB 9 and AASB 132 would be updated more frequently compared to Tier 3 requirements' proposed maintenance cycle (MA, DH); • AASB 9, AASB 132 and 139 can be challenging to apply and the AASB should aim to remove, as much as possible, the need to refer to Tier 1/Tier 2 for smaller NFP entities. *IFRS for SMEs* ED proposes removing option to opt up to IAS 39/IFRS 9. AASB should consider a similar approach to developing self-contained accounting requirements for financial instruments within Tier 3 Standard (CPA/CA ANZ); and • the appropriateness of using 'blunt instrument' such as the list of basic instruments to application of simplified accounting requirements is questionable. For example, certain units held in managed investment schemes, unit trust and similar other investment vehicles could contain embedded derivate and AASB 9 may be more appropriate. And some acquired equity

• purchased debt instruments such as listed corporate bonds and convertible notes = 19 (6%) • acquired equity instruments such as preference shares = 21 (7%) • financial guarantee contracts = 20 (7%) • interest rate swaps and forward exchange contacts = 14 (5%) • commitments to provide a loan at a below market interest rate = 26 (9%)	instruments such as preference shares may not contain any derivates features and simplified Tier 3 accounting for financial asset may be appropriate. An alternative approach for Tier 3 accounting could apply to distinguish whether an instrument contain complex features (such as conversion features or a derivatives). The Tier 3 standard could articulate the features that would distinguish a complex instruments from basic instrument to avoid a risk of entities acquiring (or, less likely, issuing) instruments with 'basic names' to be able to apply basic accounting, even if the features indicate the instrument is of a complex nature (BDO). Only a few stakeholders that provided comments disagree with the proposed list of complex financial instruments including: • unconditional bank guarantees (which may be a residential bond) may be a common instrument and would prefer guidance in Tier 3 rather than it being considered as complex financial instruments; • concessional loans are common in NFP sector and further research is encouraged to ensure that the list of basic financial instruments is as comprehensive as possible (CPA/CA ANZ); • a charity may receive preference shares (and potentially other equity instruments) as a donation or bequest and a guidance within Tier 3 Standard would be useful; • listed corporate bonds are very straightforward instruments and should be 'basic', hybrid securities usually have equity risk and should be accounted for similarly to ordinary shares (DH); and • a few NFP entities use interest rate swaps to manage interest rate risk. Measuring these at fair value is not appropriate for NFP entities as it is difficult to describe what this is and why the accounting is necessary to Boards and the members at AGMs. On the other hand, one stakeholder noted that if an NFP entity has complex financial instruments, it should not prepare financial statements using Tier 3 requirements.

Staff analysis: Although almost all stakeholders agree with the proposals to distinguish between basic and more complex financial instruments, staff think further consideration will be required to address some of the concerns noted in the feedback. In particular:

- if the Board decides to proceed with its preliminary view, the reasons, including the principles of the boundaries for basic and complex financial instruments, would be included in the basis for conclusions (staff note the feedback to the IASB on their proposed changes to the *IFRS for SMEs* may further inform the Board on this topic);
- regarding stakeholder concerns about referring to Tier 1/Tier 2 requirements for complex financial instruments is inconsistent with developing a stand-alone standard, staff noted that the Board rejected developing Tier 3 reporting requirements for financial instruments being wholly self-contained within a Tier 3 Standard. The Board considered an NFP entity that commonly holds 'more complex' financial instruments will not usually be the entity that should be preparing financial statements that comply with Tier 3 reporting requirements. The Board also considered that such an entity engaging in transactions or other events giving rise to holdings of complex financial instruments should be able to apply AASB 9. Agenda Paper 5.2.2 at the May 2022 Board meeting noted other supporting arguments to referring the application of AASB 9 or other Australian Accounting Standards for complex financial instruments, including:
  - facilitating consistency in accounting for more complex financial instruments; and

- costs are possibly largely once-off on initial application, unless the entity regularly enters transactions that are not' basic' financial instruments.

  As observed from RR19, the common types of financial instruments held by medium-sized charities were cash and cash equivalents, trade and other receivables (including accrued revenue), loan receivables (debt/bond) and term deposits. The less common financial instruments were equity investments, managed funds, financial assets held either at cost, fair value through profit or loss (FVTPL) or fair value through other comprehensive income (FVTOCI). As such, staff would not expect many smaller NFP entities hold complex financial instruments that would require to refer to Tier 1/Tier 2 requirements. However, staff note that the reasons for the IASB including the section 12 in the *IFRS for SMEs* and the feedback received on the currently proposed changes may further inform the Board in this regard.

- During its deliberations when developing its proposals, the Board also recognised that many smaller NFP entities would have difficulties identifying what assets/liabilities would fall within financial instruments and therefore proposed to develop the Tier 3 requirements by identification of instruments to provide clarity to Tier 3 preparers. Therefor staffs' preliminary view is that this would be an appropriate approach to develop the accounting requirements for basic financial instruments. However, there is also merit to explore other possible alternative approaches not yet previously considered by the Board based on the feedback provided or to supplement the list of the basic instruments with the underlying principles similarly to the conditions outlined in the *IFRS for SMEs*.

Staff will bring further analysis and possible options for the Board to consider at a future meeting whether the Tier 3 accounting requirements for financial instruments should:

- also include accounting for complex financial instruments within a Tier 3 Standard (as the Board did not make the decision in this regard) and whether to simplify accounting for them similarly to IFRS for SMEs;
- apply a different method to distinguish basic financial instruments for example where the basic instrument does not contain complex features (such as conversion features or other derivatives), and articulate in the Tier 3 requirements what features would distinguish a complex instrument from a basic one;
- proceed with the Board's preliminary view to only develop simplified accounting requirements for basic/common financial instruments in Tier 3 and require complex financial instruments to apply AASB 9 including how such requirements should be operationalised;
- include guidance for specific types of financial instruments such as bank accounts held in trust, bank guarantees, concessional loans, preference shares, listed corporate bonds and hybrid securities. Staff will consider findings from RR19 in this regard; and
- Develop application guidance and/or illustrative examples to address stakeholder concerns that guidance on disclosures would be useful for the basic and more complex financial instruments

Staff suggested action for next steps: Staff will bring **further analysis** and possible options for the accounting for basic and complex financial instruments and other issues identified in the analysis above for the Board to consider at future meeting.

Q22–27) Accounting for basic financial instruments*

Total response = 395

Respondents that did not highlight any issues with the proposals: 337 (85%) including 9 written submissions (PP, MA, CPA/CA ANZ, SD, IPA, UWA, DH, BDO, ACNC)	Most stakeholders support the proposed accounting for basic financial instruments specifically noting the following in relation to: • not separately recognising embedded derivate financial instruments that are not readily identifiable and measurable: • these instruments are unlikely held by most NFP entities. The level of complexity associated with financial instruments with embedded derivative requires reports prepared in accordance with current standards for those financial

	instruments and that there is little logic in reducing these requirements for Tier 3. If the entity is able to enter into these contracts, then it should be able to report them appropriately (UWA); • not aware of any clauses in contracts for smaller NFP entities that would give rise to embedded derivates, noting they may be not simple to identify (DH); and • smaller NFPs are not expected to have borrowings or enter into complex lease arrangements (BDO). • not permitted hedge accounting (including MA, PP, CPA/CA ANZ, IPA, DH, Deloitte, ACNC): • hedging activities are rare for smaller NFP entities and if such activities are present, it would be considered more appropriate to apply Tier 1/Tier 2 requirements (MA, ACNC); and • derivates would be scoped out of Tier 3 as complex financial instruments and AASB 9 accounting for derivatives (without hedge accounting) would apply, i.e. FVTPL (Deloitte). • initial measurement of financial instruments (MA, CPA/CA ANZ, SD, IPA, UWA, BDO, Deloitte, ACNC): • the proposals reflect the current practice and are accepted on the basis for materiality by auditors (MA); and • in circumstances where financial assets are donated rather than acquired and the transaction price may not equal fair value, additional disclosures should be developed to ensure relevant information is made available to the users (CPA/CA ANZ). • subsequent measurement of financial assets/liabilities (PP, CPA/CA ANZ, IPA, UWA, DH, BDO): • many smaller NFPs do not want fair value gains and losses impacting their 'normal' income/expense operating result. To further simplify, all changes in fair value should go through OCI irrespective of the requirements in AASB 9 (i.e. even if it requires fair value through profit or loss)) to eliminate the need for smaller NFPs to consider the nature and purpose of the financial instruments (PP); • government bonds under AASB 9 are measured at amortised costs, or sometimes at FVTOCI (with recycling) if held for sale (i.e. capital return) and similarly, Tier 3 should allow government bonds to be recognised at amortised cost or fair value (DH); • some NFP entities’ funding agreements include covenants with profit tests and subsequent measurement of financial instruments at FVTOCI can affect compliance with the covenants; • management prefers to separate fair value gains and losses from the entity's standard operations (unless the entity's operations are investment focused) to avoid volatility in the profit or loss. • impairment of financial assets (PP, MA, CPA/CA ANZ, SD, IPA, KPMG, UWA, DH, BDO, Deloitte): • guidance on practical evidence of debtor’s inability to pay would be required to enhance assurability of the proposals such as assessment of what is probable regarding collectability of the amount owed (MA); and

	• some NFP entities currently recognise the impairment loss on financial instruments using the incurred loss model for management reporting purposes as the model is more relatable to their business models with less judgement involved (KPMG, Deloitte).
	• derecognition requirements (PP, MA, CPA/CA ANZ, SD, IPA, UWA, DH, BDO, Deloitte):
	  • derecognition requirements proposed for financial liabilities clearly eliminate the complexity of Tier 1/Tier 2 requirements (MA, BDO); and
	  • smaller NFP entities are unlikely to have complex modifications of financial assets/liabilities (Deloitte).
	Other comments
	• A few stakeholders prefer a choice of FVTOCI or FVTPL because there are some NFP entities (and users of financial statements) that do not understand what OCI is. Some entities prefer accounting for the fair value gains/losses through OCI (e.g. if they hold investments as a source of other income) to avoid volatility in the profit or loss whilst others would prefer gains and losses in profit or loss if investing (and philanthropic distribution of the returns) is their main activity.
	• If Tier 3 allows opt up for complex financial instruments or by class of transaction basis, then the requirements may potentially conflict with not permitting hedge accounting requirements in Tier 3. For example, opting up by class of transaction basis would allow Tier 3 entities to apply hedge accounting under AASB 9, in addition requiring complex financial instruments such as interest rate swaps to apply AASB 9 would make hedge accounting available (CPA/CA ANZ, DH).
	• Definition of terms will be needed, for example whether initial premium or discount on acquisition is the difference between the fair value and face value for interest-free loans, or the difference between market value (purchase price) and par value for corporate bonds. Interest-free (i.e. concessionary loans) should be initially recognised at fair value, with the difference being recognised as a gain (loan payable) or a loss (loan receivable) in profit or loss (DH).
	• Tier 3 requirements need to clarify whether subsequent measurement at fair value through OCI permits (or not) recycling to profit or loss (DH).
	• Guidance may be required on what constitutes a financial asset held to generate both income and capital return as some instruments may initially be held to earn income only with view to a capital return in the distant future or not at all (subject to the investment strategy). A strict reading of the phrase 'both income and capital return' might mean only those financial assets held for both purposes would qualify for measurement at FVTOCI (BDO). Similarly, application guidance for terms and conditions in Tier 3 requirements such as 'otherwise loses control of the asset' is needed to avoid the risk of default interpretation using Tier 1/Tier 2 requirements.
	• Further simplification of terminology should be considered in developing the requirements and guidance (CPA/CA ANZ).
	• Financial instruments should be derecognised when the obligations specified in the contract either expire or are cancelled (forgiven) as this is sometimes the case in the NFP sector when lenders forgive loans effectively converted into donations (BDO).

	• Guidance on the timing of interest income and expense recognition would be useful.

58 (15%) respondents did not agree and highlighted the following items that they disagree with:
• Initial measurement of all financial instruments = 12
• Subsequent measurement of financial assets = 35 (including MA, SD, Deloitte)
• Subsequent measurement of financial liabilities = 13 (including MA, SD, Deloitte)
• Derecognition of financial assets = 9
• Derecognition of financial liabilities = 6
• Interest income/expenses = 12
• Impairment = 10
Other simplification of financial instruments = 9 (including SD, KPMG, DH)
	Some stakeholders that disagree with the proposed accounting for basic financial instruments mostly commented on the subsequent measurement of financial assets held for capital return and income. These stakeholders prefer instead to recognise changes as FVTPL instead of FVTOCI because:
	• it would be a simpler option as most preparers and users lack the understanding of what other comprehensive income is;
	• recording the change as FVOCI would require to isolate the accrued interest from net change in the fair value and result in unnecessary complexity (MA);
	• OCI is not well understood and more difficult to track to ensure investment returns are differentiated to the unrealised fair value changes. Many NFPs with investment holdings almost always contain managed funds and their investment which, given the restrictions within AASB 9 of using FVOCI for equity instruments only, have recorded their investment at FVTPL. Presentation distinction between operating and non-operating results would avoid the need to use OCI (SD); and
	• further targeted research may be needed as FVTPL measurement is common practice for NFP entities for units held in management investment schemes (Deloitte).
	Only a few stakeholders disagree with other aspects of the proposed accounting for basic financial instruments including:
	• expensing transaction costs and fee on initial recognition:
	    ○ transaction costs could create significant capital gains tax issues as that is not how they are required to be reported to the ATO. The timing of expense would not match the timing of the realisation of the asset which seems contrary to international accounting standards;
	    ○ it is uncertain if smaller NFP entities will welcome this proposal as it will negatively impact the net result of the year of acquisition of the financial instrument. Therefore it will be important to allow smaller NFP entities to opt-up to higher Tiers on a class of transaction basis (KPMG); and
	    ○ disagree transaction fees on financial liabilities should be immediately expensed as these can be relatively large. These costs should be amortised over the life of the instrument (DH).
	• not permitting hedge accounting:
	    ○ although not common, some smaller NFPs operating overseas utilise forward contracts concerning future cash outflows and should be allowed to use the hedge accounting policy choice under AASB 9. Continuing to allow smaller NFPs this accounting policy choice is consistent with the objective of simplifying financial statement preparation as smaller NFP entities can choose not to apply hedge accounting (SD); and
	    ○ whilst uncommon occurrence, the accounting community has accepted inconsistency regarding hedge accounting more generally, and a lack of consistency amongst smaller NFP entities would not be a persuasive rationale for disallowing the application of hedge accounting among this cohort (KPMG).

Staff analysis: Most stakeholders supported the proposals for Tier 3 accounting requirements developed for basic financial instruments. Staff preliminary view is that most of the non-supportive feedback related to the subsequent measurement of non-financial assets measured at FVTOCI.

RR19 identified that charities are equally likely to measure financial instruments at FVTPL or FVTOCI even though findings did not identify financial instruments as a common transaction. Interest income is identified as the most common type of income amongst charities, which corresponds with the findings that charities often have cash and cash equivalents and term deposits.

Based on the feedback and research findings, staff preliminary view is that accounting for basic financial instruments that are held to generate both income and a capital return should be developed based on the Board's preliminary views proposed in the DP (i.e. FVTOCI) because:

- majority of stakeholders agree with the Board's preliminary views;
- FVTPL adds to volatility of determining size thresholds based on income for NFP entities;
- presenting operating and non-operating profit separately would not resolve all the issues with the OCI, and the need to define the presentation distinction would not be dissimilar to the recognition through OCI;
- a choice of FVTOCI and FVTPL would not contribute to simpler and more comparable reporting of basic financial instruments.

However, staff will conduct further analysis and determine possible options for the accounting requirements for subsequent measurement of financial assets held for both income and capital return for the Board to consider at a future Board meeting, specifically whether to recognise changes in FVTPL or FVTOCI.

For the other aspects of accounting for basic financial instruments, staff think there is broad support from stakeholders to proceed with the Board's preliminary view and to begin drafting the Tier 3 requirements. During that process, staff will further consider the suggestions provided by the stakeholders, including clarification and simplification of terms and terminology and the need for application guidance.

In response to other stakeholder feedback, staff preliminary views are:

- staff do not expect significant capital tax issues would arise from expensing transaction costs,[20] unless a smaller entity acquires significant quantities of financial instruments giving rise to significant transaction costs. Findings from RR19 did not indicate a capital gain tax a common material issue for smaller NFP entities.
- The Board's preliminary views in the DP address the requests for the guidance on:
  - the derecognition of a financial liability when the obligation either expired or was cancelled, and
  - the timing of the recognition of the interest income and expense and for the recycling from OCI to profit or loss.

  However, staff will consider the need for particular application guidance or illustrative examples.
- The request on the availability of hedge accounting policy choice should be considered in conjunction with the Board's consideration of its approach to opt-up on a class of transaction basis. Staff noted that findings from RR19 indicate this is not a common accounting policy choice adopted by smaller NFP entities.

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[20] Capital gains tax (CGT) is the tax paid on profits from selling assets including shares and units. CGT is calculated based on the capital proceeds when selling the asset or another CGT event happens less the cost base. Cost base includes the cost paid to purchase the CGT asset, plus other costs incurred to hold and dispose of it. See ATO website for further information.

<table>
<tr><td colspan="2">Staff suggested action for next steps: Staff recommend to proceed with the Board’s preliminary views and begin drafting the Tier 3 requirements for accounting for basic financial instruments accompanied by further consideration of the feedback from stakeholders noted above. Staff will bring further analysis and possible options for the accounting requirement for the subsequent measurement of basic financial instruments, specifically whether to recognise changes of the fair value through profit or loss or OCI for the Board to consider at a future meeting.</td></tr>
<tr><td colspan="2">Q43–44) Employee benefits (including termination benefits and defined benefit plans)
Total response = 220</td></tr>
<tr><td>Yes = 201 (91%) consisting of:
• 63 preparers (29%)
• 117 auditors (53%)
• 4 users (2%)
• 1 regulator (0%)
• 7 others (3%)
• 1 blank (0%)
• 8 written responses (4%) (PP, MA, CPA/CA ANZ, IPA, UWA, BDO, Deloitte, ACNC)

Not applicable = 4 (2%) consisting of
• 3 preparers (1%)
• 1 user (0%)</td><td>Almost all stakeholders agree with the DP's preliminary views and support that guidance on determining the probability of long service leave should be included in Tier 3 requirements. These stakeholders noted:
• not requiring discounting of future outflows will make the preparation of financial statements easier with a limited reduction to the quality of the information provided especially considering the G100 putting high-quality corporate bond rate behind a paywall (MA).
However, a few of these stakeholders suggested the Board consider:
• the implications of portable long service leave (LSL) scheme, e.g. in Victoria, Queensland and within the health sector, especially NFP NDIS providers, need further consideration (including MA);
• LSL should be classified as a non-current liability given it is highly unlikely employees of smaller NFP entities would take LSL;
• accounting for on-cost is an on-going issue;
• that the provision for employee benefits should not consider future pay rises given it will add to the complexity of the accounting requirements (PP). However, another stakeholder thought that employee benefits should be kept up to date with salary changes; and
• clarifying whether future outflow expected is an inflation-adjusted value, whether an adjustment is required for such inflation, and whether probability should be considered, for example when calculating accumulated LSL. Recent legislative changes in the Fair Works Act 2009 have converted some eligible casual employment to permanent part-time or full time status, which could increase the likelihood of termination benefits be recognised in the future. As such, this will make the provision of clear guidance in this area of increasing importance (CPA/CA ANZ).
While stakeholders did not provide any specific industry guidelines that they currently follow, there were varying suggestions for determining probability of the outflow of economic benefits to settle the employee obligations including:
• LSL reflecting 100% probability can reduce the need for smaller entities to make complex decisions; and
• current practice is to apply the probability of 50% hence application at 100% may increase the liability.
Almost all of these stakeholders also supported not including accounting for termination benefits and defined benefit plans, as it is uncommon for smaller NFP entities (including PP, MA, CPA/CA ANZ, IPA, UWA, BDO, Deloitte ACNC, SD, DH). One stakeholder</td></tr>
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<tr><td></td><td>suggested that if termination benefits or defined benefit plans are common, it can be dealt with as part of the PIR of Tier 3 requirements (IPA).</td></tr>
<tr><td>No = 15 (7%) consisting of:
• 3 preparers (1%)
• 1 user (0%)
• 9 auditors (4%)
• 2 written responses (1%) (SD, DH)</td><td>Only a few stakeholders disagree with the Board's proposal. They had varying comments including:
• all NFP entities should apply the same accounting requirements for employee benefits for consistency with other entities;
• entitlement would be better dealt via a sinking fund provision;
• non-vesting personal leave is not typically recorded as the entitlement increases year on year on a group basis. AASB should consider default of not recording such leave other than in certain circumstances where the above fact pattern does not occur. In addition, applying probabilities has little benefit given lower value balances impacted. A simple approach of recording all liabilities from year 1 or all liabilities after an employee is 50% on the way to vesting would be simple and appropriate. Probability volatility is higher in smaller organizations and is less reliable to use history as a prediction of the future (SD); and
• not using future outflow expected to be required and not agree with examples as it contradicts some leave based on individual calculations and some on group calculations. Also, the calculation for personal leave (which seemed to include sick leave) is contrary to current practice where such leave is not accrued (DH).</td></tr>
<tr><td colspan="2">Staff analysis: Staff note that only a few stakeholders disagree. While staff have not yet fully analysed all stakeholder feedback, staff preliminary view on feedback from non-supportive stakeholders is that:
• the objective of developing Tier 3 requirements is to provide simplified accounting requirements for smaller NFP entities and the fact that almost all stakeholders supported the proposals, departure from Tier 2 may be warranted for accounting for employee benefits;
• the proposals to require employee benefits provisions to reflect the probability of future outflows expected to be required to settle the present obligation would appear to be consistent with the feedback that the entitlement would be better dealt via a sinking fund provision. This is because assessing the probability of expected future payments is required to ensure that an entity has sufficient funds to meet these expected employee benefit payments.
While staff noted the feedback that estimating future pay rises may be difficult for smaller NPF entities. However, one of the reasons not to require discounting was that the discount for the time value of money might largely negate any future pay rises such as the present value of the obligation and many obligations are expected to settle within short to medium term. As per DP, the Board observed that not requiring the liability to be measured at the present value of the obligation eliminates the need for categorisation of employee benefits related provisions as either short or long-term employee benefits for measurement purposes.
The Board sought through the DP whether it is possible to develop requirements to support the assessment the likelihood that an outflow of economic benefits will be required to settle the obligation, for example in form of a practical expedient or a rebuttable presumption. However, staff think developing such a rebuttable presumption or practical expedient would not be feasible given that NFP entities did not indicate use of any specific industry guidelines. There were also varying suggestions on the level of probability that could be used which further suggest that it would be difficult to develop a rebuttable presumption that would meet majority of NFP entities' circumstances.
However, staff noted the support for developing some form of guidance would be useful to preparers. As such, staff think developing illustrative example could be included in the Tier 3 standard to provide guidance on how an entity can factor in probability assessment for LSL calculations.</td></tr>
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<tr><td colspan="2">Based on RR19, LSL provisions and annual leave provisions were identified as common liabilities amongst charities. As such, staff consider there is evidence to support developing Tier 3 requirements for the employee benefits.
Staff also noted some stakeholders suggested the Board to consider the issue relating to portable long service schemes and guidance on on-cost. Staff will conduct further analysis to identify possible options to address this issue for the Board to consider at a future Board meeting.</td></tr>
<tr><td colspan="2">Staff suggested action for next steps: Staff will conduct further analysis and bring possible options on the accounting for employee benefits for the Board to consider at a future meeting.</td></tr>
<tr><td colspan="2">Q19–20) Changes in accounting policies and accounting estimates and correction of accounting errors
• Total response = 209[21]</td></tr>
<tr><td>Yes = 175 (84%) consisting of:
• 48 preparers (23%)
• 111 auditors (53%)
• 3 users (1%)
• 1 regulator (0%)
• 7 others (3%)
Not applicable = 3 (1%) consisting of
• 3 preparers (1%)

Written responses:
• For changes in accounting policies:
○ Yes =11 (5%) (AICD, IPA, UWA, Deloitte, ACNC, MA, CPA/CA ANZ, SD, DH, BDO, Deloitte)
• For accounting estimates:
○ Yes = 9 (4%) (PP, MA, CPA/CA ANZ, SD, IPA, UWA, DH, BDO, Deloitte)
• For correction of prior period errors:</td><td>Most stakeholders generally support the proposals on accounting for changes in accounting policies and estimates and correction of accounting errors, and welcomed the simplifications. They noted that not adjusting prior period comparatives would be clearer and more easily understood by users.
A few stakeholders provided further comments and suggestions:
• for correction of errors adequate disclosures need to be provided relating to prior period adjustments and how error occurred to increase transparency and improve users' understanding of the issue (ACNC); and
• information on the impact to solvency or other material negative impacts of the changes should be reported to a regulator, otherwise there will be an incentive to 'hide bad news'.</td></tr>
</table>

21 Some written responses agree with the majority of the proposal except for the correction of prior period errors.

○ Yes = 4 (2%) (IPA, UWA, Deloitte, ACNC)	
No = 31 (13%) consisting of: • 9 preparers (4%) • 14 auditors (7%) • 2 users (1%) Written response for correction of prior period errors: ○ No = 6 (3%) (PP, MA, CPA/CA ANZ, SD, DH, BDO)	Some stakeholders (mostly auditors) disagreed mainly in relation to the accounting for correction of prior period errors and noted that the adjustment of prior period comparatives should be required and noted: • adjusting the opening balance approach could produce misleading comparatives and obscure the current year operations in some situations (e.g., material prior year correction). Correcting comparatives ensures the users have necessary comparable information and the benefits outweigh associated cost, especially if error is significant (PP, MA, CPA/CA ANZ, BDO, DH); • there may be opportunities for management to manipulate financial reporting; and • potential implications on the audit sign-off on a known error not adjusted retrospectively. There were concerns whether the financial statements would provide true and fair view if the comparative information is known to be materially incorrect (SD). A few stakeholders that were not supportive of the proposals for both changes in accounting policies and correction of errors consider: • the Tier 3 requirements should align with AASB 108 to ensure comparability with other entities; and • adjusting opening balance may cause more questions than answers (user).

Staff analysis: Most stakeholders generally support the preliminary views in the DP and only a few stakeholders disagreed mainly in relation to the accounting for correction of prior period errors as they consider that not correcting comparative information may be misleading users or may impede the ability for auditors to sign off the financial statements as true and fair.

Given only a small minority consider prior period adjustments should align with existing requirements, staff consider there is sufficient support for simplifications within Tier 3 Standard warranting departure from Tier 2 requirements. Staff consider adequate disclosures about prior year adjustments would provide sufficient explanation to users as per stakeholder feedback.

However, staff will conduct further analysis and determine possible options for the Board to consider at a future meeting on the accounting for the corrections of prior period errors to address the feedback that: 1) the modified retrospective approach may be misleading; 2) users would benefit from the adjustments of comparative information; and 3) the benefits of the adjustments outweigh the cost. The possible options may include:

- consistently with existing requirements to require a restatement of comparative information for prior year errors with simplification of the language; or
- to proceed with Board's preliminary view to allow a modified retrospective approach for corrections of prior period errors and develop appropriate disclosure requirements.

Staff consider there is sufficient support to proceed with drafting the Tier 3 accounting requirements for voluntary changes in accounting policies applying a modified retrospective approach and prospective approach for changes in accounting estimates.

Staff suggested action for next steps: Staff recommend to **proceed with the Board's preliminary views** and begin drafting the Tier 3 requirements to apply:

- a modified retrospective approach for changes in accounting policies; and
- a prospective approach for changes in accounting estimates.

Staff will bring **further analysis** of the options for the requirements for correction of prior period errors for the Board to consider at a future meeting.