



Australian Government

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Dear Mr Golden

Proposed Accounting Standards Update Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities (File Reference No. 1810-100)

The Australian Accounting Standards Board (AASB) is pleased to provide comments on the proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (proposed ASU).

The AASB is writing in response to the IASB's Request for comment on the proposed ASU. We are also sending our comments to the IASB on the understanding that the IASB and the FASB will each be re-deliberating their proposals with a view to converging IFRS requirements and US GAAP.

In addition to this submission letter, the AASB included comments about the proposed ASU in its submissions to the IASB on ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* and ED/2010/4 *Fair Value Option for Financial Liabilities*, which are attached.

The AASB's key views on the proposed ASU are expressed below.

Classification and measurement

Fair value or mixed measurement model

The AASB considers that requiring the measurement of all financial instruments at fair value is desirable for the sake of overall consistency, and because fair values generally provide more information value than cost amounts. However, while the AASB would support requiring all financial instruments to be at fair value in the longer term, it is probably not feasible as a basis for achieving one set of global requirements on financial instruments at this time. Therefore, the AASB does not support the expansion of fair value as the default measurement attribute for financial assets and financial liabilities at this stage.

The AASB also considers that, in view of the aim of simplifying the accounting for financial instruments, the proposed ASU classification and measurement as between FVTNI and FVTOCI is relatively more complex than the FVTPL and amortised cost distinction under IFRS 9's financial assets and the IASB's financial liabilities proposals. This is because the AASB considers that the basis for the proposed ASU classification is not clear, and that the constituent feedback so far on the IFRS 9 classification criteria (based on the entity's business model in managing its financial assets) and the IASB financial liabilities proposals indicates they will be feasible to implement on a consistent basis. The AASB considers that the IFRS 9 requirements and the IASB financial liabilities proposals provide a reasonable balance between moving towards fair value measurement for financial instruments and restricting amortised cost to a readily identifiable category of loans and trade receivables. In addition, the AASB considers that IFRS 9 and the IASB financial liabilities proposals provide a sound basis for achieving convergence among most jurisdictions for financial instruments accounting.

Accordingly, the AASB supports the mixed measurement categories under IFRS 9, which is broadly consistent with the Financial Stability Board's views that are "... supportive of standards that would not expand the use of fair value in relation to the lending activities of financial intermediaries" (Report of the FSB to G20 Leaders, *Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability*, 18 June 2010, page 8).

Symmetrical accounting between financial assets and financial liabilities

The AASB appreciates the consistency of the proposed ASU's classification and measurement between financial assets and financial liabilities. The AASB considers that the IASB's asymmetrical approach as between financial assets under the existing IFRS 9 (that is in accordance with the entity's business model and cash flow characteristics) and the proposals to essentially retain the IAS 39 financial liabilities classification and measurement approach, would be a divergence from the aim of simplifying the accounting for financial instruments. Accordingly, the AASB recommends that the IASB consider revising its proposals to achieve consistency in the classification and measurement criteria for both financial assets and financial liabilities. At the very least, the AASB believes this would involve permitting the bifurcation of financial assets at amortised cost under IFRS 9, which is also raised later in this letter.

Financial liabilities

The AASB notes that the proposed accounting treatment for financial liabilities where changes in fair value relates to the entity's own credit risk is inconsistent between IASB ED/2010/4 and the proposed ASU. Under ED/2010/4, changes in the entity's own credit risk would be reclassified from the profit or loss to OCI, whereas the proposed ASU would require changes in the entity's own credit risk to be presented as a separate line item within profit or loss, or OCI, depending on the classification of the financial liability.

The AASB is highly critical of the IASB's ED/2010/4 proposal regarding 'own credit risk' because it would effectively introduce another measurement model into IFRSs. The AASB considers that the existing disclosure requirement in IFRS 7 regarding movements relating to changes in own credit risk is sufficient, and notes that the proposed ASU's presentation is closest to this approach. Accordingly, the AASB supports the proposed ASU's approach

to own credit risk as it remains faithful to its proposed measurement attribute, that is, FVTNI or FVTOCI. Furthermore, the proposed ASU is relatively simple compared with the IASB proposal in terms of the presentation of own credit risk within the statement of comprehensive income. The AASB also notes that, under the proposed ASU, the bifurcation of fair value changes relating to the entity's own credit risk depends on the significance of the change in own credit risk and that this seems likely to result in fewer cases of bifurcation compared with the IASB proposals, which would also be a welcome simplification.

Core-deposit liabilities

The AASB considers there is merit in the proposed ASU's accounting for demand deposit liabilities, on the basis that it moves these instruments closer to a fair value basis and could be considered to be consistent with the IFRS 9 model for distinguishing between financial assets measured at that fair value and those at amortised cost. That is because many constituents have indicated that demand deposits are a key source of value for many financial institutions and, if a financial institution leverages off its demand deposits, this is a strong indication that the fair value of those deposits is a key driver for its business model.

However, the AASB also has concerns with the proposed ASU in relation to demand deposits because of the possible complications in determining the 'core' amount of deposits that can be present valued and because it may not be a treatment around which other jurisdictions would want to converge.

On balance, the AASB considers that the FASB and the IASB should not consider the re-measurement of demand deposit liabilities at this stage in the spirit of convergence.

Classification and measurement of equity instruments

The AASB acknowledges that there are equity investments that are not held for trading purposes and consequently, "... presenting fair value gains and losses in profit or loss for some equity investments may not be indicative of the performance of the entity, particularly if the entity holds those equity instruments for non-contractual benefits, rather than primarily for increases in the value of the investment." (IFRS 9 paragraph BC83). Accordingly, the AASB considers there is merit in the irrevocable election at initial recognition in IFRS 9 to present subsequent changes in the fair value of equity investments not held for trading in other comprehensive income. On the other hand, the AASB notes that the FASB's proposed ASU measures equity investments at FVTNI.

The AASB considers that questions about the classification of amounts as 'profit or loss' or 'other comprehensive income' are dependent on the principles underlying such a distinction, which have yet to be developed. Therefore, the AASB is of the view that the IASB and the FASB should first develop and articulate those principles, to provide a basis for determining the merits of the FASB proposal (that all equity investments should be measured at FVTPL) compared with the corresponding IFRS 9 election (to measure equity investments that are not held for trading at FVTPL or FVTOCI). Until those principles are developed, the AASB recommends that neither the IASB nor the FASB proceed with further proposals that mandate the use of OCI.

Accounting for hybrid instruments

Symmetrical accounting between hybrid assets and hybrid liabilities

The AASB notes that the FASB has been consistent with the treatment of hybrid assets and hybrid liabilities and considers that this approach is consistent with having a simpler measurement framework for financial instruments. As mentioned before, the AASB does not support the asymmetry of the IASB's approach to accounting for hybrid assets and hybrid liabilities. The AASB understands that one of the reasons for the IASB's approach to hybrid financial assets in IFRS 9 is the relative simplicity of not having to bifurcate (IFRS 9 paragraph BC59). Accordingly, if the IASB were to proceed with its proposals on hybrid liabilities, the AASB recommends that the IASB clarify why the approach to hybrid financial assets in IFRS 9 has not been consistently adopted for hybrid liabilities.

Bifurcation

The AASB notes that the proposed ASU would require all hybrid instruments that contain embedded derivative features to be classified in their entirety at FVTNI, and that this would be similar to the IASB's approach in IFRS 9 for financial assets. The AASB considers that it is useful to permit an election for bifurcation in circumstances where the embedded derivative in a financial asset and financial liability is not clearly and closely related to its host contract. This is because the AASB believes that there will be circumstances in which more useful information would result from bifurcation. Early adoption of IFRS 9 in Australia has, for example, revealed a counter-intuitive outcome for certain financial assets containing remote puttable features, which could otherwise be more usefully treated as equity instruments if bifurcation were an option.

Consequently, the AASB urges both the FASB and the IASB to consider permitting bifurcation if particular criteria are met for both hybrid assets and hybrid liabilities.

Impairment of financial assets

The AASB notes that, as part of the FCAG and G20 recommendations, both the IASB and the FASB have proposed impairment models that would require the earlier incorporation of a greater range of information about the credit quality of financial assets than is currently allowed under accounting standards. Therefore, both the IASB's and FASB's proposals would generally be expected to result in losses being recognised earlier than currently permitted.

The AASB is highly critical of the IASB's proposals, on both conceptual and practicability aspects, regarding its expected loss model because it would involve two different impairment approaches (initial and subsequent), departs from a transaction-based approach and would corrupt the recognition of revenue that would be expected to flow from financial assets in a cost model. Instead the AASB considers that the FASB's proposed impairment model, although proposed in a fair value context, could be usefully applied in an amortised cost context and would bring forward loss recognition as recommended by the G20 and the FCAG without the complexity of the IASB's proposed model.

Accordingly, the AASB considers that the FASB's impairment model proposals would form a suitable basis for convergence and would involve fewer transition issues for entities moving from the existing IAS 39 approach to impairment.

Hedging

The AASB is supportive of the FASB's proposals and the IASB's tentative decisions to date, in particular, in enhancing the link between entities' risk management strategy and hedge accounting, acknowledging that a reasonable amount of ineffectiveness is unavoidable and hence permitted, and consequently, removing the existing requirement to fulfill an arbitrary threshold test to qualify for hedge accounting. The AASB is also supportive of the IASB's tentative decision to permit hedging of portions of non-financial items and urges the FASB to consider this approach.

However, the AASB is cautious about the potential onerous documentation requirements on entities applying hedge accounting, and the potential lack of (auditable) methods for assessing hedge effectiveness given the IASB's decision to promote entities' risk management as the key source of information for performing effectiveness assessment.

Since discussions about hedging proposals are ongoing, the AASB is unable to comment further on the proposed ASU and will endeavour to submit an addendum to this submission with more comprehensive views on both the FASB and IASB's hedging proposals once both parties' discussions on the topic are further advanced.

Other

The AASB notes the commitment made by the IASB and the FASB in the Memorandum of Understanding to "... issue comprehensive improvements ... that will foster international comparability of financial information about financial instruments." The AASB does not believe that the divergent timelines and proposals put forward by the IASB and the FASB reflect the process envisaged in the Memorandum of Understanding. In particular, the AASB considers that the different timing of the IASB and FASB proposals will require duplication of effort by the IASB and FASB's constituents in striving for converged outcomes on financial instruments. The AASB urges the IASB and the FASB to better coordinate their efforts and make best use of limited standard setting resources and the limited time available to constituents to comment on proposals.

If you have any queries regarding any matters in this submission, please contact me or Christina Ng (cng@aab.gov.au).

Yours sincerely



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Chairman and CEO
Australian Accounting Standards Board

cc Sir David Tweedie
Chairman of International Accounting Standards Board