Australian Government

Australian Accounting Standards Board

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Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Hans

ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9*

The Australian Accounting Standards Board (AASB) welcomes the opportunity to provide comments on ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9*. In formulating its comments, the AASB sought and considered the views of Australian constituents through comment letters and other consultation. The comment letters received are published on the AASB's website.

The AASB broadly supports the proposals in ED/2012/4. However the AASB is concerned about the increase in complexity that would be introduced into IFRS 9 by introducing a mandatory fair value through other comprehensive income (FVOCI) category for financial instruments. We note that the FVOCI designation in IFRS 9 for equity securities does not involve recycling; however the mandatory FVOCI category would require recycling of amounts from OCI to profit or loss. The proposals in this Exposure Draft would therefore result in inconsistent treatment for equity instruments designated as FVOCI and debt instruments which are required to be measured at FVOCI without a conceptual basis for the difference.

The AASB considers that should the IASB proceed with this proposal, the amendments should be made concurrently with the issuance of the impairment requirements in IFRS 9. This would limit the number of versions of IFRS 9 available for early adoption and increase comparability between entities.

If you have any queries regarding any matters in this letter, please contact Sue Lightfoot (slightfoot@aasb.gov.au).

Yours sincerely

K.M. Stevenson

Kevin M. Stevenson
Chairman and CEO

AASB's Specific Comments on the IASB Exposure Draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9*

The AASB's views on the questions in the Exposure Draft are as follows:

Question 1: Do you agree that a financial asset with a modified economic relationship between principal and consideration for the time value of money and the credit risk could be considered, for the purposes of IFRS 9, to contain cash flows that are solely payments of principal and interest? Do you agree that this should be the case if, and only if, the contractual cash flows could not be more than insignificantly different from the benchmark cash flows? If not, why and what would you propose instead?

Question 2: Do you believe that this Exposure Draft proposes sufficient, operational application guidance on assessing a modified economic relationship? If not, why? What additional guidance would you propose and why?

Question 3: Do you believe that this proposed amendment to IFRS 9 will achieve the IASB's objective of clarifying the application of the contractual cash flow characteristics assessment to financial assets that contain interest rate mismatch features? Will it result in more appropriate identification of financial assets with contractual cash flows that should be considered solely payments of principal and interest? If not, why and what would you propose instead?

1 The AASB supports the proposal in ED/2012/4 to broaden the notion of what is 'solely payments of principal and interest' to include contractual cash flows of financial assets which could not be more than insignificantly different from cash flows of a benchmark instrument. The AASB previously commented on IASB ED/2009/7 *Financial Instruments: Classification and Measurement* that they considered the 'solely payments of principal and interest' condition to be too narrow and that it would inappropriately result in classification of some instruments that are managed on a contractual yield basis being measured at fair value.

2 The AASB considers that the IASB should apply a more principle-based approach to the notion of interest to enable assets that economically represent solely payments of principal and interest to be measured at amortised cost (subject to meeting the business model condition), rather than using the comparison to benchmark instrument methodology as proposed.

3 Feedback from constituents has indicated that there are some financial assets (for example, certain financial assets in regulated markets) for which the contractual cash flows would not be considered to be solely principal and interest under the proposed approach. An example is Chinese mortgage bonds where interest rates are set by a regulator or government agency without regard to a market-based link between interest rates and maturities. This could preclude such assets being measured at amortised cost, which some may consider would be the most appropriate measurement category. However, if the IASB proceeds with the proposed amendments in their current form, additional guidance should be provided regarding identification of the appropriate benchmark instrument to be used for the assessment of solely payments of principal and interest for such assets.

4 The AASB also recommend that the IASB provide additional application guidance to clarify when the assessment of whether contractual cash flows are solely principal and interest is required. Guidance similar to that concerning reassessment of embedded derivatives in IFRIC 9 *Reassessment of Embedded Derivatives* could be given such that (re)assessment would be required only when:

(a) the entity first becomes party to the contract; and

(b) a change in the terms of the contract significantly modifies the cash flows that would otherwise have been required under the contract.

Question 4: Do you agree that financial assets that are held within a business model in which assets are managed both in order to collect contractual cash flows and for sale should be required to be measured at fair value through OCI (subject to the contractual cash flow characteristics assessment) such that:

(i) interest revenue, credit impairment and any gain or loss on derecognition are recognised in profit or loss in the same manner as for financial assets measured at amortised cost; and

(ii) all other gains and losses are recognised in OCI?

If not why? What do you propose instead and why?

Question 5: Do you believe that the Exposure Draft proposes sufficient, operational application guidance on how to distinguish between the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the guidance provided to describe those business models? If not, why? What additional guidance would you propose and why?

5 Overall, the AASB supports the proposal to introduce a mandatory FVOCI measurement category for financial assets that are held within a business model in which assets are managed both in order to collect contractual cash flows and for sale (subject to the contractual cash flow characteristics assessment). Feedback from Australian constituents suggests that having only two measurement categories for debt assets is too limiting and that amortised cost-based measurements in profit and loss and fair value measurements in the balance sheet would provide useful information to users. Introducing this category would address some of the concerns about the amortised cost category being too narrow and fair value through profit or loss (FVPL) not being the most useful performance measurement for some financial assets (such as liquidity portfolios).

6 The AASB is, however, concerned that the IASB's original aim of simplifying financial instrument accounting is being undermined by the proposals. Consistent with paragraph AV5 of ED/2012/4, the proposals would involve greater need for judgement in determining the appropriate business model and dealing with reclassifications on a change in business model. Should the IASB proceed with this proposal, the AASB recommends that robust application guidance on identifying business models is provided in the standard.

7 The AASB is also concerned about the inconsistency which would be introduced between equity instruments that are designated as FVOCI and financial assets that are mandatorily measured at FVOCI, with respect to recycling from OCI to profit or loss.

8 The AASB also has concerns about the interaction of the proposals with the other phases of IFRS 9 which have not yet been completed i.e. hedge accounting and impairment. Until entities undertake a comprehensive review of IFRS 9 it may not be apparent whether there could be unintended consequences arising from introducing a mandatory FVOCI category.

9 The AASB's support of this proposal is subject to the existing fair value option also being extended to these financial assets (see response to Question 6 below).

Question 6: Do you agree that the existing fair value option in IFRS 9 should be extended to financial assets that would otherwise be mandatorily measured at fair value through OCI? If not, why and what would you propose instead?

10 The AASB agrees that the existing fair value option (fair value through profit or loss) should be extended to financial assets that would otherwise be mandatorily measured at FVOCI.

11 IFRS 9 requires that, in order to be eligible to apply the fair value option, the fair value designation must eliminate or significantly reduce a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') (IFRS 9 paragraph 4.1.5). IFRS 9 contains limited guidance on how an entity should determine whether an accounting mismatch exists.

12 In the context of its insurance contracts project, the IASB has tentatively decided that certain components of insurance liabilities (remeasurements due to changes in discount rates) would be recognised through OCI. The IASB intends that introducing the mandatory FVOCI category would reduce the mismatch between financial assets and insurance liabilities. However, as well as a mismatch arising from changes in discount rates used in measuring insurance liabilities there is also likely to be a mismatch from changes in inflation rates. Feedback from Australian insurers and regulators is that they want the ability to measure insurance liabilities through profit or loss and assets backing insurance contracts at FVPL.

13 The AASB recommends that the IASB clarify whether insurers would be eligible to use the fair value option for financial assets that would otherwise be mandatorily measured at FVOCI and to include all movements in insurance liabilities in profit or loss, if to do otherwise would create an 'accounting mismatch'.

14 The AASB also recommends that the IASB clarify how the 'accounting mismatch' should be performed for portfolios of instruments and when there is a mismatch in the tenor of financial assets and liabilities.

Question 7: Do you agree that an entity that chooses to early apply IFRS 9 after the completed version of IFRS 9 is issued should be required to apply the completed version of IFRS 9 (ie including all chapters)? If not, why? Do you believe that the proposed six-month period between the issuance of the completed version of IFRS 9 and when the prohibition on newly applying previous versions of IFRS 9 becomes effective is sufficient? If not, what would be an appropriate period and why?

Question 8: Do you agree that entities should be permitted to choose to early apply only the 'own credit' provisions in IFRS 9 once the completed version of IFRS 9 is issued? If not, why and what do you propose instead?

Question 9: Do you believe there are considerations unique to first-time adopters that the IASB should consider for the transition to IFRS 9? If so, what are those considerations?

15 The AASB agrees that in the interest of increasing comparability between entities, an entity that chooses to early apply IFRS 9 after the completed version of IFRS 9 is issued should be required to apply the completed version of IFRS 9. The six-month withdrawal period between issuance of the completed version and the introduction of the prohibition on newly applying previous versions of IFRS 9 appears sufficient.

16 The AASB also agree that entities should be permitted to choose to early apply only the 'own credit' provisions in IFRS 9 once the completed version of IFRS 9 is issued.

17 No considerations unique to first-time adopters have been identified.