AUSTRALASIAN
COUNCIL OF
AUDITORS-GENERAL

2 July 2010

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West
Victoria 8007

Dear Mr Stevenson

Exposure Draft ED 196 Fair Value Option for Financial Liabilities

Attached is the Australasian Council of Auditors-General (ACAG) response to the Exposure Draft referred to above.

The views expressed in this submission represent those of all Australian members of ACAG.

The opportunity to comment is appreciated and I trust you will find the attached comments useful.

Yours sincerely

Simon O'Neill
Chairman
ACAG Financial Reporting and Auditing Committee

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ACAG
AUSTRALASIAN
COUNCIL OF
AUDITORS-GENERAL

2 July 2010

Sir David Tweedie
Chairman
International Accounting Standards Board
1st Floor
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David

Exposure Draft ED/2010/4 Fair Value Option for Financial Liabilities

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cc: Mr Kevin Stevenson, Chairman, Australian Accounting Standards Board

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Attachment

ED 196 / ED/2010/4 – Fair Value Option for Financial Liabilities

AASB Specific Matters for Comment

The AASB has requested specific comments on whether:

(a) there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
- **(i) not-for-profit entities; and**
- **(ii) public sector entities;**

ACAG Comment:

Yes, there are other issues arising in the Australian public sector environment that may affect the implementation of the proposals.

In Australia there is currently a mix of for-profit and not-for-profit public sector entities which have significant financial liabilities that are accounted for through profit or loss.

Australian state central borrowing authorities are the most significant public sector entities that have historically adopted the option to account for all changes in fair value of financial liabilities through the profit or loss. Many state electricity companies and investment entities also account for derivatives and some other financial liabilities at fair value through profit or loss.

ACAG is aware that the Australian state central borrowing authorities have written to the AASB and IASB outlining concern that ED 196 will likely detract from the clarity of their financial statements, and may result in misleadingly reporting profit or loss. For the reasons outlined further below, ACAG supports only allowing all changes in the fair value of financial instruments to be through profit or loss, supplemented by the existing disclosure requirements around credit risk contained in AASB 7.

(b) overall, the proposals would result in financial statements that would be useful to users;

ACAG Comment:

No. In the case of Australian state central borrowing authorities, electricity companies and investment entities who value financial liabilities at fair value through profit or loss, ACAG is concerned that the proposals in ED 196 may result in financial statements that are unnecessarily complicated and not useful to users. Also, this may likely lead to misleading measurement and reporting of financial risk. Further explanation for this position is outlined below.

(c) the proposals are in the best interests of the Australian and New Zealand economies;

ACAG Comment:

No additional comment.

and (d) there are any implications for GAAP/GFS harmonisation.

ACAG Comment:
No additional comment.

Questions from the IASB

Question 1

Do you agree that for all liabilities designated under the fair value option, changes in the credit risk of the liability should not affect profit or loss? If you disagree, why?

And

Question 2

Or alternatively, do you believe that changes in the credit risk of the liability should not affect profit or loss unless such treatment would create a mismatch in profit or loss (in which case, the entire fair value change would be required to be presented in profit or loss)? Why?

And

Question 3

Do you agree that the portion of the fair value change that is attributable to changes in the credit risk of the liability should be presented in other comprehensive income? If not, why?

ACAG Comment:

No, we do not agree with the proposals outlined in Questions 1, 2 or 3.

We believe that all changes in the credit risk of financial liabilities designated at fair value through profit or loss should affect profit or loss and that the most appropriate means of specifically disclosing the impact of changes in credit risk is through the associated disclosures required by AASB 7. Otherwise, entities that elect to designate financial liabilities at fair value through profit or loss and manage financial assets and liabilities on a fair value basis would report a mismatch as only a portion of the changes in fair value of financial liabilities will be reflected in the profit or loss, whereas changes in the fair value of financial assets are fully reflected in profit or loss. A mismatch introduces increased profit and loss volatility in annual financial statements thereby defeating the purpose of the initial designation. The reporting of a valuation related mismatch between financial assets and liabilities at fair value through profit or loss is also misleading in terms of the measurement and existence of risk exposure.

In addition, the allocation of the credit risk component to other comprehensive income will introduce subjectivity into an area where data is currently adequate, objective and verifiable.

We also do not support the alternative proposal outlined in Question 2, as we believe that changes in the credit risk of all financial liabilities should be treated consistently with the measurement of financial assets as outlined in IFRS 9, not only when a mismatch in profit or loss would be created.

Question 4

Do you agree that the two-step approach provides useful information to users of financial statements? If not, what would you propose instead and why?

And

Question 5

Do you believe that the one-step approach is preferable to the two-step approach? If so, why?

And

Question 6

Do you believe that the effects of changes in the credit risk of the liability should be presented in equity (rather than in other comprehensive income)? If so, why?

<u>ACAG Comment</u>:

No, these approaches would not provide useful information to users of financial statements. ACAG's preferred approach is to continue the current practice of recognising the entire fair value change in profit or loss, supplemented by the existing disclosure requirements around credit risk contained in AASB 7.

Entities that have elected to designate financial liabilities at fair value through profit or loss and manage financial asset and liability instruments on a fair value basis would report a mismatch under both the one-step and two-step approaches, as only a portion of the changes in fair value of financial liabilities will ultimately be reflected in the profit or loss. We believe both proposed approaches would result in the following undesirable outcomes:

i. misleading measurement and reporting of financial risk;
ii. increased volatility of profit or loss in annual financial statements;
iii. practical issues of measuring fair value changes attributable to credit risk; and
iv. decreased comparability of financial statements across entities.

Question 7

Do you agree that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income (or included in equity if you responded 'yes' to Question 6) - should not be reclassified to profit or loss? If not, why and in what circumstances should they be reclassified?

<u>ACAG Comment</u>:

As per the response to Question 6, gains or losses resulting from changes in a financial liability's credit risk should not necessarily be separated on the face of the financial statements. ACAG's preferred approach is to continue the current practice of recognising the entire fair value change in profit or loss supplemented by the existing disclosure requirements around credit risk contained in AASB 7. In addition, we do not believe that gains or losses resulting from changes in a liability's credit risk should be *reclassified* to profit or loss.

Question 8

For the purposes of the proposals in this exposure draft, do you agree that the guidance in IFRS 7 should be used for determining the amount of the change in fair value that is attributable to changes in a liability's credit risk? If not, what would you propose instead and why?

ACAG Comment:

Entities currently comply with the requirements of AASB 7 (IFRS 7) and accordingly the guidance in AASB 7 should be used for determining the amount of the change in fair value that is attributable to changes in a liability's credit risk.

Question 9

Do you agree with the proposals related to early adoption? If not, what would you propose instead and why? How would those proposals address concerns about comparability?

ACAG Comment:

Yes, we agree with the proposals related to early adoption.

Question 10

Do you agree with the proposed transition requirements? If not, what transition approach would you propose instead and why?

ACAG Comment:

Yes, we agree with the proposed transitional requirements.