ED184 sub 3

New South Wales
TREASURY

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Dear Mr Stevenson

Exposure Draft 184 Financial Instruments: Classification and Measurement

New South Wales Treasury welcomes the opportunity to provide comments on the above exposure draft.

We agree with the need to provide less complex classification and measurement requirements for financial instruments. But we do not think the exposure draft proposals go far enough to achieve this goal. We prefer the alternative dissenting view of Mr Leisenring that proposes measuring all financial instruments at fair value through profit or loss, for the reasons he provides. This includes the stipulation that presentation in other comprehensive income should only be permitted when a single statement of comprehensive income is presented (paragraph AV14). We would accept his alternative in paragraph AV17.

We have concerns related to:

- the speed at which the AASB and IASB are moving in what is acknowledged by all to be a very complex area
- the potential lack of convergence with US GAAP
- the difficulty of a staged approach where we are expected to make decisions now when the proposals in future related phases/projects are as yet unknown

Our detailed views in relation to the matters raised in the exposure draft follow.

Yours sincerely

Robert Williams

for Secretary

AASB Exposure Draft 184 Financial Instruments: Classification and Measurement

New South Wales Treasury provides the following views on specific questions asked by the AASB:

(a) whether there are any regulatory 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.

A goal for public sector entities is to achieve Government Finance Statistics (GFS) / GAAP convergence. The principle of GFS reporting requires financial instruments to be classified and measured at fair value. Therefore, public sector entities would favour proposals supporting fair value measurement.

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

Yes, overall, by reducing complexity. But the dissenting view more fully achieves this.

and

(c) whether the proposals are in the best interests of the Australian economy.

No comment.

Concerns

Potential lack of convergence with US FASB

FASB has tentatively decided to go the route of requiring all financial instruments to be measured at fair value, with an option to allow own debt to be recognised at amortised cost in certain circumstances. Gains or losses will be recorded either in profit or loss or in other comprehensive income. This is very different from the IASB proposals, although similar to one of the alternatives provided, and could delay the objective of convergence with FASB.

Problems with the current approach

Because of the high priority of the project, constituents are being bombarded with exposure drafts, request for comment, etc. All of these are important issues that require time to consider. We appreciate that the IASB wants to accelerate the project to enable users to have the option to early adopt in their 31 December year-ends, even though the mandatory application date will be much later.

Problems with a phased approach

It is difficult to make any quick or final decisions without knowing the total picture. We agree that classification and measurement lay the foundation. But it would still help to know how the other phases (impairment and hedging) plus other relevant topics (e.g. fair value measurement) will or will not impact the current proposals.

SPECIFIC MATTERS FOR COMMENT

Classification approach (paragraphs 3-5)

Question 1
Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

Yes, for simple financial instruments with cash flows expected to be recovered by interest and principal payments. However, measuring all financial instruments using one attribute, i.e. fair value, provides better decision-useful information.

Question 2
Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a contractual yield basis'? If not, why? What additional guidance would you propose and why?

We would like to see more guidance on what is meant by 'is managed on a contractual yield basis' because this concept is different from the current 'management's intention' approach.

It will be difficult to distinguish, for financial instruments that sit in the middle ground, those to be held for their entire term to generate income and those to be traded for profit in the short term. This would be of particular concern to investors of surplus funds who invest temporarily to retain a liquidity reserve. Should these investments be at fair value? The IASB webcast noted that the IASB has not yet concluded on this point and it is likely that additional guidance will be needed.

Question 3
Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost?
Yes.
If so,

(a) *what alternative conditions would you propose? Why are those conditions more appropriate?*

    NSW Treasury suggests substituting "not managed on a fair value basis" for "managed on a contractual yield basis" because users are familiar with what is meant by "managed on a fair value basis" so less guidance would be required.

(b) *if additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in information that is more decision-useful than measurement at fair value?*

    Not applicable.

(c) *if financial assets or financial liabilities that the exposure draft would measure at amortised cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?*

    Yes, as the default condition.

Embedded derivatives (paragraphs 6-8)

Question 4

(a) *Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.*

Yes, if you want to reduce complexity. However, it is inconsistent with the 'business model' or 'management's intention'. Therefore, it is difficult to support the argument provided. Also, we don't know yet what the hedging proposals will be.

Another issue with embedded derivatives is the different treatment depending on whether it's a hybrid contract with a financial host or a hybrid contract with a non-financial host. The Board concluded that the requirements for hybrid contracts with non-financial hosts should be considered in a later phase, even though those requirements are complex and have resulted in application problems (paragraph BC47), so there may be inconsistent treatment for some time.

(b) *Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (i.e. tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would the approach simplify the accounting requirements and improve the decision usefulness of information about contractually subordinated interests?*

Yes, we agree that a tranche that provides credit protection to other tranches does not have basic loan features; i.e. the cash flows are not principal and interest because the holder is compensated for providing credit protection.

Fair value option (paragraph 9)

Question 5

Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?

Yes, because it increases financial instruments measured at fair value. However, options reduce comparability.

Question 6

Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

Yes, we would prefer fair value to be allowed under most circumstances without any restrictions. If fair value provides useful information, it should be permitted. This would better align with FASB and facilitate convergence. We therefore support the dissenting view to measure all financial instruments at fair value, with or without the restriction specified in paragraph AV14.

Reclassification (paragraph 10)

Question 7

Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide *understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?*

Yes. **Investments in equity instruments that do not have a quoted market price and whose fair value cannot be reliably measured**

Question 8

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

Yes. Requiring all equity instruments to be measured at fair value enhances comparability, encourages consistency and reduces complexity. The question of how to 'measure' any asset or liability when it cannot be reliably measured is an issue that the Fair Value Measurement exposure draft should address.

Question 9

Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

The question of cost versus benefit; i.e. measurement, is an issue that the Fair Value Measurement exposure draft should address.

Investments in equity instruments that are measured at fair value through other comprehensive income (paragraphs 21 and 22)

Question 10

Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

No, although we note that this option only applies to certain equity instruments that are not held for trading. Instead, NSW Treasury prefers simplifying accounting for financial instruments, eliminating options wherever possible and avoiding the use of other comprehensive income. In addition, the fact that the option is irrevocable, and entities will not be able to recycle gains and losses or record dividends in profit or loss, may limit its use.

We only agree with items being presented in other comprehensive income where a single statement of comprehensive income is presented, and the reasons for allowing this are fully described in the proposed standard, as the dissenting view suggests at paragraph AV14.

Question 11

Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition?

Refer to our response to question 10 where we generally disagree with permitting entities to present items in other comprehensive income. However, if entities were to do this, we agree that it should be permitted only at initial recognition. Otherwise the use of the option could be manipulated.

If not,

(a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?

Not applicable.

(b) *should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?*

Not applicable.

Effective date and transition (paragraphs 23-33)

Question 12

Do you agree with the additional disclosure requirements for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

Yes, because we believe the additional information required should be available and will provide comparability between those who early adopt the standard and those that do not.

Question 13

Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

Yes, and the relevant Basis for Conclusion paragraphs B79-B86 have adequately considered difficulties that may arise.

An alternative approach

In principle, to converge with the GFS Framework, most financial instruments should be designated at fair value through profit or loss.

NSW Treasury generally supports the dissenting view of James J Leisenring who proposes to measure all financial instruments at fair value through profit or loss, or, if this is not accepted, measure all at fair value through profit or loss with certain exceptions; e.g. originated loans retained by the originator, trade receivables and accounts payable, only if one statement of comprehensive income is presented. We acknowledge that determining what constitutes "trade receivables" and "accounts payable" may not always be transparent for some entities and guidance may be required. However, we still believe this is preferable to the proposal in the exposure draft and the alternatives / variants. Mr Leisenring's first choice is also more aligned to the tentative US FASB decision to measure all financial instruments at fair value.

Question 14

Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortised cost, specifically:

(a) in the statement of financial position?

(b) in the statement of comprehensive income?

If so, why?

No. NSW Treasury does not believe the alternative approach goes far enough. Adding the additional requirement should result in more financial instruments being measured at fair value, but we do not believe this would necessarily mean the information provided would be more decision-useful. We also disagree with disaggregating fair value changes in profit or loss and other comprehensive income as this is increasing, rather than decreasing, complexity.

Question 15

Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

Possibly. One of the variants is similar to the tentative decision of US FASB so would further convergence and is also closer to the dissenting view of Mr Leisenring.