ED184 sub 5

Department of Treasury and Finance

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Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
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Dear Mr ~~Stevenson~~ Kevin

EXPOSURE DRAFT 184 FINANCIAL INSTRUMENTS: CLASSIFICATION AND MEASUREMENT

The Heads of Treasuries Accounting and Reporting Advisory Committee welcomes the opportunity to provide comments to the Australian Accounting Standards Board on ED 184 *Financial Instruments: Classification and Measurement.*

HoTARAC is of the view that the proposals set out in the Exposure Draft should reduce the complexity in the classification and measurement of financial instruments. However, HoTARAC is reluctant to support the proposals whilst the concept of fair value is being developed.

HoTARAC is of the opinion that, in the case where there is no active and efficient market for financial instruments, the use of fair value based on market (exit) price does not meet the qualitative characteristics required of financial reports as set out in the Conceptual Framework.

The principles of the Fair Value Measurement and the Conceptual Framework Measurement Projects are pervasive aspects of this ED and, as such, it is HoTARAC's opinion that it would be imprudent to finalise this ED whilst these projects are still in progress.

HoTARAC's response to the questions set out in the ED are attached.

If you have any queries regarding HoTARAC's comments, please contact Peter Gibson from the Australian Department of Finance and Deregulation on 02 6215 3551.

Yours sincerely

D W Challen
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

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Encl

Contact: Sarah Woods
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ED Financial Instruments: Classification and Measurement

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 both financial assets and financial liabilities.
>
> HoTARAC is of the view that amortised cost adequately reflects the economic substance of these simple financial instruments and, as such, provides adequate decision-useful information.

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?

> No.
>
> HoTARAC is of the view that, the IASB needs to provide clearer guidance, in the application guidance, on whether loans with below-market interest rates can have basic loan features. B1 of the application guidance states that, interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time. Given this definition, it appears that instruments issued at a below-market interest rate do not have basic loan features. However, B3(a)(iv) mentions debt instruments, issued at a discount that are a combination of fixed returns and variable returns, do have basic loan features. In practice, most loans issued at below-market interest rates in Australian jurisdictions have basic loan features and are managed as if they have basic loan features.
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> HoTARAC is of the view that, the guidance provided in Paragraph B3(c) is unclear and requires clarification. While Paragraph B3(c) lists conditions which are not considered by the IASB to be contingent on future events, HoTARAC is of the opinion that some of these conditions do relate to future events.
>
> HoTARAC considers Paragraph B8 could be improved by clearly distinguishing between the circumstances described in Paragraphs B6 and B8.

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? If so:

    a. What alternative conditions would you propose? Why are those conditions more appropriate?

    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?

    c. If financial assets or financial liabilities that the ED 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?

No.

HoTARAC does not believe there are other conditions that are more appropriate to identify which financial assets and liabilities should be measured at amortised cost.

HoTARAC is of the view that the two conditions set out in the ED adequately capture the instruments that should be measured at amortised cost. In HoTARAC's opinion, amortised cost is not appropriate for more sophisticated instruments.

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, explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

HoTARAC agrees that where a derivative is attached to a financial instrument, but is contractually transferable independently of that instrument, or has a different counter-party to that instrument, the derivative is not an embedded derivative, but a separate financial instrument (Paragraph 6). HoTARAC considers the requirement to separate these instruments will ensure that the true substance of the instruments are recognised.

However, if the derivative cannot be dealt with separately, has the same counterparty, and is intended by both parties to be handled in unison with the main financial instrument, HoTARAC considers that the embedded derivative should not be separated. HoTARAC considers the current requirements to measure at fair value, when it is not possible to split the host and the embedded derivatives, should remain.

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 that approach simplify the accounting requirements and improve the decision usefulness of information about contractually subordinated interests?

HoTARAC generally supports the proposed classification approach to contractually subordinated interests, but recommends a clearer distinction be made between the circumstances in Paragraphs B6 and B8.

HoTARAC is of the view that a creditor's potential ranking, compared to another creditor, should not generally be a determining factor when classifying an instrument under the proposed standard (as per Paragraph B6). However, HoTARAC agrees that tranches that offer explicit credit protection to some tranches over others would not have basic loan features. Further guidance would also be useful regarding whether some tranches could have basic loan features and, if so, under what circumstances.

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?

Agree.

HoTARAC supports the continuation of the option to elect fair value through profit or loss if such designation reflects the way the associated business arrangement work. HoTARAC is of the view that this election improves the usefulness and relevance of the information presented in the financial statements by eliminating, or significantly reducing, accounting mismatch.

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.

HoTARAC is of the view that amortised cost adequately reflects the economic substance of instruments with basic loan features and managed on a contractual yield basis. However, it believes that where fair value can be determined, it should be allowed to be applied when it improves the decision usefulness of financial statements.

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?

> HoTARAC does not support a prohibition on re-classification of financial instruments.
>
> Economic substance, and the provision of information for decision-making by users, suggest that the purpose of holding an instrument is of prime relevance to its classification. Instruments held for trading, or for certain other purposes should, prima facie, be at fair value; for other instruments, amortised cost could be appropriate. From time to time, entities may change the purpose for which they hold an instrument. This would ideally be reflected in a reclassification of that instrument.
>
> However, HoTARAC acknowledges that this may be difficult to achieve in a way that removes the opportunity for management to manipulate earnings and financial positions.

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?

> HoTARAC is of the view that the answer to this Question is dependent on the outcome of the Fair Value Project.
>
> The Fair Value Project proposes a fair value hierarchy and disclosure for each level in the hierarchy.
>
> For equity instruments that are traded on the open market, fair value provides adequate information.
>
> The majority of HoTARAC members consider that, for equity instruments that are not traded, it is questionable whether fair value based on exit-price will provide adequate decision-useful information, even if sufficient information is disclosed about the inputs used to determine the fair value. The minority of HoTARAC members consider fair value would provide more decision-useful information than cost. These members do not believe historical cost for an equity instrument would be decision-useful or would be any more reliable than fair value.

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?

HoTARAC is of the view that this Question is more relevant to the Fair Value Measurement ED.

HoTARAC believes that there will be situations where the costs of determining fair value using level 3 inputs (and occasionally level 2) will outweigh the benefits and, in these situations, the instrument should be allowed to be recognised at cost. For example, equity instruments that are infrequently traded require the development of extensive, costly models to determine an appropriate value – where simpler valuation techniques may achieve adequate measures of value.

HoTARAC also believes that, the costs of the expected loss method, for impairing assets recognised at amortised cost, currently being explored by the IASB, will outweigh the benefits to users.

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?

Yes.

HoTARAC is of the opinion that recognising fair value changes in other comprehensive income have the following benefits:

- it reduces the volatility in profit and loss;
- it allows users of financial statements to assess the stewardship of management without taking into account factors, which to some extent, are outside the control of management; and
- it allows users to estimate future cash flows on information that is not distorted by unrealised gains/losses.

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? If not:

    a. How do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?

    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?

HoTARAC agrees that an entity should be permitted to present, in other comprehensive income, such fair value changes and dividends, only if it elects to do so on initial recognition of the associated equity instrument.

HoTARAC is of the opinion that entities should be permitted to present, in other comprehensive income, all unrealised changes in financial instruments for the reasons listed in Question 10 above. Changing the presentation method would give management an opportunity to manipulate profit and loss.

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

Agree.

HoTARAC is of the opinion that the additional disclosure will provide decision-useful information to users and is not onerous.

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?

Agree.

HoTARAC is of the view that the proposal and transition guidance are sensible and practical and will not burden preparers. HoTARAC considers that, where retrospective application of a new classification to comparative periods would require the determination of different figures for both the reporting period and the comparative period, the costs may outweigh the benefits for the comparative figures. In this case, HoTARAC would urge a lengthy lead time to the effective date, to allow progressive collection of different information to comply in future with that different measurement basis.

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?

The majority of HoTARAC members do not believe the alternative approach provides more decision-useful information than measuring those financial assets at amortised cost. These members consider that, for simple "principal and interest instruments", the benefits of fair value do not outweigh the cost and, as such, HoTARAC supports the use of amortised cost for these instruments as set out in the ED. A minority of HoTARAC members consider there to be benefits in terms of comparability and reduced complexity in measuring all financial instruments at fair value. These members believe that, while a compromise, the alternative view would improve the usefulness of information.

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 ED? If so, which variant and why?

Regarding the variants of the alternative approach, HoTARAC has the same concerns as mentioned in response to Question 14.