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

AASB EXPOSURE DRAFT 196 FAIR VALUE OPTION FOR FINANCIAL LIABILITIES

The Heads of Treasuries Accounting and Reporting Advisory Committee welcomes the opportunity to provide comments to the Australian Accounting Standards Board on Exposure Draft 196 *Fair Value Option For Financial Liabilities*.

The majority of HoTARAC members believe that changes in the credit risk of the financial liability designated under the fair value option should not affect profit or loss. This addresses the long-standing concern that recognising changes in the credit risk of a liability in the entity's operating result is counter intuitive and potentially misleading to users, particularly in times of financial distress.

The majority of HoTARAC members support the IASB proposal to recognise changes attributable to credit risk in other comprehensive income rather than as a direct entry to equity, as these changes in the fair value of a liability are re-measurements and not a transaction with equity holders. HoTARAC also notes that this accounting treatment would better align with the Australian Bureau of Statistics Government Finance Statistics, which recognises re-measurements of financial liabilities as other economic flows.

The majority of HoTARAC members do not support the two-step approach. HoTARAC believes that the one-step approach, in conjunction with reconciliation of the total changes in fair value as note disclosure, would provide users with the most useful information.

Comments by HoTARAC on AASB specific matters are in Attachment 1. Comments on the Exposure Draft are contained in Attachment 2.

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

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Attachment 1

ED 196 AASB Specific Matters for Comment

Question 1: Are there any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

1. **Not-for-profit entities; and**
2. **Public sector entities.**

1.1 HoTARAC does not consider that there are any regulatory or other issues that may affect the implementation of the proposals for the public sector.

Question 2: Overall, will the proposals result in financial statements that would be useful to users.

2.1 Overall, the majority of HoTARAC members believe that the proposals will result in financial statements that are useful to users, particularly by addressing the effects of changes in the credit risk of a liability in profit or loss.

Question 3: Are the proposals in the best interest of the Australian and New Zealand economies.

3.1 HoTARAC offers no comment on whether the proposals are in the best interest of the Australian and New Zealand economies.

Question 4: Are there any implications for GAAP-GFS harmonisation.

4.1 HoTARAC supports presentation in other comprehensive income as it better aligns with the Australian Bureau of Statistics Government Finance Statistics treatment. Presenting the portion of change in fair value attributable to changes in the credit risk of the liability in other comprehensive income is consistent with GFS, as GFS recognises changes in the volume or value of assets, liabilities and equity that do not result from transactions as "other economic flows". However, HoTARAC notes that, under GFS, the entire change in fair value of the financial liability will be presented in "other economic flows".

4.2 A minority of HoTARAC members believe that the presentation of credit risk in other comprehensive income may be made more complex under GAAP-GFS, as the entire change in fair value of financial liabilities represents an "other economic flow" and therefore, under this proposal the "other economic flow" will be presented in two sections of the Statement; i.e. profit and loss and in other comprehensive income.

Attachment 2

ED 2010/4 IASB Specific Matters for Comment

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?

1.1 HoTARAC agrees that changes in the credit risk of financial liabilities designated under the fair value option should not affect profit or loss.

1.2 HoTARAC considers that it is counter intuitive for an entity's operating result to improve when there has actually been a reduction in the credit quality of its liabilities and vice versa. Such reporting would not provide useful information to users and may be misleading, particularly during situations such as the Global Financial Crisis.

1.3 A minority of HoTARAC members believe that all changes in fair value should be recognised consistently in profit or loss. The minority believe that, until the IASB has examined the rationale for the use of the other comprehensive income category, it is difficult to justify classifying a portion of fair value changes to other comprehensive income.

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?

2.1 HoTARAC does not support the alternative approach which would allow changes in the credit risk of the liability to be recognised in profit or loss where an accounting mismatch would result.

2.2 A minority of HoTARAC members believe that the entire movement in fair value should be recognised through profit or loss.

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?

3.1 The majority of HoTARAC members agree that the portion of fair value change that is attributable to changes in the credit risk of the liability should be presented in other comprehensive income rather than in profit or loss.

3.2 In addition, the majority of HoTARAC members agree with the IASB, particularly in the Board's Basis for Conclusion BC 34, that these changes should not be presented directly in equity. Fair value changes attributable to credit risk of the liability are essentially re-measurements and not transactions with equity holders, and therefore should not be presented directly in equity.

3.3 While the majority of HoTARAC members support presentation in other comprehensive income, HoTARAC believes that the IASB needs to outline principles that guide which items should be reported in other comprehensive income, as this is currently not clear.

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?

4.1 While HoTARAC acknowledges that the two-step approach provides some information to users, the majority of HoTARAC members do not support this approach as it is likely to be confusing rather than helpful. The majority do not believe that the two-step approach provides any more useful information than the one-step approach (subject to comments below). In addition, the two-step approach introduces a new presentation method by recognising the change in profit or loss and subsequently reversing it into other comprehensive income. The majority of HoTARAC members do not support the introduction of a new presentation method.

4.2 In addition to the disclosure in IFRS 7, HoTARAC believes that the one-step approach in conjunction with a reconciliation of the total change in fair value in the notes would provide users with more useful information. The disclosure would reconcile the total change in fair value of the liability with the amounts presented in profit or loss and those presented in other comprehensive income.

4.3 A minority of HoTARAC members do not agree with the recognition of credit risk in other comprehensive income but, if the proposals proceed, they support the two step approach, as it more clearly identifies the entire change in fair value, including credit risk, consistent with the measurement category; i.e. fair value through profit or loss.

Question 5: Do you believe that the one-step approach is preferable to the two-step approach? If so, why?

5.1 As proposed in Paragraph 4.2, the majority of HoTARAC members consider the one-step approach with additional note disclosure is preferable to the two-step approach.

5.2 The majority of HoTARAC members consider the one-step approach to be more efficient and less confusing than the two step approach, with both approaches having the same net result in profit or loss and other comprehensive income.

5.3 As discussed above (Paragraph 4.3), a minority of HoTARAC members support the two step approach, if the proposal is to proceed.

Question 6: Do you believe that the effects of changes in the credit risk of the liability should be presented in equity (rather than other comprehensive income)? If so, why?

6.1 The majority of HoTARAC members believe that the effects of changes in the credit risk of the liability should be presented in other comprehensive income, rather than directly in equity.

6.2 As discussed in Paragraph 4.1, HoTARAC agrees with the IASB BC34 that re-measurements of assets and liabilities should not be presented directly in equity because re-measurements are not transactions with equity holders.

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?

7.1 The majority of HoTARAC members agree that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income should not be reclassified to profit or loss. HoTARAC supports the IASB's view that gains or losses should only be recognised once.

7.2 The majority of HoTARAC members agree that an entity should be able to transfer the cumulative gain or loss within equity on de-recognition of a liability.

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?

8.1 The majority of HoTARAC members agree with the proposal to use the guidance in IFRS 7 (or another method if the default method does not provide a faithful representation) for determining the amount of the change in fair value that is attributable to changes in a liability's credit risk. While recognising that this is not a precise measure, it does provide a reasonable proxy of the change in fair value attributable to credit risk.

8.2 The minority of HoTARAC members believe that the IFRS 7 guidance is an inappropriate basis to determine classification in a primary financial statement. Instead, they agree with the FASB ED *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (Paragraph BC 164), which states that IFRS 7 does not accurately reflect the change in own credit risk as it includes the change in price of credit which is not specific to the entity.

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?

9.1 HoTARAC agrees with the proposals related to early adoption, particularly the requirement that an entity which early adopts must also apply any preceding requirements in IFRS 9. Consistent with BC 49, HoTARAC is concerned that permitting entities to early adopt without also adopting preceding phases of the multi-phase Project will result in significant incomparability.

Question 10: Do you agree with the proposed transition requirements? If not, what transition approach would you propose instead and why?

10.1 HoTARAC agrees with the proposed transition requirements. HoTARAC does not consider that there are any impediments to providing retrospective application due to the availability of credit risk information currently required by IFRS 7.