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Discussion Paper *Reducing Complexity in Reporting Financial Instruments*

The staff at the Australian Accounting Standards Board welcomes the opportunity to comment on the IASB's Discussion Paper *Reducing Complexity in Reporting Financial Instruments*.

We support the work being undertaken by the IASB in respect of financial instruments, and generally support the proposals in the Discussion Paper as they provide pragmatic solutions to reducing some of the complexities of accounting for financial instruments. However, we are not convinced that all of the proposals are appropriate as intermediate steps to reducing complexity.

Australian constituents have complied with the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* since adoption of IFRSs in 2005, and despite the concerns regarding the complexity of applying some of the aspects of the Standard, both preparers and users have become familiar with its requirements. In the absence of a comprehensive revision of financial instrument accounting, we are not aware of any constituents with ongoing concerns about the classification of financial instruments. Therefore, in the context of the existing general approach under IAS 39 it is uncertain whether the proposal in Approach 1 would provide significant relief, and it may simply create a new set of rules, thereby increasing the cost of compliance to users.

We are also concerned with the proposal in Approach 2 that would replace the existing measurement requirements with a fair value measurement attribute with some optional exceptions. We do not believe that such a principle can be applied prior to completing both the *Fair Value Measurements* and *Conceptual Framework (Phase C: Measurement)* projects, that will assist in determining whether the use of fair value is appropriate to all financial instruments. In addition, we are concerned that this proposal would not sufficiently improve and simplify the accounting treatment of financial instruments in the intermediate term to justify the cost of change because Australian constituents have become familiar with classification and measurement requirements of IAS 39.

Financial instruments are inherently complex and there will therefore be some level of complexity in their accounting, however we believe that improving the requirements with a principles-based approach would reduce the interpretative uncertainty associated with a number of the requirements. We would recommend that the IASB undertake a thorough review of the hedge accounting requirements in the longer-term and consider the practical issues raised by users, preparers and auditors to assist in developing a standard that reduces complexity in the reporting of financial instruments. Many of the proposals in respect of hedge accounting are not 'quick fixes' and may therefore result in increased time spent by the IASB in its drafting and by those using the standard when considering the implications of the proposals and whether the resulting accounting outcomes provide useful information. This may ultimately delay the longer-term project to reduce complexity in reporting financial instruments. We therefore suggest that very minor amendments are made to simplify hedge accounting in the intermediate-term, and that the IASB consider fully the hedge accounting requirements as part of the longer-term project.

Please find our responses to the specific questions accompanying the Discussion Paper in the attachment to this letter. In formulating our views, we have sought and considered the views of Australian constituents.

If you have any queries regarding any matters in this submission, please contact Natalie Batsakis (nbatsakis@aasb.com.au) or myself.

Yours sincerely

A handwritten signature in dark ink, reading "David Boymal". The signature is written in a cursive, flowing style.

David Boymal
Chairman

Discussion Paper *Reducing Complexity in Reporting Financial Instruments*

Section 1 – Problems related to measurement

Question 1

Do current requirements for reporting financial instruments, derivative instruments and similar items require significant change to meet the concerns of preparers and their auditors and the needs of users of financial statements? If not, how should the IASB respond to assertions that the current requirements are too complex?

We agree that the current requirements for reporting financial instruments, derivative instruments and similar items are complex and that significant change is required in order to meet the needs of users of financial statements. Generally speaking, given their nature, it is expected that there will be some level of complexity in accounting for financial instruments. However, we believe that consideration of the issues that have arisen since the implementation of the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* in developing a principles-based standard will provide clearer guidelines for preparers, users and auditors in accounting for these instruments.

We also believe that consideration should be given to the compliance costs for smaller privately owned and not-for-profit entities. We are aware that the requirements can be particularly onerous, and we would therefore support further consideration of these requirements in that context – perhaps in conjunction with the IASB's *Private Entities* project.

Section 2 – Intermediate approaches to measurement and related problems

Question 2

(a) Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that the IASB should not make any intermediate changes, please answer question 5 and 6, and the questions set out in Section 3.

Generally we would support the development of an intermediate approach, but only if it would not impact or delay the longer term financial instruments project, the changes represent a significant simplification to the requirements of the Standard and the benefits of its application outweigh the costs.

(b) Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?

Generally we agree with the criteria set out in paragraph 2.2, however, we believe that it is inappropriate to prescribe a long-term measurement objective of fair value, without completing and giving due consideration to the outcomes of the *Conceptual Framework* and *Fair Value Measurements* projects. These projects will provide a basis for determining the suitability of attributing a fair value measurement to more financial instruments than already prescribed in the Standard.

Question 3

Approach 1 is to amend the existing measurement requirements. How would you suggest existing measurement requirements should be amended? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph 2.2?

We do not agree with this approach as an intermediate change for reducing complexity in reporting financial instruments. As discussed in our letter, entities in Australia have applied the classification and measurement requirements of IAS 39 for some time and are now familiar with them. We do not believe that the changes proposed would result in benefits that would outweigh the costs of developing such guidance and of users of IAS 39 learning about those changes.

Question 4

Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions.

- (a) What restrictions would you suggest on the instruments eligible to be measured at something other than fair value? How are your suggestions consistent with the criteria set out in paragraph 2.2?*
- (b) How should instruments that are not measured at fair value be measured?*
- (c) When should impairment losses be recognised and how should the amount of impairment losses be measured?*
- (d) Where should unrealised gains and losses be recognised on instruments measured at fair value? Why? How are your suggestions consistent with the criteria set out in paragraph 2.2?*
- (e) Should reclassifications be permitted? What types of reclassifications should be permitted and how should they be accounted for? How are your suggestions consistent with the criteria set out in paragraph 2.2?*

We do not agree with replacing the existing measurement requirements as proposed in Approach 2. As mentioned in the response to Question 3, Australian entities are familiar with the measurement requirements of IAS 39.

We also believe that the current classifications provide useful information to users regarding the types of financial instruments held in an entity's balance sheet and how they are measured. In light of the many unresolved issues surrounding fair value measurement, we believe that replacing the existing measurement requirements with a fair value measurement principle, in the absence of a fundamental consideration of the issues, may simply result in replacing the existing IAS 39 measurement issues with another set of measurement issues and reduce comparability of reporting. Therefore, consistent with our response to Question 2(b), we believe that before the IASB prescribes a fair value measurement attribute for all financial instruments, work must be undertaken on the appropriateness of such a proposal as part of its *Conceptual Framework* project and the issues surrounding fair value measurement need to be dealt with in its *Fair Value Measurements* project.

Question 5

Approach 3 sets out possible simplifications of hedge accounting.

(a) Should hedge accounting be eliminated? Why or why not?

No, we do not believe that hedge accounting should be eliminated. The hedge accounting requirements are optional and allow management to report on its management of the risks associated with the various transactions which they undertake, and whilst many entities find the requirements onerous and often complex, they are commonly applied. This indicates to us that the perceived benefits often outweigh the costs of complying with the requirements.

In addition, we believe that the potential elimination of hedge accounting is a fundamental reconsideration of the accounting treatments available in IAS 39 and should be deferred until the longer-term project. We believe that making such changes in the intermediate term would involve those using hedging treatments spending considerable resources adjusting their systems which may automatically apply hedge accounting in certain circumstances. It is also likely that the IASB would need to provide complex transitional provisions to allow those applying hedge accounting to unwind their long term hedge positions. In addition, we believe that consideration of such an issue would likely delay finalisation of the intermediate solution and ultimately delay the longer-term project.

(b) Should fair value hedge accounting be replaced? Approach 3 sets out three possible approaches to replacing fair value hedge accounting.

(i) Which method(s) should the IASB consider, and why?

(ii) Are there any other methods not discussed that should be considered by the IASB? If so, what are they and how are they consistent with the criteria set out in paragraph 2.2? If you suggest changing measurement requirements under approach 1 or approach 2, please ensure your comments are consistent with your suggested approach to changing measurement requirements.

As an intermediate solution, we do not believe that the IASB should consider replacing fair value hedge accounting. Each of the three approaches identified appear to have their own complexities and replacing the existing requirements may simply result in replacing the complexities and practical issues associated with the current requirements with a new set of complexities and practical issues. Therefore the criteria set out in paragraph 2.2 would not be satisfied.

A better use of IASB resources would be to assess hedge accounting requirements as part of a long-term IASB project, in order to develop appropriate principles-based requirements.

Question 6

Section 2 also discusses how the existing hedge accounting models might be simplified. At present, there are several restrictions in the existing hedge accounting models to maintain discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings. This section also explains why those restrictions are required.

(a) What suggestions would you make to the IASB regarding how the existing hedge accounting models could be simplified?

We have considered the possible simplifications proposed by the IASB in Section 2 of the Discussion Paper. We believe that an appropriate intermediate solution would be to incorporate some of the proposals detailed in this section. At this stage, we would only agree with making amendments to the hedge documentation and hedge effectiveness requirements (discussed further below), because we do not consider the other suggestions to be ‘quick fixes’ and we believe that the IASB needs to undertake a thorough review of the implications of the other proposals to ensure that a simplified, principles-based standard is developed that results in accounting outcomes provide useful information and are consistent with, and representative of, the firms risk management strategy. In addition, we are concerned that developing guidance or any necessary amendments in respect of these proposals would require significant IASB resources and time and would likely delay the IASB from achieving the objective of reducing the complexity of hedge accounting requirements in the intermediate term, and therefore delay any benefit to the users/preparers.

Therefore, we believe that the most efficient way to reduce complexity of the hedge accounting requirements would be as follows:

- *Simplification of the hedge documentation requirements* – hedge documentation requirements in paragraph 8 of IAS 39 act as a checklist for documenting the entity’s objectives in undertaking the hedging transaction, the key aspects of the hedge, the expected outcomes/effectiveness of the transaction and how it will be tested to ensure it meets its objectives. This limits the entity’s ability to make amendments retrospectively in order to manipulate results. We understand the need for such documentation but consider that simplifying hedge documentation requirements, as discussed in paragraph 2.61 of the Discussion Paper, by making them focus on the objectives of the hedging transaction and reducing the emphasis on ongoing assessment of the hedge instrument’s effectiveness would provide significant relief to preparers. We also believe that this would reduce the risk that the hedge will be deemed ineffective despite it being consistent with the organisation’s risk management strategy; and
- *Simplification of the hedge effectiveness testing requirements* – the existing requirements are onerous because the method used to test effectiveness is required to be documented and the method selected may not render the hedge effective. As discussed at paragraph 2.59, different methods may yield different conclusions about the effectiveness of a hedging relationship, therefore as suggested in paragraph 2.61 (and discussed above), allowing management to set a broad hedging policy for testing effectiveness that would allow the use of an alternative method for testing effectiveness may reduce the instances where a hedging relationship that is consistent with the firms risk management policy is deemed ineffective for accounting purposes.

There have been suggestions that quantitative prospective testing requirements should be removed and replaced with qualitative tests, with quantitative prospective testing only at the inception of the hedge.

(b) Would your suggestions include restrictions that exist today? If not, why are those restrictions unnecessary?

Yes, we believe that the restrictions for hedge accounting, with some amendments as discussed in part (a) of Question 6 above, must be retained at this interim stage within the existing rules-based framework. The restrictions provide discipline to the use of the hedge accounting requirements. As discussed in the Discussion Paper, the restrictions play an important role in mitigating against misuse of the hedge accounting requirements and help ensure transparency in an entity's approach to hedge accounting. We believe however that the restrictions should be reviewed and assessed as part of the longer-term project.

(c) Existing hedge accounting requirements could be simplified if partial hedges were not permitted. Should partial hedges be permitted and, if so, why? Please also explain why you believe the benefits of allowing partial hedges justify the complexity.

We believe that the accounting requirements for partial hedges should be retained. As discussed in the Discussion Paper, although the requirements are considered to be complex, entities are choosing to deal with that complexity because it provides the ability to account for transactions in a way that is consistent with the organisational risk management strategy. We acknowledge that SFAS 133 *Accounting for Derivative Instruments and Hedge Accounting Activities* does not allow hedge accounting of partial hedges but we believe that the decision to allow or disallow these hedging relationships should be deferred and considered as part of the longer-term project.

(d) What other comments or suggestions do you have with regard to how hedge accounting might be simplified while maintaining discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings?

We do not have any other comments or suggestions about simplifying hedge accounting in the short term. We believe that the IASB should review hedge accounting requirements as part of the longer-term project.

Question 7

Do you have any other intermediate approaches for the IASB to consider other than those set out in Section 2? If so, what are they and why should the IASB consider them?

We do not have any other intermediate approaches for the IASB to consider.

Section 3 – A long-term solution - a single measurement method for all types of financial instruments

Question 8

To reduce today's measurement-related problems, Section 3 suggests that the long-term solution is to use a single method to measure all types of financial instruments within the scope of a standard for financial instruments. Do you believe that using a single method to measure all types of financial instruments within the scope of a standard for financial instruments is appropriate? Why or why not? If you do not believe that all types of financial instruments should be measured using only one method in the long term, is there another approach to address measurement-related problems in the long term? If so, what is it?

Some of our constituents have expressed concern that the use of a single method to measure the wide variety of financial instruments that exist in the market would not necessarily reflect the economic substance of transactions and the performance presented in the financial statements may not reflect the entity's business model, strategy and objectives.

Therefore, we believe that the IASB must undertake the necessary research in determining the appropriateness of applying a single method to the measurement of all financial assets, liabilities and equity items. The outcomes of Phase C of the *Conceptual Framework* project will assist in this determination.

Question 9

Part A of Section 3 suggests that fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments.

(a) Do you believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?

We consider that measuring all financial instruments at fair value would simplify the drafting of IAS 39, but we do not believe that the volume and variety of requirements is necessarily the only aspect of the complexity issue. Fair value measurement has its own complexities and these have been outlined in Section 3 of the Discussion Paper and are in the process of being addressed as part of the IASB's *Fair Value Measurements* project. Concluding that fair value is the most suitable measurement attribute for all types of financial instruments may be premature, because whilst it may appear to be simple and the most appropriate outcome, there are many different types of financial instruments and these are held for many different reasons.

We believe that clarification of the meaning of 'fair value' is required before it can be determined whether fair value is the only appropriate measurement attribute for all financial instruments in all circumstances, and we therefore recommend that the IASB first complete its projects on the *Conceptual Framework* and *Fair Value Measurements* before further developing the proposal that fair value is the only measurement attribute that is appropriate for all types of financial instruments. Until such further analysis and consideration is given, we cannot comment on the appropriateness of measuring all financial instruments using a fair value measurement attribute.

(b) If not, what measurement attribute other than fair value is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Why do you think that measurement attribute is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Does that measurement attribute reduce today's measurement-related complexity and provide users with information that is necessary to assess the cash flow prospects for all types of financial instruments?

As expressed in Question 8, there is uncertainty surrounding the merit of applying a single measurement attribute to all financial instruments. We acknowledge that multiple measurement bases add to the number of requirements in IAS 39, however, until further work is completed on the *Conceptual Framework* and *Fair Value Measurements* projects, it is premature to comment on the appropriateness of the use of a single measurement attribute for measuring all financial instruments.

Question 10

Part B of Section 3 sets out concerns about fair value measurement of financial instruments. Are there any significant concerns about fair value measurement of financial instruments other than those identified in Section 3? If so, what are they and why are they matters for concern?

As discussed in the response to Question 9, we believe that before fair value measurement can be selected as the most appropriate method for measuring all financial instruments, it is necessary for the IASB to complete its projects on the *Conceptual Framework* and *Fair Value Measurements*. We believe this will address two key concerns of our constituents:

- (i) the appropriateness of a single method for measuring all financial instruments; and
- (ii) what is meant by the term fair value, because some constituents are concerned that this term has not been applied consistently throughout SFAS 157 *Fair Value Measurements* (which was the basis for the IASB Discussion Paper *Fair Value Measurements*).

We believe that at this point the IASB can address the concerns raised in Part B of Section 3 of the Discussion Paper to reach appropriate conclusions as to whether fair value is the only appropriate measurement attribute for financial instruments.

Question 11

Part C of Section 3 identifies four issues that the IASB needs to resolve before proposing fair value measurement as a general requirement for all types of financial instruments within the scope of a standard for financial instruments.

- (a) Are there other issues that you believe the IASB should address before proposing a general fair value measurement requirement for financial instruments? If so, what are they? How should the IASB address them?***

We agree with the four issues identified by the IASB that must be resolved before proposing fair value measurement as a general requirement for all types of financial instruments within the scope of a financial instruments standard.

Prior to proposing a general fair value measurement objective and in determining the scope of a financial instruments standard, we believe that it is not only important for the IASB to consider the definition of a financial instrument, but that consideration should also be given to the

possibility of including exemptions if it is concluded that the fair value measurement attribute is not appropriate for all classes of financial instruments that fall within the scope of the standard.

We believe that the completion of the *Conceptual Framework* projects, particularly Phase A: Objectives of Financial Reporting and Phase C: Measurement, as well as the *Fair Value Measurements* project will assist in resolving some of the issues.

(b) Are there any issues identified in part C of Section 3 that do not have to be resolved before proposing a general fair value measurement requirement? If so, what are they and why do they not need to be resolved before proposing fair value as a general measurement requirement?

We believe that all the issues identified in Part C of Section 3 should be resolved before proposing a general fair value measurement requirement.

Question 12

Do you have any other comments for the IASB on how it could improve and simplify the accounting for financial instruments?

Australian constituents have raised the following concerns:

- (a) IFRS 7 *Financial Instruments: Disclosures* – the disclosures are complex and difficult to interpret and apply and result in many more pages of disclosures than any other Standard requires. We recommend that any intermediate or long-term solution should not increase the number of disclosures required unless they are significant to the usefulness and understanding of the financial statements;
- (b) Embedded derivatives – the requirements of IAS 39 on the identification and possible separation of embedded derivatives are difficult to understand and apply for many preparers, and there is debate surrounding the meaning of ‘routinely denominated’ and ‘economic environment’ and the associated application guidance. The terms ‘routinely denominated’ and ‘economic environment’ are not defined and there is limited guidance. This has resulted in some accounting firms resorting to compiling lists of goods (mainly minerals/oils and gas commodities) which if traded in USD are deemed to be ‘routinely denominated’ and therefore closely related to the host contract and exempt from fair value accounting as per paragraph 11 of IAS 39. In addition, the guidance (see IG C.9) explains that each good can only be traded in one currency for it to be routinely denominated, which would seem to be an outdated notion in a world with several trading currencies. The guidance appears to be inconsistent with the current business environment. We believe that the concerns surrounding these terms should be addressed as part of the longer-term project; and
- (c) Impact on private entities – we believe that the long-term objectives of reducing complexity in reporting financial instruments should include consideration to the appropriateness of the requirements for smaller privately-owned entities.