ED196 sub 5

New South Wales
TREASURY

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

Contact: D. McHugh
Telephone: (02) 9228 5340
Our Reference:
Your Reference:

2 July 2010

Dear Mr Stevenson

AASB Exposure Draft ED 196 "Fair Value Option for Financial Liabilities"

New South Wales Treasury welcomes the opportunity to provide comments on the above Exposure Draft. Detailed comments to the IASB are attached.

We do not support the proposals for the following main reasons:

- We do not agree with the view that symmetry with the treatment of financial assets is unnecessary and we believe that the proposals will increase inconsistency and complexity.
- The proposals will increase the use of the 'other comprehensive income' (OCI) category, when there is no clear rationale for its use. Instead, we believe that the rationale for the use of the OCI category should be examined as part of the IASB *Financial Statement Presentation* project, in conjunction with the concept of 'remeasurements'.
- We are concerned that the differences in treatment compared to the FASB proposals have not been made transparent and we are concerned that there was only limited time available to review the Exposure Draft, in the context of the FASB proposals.

However, if the proposal does proceed, we agree with the FASB that the issue should be restricted to own credit risk and that the basis used to determine credit risk in IFRS 7 is inappropriate. This is because IFRS 7 does not distinguish between own credit risk and changes in the price of credit.

In terms of GFS/GAAP, in our view, the entire change in fair value of financial liabilities represents an 'other economic flow' (refer AASB 1049, para 31(a)(ii)). Therefore, we believe that the presentation in the Statement of Comprehensive Income is made more complex, as the 'other economic flows' will be presented in two different sections of the Statement; i.e. in profit and loss and in other comprehensive income.

For the above reasons, NSW Treasury does not believe that overall the proposals would result in financial statements that would be useful to users.

If you have any queries on these matters, please contact me on (02) 9228 3019 or Dianne McHugh on (02) 9228 5340.

Yours sincerely

RWilliams

Robert Williams
for Secretary

New South Wales
TREASURY

Sir David Tweedie
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30 Cannon Street
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Contact: D. McHugh
Telephone: (02) 9228 5340
Our Reference:
Your Reference:

2 July 2010

Dear Sir David

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

New South Wales Treasury welcomes the opportunity to provide comments on the above Exposure Draft. Detailed comments are attached.

We do not support the IASB proposals for the following main reasons:

- We do not agree with the view that symmetry with the treatment of financial assets is unnecessary and we believe that the proposals will increase inconsistency and complexity.

- The proposals will increase the use of the 'other comprehensive income' (OCI) category, when there is no clear rationale for its use. Instead, we believe that the rationale for the use of the OCI category should be examined as part of the IASB *Financial Statement Presentation* project, in conjunction with the concept of 'remeasurements'.

- We are concerned that the differences in treatment compared to the FASB proposals have not been made transparent and we are concerned that there was only limited time available to review the Exposure Draft, in the context of the FASB proposals.

However, if the proposal does proceed, we agree with the FASB that the issue should be restricted to own credit risk and that the basis used to determine credit risk in IFRS 7 is inappropriate. This is because IFRS 7 does not distinguish between own credit risk and changes in the price of credit.

If you have any queries on these matters, please contact me on 612 9228 3019 or Dianne McHugh on 612 9228 5340.

Yours sincerely

R Williams

Robert Williams
for Secretary

IASB EXPOSURE DRAFT ED/2010/4 FAIR VALUE OPTION FOR FINANCIAL LIABILITIES

Introductory comments

NSW Treasury does not agree with the view that symmetry with the treatment of financial assets is unnecessary. Although we note that there is already inconsistency in the treatment of financial assets and financial liabilities, we are concerned that the IASB proposal, by separately addressing financial assets and financial liabilities, will increase inconsistency and complexity[1].

In particular, we do not support recognising the impact of changes in credit risk in other comprehensive income (OCI). Instead, we believe that the rationale for the use of the OCI category should be examined as part of the IASB *Financial Statement Presentation* project, in conjunction with the concept of 'remeasurements'. Pending such a review we believe that there is little or no justification for categorising additional items, such as changes in credit risk, as part of OCI.

While we note that the ED is in part a response to the Global Financial Crisis, it does not seem to resolve the issue it was meant to address, that is the counterintuitive impact on profit of changes in own credit risk. This is because the ED, in discussing credit risk, does not distinguish between changes in own credit risk and changes in the general price of credit. This issue was also raised by the FASB, which, unlike the IASB, determined not to use the IFRS 7 basis for calculating credit risk.

Further, NSW Treasury is concerned that the differences between the IASB and FASB proposals have not been made more transparent. As the FASB proposals were issued *after* the IASB proposals (and with a later comment period), there is limited time to review the IASB ED, in the context of the FASB proposals. Ideally, we would have preferred that proposals were issued jointly by the IASB and FASB. However, as a minimum, we believe that the differences between the two proposals should have been made more transparent and with comment periods that coincided.

More detailed comments on these issues are discussed in the following.

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?

No. The case for this treatment has not been made. Until the IASB has examined the rationale for the use of the OCI category it seems difficult to justify classifying a portion of a fair value change to OCI. In this regard, we would argue that all changes in fair value, including the change in credit risk, should be treated consistently, in accordance with the measurement basis; i.e. 'fair value through profit or loss'.

[1] For example, we are concerned that under IFRS 9, for financial assets, an entity will not be able to separate an embedded derivative from the host contract, but for financial liabilities, it will be required to separate these two elements and measure them separately, where they are not closely related to the host contract. Therefore, the issuer and borrower will account for the same financial instrument differently.

NSW Treasury believes that the role and meaning of OCI needs to be reviewed by the IASB as a high priority. In the meantime, we support continuing to provide information regarding changes in credit risk as a note disclosure only.

We also note that the main argument for the treatment proposed in the ED is in relation to changes in own credit risk, rather than from changes in the general price of credit. However, the ED does not distinguish between these two concepts (i.e. they are both included in the change in credit risk), and therefore even if it is accepted that own credit risk changes should be separated, the ED does not achieve this objective. Therefore, while we do not support recognition in OCI, if the IASB proposal proceeds, we believe that this should be restricted to own credit risk only (refer also to response to question 8).

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? Why?

NSW Treasury believes that the entire movement in fair value should be recognised through profit of loss and as such, this alternative is not necessary.

Question 3 Do you agree that the portion of the fair value change that is attributable to changes in the credit risk should be presented in other comprehensive income? If not why?

No. Refer response to question 1.

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?

NSW Treasury believes that all changes in fair value, including changes in credit risk, should be recognised through profit or loss. However, if the IASB proceeds with its proposal, then we agree with the two step approach, as it more clearly identifies the entire change in fair value, including the credit risk.

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

No, as this does not clearly disclose the total change in fair value. It also seems contrary to the nature of the category itself; i.e. 'fair value through profit or loss'.

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?

No. We do not believe that changes in the credit risk should be presented in equity, as we do not view the change in credit risk as a wealth transfer between debt holders and equity holders. It also replaces one problem (recognition through OCI) with another (recognition through equity), both of which seem difficult to justify and have no clear rationale.

Question 7 Do you agree that gains or losses resulting from changes in a liability's credit risk included in OCI should not be reclassified to profit or loss? If not, why and in what circumstances should they be reclassified?

Yes. We do not support recycling, and agree with the Board that a gain or loss should be recognised only once.

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?

No. We believe that the IFRS 7 guidance is an inappropriate basis to determine classification in a primary financial statement. This is because such guidance was developed for note disclosure purposes only, and only provides a proxy for credit risk changes. We agree with the FASB ED *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging* Activities (para BC 164), which states that IFRS 7 does not accurately reflect the change in own credit risk as it includes the change in the price of credit which is not specific to the entity.

Therefore, while we do not support recognition in OCI, if the IASB proposal does proceed, we believe that recognition in OCI should be limited to own credit risk only. Consistent with FASB, given that several different methods may be used, it may not be possible or appropriate for the IASB to prescribe the method.

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?

If the ED is approved, 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?

No comment.