RCRFI sub 5

Group Finance
Level 8, 100 Queen Street
Melbourne Vic 3000
Phone 03 9273 4397
Fax 03 9273 6150
buggles@anz.com
www.anz.com

Shane Buggle
Group General Manager Finance

2 September 2008

Mr David Boymal
Chairman
Australian Accounting Standards Board
P.O. Box 204
Collins Street West VIC 8007

Dear David

Reducing Complexity in Reporting Financial Instruments

Thank you for the opportunity to provide comments on the Discussion Paper 'Reducing Complexity in Reporting Financial Instruments'.

Reducing complexity in accounting for financial instruments is an initiative that we strongly support. We also embrace consistency and transparency of financial information. However, we do not support a full fair value model for measuring financial instruments until certain key issues are addressed. These issues include artificial stability and volatility, unreliability of fair value measurement where instruments are not traded and non-alignment with management of the instruments. We believe that resolution of these issues is a necessity prior to considering further use of fair value measurement of financial instruments.

As a financial institution we also have other, potentially greater concerns such as how changes in fair value should be presented in an entity's income statement and how they marry with the entity's performance measurement objectives. Furthermore, we consider that fair value will not represent economic reality or be truly effective as a measurement methodology until such time as it is used by entities for risk management purposes and until such time as efficient markets exist for all financial instruments. Furthermore, users of financial instruments must find fair value as the most relevant measure in order for it to be meaningful.

Lastly we note that the IASB is dealing with aspects of accounting for financial instruments, including measurement, in advance of the finalisation of the Conceptual Framework project. We therefore question whether the timing of this initiative is appropriate.

Our responses to specific questions raised in the Discussion Paper are also attached to this letter.

Should you have any queries on our comments, please contact Alane Fineman, Senior Manager of Accounting Policy at Alane.Fineman@anz.com.

Yours sincerely

SHANE BUGGLE
Group General Manager Finance

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?

The usage of financial instruments can vary greatly and serve many different purposes. For example, the same financial instrument (a derivative) can be used for short term trading, risk management, or simply provide optionality in a wider transaction. The current mixed measurement model under IFRS caters for the diversity in the purpose of financial instruments.

There is no doubt that the current requirements are complex, but this is due to the fact that any valuation model must take into account the differing nature and purpose of a wide range of financial instruments. In our view, a full fair value approach to measuring financial instruments does not appropriately reflect the performance impact relating to the intended use of all instruments. Moreover, a fair value approach with permissible exceptions (or "opt-outs") would, in practice, differ little from the current mixed measurement model.

The existing measurement requirements, while in some aspects complex, are accepted and implemented within the financial community. Additional changes of any significance will result in the modification of systems, increase costs and create potential confusion for users and preparers of financial statements, while in our view providing little alleviation of complexity. We consider the necessary improvements centre around modifying the existing standards to address practical issues and specific problem areas, such as hedge accounting and the incurred loss model for impairment measurement.

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 questions 5 and 6, and the questions set out in Section 3.*

Yes, the IASB should consider intermediate steps to address complexity arising from measurement and hedge accounting. However, it is our position that these steps should focus on the issues and difficulties that entities face in the current environment when applying the existing requirements. Intermediate steps are necessary, but a fundamental change to the current measurement criteria is not. We must remain aware of the fact when dealing with financial instruments, complexity in some form will always exist.

Hedge accounting requirements can result in significant implementation and monitoring difficulties, consequently they are inconsistent with good business practice. The current hedge accounting requirements often encourage behaviours which are driven by the desire to attain an accounting outcome, rather than being aligned with prudent risk management policies, practices and the underlying economics of transactions.

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

While we agree with most of the criteria, we do not consider it appropriate to set an objective for full fair value accounting at this point in time. Instead we should be seeking the objective of achieving a clear principles-based framework for accounting for financial instruments. We also believe that there should be an additional objective of no significant increase in disclosures for financial instruments, as entities are already overburdened in this regard.

Question 3

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

We are supportive of amending the existing measurement requirements however, in our view, improving hedging rules and changes to the incurred loss impairment criteria would be the most beneficial.

The necessary improvements that we consider imperative to the current hedge accounting requirements are outlined under question 6 (d) below. In relation to the impairment of amortised cost financial assets, a change from a pure incurred loss model to a model combined with an expected loss methodology would provide a better reflection of economic reality. If applied with sound internal risk ratings and methodologies, expected loss can provide a clearer indication of management decision making and performance than the incurred loss methodology. The expected loss method is also congruent with how prudential supervisors regulate companies.

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?*

When the issues regarding the use of fair value have been addressed, it is expected that many non-traded financial instruments would require an amortised cost "opt-out" from fair value. Moreover, as there is a need for the statement of financial performance to reflect the nature and purpose of the underlying instrument, it is expected that fair value movements on equity instruments which are not held for trading and certain hedging arrangements would go through comprehensive income and not profit and loss.

Overall, the "fair value with optional exceptions" approach is flawed due to the need for this fair value opt out, as the ultimate result will be similar to the current mixed measurement model. Therefore, it will not satisfy criteria 4 in paragraph 2.2.

(b) *How should instruments that are not measured at fair value be measured?*

These instruments should be measured at amortised cost or alternatively measured at fair value with subsequent fair value movements taken to a reserve.

(c) *When should impairment losses be recognized and how should the amount of impairment losses be measured?*

For financial instruments measured on an amortised cost basis, impairment should reflect incurred loss where a loss event has been identified. However, where no impairment loss is observed, an expected loss model would better reflect the true economics of the instrument. Additionally, if applied with consistent use of internal risk ratings and methodologies, expected loss can provide a better indication of management decision making and performance than a pure incurred loss methodology. An expected loss methodology is also compatible with the approach taken by prudential supervisors when regulating businesses.

(d) *Where should unrealized gains and losses be recognized on instruments measured at fair value? Why? How are your suggestions consistent with the criteria set out in paragraph 2.2?*

The treatment of the instrument should follow its intended nature and purpose. As an example, if the instrument related to the underlying business operations, such as sale transactions in a foreign currency, the changes in fair value should be recognised through profit and loss. In contrast, where the instruments relate to financing/funding activities the changes in fair value should be recognised as part of comprehensive income.

(e) *Should reclassification 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?*

Reclassification should be permitted, where the reclassification follows a change in the nature or purpose of the instrument. However, this change will need to be substantiated and justified accordingly.

Question 5

Approach 3 sets out possible simplification of hedge accounting.

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

No, hedge accounting should not be eliminated. Hedging is a common and prudent risk management practice. The elimination of hedge accounting would result in accounting standards becoming removed from business reality thus leading to further disaffection with the standard-setting process.

It is our view that standard-setters should be searching for solutions and developing accounting standards which faithfully represent the underlying economics and substance of business transactions.

(b) *Should fair value hedge accounting be replaced? Approach 3 sets out three possible approaches to replacing fair value hedge accounting. Which method(s) should the IASB consider, and why?*

We do not support the full fair value methodology for measuring financial instruments at this time. Hence, we are not seeking a replacement of hedge accounting; instead we seek to address the associated issues with the current model.

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.

Refer comments in the next section.

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.

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

Following on from our position that accounting requirements should faithfully represent business transactions, a "management approach" to hedge accounting would be the most effective in reducing complexity. This approach would involve a principle that if hedging transactions are consistent with the company's mandate and risk management policies, hedge accounting would be permissible. Consequently, there should not be a need to prepare detailed accounting requirements relating to the designation and effectiveness of hedges. To prevent avoidance, specific documented policies and procedures would need to be put in place which outline the entity's formal requirements for designation and ongoing assessment of effectiveness.

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

No, it is our view that the restrictions that exist today such as those relating to designation and effectiveness discourage entities from employing hedging activities Restrictions such as these are rules based directives and do not promote a principles based approach to financial reporting.

(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?*

Partial hedges should be permitted and in our view this would result in only a marginal increase in complexity. Again following the principle that accounting should faithfully represent economic reality, if an entity enters into a partial hedge as part of its risk management strategy that hedge should be recognised by the accounting rules. As part of their management strategy entities have protocols and practices, including monitoring activities, and if a hedge transaction is within the risk management policies of the entity, the accounting should reflect the status of those activities. As an example an entity may enter a partial hedge because this is the best outcome it can achieve and is consistent with maximising the outcome for shareholders. Restricting hedge accounting for such transactions may impede management decision making on value adding or value preserving transactions.

(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?*

There are many practical issues with the current requirements for hedge accounting that could be easily remedied. A list of these items is provided below. Hedge accounting should ultimately enable the financial information of an entity to encapsulate its underlying business performance. All methods of hedging should be allowed as they reflect normal risk mitigation systems that an entity may implement. Accounting should not drive decision making. Regardless of complexity, accounting should reflect decision making, not drive decision making.

Necessary amendments to current hedge accounting requirements include:

- **It should be possible to hedge a margin or a transaction with variable volume to fix the cash flow per volume**
- **Hedging foreign debt with a cross currency swap should be possible with the local currency interest rate profile without requiring a de-designation of the initial cross currency interest rate swap.**
- **Allowing the segregation of the fair value of a derivative at inception so that re-designation can occur and still meet hedge effectiveness criteria**

- **Identification of the hedged risk in respect of commodity hedges should be allowed**
- **Deferring the time value of purchased options should be possible**
- **CPI hedging should be permitted**
- **It should be possible to designate physical contracts at FVTPL in a trading environment**
- **Allowing hedging of foreign subsidiary income streams**
- **Modification of the definition of firm commitment in order not to require a fixed volume and fixed price**
- **The routinely denominated/commonly used must both be clearly defined as it is currently interpreted differently**

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?

Refer to Question 6

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?

Conceptually, a single measurement model may be the most appropriate in the long term, however we cannot support a full fair value methodology before issues relating to how the changes in fair value impact the performance statement and other measurement issues and the other concerns documented in this paper are resolved. Furthermore, the measurement of financial instruments in the long-term should not be part of the current project, instead long-term issues should be addressed in the first instance as part of the conceptual framework project dealing with measurement.

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?*

  Depending on the nature and purpose of the financial instrument, it is arguable that amortised cost (or fair value with movements recognised in comprehensive income) is more appropriate in certain circumstances. Refer to comments in questions 1 and 4 above.

(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?*

Refer to comments in question 1 and 4 above.

Question 10

Part B of Section 3 sets out concerns about fair value measurements of financial instruments.

Are there 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?

There are significant concerns about the fair value measurement of financial instruments. These primarily relate to risk management and the perspective of the users of financial instruments. Entities must be using fair value to manage their business if fair value is to be considered the most relevant measurement model, currently this not the case for a large portion of financial instruments. Moreover, users must find fair value meaningful in order to create useful financial information. Finally, in order for fair value to be the most appropriate measurement model, efficient markets must exist for financial instruments to be measured effectively, accurately and consistently. These concerns related to those listed in Part B of section 3.

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?*

Part C adequately identifies the issues that require resolution.

(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?*

All issues require appropriate resolution.

Question 12

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

It must be stressed that we support improvements to the current mixed measurement model only in the areas of hedging and impairment. Any other interim solution is likely to cause more change, uncertainty and instability in the accounting environment and add little value to its preparers and users.