Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Not-for-Profit Private Sector Financial Reporting Framework**	**Meeting:**	M187
Topic:	**Tier 3 – Financial Instruments**	**Agenda Item:**	5.2.2
		Date:	2 May 2022
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		Decision-Making:	High
		Project Status:	Initial deliberations

Objective of this paper

1 The objective of this agenda paper is for the Board to **decide** its preliminary views on Tier 3 reporting requirements for a not-for-profit (NFP) private sector entity's financial instruments for inclusion as part of a discussion paper (DP)[1] for the following topics:

(a) extent of requirements and guidance (paragraphs 3 – 17);

(b) initial measurement of financial assets and financial liabilities (paragraphs 18 – 26);

(c) approach to subsequent measurement – accounting policy options (paragraphs 27 – 42);

(d) approach to subsequent measurement – simpler accounting policies (paragraphs 27 – 42);

(e) measurement of interest income and interest expense – effective interest method (paragraphs 43 – 49); and

(f) impairment of financial assets that are debt instruments (paragraphs 50 – 59).[2]

Summary of staff recommendations

2 Staff recommend that the Tier 3 reporting requirements for financial instruments should:

(a) be wholly self-contained within a Tier 3 Standard (i.e. without cross-referencing to higher tier requirements);

(b) require financial assets and financial liabilities to be initially measured at transaction price; and where the transaction includes a financing element, at the cash price;

1 For succinctness, in general, references to 'AASB 9' in this paper and in Agenda Paper 5.2.1 are to the suite of Tier 1 financial instrument-related standards, rather than to AASB 9 *Financial Instruments* in particular.

2 Agenda Paper 5.2.1 identified the topics considered for potential simplification. The remaining topics not covered by this staff paper will be brought to the June 2022 meeting. Agenda Paper 5.2.1 also contains a summary of the current Australian Accounting Standards requirements, summary approaches taken by selected other jurisdictions, summary of the feedback from Australian stakeholders, findings from academic research and other literature, and the findings from staff review of a sample of financial statements. These informed staff when developing the options for the Board to consider.

(c) require the directly attributable transaction costs of a financial asset and financial liability to be expensed in the period the costs are incurred;

(d) specify simpler subsequent measurement requirements for financial instruments; being for:

  (i) financial assets that are held to generate both income and capital investment return for the entity to be measured at FVTPL;

  (ii) derivative financial instruments to be measured at fair value through profit or loss (FVTPL); and

  (iii) all other financial assets and financial liabilities to be measured at cost less impairment;

(e) require interest income and interest expense to be recognised as amounts are earnt or incurred, calculated by applying the contractual interest rate to the amount on which interest is earnt;

(f) require for a financial instrument not measured at fair value, any initial premium or discount to be amortised on a straight-line basis over the life of the instrument (unless another systematic basis or shorter period is more reflective of the period to which the premiums or discounts relate). Any directly attributable fees and deferred transaction costs should be similarly treated;

(g) require, for debt instruments measured on a basis other than fair value, that an impairment loss be recognised when it is probable that the amount owed will not be collectible, measured at the expected uncollectible amount;

(h) require, for equity instruments measured at cost less impairment, that:

  (i) impairment be charged only when there is objective evidence to indicate that the carrying amount of the financial asset is unlikely to be recovered in the future; and

  (ii) for the impairment loss to be measured as the difference between the carrying amount of the asset and its fair value at the reporting date.

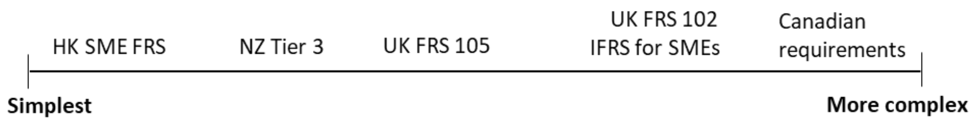
Identified proposed simplification 1 – Approach to extent of requirements and guidance

3 Staff think the Board should form a view with regards to its approach to the extent of requirements and guidance for financial instruments for inclusion in a Discussion Paper. That is, the extent to which the Board intends to require preparers to consider AASB 9. Staff note that there may be some overlap between this Board decision and the other proposed simplifications,[3] but think that having clarity about the Board's position will allow stakeholders to evaluate better the complexity of the Board's financial instrument proposals.

4 To aid in Board member consideration of the requirements and guidance, staff have classified the complexity of the financial instrument requirements of the selected other jurisdictions on the following scale:[4]

3 For example, if the Board decides to develop Tier 3 hedge accounting requirements, it must decide whether to specify such requirements within a Tier 3 pronouncement, or whether to direct an entity that wishes to apply hedge accounting to the hedge accounting provisions set out in AASB 9 (or AASB 139). In contrast, if the Board decides that its Tier 3 reporting requirements should not allow hedge accounting as an available accounting policy, this Board decision is irrelevant, as there is no need for entities to be referred to AASB 9.

4 This scale is a staff view. It has not been verified with the individual jurisdictions.



5 Staff think that the Tier 3 reporting requirements for financial instruments should be substantially reduced from AASB 9. With reference to the Board's agreed approach to simplification,[5] staff's view is that the appropriate balance of requirements and guidance is somewhere between the extent specified by the *IFRS for SMEs* and UK FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. That is, broader and simpler requirements and less guidance than the *IFRS for SMEs* but more guidance than UK FRS 105. Staff consider that Australian stakeholders would not be best served by too little guidance, as this could inadvertently introduce complexity for preparers to develop appropriate accounting policies.

6 Having regard to its comments above, staff propose the Board simplification of the extent of financial instrument requirements and guidance could be actioned either by:

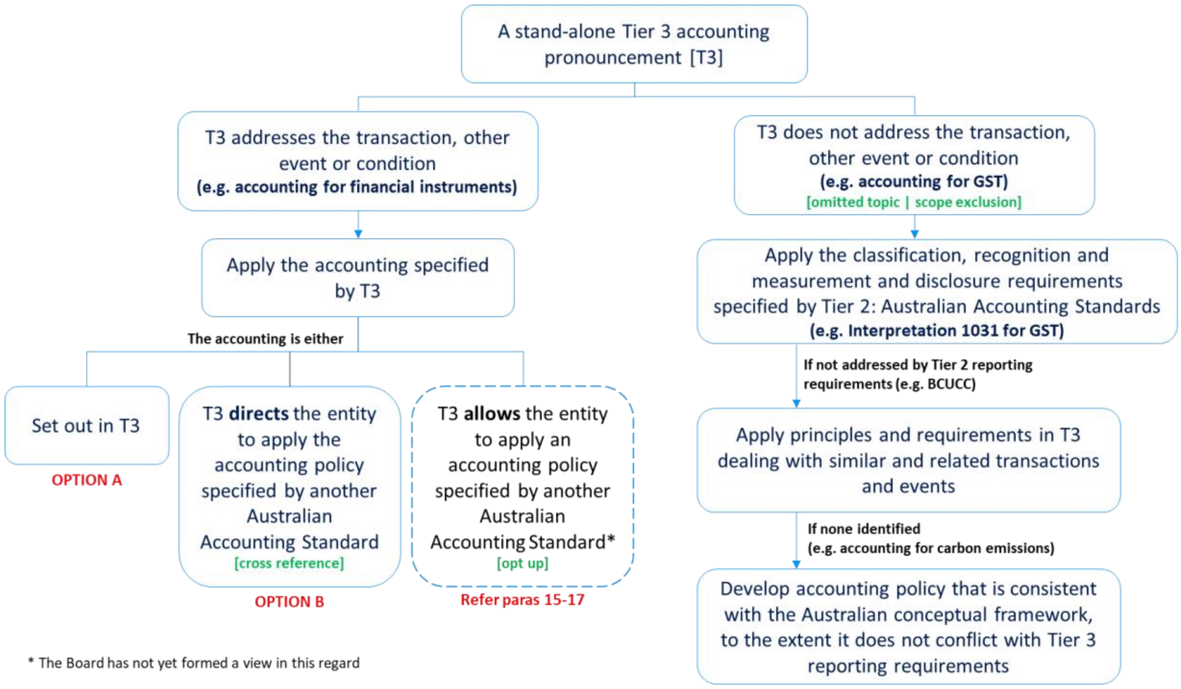
(a) **Option A** – completely containing the reporting requirements for financial instruments within the Tier 3 Standard. That is, there should be no 'signpost' or direction for entities to consider the guidance or requirements in AASB 9 for transactions that are not specifically addressed, or a cross-reference to particular requirements of a higher tier. This Option is consistent with the approach adopted by many of the selected other jurisdictions; or

(b) **Option B** – specifying the reporting requirements for financial instruments in part within the Tier 3 Standard, and in part by cross-reference to AASB 9. This Option would still be consistent with the June 2021 Board decision to develop a Tier 3 Standard that would only have minimal cross-referencing to other Australian Accounting Standards requirements.[6] This Option is consistent with the Tier 1 Australian Accounting Standards (and Canada and the USA) approach where for-profit requirements apply 'except as amended'.

5 Refer Appendix B of Agenda Paper 5.2.1

6 AASB June 2021 meeting minutes: https://www.aasb.gov.au/media/bjajvtal/aasbapprovedminutesm181_4aug21.pdf

7 The flowchart below illustrates the difference between Option A and Option B:



8 As reflected by the flowchart, an **Option A** approach means that:

(a) Except where specifically scoped out of the Tier 3 Standard, the requirements specified in the Tier 3 Standard take precedence over any specific Tier 2 recognition and measurement extended requirements or guidance. By default, a Tier 3 preparer has access to a different set of directions and guidance than a Tier 1/ Tier 2 preparer. In contrast, some specific AASB 9 requirements or guidance could be incorporated into a Tier 3 Standard by cross-reference under an Option B approach.

(b) Should the Board determine not to develop a requirement that addresses the particular financial instrument (scope exclusion), under the hierarchy previously tentatively agreed to by the Board, the entity will need to apply the Tier 2 accounting requirements in the first instance. Similar accounting applies under an Option B approach.

For example, the Board may decide that its general financial instrument accounting provisions should not apply to any rights or obligations arising under an insurance contract other than a financial guarantee contract. Applying the hierarchy will require the entity to account for those rights or obligations in accordance with AASB 17 *Insurance Contracts* (assuming that the Board does not develop Tier 3 requirements for insurance contracts).

9 To illustrate the impact, Table 1 below lists examples of possible outcomes under Option A and Option B.

Table 1: Contrasting Option A and Option B outcomes

Example of possible outcomes under Option A *(Financial instrument requirements are self-contained within a Tier 3 Standard)*	**Example of possible outcomes under Option B** *(Financial instrument requirements are specified within a Tier 3 Standard and by cross-reference to AASB 9 or other Australian Accounting Standard)*
A change in own credit risk is treated like any other change in fair value of a financial liability (unless the Board decides otherwise).	A change in own credit risk is recognised in OCI in accordance with AASB9.5.7.7 if the financial liability is one designated as FVTPL, unless the financial liability is a commitment to provide a loan at a below-market interest rate or a financial guarantee contract.
A commitment to provide a loan at a below-market interest rate and a financial guarantee contract is measured at cost, similar to other financial liabilities (or other measurement basis, depending on the Board decision at this meeting).	A commitment to provide a loan at a below-market interest rate and a financial guarantee contract is measured in accordance with AASB9.4.2.1(c) and 4.2.1(d) at the higher of the amount of the loss allowance determined in accordance with Section 5.5 of AASB 9 and the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of AASB 15.
Derivative financial instruments are measured at fair value (or cost or other measurement basis, depending on the Board decision at this meeting). Hedge accounting is permitted only if allowed by the Tier 3 Standard (subject to the Board decision at its June meeting).	Derivative financial instruments are measured at fair value. Hedge accounting may be applied instead to a derivative financial instrument that is used to hedge an exposure, when the rigorous hedge accounting conditions set out in AASB 9 are met.
An entity must apply judgement to determine whether a financial asset meets the conditions for derecognition based on the guidance in the Tier 3 Standard (subject to the Board decision at its June meeting).	An entity considers specified 'continuing involvement' guidance in AASB 9 when deciding whether a financial asset meets the conditions for derecognition when the entity continues to hold some risks and rewards of ownership of the financial asset.
An embedded derivative is not separately recognised from its host financial liability contract (unless the Board makes a decision otherwise).	An embedded derivative must be separately accounted for from its host contract in accordance with AASB 9.4.3.3-4.3.7 and B4.3.1-B4.3.12.

10 In accordance with the Board's agreed approach to simplification as set out in the flowchart included in Appendix B to Agenda Paper 5.2.1, staff have analysed reasons for supporting one Option over the other:

Table 2: Staff analysis of Option A and Option B

Arguments in support of Option A over Option B *(Financial instrument requirements are self-contained within a Tier 3 Standard)*	**Arguments in support of Option B over Option A** *(Financial instrument requirements are specified within a Tier 3 Standard and by cross-reference to AASB 9 or other Australian Accounting Standard)*
• consistent with the objective of developing Tier 3 reporting requirements as a simple, proportionate response for smaller entities • avoids costs and reduces complexity for an entity by avoiding 'sending' the entity to consider AASB 9 to understand whether there are more detailed or specific requirements that apply – or that could apply – to the accounting for the financial instruments held by the entity. • gives entities a little more flexibility in interpreting the Tier 3 requirement, which should reduce costs	• facilitates consistency in accounting for more complex financial instruments. For complex instruments, the accounting result may otherwise not provide useful financial information to users • smaller entities may be disadvantaged as they do not have access to all the guidance or special requirements available to entities applying Tier 1 or Tier 2 Australian Accounting Standards • as there is greater detail and specificity, the extent of management judgement is more confined under Option B compared to Option A. A different accounting treatment may develop under Option B compared to the accounting applying under Option A. • costs are possibly largely once-off on initial application, unless the entity regularly enters into transactions that are not 'basic' financial transactions

11 **Staff view.** Option B prioritises retaining consistency in accounting for more complex financial instruments and transactions, even though this will create complexity for the preparer. This Option acknowledges that the scope of issues identified in staff research and preliminary outreach were relatively narrow, rather than a general expressed difficulty with applying AASB 9.[7] It should also be anticipated that only a limited subset of Tier 3 entities would ever be likely to need to consider any cross-referenced requirements of AASB 9.

12 However, staff are conscious of stakeholder feedback suggesting that AASB 9 can be overly complex and detailed to apply. To keep Tier 3 requirements simple and clear, staff give weight to not directing stakeholders to that Standard. This avoids inadvertently causing preparers to consider that they will need to be familiar with AASB 9.

13 Consequently, on balance, staff recommend Option A. That is, for financial instrument requirements to be wholly self-contained within a Tier 3 pronouncement. Option A recognises that, consistent with the Board's objectives in developing the reporting Tier, Tier 3 reporting requirements cannot, and should not, be expected to address all possible scenarios. Tier 3 accounting should be targeted to the common financial transactions and financial instruments

7 The most common issue highlighted was the inability of a smaller NFP private sector entity to apply FVTOCI measurement to its investments in managed investment schemes, and the complexity of the related requirements.

held by smaller entities even though there may be instances of the sacrifice of arguably more relevant measurement information.

14 Staff note that employing overall simpler accounting for financial instruments is consistent with the approach taken by some other jurisdictions.

Question for Board members

Q1 Do Board members agree, for the purposes of the Discussion Paper, with wholly self-containing financial instrument requirements within a Tier 3 Standard (Option A)?

If not, do Board members prefer adopting a limited cross-reference or 'NFP amendment to AASB 9' approach (Option B)?

Consideration whether the Board should permit a Tier 3 entity to apply AASB 9 in its entirety rather the requirements specified by a Tier 3 Standard

[the box labelled 'opt up' in the flowchart in paragraph 7]

15 As described earlier, the *IFRS for SMEs* and UK FRS 102 allows smaller entities to choose to apply the classification, recognition and measurement requirements of IAS 39 (UK: also IFRS 9) in its entirety. Similarly, the New Zealand Tier 3 reporting requirements permit an entity that wishes to revalue its investments or apply hedge accounting to opt up to the accounting policies specified by a higher NZ reporting tier.

16 At its meeting in September 2021, the Board decided not to form a view on developing requirements about an entity's ability to opt up for the discussion paper. Rather, the Board decided to seek stakeholder feedback as part of the discussion paper as to whether:

(a) opt up to a higher tier accounting policy should always be permitted;

(b) opt up to a higher tier accounting policy should be permitted only where explicitly permitted by the Board; or

(c) opt up to a higher tier accounting policy should never be permitted.

17 Consequently, at this time staff are not asking the Board to form a decision on whether to permit an entity to opt up to the classification, recognition and measurement requirements of AASB 9 in its entirety, or for specific topics, as an alternative to the Tier 3 recognition and measurement requirements for financial instruments. This is because such action presupposes the Board decision to seek stakeholder feedback on opt up in the Discussion Paper.

Identified proposed simplification 2 – Initial measurement of financial assets and financial liabilities

Initial measurement at transaction price

18 Rather than requiring initial measurement at fair value, staff propose the Board instead develop a requirement for financial assets and financial liabilities to be initially measured at transaction price or, where the transaction includes a financing element, at the (buy now) cash price. Staff consider this simplification to be consistent with the Tier 3 principles agreed by the Board at its August 2021 meeting.[8]

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8 The Tier 3 principles are described in Appendix B to Agenda Paper 5.2.1.

19 Table 3 analyses pros and cons of this possible simplification.

Table 3: Arguments for and against initial measurement at transaction price

Arguments in support of initial measurement at transaction price (or cash price)	Arguments in support of maintaining the initial measurement requirements of AASB 9 (fair value)
• avoids using 'fair value' in favour of clear language identifying the amount to be initially recognised • having regard to the common instruments held by smaller NFP private sector entities (per staff review of the sample of financial statements), staff think that for most transactions, the transaction price could be expected to be the same as the financial instrument's fair value. That is, for common transactions of Tier 3 entities, the result is likely to be consistent with that required by Tier 1 measurement criteria • consistent with the Tier 3 initial measurement requirements for property, plant and equipment • consistent with the cost/transaction price measurement adopted by some other jurisdictions for some or all financial instruments (IFRS for SMEs, UK, NZ, HK)	• facilitates consistency in accounting for more complex financial instruments (e.g. a financial guarantee contract or loan commitment). For complex instruments, the accounting result may otherwise not provide useful financial information to users as a 'Day 1' gain or loss is ignored • consistent with Tier 1 measurement criteria. Similar to AASB 9, guidance can be developed to clarify that fair value will in many cases be provided by the transaction price. • The simplification is an unnecessary edit to the Tier 1 requirement, as there is likely to be limited cost savings from the amendment. AASB 9 already requires trade receivables without a financing component are initially measured at transaction price

20 **Staff view.** Staff think that part of the complexity with AASB 9 for smaller entities is the terminology employed by the Standard. For this reason, staff think requirements should be stated clearly using simpler language, and maintain consistency in description of the measurement basis across assets and liabilities where possible. This is especially so where the result is not expected to be materially different between the different measurement bases. Consequently, staff recommend developing a requirement for:

(a) financial assets and financial liabilities to be initially measured at transaction price; and

(b) where the transaction includes a financing element, at the cash price.

21 Staff think this would be consistent with the objective of developing Tier 3 reporting requirements as a simple, proportionate response for smaller entities.

Question for Board members

Q2 Do Board members agree, for the purposes of the Discussion Paper, that:

(a) financial assets and financial liabilities be initially measured at transaction price; and

(b) where the transaction includes a financing element, at the cash price?

If not, do Board members prefer that financial assets and financial liabilities be initially measured at fair value?

Treatment of transaction costs

22 AASB 9 requires, in the main, any directly attributable transaction costs to be included as part of the initial measurement of a financial asset or financial liability. Under the effective interest method, these costs are then amortised as interest income/expense over the life of the instrument.

23 As a simplification, the Board could consider instead developing a requirement for directly attributable transaction costs to be immediately expensed rather than deferred as part of the initial measurement of the financial instrument. Staff consider this simplification to be consistent with the Tier 3 principles agreed by the Board at its August 2021 meeting.[9]

24 Table 4 analyses pros and cons of this possible simplification.

Table 4: Arguments for and against the immediate expense of transaction costs

Arguments in support of immediately expensing transaction costs	Arguments in support of transaction costs being part of the financial instrument's initial measurement, per AASB 9
• accounting is simple as amounts are expensed as incurred • the relative amount of transaction costs could be expected not to be significant to the financial statements; consequently, a policy of immediate expense is unlikely to result in any material misassignment of the cost-to-benefit periods or create issues for higher-level consolidation by a parent preparing Tier 1 or Tier 2 compliant financial statements • immediately expensing transaction costs avoids some of the complexity associated with the effective interest method • aligns with the approach taken by NZ Tier 3 reporting requirements; facilitating trans-Tasman harmonisation • reduces costs of monitoring and amortising the transaction costs over the life of the financial instrument • avoids costs of identifying which costs are transaction costs	• maintains consistency with Tier 1 measurement • consistent with the initial measurement requirements of property, plant and equipment • The simplification introduces complexity for practitioners as it is a 'new' accounting treatment. Preparers can already access such accounting if transaction costs are immaterial to the financial statements • deferring transaction costs is consistent with the practice adopted by some other jurisdictions (IFRS for SMEs, UK, HK, Canada)

25 **Staff view.** Staff think that immediate expensing transaction costs reduce preparer costs without any significant loss of useful information to users of Tier 3 financial statements or material misrepresentation of the financial statements over the life of the related financial instrument. Staff think that the materiality of transaction costs is unlikely to result in consolidation issues should the Tier 3 entity's financial results be consolidated into Tier 1/Tier 2 consolidated financial statements.

9 The Tier 3 principles are described in Appendix B to Agenda Paper 5.2.1.

26 In addition, while staff do not have any evidence from the preliminary outreach activity, it may be the case that the practice of at least some Tier 3 entities is already consistent with such policy. Accordingly, on balance, staff recommend developing a requirement for the directly attributable transaction costs to be expensed in the period the costs are incurred.

Question for Board members

Q3 Do Board members agree, for the purposes of the Discussion Paper, with expensing directly attributable transaction costs of a financial asset and financial liability in the period the costs are incurred?

If not, do Board members prefer requiring the directly attributable transaction costs of a financial asset and financial liability to be included as part of the initial measurement of the financial instrument?

Identified proposed simplifications 3 & 4 – Subsequent measurement: limiting accounting policy options and developing simpler accounting policies

27 Topic 3 regarding the approach to accounting policy choices and Topic 4 regarding specified accounting policies are discussed together as they are interrelated.

28 Staff propose the following subsequent measurement simplification options for financial assets and financial liabilities for the Board's consideration:

(a) **Option A:** Require financial assets and financial liabilities to be measured at cost (less impairment) or FVTOCI;

(b) **Option B:** Require financial assets that are held to generate both income and capital investment return for the entity and derivative financial instruments to be measured at FVTPL. Require all other financial assets and financial liabilities to be measured at cost (less impairment); or

(c) **Option C:** Require financial assets that are held to generate both income and capital investment return for the entity to be measured at FVTOCI, with amounts recognised in OCI not 'recycled' on sale of the financial asset. Require derivative financial instruments to be measured at FVTPL. Require all other financial assets and financial liabilities to be measured at cost (less impairment).

29 An example of a financial asset held to generate both income and capital investment return is a listed share, or investment in managed investment scheme. An example of a financial asset is not held to generate both an income and capital investment return is a term deposit, or a held-to-maturity bond.

30 There are many other possible combinations for simplifying the subsequent measurement accounting specified by AASB 9 – for example, requiring certain financial instruments to be measured at amortised cost rather than cost, requiring all financial instruments to be measured at cost, or limiting fair value measurement to only a subset of financial instruments.[10] However, staff think that Options A-C above present the best basis for the Board's deliberations. This is because these options propose that an accounting distinction is made between those financial instruments used to finance or conduct the entity's day-to-day operations (e.g. trade receivables, bank loans) and those financial assets that arise from

10 Staff note that the Board previously rejected a staff proposal that investment property be measured at fair value only if its fair value was able to be determined without undue cost or effort

investing excess cash, and for which the entity is willingly exposed to the risk of losing the invested principal amount in return for potential capital appreciation.

31 Options A – C consider that fair value remains an appropriate basis for measuring financial instruments, even if an entity is of the size the Board has in mind when developing Tier 3 requirement proposals.

Analysis of Options A – C

32 Management judgement is limited under the three options. Options A – C do not require a preparer to treat a debt instrument in a certain way having regard to its features; in particular, compliance with the 'business model' and 'solely payments of principal and interest' (SPPI) tests. Rather, in effect, only the nature of the financial instrument is relevant. This simplifies its measurement and acknowledges the stakeholder feedback regarding the complexity in applying the SPPI test.

33 Also recognising the stakeholder feedback received, the Options above allow for investments in debt instruments and equity instruments to be treated consistently to simplify financial instrument accounting. Consistent treatment for these investments eliminates the potential for application error, should preparers inappropriately identify a debt instrument as an equity instrument. Option B and Option C eliminate the need for a business model test, while Option A accords preparers the flexibility to measure financial assets in a manner that reflects their use in the business model if the entity wishes to do so.

34 Under Options A – C, there is no ability for an entity to designate a financial asset or financial liability as at FVTPL to manage an accounting mismatch. The proposed Options recognise that a smaller NFP private sector entity is not expected to engage in such financial risk management practices and, therefore, would not need such an accounting option.

35 Options A – C propose cost, rather than amortised cost, as a measurement basis. This is because:

(a) cost is consistent with the staff recommendations with regard the accounting for transaction costs (refer paragraph 26) and calculation of interest income and interest expense (refer paragraph 48); and

(b) staff think that 'amortised cost' requires more explanation for application by less financially literate preparers, and will, for many common financial assets (trade receivables, term deposits) and financial liabilities (trade payables, bank loans) held by a Tier 3-sized entity, be the same amount as returned under a 'cost' measurement basis. Also, depending on the Board's decisions with regards to transaction costs and interest, staff note that amortised cost measurement can be achieved through plainer description of the accounting without using the terminology 'amortised cost', as evidenced by UK FRS 105 and the Hong Kong FRF & FRS.

36 Table 5 analyses Options A – C.

Table 5: Staff analysis of the comparative advantages of Options A – C

Arguments supporting Option A (free choice: cost or FVTPL)	**Arguments supporting Option B (investments and derivatives @FVTPL; other financial assets and financial liabilities @cost)**	**Arguments supporting Option C (investments @FVTOCI; derivatives @FVTPL; other financial assets and financial liabilities @cost)**
• is the simplest of the 3 Options presented to understand and apply, and	• more transparent and provides more relevant information to users	• more transparent and provides more relevant information to users

Arguments supporting Option A (free choice: cost or FVTPL)	**Arguments supporting Option B (investments and derivatives @FVTPL; other financial assets and financial liabilities @cost)**	**Arguments supporting Option C (investments @FVTOCI; derivatives @FVTPL; other financial assets and financial liabilities @cost)**
therefore, expected to be the least costly option • in contrast to Option C, requires financial investments to be accounted for on a similar basis to revalued investment property • recognises that the entity may find it costly or challenging to determine fair value	compared to Option A, as all unrealised gains and losses from derivatives and financial investments are communicated to users in the period of the gain or loss. This provides users with a better representation of the 'true' financial performance of the entity • stakeholders have indicated a preference for consistent accounting to be applied to both debt investments and equity investments • having regard to the common financial instruments held by smaller NFP private sector entities is arguably the Option that most aligns with the accounting available under AASB 9 • is arguably the Option that presents the most level playing field with other jurisdictions (which do not, in the main, accord entities the ability to present items in OCI) • in contrast to Option C, requires financial investments to be treated in the same way as revalued investment property • possibly less costly to preparers than Option C, as amounts do not need to be distinguished between dividends and interest recognised in profit and loss and fair value gains and losses recognised in OCI	compared to Option A, as all unrealised gains and losses from derivatives and financial investments are communicated to users in the period of the gain or loss. This provides users with a better representation of the 'true' financial performance of the entity • in contrast to Option A and Option B, requires financial investments to be accounted for somewhat similarly to revalued property, plant and equipment (however, both gains and losses are not recognised in profit or loss under the FVTOCI measurement basis). This acknowledges that the entity's interest in investing is to obtain a periodic return to fund operations, rather than an interest in gains or losses of a more capital nature • stakeholders have indicated a preference for being able to recognise all financial investment gains and losses in OCI rather than as part of the profit or loss • separates 'operating' and 'non-operating' activity gains and losses by keeping all fair value gains and losses on financial investments outside the profit or loss. This distinction may provide less sophisticated users with more understandable – and therefore, more useful – information. There is little loss of information as these gains and losses will continue to be visible to users as the Board has tentatively decided to continue to require a

Arguments supporting Option A (free choice: cost or FVTPL)	Arguments supporting Option B (investments and derivatives @FVTPL; other financial assets and financial liabilities @cost)	Arguments supporting Option C (investments @FVTOCI; derivatives @FVTPL; other financial assets and financial liabilities @cost)
		statement of profit and loss and other comprehensive income (SOCI) to be presented

Staff view

37 Staff observe that any proposed simplification of the AASB 9 requirements for investment assets is likely less faithfully represent the substance of the asset to users of the financial statements. Also, it affects comparability against entities in different reporting Tiers and makes it more difficult for practitioners to move between different sized entities. It may also add to consolidation costs.

38 However, having regard to:

(a) the stakeholder feedback on the complexity of AASB 9;

(b) the predominantly 'by nature' and 'no-accounting policy choices' approaches taken by other jurisdictions within their equivalent 'Tier 3' type pronouncement (i.e. ignoring opt up); and

(c) the type of financial assets and financial liabilities commonly held by Tier 3-sized entities;

staff think departing from AASB 9 is an appropriate and proportionate response for a Tier 3 Standard for subsequent measurement of financial assets and financial liabilities.

39 With regards to the form of the simplification, on balance, staff recommend Option B over Option A and Option C. While staff consider that Options A – C are all consistent with the Tier 3 principles agreed by the Board at its August 2021 meeting, staff think Option C most closely aligns with the Tier 3 principles agreed to by the Board compared to Option A and Option B. This is because Option C simply removes the options available to the entity under AASB 9.[11] Staff consider this Option strikes an appropriate cost-benefit balance for smaller NFP entities (i.e. those with revenue between $500k and $3m) as it is simple, requiring a single measurement method for all investment forms for which the entity is exposed to both risks and rewards of ownership of the asset.

40 Staff consider Option A accords preparers too much flexibility and could result in less comparability between entities. However, staff think that, practically, if a requirement consistent with Option A were to be developed, many entities would recognise investments in managed investment schemes and equity securities at fair value – that is, diversity in practice will not eventuate if the measurement basis is optional, rather than required;

41 Likewise, staff do not recommend Option C as a preference. This is primarily because staff support treating financial and non-financial investments consistently under a simplified accounting approach. Staff recommend requiring a FVTPL measurement over FVTOCI measurement having regard to the mixed feedback on FVTOCI received as part of ITC 47 *Request for Comment on IASB Request for Information on Post-implementation Review of IFRS*

11 On presumption that a smaller Tier 3 private sector entity is unlikely to have a business model that involves selling debt instruments.

9 Financial Instruments – Classification and Measurement[12] and on the observation that requiring FVTOCI measurement would create three measurement categories for measuring financial assets and financial liabilities within a Tier 3 Standard. Consequently, staff think that Option C is incrementally more complex than Option B.

42 However, staff observe that Option C is probably the option that best leverages the information management uses to make decisions about the entity's operations and that it may present users with more useful information about the entity. Staff do not think that users would be disadvantaged if the Board were to elect to develop a requirement consistent with Option C.

Question for Board members

Q4(a) Do Board members agree to develop simpler subsequent measurement requirements for a Tier 3 Standard, compared to that specified by AASB 9?

Q4(b) If yes, do Board members agree, for the purposes the Discussion Paper, with Option B? That is, for:

(a) financial assets that are held to generate both income and capital investment return for the entity to be measured at FVTPL;

(b) derivative financial instruments to be measured at FVTPL; and

(c) all other financial assets and financial liabilities to be measured at cost less impairment.

If not, what form of simplification amendment does the Board wish to develop?

Identified proposed simplifications 5 – Measurement of interest income and interest expense

43 The effective interest rate (defined in AASB 9, Appendix A) is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. It may differ from the contractual interest rate as it takes into consideration any fees that are an integral part of the effective interest rate (e.g. origination fees), points paid or received, transaction costs and other premiums or discounts on acquisition of the financial instrument.

44 AASB 9 requires interest to be recognised and measured using the effective interest method. The effective interest method requires interest to be calculated by:

(a) applying the effective interest rate to the gross carrying amount of a financial asset;

(b) applying the effective interest rate to the amortised cost of a credit-impaired financial asset; or

(c) applying the credit-adjusted effective interest rate to the amortised cost of a purchased or originated credit-impaired financial assets.

45 As a simplification of explanation and interpretation, rather than requiring interest to be calculated using the effective interest method, staff propose the Tier 3 reporting requirements should:

12 The feedback was summarised in Agenda Paper 5.2.1

(a) require interest income and interest expense to be recognised as amounts are earnt or incurred, calculated by applying the contractual interest rate to the amount on which interest is earnt; and

(b) for a financial instrument not measured at fair value, separately require the amortisation of any initial premium or discount on a straight-line basis over the life of the instrument (unless another systematic basis or shorter period is more reflective of the period to which the premiums or discounts relate).

46 As noted in paragraph 25 and Question 3 to the Board, staff recommend the immediate recognition of transaction costs when incurred. Staff propose that the same treatment be applied to fees incurred that are attributable to the instrument. If the Board decides to instead develop a requirement for transaction costs to be included in the initial measurement of the financial asset or financial liability, staff think these costs, and similarly any fees attributable to the instrument, should be amortised on a consistent basis to that proposed for any initial premium or discount.

47 Table 6 analyses pros and cons of the proposed interest measurement simplification. Staff consider this simplification to be consistent with the Tier 3 principles agreed by the Board at its August 2021 meeting.

Table 6: Arguments for and against the proposed interest measurement simplification

Arguments in support of the proposed interest measurement simplification	**Arguments in support of requiring interest be measured using the effective interest method, per AASB 9**
• accounting is simple to understand and apply as interest measurement matches the contractual interest rate • consistent with the Tier 3 requirement to measure lease payments and lease income on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern of the user's benefit • for a smaller entity, the benefits of more faithfully representative interest representation do not appear to justify the costs involved in identifying transaction costs and fees that are an integral part of the effective interest rate, calculating an effective interest rate, and monitoring changes in the effective interest rate over the life of the financial instrument • application of the effective interest method to impaired financial assets is unnecessarily complex for smaller entities, who may not commonly have financial instruments impacted by such AASB 9 criteria • recognising interest based on the contractual rate and when it is earnt or incurred is consistent with the approach taken by NZ	• maintains consistency with Tier 1 measurement • acknowledges and more faithfully represents the true "interest" implicit in the terms of the financial instrument • smaller NFP private sector entities might not commonly access financial instruments that have a premium or discount on issue, or incur origination and other fees. Consequently, the simplification may be 'unnecessary' because the effective interest rate is the same as the contractual interest rate. Guidance could be developed to provide clarity for preparers in this regard • the proposed simplification justifies current practice, rather than improving accounting practices by smaller entities

Tier 3 reporting requirements; facilitating trans-Tasman harmonisation	

48 **Staff view.** Staff think that requiring interest to be recognised and measured by reference to the contractual interest rate is a simplification that the Board could take to reduce an element of preparer cost without any significant loss of useful information to users of the Tier 3 financial statements or material misrepresentation of the financial statements over the life of the related financial instrument. Staff think that the materiality of any difference between the effective interest method and the result under the proposed simplification is unlikely to result in consolidation issues should the Tier 3 entity financial results be consolidated into Tier 1/Tier 2 consolidated financial statements.

49 In addition, while staff do not have any evidence in this regard from the preliminary outreach activity, staff think it is likely that the practice of many Tier 3 entities is already consistent with such policy, and as such, the simplification better leverages the information that management uses to make decisions and limits transition costs.

Question for Board members

Q5 Do Board members agree, for the purposes of the Discussion Paper, that:

(a) interest income and interest expense should be recognised as amounts are earnt or incurred, calculated by applying the contractual interest rate to the amount on which interest is earnt; and

(b) for a financial instrument not measured at fair value, any initial premium or discount should be amortised on a straight-line basis over the life of the instrument, unless another systematic basis or shorter period is more reflective of the period to which the premiums or discounts relate? Any directly attributable fees and deferred transaction costs should be similarly treated.

If not, do Board members prefer requiring an entity to recognise and measure interest using the effective interest method?

Identified proposed simplifications 6 – Impairment of financial assets that are debt instruments

50 The AASB 9 impairment model applies only to financial assets held at amortised cost, as under AASB 9, equity instruments are always measured at fair value. As noted in Agenda Paper 5.2.1, the AASB 9 impairment model is an expected credit loss model that requires the impairment loss to be calculated using a probability-weighted estimate of credit losses over the expected life of the financial instrument. A credit loss is calculated as the present value of the difference between (a) the contractual cash flows due to an entity under the contract and (b) the cash flows that the entity expects to receive.

51 The expected losses differ depending on the type of financial asset held and the extent of change in credit riskiness of the financial asset.

52 As a simplification of the impairment recognition and measurement criteria, staff propose the following simplification options for impairment of financial assets that are debt instruments that are not measured at fair value. Staff think both Option A and Option B reflect an expected loss model:

(a) **Option A:** Require an impairment loss to be recognised when it is probable that the amount owed will not be collectible, measured at the expected uncollectible amount.

(b) **Option B:** Require an impairment loss to be recognised for all lifetime expected credit losses. This option proposes extending the AASB 9 simplified approach for trade receivables[13] to all debt instruments held by the entity.

53 In accordance with the Board's agreed approach to simplification as set out in the flowchart included in Appendix B to Agenda Paper 5.2.1, staff have analysed reasons for supporting one Option over the other:

Table 7: Staff analysis of Option A and Option B

Arguments in support of Option A over Option B *(Require an impairment loss to be recognised when it is probable that the amount owed will not be collectible, measured at the expected uncollectible amount)*	**Arguments in support of Option B over Option A** *(Require an impairment loss to be recognised for all lifetime expected credit losses)*
• the resulting impairment loss is more understandable and explainable to users of the financial statements compared to the AASB simplified approach, as the impairment loss is directly 'relatable' to debtor balances • for smaller NFP and their common transactions, it is less complex to understand and apply, and requires less management judgement, compared to Option B. Consequently, it is less costly to implement and audit compared to Option B. • Option A better leverages the information that management is likely to use to make decisions • Appears consistent with the requirements specified by UK FRS 105, Hong Kong and New Zealand	• maintains better consistency with Tier 1 recognition and measurement criteria. As such, Option B is more 'neutral' compared to the more conservative position under Option A • may give management better insight into its financial management practices • the resulting impairment loss is likely to be the same amount as Option A if, rather than identifying a risk probability for each default scenario, management makes an absolute determination (recoverable/not recoverable) when assessing the expected credit losses of an asset

54 **Staff view.** Staff recommend Option A for the reasons identified in Table 7. Staff think that Option B remains too complex a proposition for smaller NFP private sector entities and is unlikely to have widespread impact given the types of assets commonly held by smaller NFP private sector entities. Also, staff suspect that Option B is unlikely to be operationalised in the spirit of the AASB 9 requirement by these entities. Staff further consider that it may be challenging to audit the management judgements informing the likelihood of each probable default scenario. Consequently, staff are concerned that Option B, while a simplification of AASB 9, does not present a sufficiently proportionate response for smaller entities as the benefits of applying this option do not appear to exceed its costs.

Question for Board members

Q6 Do Board members agree, for the purposes of the Discussion Paper, that an impairment loss on a debt instrument that is not measured at fair value should be recognised when it is

13 The AASB 9 simplified approach applies also to contract assets and lease receivables held by the entity.

probable that the amount owed will not be collectible, measured at the expected uncollectible amount (Option A)?

If not, do Board members prefer requiring an impairment loss to be recognised for all lifetime expected credit losses?

Equity instruments measured at cost, less impairment

55 In its earlier proposals (see paragraph 28), staff proposed that certain financial assets are permitted to be measured at cost less impairment. These financial assets may include equity instruments. This section is only relevant if the Board supports Option A in paragraph 28 or if the Board decides to develop a requirement that would require certain equity instruments to be subsequently measured at cost less impairment.[14,15]

56 With regards to the impairment of equity instruments measured at cost, staff propose that the Board develop a requirement that:

(a) impairment be charged only when there is objective evidence to indicate that the carrying amount of the financial asset is unlikely to be recovered in the future;

(b) the impairment loss is measured as the difference between the carrying amount of the asset and its fair value at the reporting date.

57 This proposal is similar to the measurement criteria previously specified by IAS 39 for available-for-sale financial assets. Under the proposal, an impairment loss might not be immediately recognised if the share price of a listed equity instrument at the reporting date is below its carrying amount.

58 Alternatively, with regards to the impairment of equity instruments measured at cost, the Board could require an impairment loss to be recognised for the excess of the carrying amount of the financial asset at the reporting date over its fair value on that date. The resultant financial asset would be measured at its fair value, with a ceiling imposed on the fair value measurement.

59 **Staff view.** On balance, staff recommend the approach described in paragraph 56. Staff have formed their view having regard to the following considerations:

(a) the approach is broadly consistent with the Board's tentative decisions regarding the impairment of a non-financial asset.[16] Maintaining consistency in requirements across different assets and liabilities reduces preparer costs, as a preparer need not consider different specific rules for different types of assets and liabilities;

(b) the approach consistent with the approach taken by NZ Tier 3 reporting requirements; facilitating trans-Tasman harmonisation;

14 For example, investments in subsidiaries and associates. Staff note that the Board has not yet considered how an investment in a subsidiary, associate or joint venture should be measured in the separate financial statements of an entity, if consolidated financial statements are not presented.

15 This section is not relevant if the Board supports Option B or Option C as proposed. This is because equity instruments are measured at fair value under Option B and Option C.

16 At its April 2022 meeting, the Board decided that impairment would be assessed for a non-financial asset only if the asset were physically damaged or if the asset's service potential might have been adversely affected by a change in the entity's strategy or changes in external demand for the entity's services

(c) the approach is less costly compared to the alternative approach. This is because the alternative approach requires a fair value determination to be conducted at every reporting date.

Question for Board members

Q7 Do Board members agree, for the purposes of the Discussion Paper, that:

(a) impairment should be charged on an equity instrument measured at cost less impairment only when there is objective evidence to indicate that the carrying amount of the financial asset is unlikely to be recovered in the future; and

(b) the impairment loss should be measured as the difference between the carrying amount of the asset and its fair value at the reporting date.

If not, do Board members prefer requiring an impairment loss to be recognised for the excess of the carrying amount of the financial asset at the reporting date over its fair value on that date (the Alternative approach in paragraph 58)?