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National Institute of Accountants

Submission on IASB Exposure Draft of Proposed Amendments to IAS 32 "Financial Instruments: Disclosure and Presentation" and IAS 39 "Financial Instruments: Recognition and Measurement"

Prepared by:

Associate Professor Julie Cotter
University of Southern Queensland

Contact details:

National Institute of Accountants
PO Box 18204
Collins Street East
Melbourne, Vic, 8003
Australia

Technical Policy Manager
Mr Gavan Ord
Phone: +(61 3) 8665 3114
Email: gavano@nia.org.au

Research Advisor
Associate Professor Julie Cotter
Phone: +(61 7) 4631 2916
Email: cotter@usq.edu.au

Background

Introduction

The Exposure Draft proposes improvements to IAS 32 "Financial Instruments: Disclosure and Presentation" and IAS 39 "Financial Instruments: Recognition and Measurement", with the objective of clarifying and adding guidance, eliminating internal inconsistencies, and incorporating key elements of Standing Interpretation Committee (SIC) Interpretations and IAS 39 implementation guidance. The International Accounting Standards Board (IASB) is not considering changes to the basic principles in the Standards at this time.

IAS 32 deals with the presentation and disclosure of financial instruments and IAS39 deals with the recognition and measurement of financial instruments. While there is currently no Australian standard dealing with the recognition and measurement of financial instruments, AASB 1033 deals with the presentation and disclosure of financial instruments.

Statement of Overall Opinion

The National Institute of Accountants (NIA) welcomes the opportunity to make a submission on the IASB Exposure Draft of Proposed Improvements to International Accounting Standards.

The NIA supports the IASB's Program of Improvements to International Accounting Standards and its emphasis on the international convergence of accounting Standards. We applaud the IASB's decision to reduce or eliminate alternatives, redundancies and conflicts within existing standards and make other improvements to them.

Further, we support the Australian Accounting Standards Board's (AASB) allegiance to international convergence and harmonisation of accounting standards, and are ourselves committed to working with the AASB and IASB towards achieving the goal of a single set of high quality accounting standards for world-wide use.

Our overall conclusions in relation to the proposed changes to IAS 32 and IAS 39 are given below. This is followed by detailed commentary in relation to several of the questions contained in the Invitation to Comment. We hope that you find our comments useful when preparing the final drafts of these revised Standards. If you require any further elaboration on our remarks, please do not hesitate to contact the writer.

Overall conclusions about the proposed changes to Standards

IAS 32, Financial Instruments: Disclosure and Presentation

We agree with the proposal to first separate and measure liability elements of financial instruments, with the residual to equity. However, we disagree with the requirements that will result in resetting preference shares and units in unit trusts to be classified as debt rather than equity. There are practical implications of these changes that should not be ignored or underestimated.

IAS 39, Financial Instruments: Recognition and Measurement

While we are generally in agreement with the majority of the proposed changes, we disagree with the proposals in questions 8 and 9 in relation to hedges. Both of these proposed changes appear to introduce unnecessary complexity into the accounting requirements.

Further, we would like to suggest a broadening of the proposal to irrevocably designate any financial instrument as 'held for trading'. That is we propose that entities should be able to irrevocably designate any financial instrument as either 'held for trading' or 'available for sale'. Our detailed justification for this suggestion is contained in our response to question 4.

Detailed Commentary on Proposed Changes to Particular Standards

IAS 32 "Financial Instruments: Disclosure and Presentation"

Our response to the IASB's Invitation to Comment on IAS 32 focuses on the particular questions pertaining to the issues of most concern to NIA members.

Q1 Should the classification of a financial instrument as a liability or equity be made without regard to the probabilities of different manners of settlement?

We disagree with the proposal to classify financial instruments as either liability or equity without regard to the probabilities of different manners of settlement. In particular, the proposed changes will have significant reporting implications for many Australian companies. That is, resetting preference shares and units in unit trusts will need to be reclassified from equity to debt.

While classification in accordance with substance over form is conceptually superior, the practical implications of such a change should not be ignored or underestimated. For example, the recent introduction of the Canadian standards for financial instruments requiring retractable preferred shares be classified as debt caused Canadian companies to reduce the amount of these shares and/or other liabilities outstanding, and/or to increase the amount of equity outstanding (see Murdoch, 1998). Preferred shares play a valuable role, including the provision of venture capital (Triantis, 2001), and accounting requirements that lead to a reduction in their use will impose costs on entities that would otherwise benefit from issuing this particular type of capital. The same potential implications of such a rule apply to units in unlisted unit trusts.

Q2 Should the equity component of a compound financial instrument be measured as the residual amount after deduction of the amount determined for the liability component?

We agree with the proposal that any liability element of a compound financial instrument should be separated and measured first and then the residual assigned to the equity element. This is consistent with the requirements of IAS 39 and will ensure that the liability component of the compound instrument reflects the fair value of the contractual obligation.

IAS 39 "Financial Instruments: Recognition and Measurement".

Our response to the IASB's Invitation to Comment on IAS 39 focuses on the particular questions pertaining to the issues of most concern to NIA members.

Q4 Should an entity be able to irrevocably designate any financial instrument as one that is measured at fair value with changes in fair value recognised in profit or loss?

We agree with the flexibility allowed by this proposal. Indeed, we would like to suggest a broadening of the 'classification by designation' concept embodied in this proposed change. Our suggestion is that, in addition to making the rules related to 'available for sale' financial instruments optional, the rules related to 'held for trading' financial instruments should also be made optional. That is, there should be an option to classify some currently 'held for trading' items as 'available for sale'. This alternative would allow the elimination of artificial volatility in profit or loss and equity that results when matched positions of assets and liabilities are not measured consistently. Further, it overcomes some of the anomalies that result from different measurement attributes in the Standard, thereby achieving the desired result of simplifying the application of IAS 39.

However, contrary to claims in this Exposure Draft, we do not believe that the proposed change will overcome issues related to embedded derivatives. It appears that the proliferation of embedded derivatives in the United States is a creative response to requirements of FASB Statement 133 in relation to assets designated as held for trading. Our suggestion to make the 'held for trading' rules optional would overcome this problem.

Our opposition to the mandatory requirement to classify certain financial instruments as 'held for trading' derives from our view that *gains* associated with restating financial instruments at their fair values should not be included in income until they are realised. A mandated requirement to recognise fair value increases in the income statement in the reporting periods in which they arise is inconsistent with both currently accepted accounting practices for other types of assets and the conservative nature of accounting. The combining of fair value income for financial instruments with historical cost income for non-financial items results in a hybrid measure of income that is neither conceptually nor practically superior to income calculated using conservative historical cost principles.

On the other hand, there are advantages to recognising unrealised gains outside of the income statement (or indeed requiring mere disclosure of these gains in the footnotes) over recognition within the income statement. These advantages pertain to concerns that the gain will not be realised. If enterprises are allowed to, or indeed required to, recognise unrealised gains in the income statement, the degree of reliance that financial statement users are able to place upon the accounts will be reduced. In particular, the ability of the income statement to facilitate the stewardship of management will be compromised. While we agree that management should be held accountable for its decisions to hold and owe financial assets and liabilities, this can be best achieved through the immediate recognition of losses in the income statement and the disclosure of gains outside of the income statement until they are realised.

Therefore, we propose that entities should be able to irrevocably designate any financial instrument as either:

(a) one that is measured at fair value with changes in fair value recognised in profit or loss; or
(b) one that is measured at fair value with:
   - losses recognised in the income statement in the reporting periods in which they arise; and
   - gains recognised directly in equity until the financial asset is derecognised, when the gain is taken to net profit or loss for the period.

Q6 Should assets that are not individually impaired be grouped with similar assets and collectively evaluated for impairment using the methods outlined?

We agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment. Such a treatment is necessary to ensure that normal degrees of non-payment that exist for groups of loans or receivables are provided for, even though there is no objective evidence of impairment. Moreover, we agree that the occurrence of an event or a combination of events should not be a precondition for including an asset in a group of assets that are collectively evaluated for impairment.

We also agree with the proposed methodology for measuring impairment outlined in paragraphs 113A to 113D.

Q7 Should impairment losses for available-for-sale investments be reversed?

We agree with the proposal not to permit reversals of these impairment losses to be made. Any subsequent increases in the fair value of available-for-sale investments should be treated consistently with the requirements pertaining to all other increases in fair value of these investments. That is, to credit them directly to an equity account and transfer them to the income statement once they are realised.

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This treatment is consistent with our preferred method of accounting for ALL available-for-sale investments. That is:

(a) Unrealised losses should be recognised in the income statement in the reporting periods in which they arise.
(b) Unrealised gains should be deferred in a special category of equity, and only recognised in the income statement when they are realised.

Our justification for this view is provided in our response to question 4 above.

Q8 Should hedges of unrecognised firm commitments be accounted for as fair value hedges instead of cash flow hedges?

We disagree with the proposal to account for hedges of unrecognized firm commitments as fair value hedges instead of cash flow hedges. We acknowledge that, in concept, hedges of firm commitments represent exposures to changes in fair value. However, the reality of including increases in the value of unrecognised commitments in the calculation of net income appears unnecessarily complex.

We disagree with the broad concept of requiring unrealised *gains* to be taken to the income statement. When the assets or liabilities that these unrealised gains pertain to are not themselves recognised in the accounts, it appears unnecessary to require that associated, unrealised gains be included in the calculation of net income.

In relation to unrealised *losses* on firm commitments: We can see a case for requiring these to be taken to the income statement. However, it these items were not hedged, the unrealised loss would not appear in the income statement until the firm commitment was recognised as an asset at the time of the purchase transaction. Cash flow hedging will achieve the same outcome.

Q9 Should gains and losses relating to hedged forecast transactions be recognised directly in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?

We disagree with this proposal, and recommend the retention of the basis adjustment method of accounting for these gains and losses. The proposal would introduce unnecessary complexity and subjectivity into the accounting requirements. Further, an adjustment to the initial carrying amount at the time of the purchase or sale reflects the intention of the hedge. That is, to hedge against changes in the purchase or sale price.

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