CL 54

14 October 2002

International Accounting Standards Board
30 Cannon Street
LONDON
EC4M 6Xh
United Kingdom

Dear Sir or Madam

PROPOSED AMENDMENTS TO IAS 32 AND IAS 39

The Financial Reporting Standards Board (FRSB) of the Institute of Chartered Accountants of New Zealand is pleased to submit its comments on the Exposure Draft of Proposed Amendments to IAS 32, *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* (issued June 2002).

Although the FRSB focussed on the specific questions raised in the ED, comments are also provided in respect of some of the proposals not specifically addressed by the questions.

If you have any queries, or require clarification of any matters in the submission, please contact Sanel Tomlinson (sanel_tomlinson@icanz.co.nz) or me (tony_vanzijl@icanz.co.nz) at the Institute of Chartered Accountants of New Zealand.

Yours faithfully

Tony van Zijl
CHAIR – FINANCIAL REPORTING STANDARDS BOARD

IAS 32 *FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION*

Question 1 - Probabilities of different manners of settlement (paragraphs 19, 22, and 22A)

Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).

The FRSB agreed with the proposed amendments to clarify that a financial instrument should be classified as a liability or as equity in accordance with the substance of the contractual arrangement.

However, the FRSB does not support the proposed deletion of the example in paragraph 24. The FRSB considers that the example provides helpful guidance in respect of the classification of complex items, where the substance is not apparent. If the IASB does not agree with the current example, it should replace it with other relevant examples.

The FRSB further considers that the illustration in paragraph 22A deals with a compound instrument and to require classification as a financial liability contradicts the principle in paragraph 23. The FRSB recommends that paragraph 22A be amended to reflect the principle in paragraph 23.

Question 2 -- Separation of liability and equity elements (paragraphs 28 and 29)

Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?

The FRSB agrees with the proposal.

Question 3 -- Classification of derivatives that relate to an entity's own shares (paragraphs 29C – 29G)

Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?

The FRSB considers that the classification of a financial instrument should be based on the conceptual framework, in particular the definitions of a financial asset, a financial liability and equity instrument.

The FRSB disagrees with the proposal to classify equity-based derivatives as equity instruments only where they are to be settled by exchanging a fixed number of the entity's own equity instruments for a fixed amount of cash or other financial assets. Furthermore, derivatives that are to be settled with the entity's own equity instruments do not meet the definition of a financial liability and to require such derivatives to be treated as financial liabilities contradicts the classification principle in paragraph 18.

The FRSB also agrees that equity-based derivatives which are to be settled on a net basis with cash or other financial assets should be classified as financial liabilities or financial assets because it is consistent with the definitions of a financial liability and a financial asset.

However, the FRSB does not agree with such classification (as financial asset/liability) where the equity-based derivatives are to be settled net with the entity's own equity instruments. The substance of an equity-based derivative that is to be settled on a net basis with the entity's own equity instruments is the same as another that is to be settled on a gross basis. To treat them differently is to allow the classification of a financial instrument being governed by its form and not its substance. Accordingly, the FRSB considers that equity-based derivatives that are to be settled net with the entity's own equity instruments should be classified as equity.

The FRSB also considers that paragraph 29E(b) should be deleted, as an issuer that has never issued a similar kind of instrument, would not be able to satisfy this criterion and would therefore be required to classify the item as a derivative asset/liability as opposed to an equity instrument.

Question 4 – Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard

Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)

Although this would lead to a lengthy standard, the FRSB agrees that for ease of reference, the two standards should be integrated.

IAS 39 *FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT*

Question 1 -- Scope: loan commitments (paragraph 1(i))

Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?

The FRSB agrees that for practical reasons (as opposed to conceptual reasons), such loan commitments should be excluded from the scope of IAS 39.

Question 2 -- Derecognition: continuing involvement approach (paragraphs 35-57)

Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?

The FRSB considers that the continuing involvement approach is an appropriate interim measure. It has the advantages of components being derecognised where there is no more continuing involvement and eliminating problems with having a dual model of control and the risks and rewards approach, but the FRSB considers that it could be prone to manipulation.

The FRSB recommends that the full components approach, developed by the Joint Working Group, should be further developed and field tested.

Question 3 -- Derecognition: pass-through arrangements (paragraph 41)

Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?

The FRSB supports the proposals, but considers that it should rather be expressed in terms of a principle, than a rule for specific circumstances. The FRSB noted from the basis for conclusions that, in the circumstances specified in paragraph 41, the financial asset does not meet the definition of an asset of the transferor and the financial liability does not meet the definition of a liability. In these circumstances no asset and liability should be recognised. This is sensible, but it should apply wherever an instrument fails to meet the definitions.

More specifically, the FRSB considers that paragraph C51 of the Basis for Conclusions should clarify whether both the originator and the SPE could be regarded as "transferors" and that both could apply pass-through accounting.

Question 4 -- Measurement: fair value designation (paragraph 10)

Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?

The FRSB agrees that designation of measurement at fair value should be irrevocable. However, the FRSB considers that such designation should be required for classes of financial instruments as opposed to each individual financial instrument to ensure consistent treatment of similar items. The FRSB considers that entities should be permitted to designate measurement at fair value at any time (i.e. not only at initial recognition), because it would promote the long-term objective of recognising all financial instruments at fair value.

The FRSB considers that the last sentence of the definition of the "held-for-trading" category should be moved to the start of the definition. Also, given that entities are required to classify financial instruments designated to be measured at fair value as a separate category (as per paragraph C57), it would be helpful for the standard to reflect five categories of financial instruments, that is:

- *Financial instruments held for trading;*
- *Held-to- maturity investments;*
- *Loans and receivables originated by the entity;*
- *Available-for-sale financial assets; and*
- *Financial instruments designated to be measured at fair value.*

Question 5 -- Fair value measurement considerations (paragraphs 95-100D)

Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95---100D of the Exposure Draft? Additional guidance is included in paragraphs A32---A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?

The FRSB considers that entities should not be required to follow the suggested hierarchy in determining fair values. However, entities should be allowed, for cost-benefit reasons, to use the "level" that is most relevant to the entity provided that (subject to materiality) the method adopted meets the fair value measurement objective. In addition to cost-benefit reasons, entities could, in some circumstances, for example, markets with limited liquidity, obtain a more reliable measure of fair value by using a lower "level" of the hierarchy even if some information is available from one of the higher "levels". For example, the models used by the New Zealand Treasury to value their US Dollar Yankee Bonds provide better evidence of fair value than recent market transactions.

The FRSB considers that entities should be required to disclose the assumptions and evidence supporting the appropriateness of the chosen "level" in their financial statements.

The FRSB also suggests that additional guidance be included under the cash flow adjustment approach to indicate that entities could also apply this approach by adjusting the expected value of the cash flows for uncertainty by either subtracting a margin or adjusting the probabilities and then discounting at the risk-free rate.

Question 6 -- Collective evaluation of impairment (paragraphs 112 and 113A--113D)

Do you 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? Do you agree with the methodology for measuring such impairment in paragraphs 113A-113D?

The FRSB supports the proposals.

Question 7 -- Impairment of investments in available-for-sale financial assets (paragraphs 117--119)

Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?

The FRSB disagrees with the proposal because it is inconsistent with other guidance on impairment.

Question 8 -- Hedges of firm commitments (paragraphs 137 and 140)

Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?

The FRSB disagrees with the proposal because there is no material difference between a forecasted transaction and a firm commitment. The treatment should therefore not be different, i.e. both should be treated as cash flow hedges.

Question 9 -- 'Basis adjustments' (paragraph 160)

Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should

remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?

The FRSB disagrees with the proposal and considers that the previous requirements were more practical (i.e. adjust against the asset). The proposal would result in inconsistent treatments in respect of hedged firm commitments and hedged forecast transactions. Entities would be prohibited to basis adjust for a hedged forecast transaction because it is treated as a cash flow hedge, but would be required to basis adjust for a hedged firm commitment because it is treated as a fair value hedge. It would also create an onerous administrative burden for entities, as they would have to keep track of the gains or losses for every cash flow hedging transaction.

Question 10 -- Prior derecognition transactions (paragraph 171B)

Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (ie that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?

The FRSB supports recognition of financial assets on transition to the Standard where such financial assets would not have been derecognised had the Standard been applied.

APPENDIX

The FRSB considers that paragraphs A18 to A24 could be improved as follows:

Relationship between Discount Rates and Projected Cash Flows

A18. The present value of projected cash flows may be estimated using a discount rate adjustment approach or a cash flow adjustment approach, as appropriate.

A19. *Discount rate adjustment approach.* Under the discount rate adjustment approach, the stream of contracted cash flows forms the basis for the present value computation, and the rate(s) used to discount those cash flows reflects the uncertainties of the cash flows. This approach is most readily applied to financial instrument contracts to receive or pay fixed cash flows at fixed future times, ie instruments for which the only significant uncertainties in amount and timing of cash flows are caused by credit risk.

A20. The discount rate adjustment approach is consistent with the manner in which assets and liabilities with contractually specified cash flows are commonly described (as in 'a 12 per cent bond') and it is useful and well accepted for those instruments. However, because the discount rate adjustment approach places the emphasis on determining the interest rate, it is more difficult to apply to complex financial instruments where cash flows are conditional or optional, and where there are uncertainties in addition to credit risk that affect the amount and timing of future cash flows.

A21. *Cash flow adjustment approach.* Under the cash flow adjustment approach, the projected cash flows for a financial instrument reflect the uncertainties in timing and amount, ie they are weighted according to the probability of their occurrence, and ~~adjusted~~ discounted to reflect the market's evaluation of the non-diversifiable risk relating to the uncertainty of those cash flows. The cash flow adjustment approach has advantages over the discount rate adjustment approach if an instrument's cash flows are conditional, optional, or otherwise particularly uncertain for reasons other than credit risk.

Paragraph A21 reads as if the cash flow adjustment approach consists of firstly taking the expected value of the cash flows and then subtracting a margin for non-diversifiable risk. However, the example in paragraph A22 makes it clear that what was intended was calculation of expected value followed by discounting at a rate commensurate with the level of non-diversifiable risk. The intent of paragraph A21 can be achieved by substituting the word "discounted" for the word "adjusted".

A22. To illustrate this, suppose that an entity holds a financial asset such as a derivative that has no specified cash flows and the entity has estimated will receive 300. Further, suppose that the cash flows are expected to occur one year from the measurement date regardless of the amount. The expected cash flow is then 10 per cent of 100 plus 60 per cent of 200 plus 30 per cent of 300, which gives a total of 220. The discount rate used to estimate the instrument's fair value based on that expected cash flow would then be the basic ('risk-free') rate adjusted for the premium that market participants would be expected to receive for bearing the uncertainty of expected cash flows with the same level of non-diversifiable risk.

A23. The cash flow adjustment approach also can incorporate uncertainties with respect to the timing of projected cash flows. For example, if the cash flow in the previous example was certain to be 200, and there was a 50 per cent chance it would be received in one year and a 50 per cent chance it would be received in three years, the present value computation would weight those possibilities accordingly. Because the interest rate for a two-year instrument is not likely to be the weighted average of the rates for one-year and three-year instruments, two separate present value computations would be required. One computation would discount 200 for one year at the basic interest rate for a one-year instrument and the other would discount 200 for three years at the basic interest rate for a three-year instrument. The ultimate result would be determined by probability weighting the results of the two computations. Since the probabilities of each are 50 per cent, the fair value would be the sum of 50 per cent of the results of each present value computation, after adjustment for the estimated effect of any non-diversifiable risk related to the uncertainty of the timing of the cash flow.

A24. The discount rate adjustment approach would be difficult to apply in the previous example because it would be difficult to find a discount rate that would reflect the uncertainties in timing.