New South Wales
TREASURY

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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

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

<u>Proposed Amendments to International Accounting Standards IAS 32 "Financial Instruments: Disclosure and Presentation" and IAS 39 "Financial Instruments: Recognition and Measurement"</u>

I refer to the AASB's Invitation to Comment on the "Proposed Improvements to International Accounting Standards IAS 32 and IAS 39". NSW Treasury's comments on IAS 39 are attached.

Notwithstanding problems of consistency associated with a mixed measurement model, the approach proposed in IAS 39 is preferred over the full fair value approach put forward in the Joint Working Group Draft Standard.

Treasury's main comments relate to the treatment of gains and losses on re-measurement. Treasury's view is that gains and losses should be treated consistently in the profit or loss for the period, rather than as a direct adjustment to equity.

In addition, Treasury does not support "recycling" of valuation adjustments through the profit or loss account. The current prohibition on recycling contained in the Australian Accounting Standards is supported.

It is understood that some of these issues may be resolved as part of the IASB's current project on performance reporting.

If you have any queries regarding Treasury's response, please do not hesitate to contact me on 61 2 9228 3019 or Dianne McHugh on 61 2 9228 5340.

Yours faithfully

Robert Williams
for Secretary

Governor Macquarie Tower, 1 Farrer Place, Sydney 2000. Switchboard: (61 2) 9228 4567 Facsimile: (61 2) 9221 7029

COMMENTS ON PROPOSED AMENDMENTS TO IAS 39 "FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT"

Gains and losses

IAS 39 treats gains or losses on re-measurement inconsistently. For example gains or losses on "held for trading" financial assets and liabilities are recognised in the profit or loss for the period, while gains or losses for "available for sale" financial assets must be recognised direct in equity, until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity shall be recognised in profit or loss for the period.

The only "rationale" for the different treatment between "held for trading" and "available for sale" assets seems to be related to volatility considerations. However, this argument is disputed in the dissenting view to FAS 115 "Accounting for Certain Investments in Debt and Equity Securities", as follows:

> "The Board concluded that unrealised changes in fair value for trading securities should be reported in earnings because that reporting reflects the economic consequences of the events of the enterprise (such as changes in fair values) as well as the transactions (such as sales of securities) when those events and transactions occur and results in more relevant reporting….However, the Board concluded that similar reporting of unrealised changes in fair value for available for sale securities has the potential for significant earnings volatility that is unrepresentative of both the way enterprises manage their businesses and the impact of economic events on the overall enterprise and, therefore, decided that those changes should be excluded from earnings…Those conclusions do not alleviate the potential for volatility in reported earnings; rather, they provide the opportunity for selective volatility in reported earnings – that is, the volatility in reported earnings that results from the recognition of unrealised changes in fair value in earnings through selective sales of securities".

Prior to the proposed amendments, the mixed measurement model was based primarily on intentions. However, the proposed Standard now permits designation as "held for trading" or "available for sale" where a financial instrument would not normally fall within those categories. While this amendment is supported, this further blurs the reasoning behind the mixed measurement approach, as well as any rationale behind treating some gains/losses through equity and some through profit and loss. As a result, the distinction between "available for sale" and "held for trading" assets and liabilities is not meaningful and is unnecessary if gains and losses were treated identically.

NSW Treasury is of the view that all gains and losses on re-measurement should be recognised consistently in the profit or loss for the period. However, concerns regarding volatility should be addressed as a disclosure issue for the Statement of Financial Performance. In this regard, Treasury supports the IASB's current project on reporting performance and in particular the concept of "comprehensive income" and the classification of a performance statement using four main categories (ie operating and financing; current performance and revisions / re-measurements). If approved, this would impact on the IAS 39 requirements and potentially alleviate some of Treasury's current concerns.

Recycling

IAS 39 requires the "recycling" of valuation adjustments to profit and loss in a number of instances. For example, "available for sale" financial assets must be recognised direct in equity, until the financial asset is derecognised at which time the cumulative gain or loss previously recognised in equity shall be recognised in profit or loss for the period.

Recycling is prohibited under the Australian Accounting Standards. NSW Treasury supports the prohibition on recycling. It is understood that the IASB project on performance reporting similarly supports a prohibition and if approved, this would impact on the IAS 39 requirements.

Fair Value measurement

IAS 39 states that the "fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price" (para 99). However, this approach does not take account of large holdings where the exit price per unit would not necessarily be equivalent to the exit price for individual items or smaller holdings. NSW Treasury is of the view that the impact of large holdings on the exit price should be considered when determining the fair value of a portfolio.

In addition, IAS 39 only permits mid-market prices to be used where the entity has matching asset and liability positions (para 99). However, Treasury is of the view that the mid-point may be the appropriate price in certain other circumstances, as it reflects the commercial reality that the fair value is likely to fall somewhere between a market entry and exit price. This is particularly the case in more volatile markets such as the electricity industry in Australia.

The proposed IAS 39 also does not acknowledge situations where reliable measurement may not be possible or difficult, apart from equity instruments that do not have a quoted market price in an active market and derivatives that are linked to them (para 101). At a minimum, further implementation guidance is required for difficult to measure financial instruments. For example, in the electricity industry in Australia the national electricity market is currently not a sufficiently liquid market and is subject to a high level of volatility.