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SUBMISISON ON AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS: THE FAIR VALUE OPTION

Please find attached Treasury's draft submission in respect of the IASB Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: The Fair Value Option. We will be providing the finalised submission directly to the IASB.

In summary, we are not supportive of the proposed amendments. While IAS 39 (and therefore NZ IAS 39) contains numerous options, these reflect the complexity involved in the recognition of financial instruments. Normally we are not supportive of options, however, in this case the proposed amendments will make the standard even more complex by limiting the use of fair value, which in the current standard is arguably a more valid option than what the Exposure Draft will allow.

The fair value options in the existing version of IAS 39 are the culmination of many years of work in designing a standard for financial instruments. The extensive consultation on the existing standard is reflected in endorsement of the fair value option by the substantive majority of submitters who commented on this issue. We do not consider the case has been sufficiently made for the proposed changes.

Our views are similar to, and draw on, those submitted to the IASB by Australia's Heads of Treasuries Accounting and Reporting Advisory Committee (HOTARAC).

Detailed responses to the IASB questions are attached.

Steve Leith (471 5254) and Ken Warren (471 5128) are happy to discuss our comments further if required.

Yours sincerely

Ken Warren
Chief Accounting Advisor

EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS: THE FAIR VALUE OPTION

IASB Specific Questions

IASB Question 1

Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

Response

The New Zealand Government has yet to decide the appropriate Crown accounting recognition policies in respect of financial assets and liabilities to be included in the consolidated financial statements of the New Zealand Government; in particular whether to seek to fair value all financial liabilities. These choices are currently being considered as part of the implementation of NZ IFRS by the New Zealand Government and the reporting entities included in the consolidation.

Although a decision has yet to be in respect of the New Zealand Crown financial statements, the New Zealand Treasury is not supportive of the proposed amendments. While IAS 39 (and therefore NZ IAS 39) contains numerous options, these reflect the complexity involved in the recognition of financial instruments. Normally we are not supportive of options, however, in this case the proposed amendments seek to limit an option that is arguably more valid that what the proposed standard will allow – i.e. it is limiting the use of fair value.

We consider that reporting entities (including Governments that adopt GAAP) should have the option to report financial instruments at fair value if this is determined to provide more meaningful information to users of its financial statements. Accordingly, we consider the existing standard should be implemented without further amendment at this time.

We consider that safeguards such as irrevocable designation, tainting rules and the required disclosures sufficiently mitigate the risk of inappropriate use of the option to designate instruments at fair value through profit and loss. The effectiveness of these safeguards should be periodically reviewed, as should standards in general.

In response to the stated rationale for the proposed amendments (BC9 of IASB Exposure Draft):

- We do not agree that the standard should be changed as proposed to address concerns expressed by some regulators. The designation of instruments at fair value through profit and loss is optional. We presume that if domestic regulators are sufficiently concerned about the use of this option then they have mechanisms for restricting its use by entities within their jurisdiction. Such restrictions should not impair these entities from complying with IAS 39 if they use one of the other permitted measurement bases.

- We do not agree that the fair value option should be restricted because it might “increase, rather than decrease volatility in profit and loss”. As reducing volatility is not an objective of financial statements this should not be a key consideration for amending the standard. Furthermore, entities can choose not to use the fair value option if concerned about volatility arising from applying fair value to only one side of a matched position. If there is sufficient concern that the fair value option may be inappropriately applied to only one side of a matched position, then the IASB could consider requiring matched positions to be valued on a consistent basis.

- We do not agree to the intent to restrict application of the fair value option to financial liabilities in order to avoid recognising gains or losses due to changes in an entity's own creditworthiness. This issue was specifically addressed when the existing fair value option was promulgated. We will not repeat the full discussion of the pros and cons provided in the Basis for Conclusions of IAS 39 (refer BC87 to BC 92), but note we concur with these conclusions, in particular noting that creditworthiness is reflected in the amount initially recognised for an entity's financial liabilities and that disclosures required under IAS 32 inform users, via a proxy, of changes in value arising from changes in the credit risk of a liability.

We are also concerned that applying the "substantial offset" and "contractually linked" provisions could be problematic. For example, should the designation of fair value though profit and loss be revoked if subsequent to initial recognition the proposed criteria are not met (e.g. the offsetting instrument is derecognised)? What guidance will be given to ensure that these provisions are interpreted and applied in a consistent manner?

And finally, we consider the emphasis on verifiability as defined in the standard introduces an ad hoc and inconsistent approach to ensuring reliability of information presented in financial statements. Essentially there will be two tests for recognising financial instruments at fair value; the verifiability test proposed in the Exposure Draft and the reliability of measurement criterion required by the IASB Framework to be applied to financial instruments held for trading or available for sale (and to all other information provided in financial statements). We fail to see the rationale for having the two approaches. We support using a consistent approach and for this approach to draw on the qualitative characteristics in the Framework. Any concerns about these characteristics should be addressed by amending the Framework, not through ad hoc changes in individual standards. We note that New Zealand's Statement of Concepts defines reliability as:

> *"4.9 Information is reliable when it:*
>
> *(a) corresponds with the actual underlying transactions and events (representational faithfulness);*
>
> *(b) is capable of independent verification (verifiability); and*
>
> *(c) is free from bias (neutrality).*
>
> *4.11 Information is verifiable if knowledgeable and independent observers could be expected to concur that the presentation of a transaction or event agrees, with a reasonable degree of precision, with the actual underlying transaction or event. Verifiability focuses on whether a particular basis of measurement is correctly applied, rather than on whether it is appropriate."*

Australia also considers verifiability to be an attribute of reliable measurement. The IASB may want to consider amending its Framework to explicitly refer to verifiability as an attribute of reliable measurement.

IASB Question 2

Are you aware of any financial instruments to which entities are applying, or are intending to apply, the fair value option that would not be eligible for the option if it were revised as set out in this Exposure Draft? If so:

a) Please give details of the instrument(s) and why it (they) would not be eligible.

b) Is the fair value of the instrument(s) verifiable (see paragraph 48B) and if not, why not?

c) How would applying the fair value option to the instrument(s) simplify the practical application of IAS 39?

Response

The limitations in this Exposure Draft may affect decisions by the New Zealand Government on the accounting treatment of New Zealand government NZD denominated debt (for example, New Zealand government domestic bonds or Treasury bills) and foreign-currency denominated debt. At the consolidated level, New Zealand Government debt is around NZD36.5 billion (around 26% of GDP).

Generally, these instruments are actively traded (by the holders of debt) and therefore their fair value is verifiable. In fact they represent the most readily verifiable asset or liability on the Government's balance sheet, certainly more than the livestock or forestry assets that IAS require to be fair valued.

The potential benefits of adopting the fair value approach could include:

(i) it would provide an opportunity for reporting entities to report on all financial instruments on a consistent basis (i.e. fair value). This could provide users of accounts with more meaningful information than a mixed measurement approach

(ii) in the case of the New Zealand Crown financial statements situation, it could allow consistent treatment for all New Zealand government domestic bonds across all the reporting entities that make up the Crown financial statements (i.e. where New Zealand government domestic bonds are held as both assets and liabilities – albeit they eliminate on consolidation to the extent of cross holdings)

(iii) it is consistent with future plans for the internal management of New Zealand government domestic bonds

(iv) it could simplify financial reporting systems if applied across all financial instruments.

IASB Question 3

Do the proposals contained in this Exposure Draft appropriately limit the use of the fair value option so as to address adequately the concerns set out in paragraph BC9. If not, how would you further limit the use of the option and why?

Response

Refer to our response to Question 1.

We do not consider that the concerns raised in BC9 are sufficient to warrant the proposed amendments. We consider the existing safeguards to be satisfactory at this time and no further limits should be made on the use of the fair value option.

IASB Question 4

Paragraph 9(b)(i) proposes that the fair value option could be used for a financial asset or financial liability that contains one or more embedded derivatives, whether or not paragraph 11 of IAS 39 requires the embedded derivative to be separated. The IASB proposes this category for the reasons set out in paragraphs BC6(a) and BC16-BC18 of the Basis for Conclusions on this Exposure Draft. However, the IASB recognises that a substantial number of financial assets and financial liabilities contain embedded derivatives and, accordingly, a substantial number of financial assets and financial liabilities would qualify for the fair value option under this proposal.

Is the proposal in paragraph 9(b)(i) appropriate? If not, should this category be limited to a financial asset or financial liability containing one or more embedded derivatives that paragraph 11 of IAS 39 requires to be separated?

Response

Refer to our response to Question 3.

We consider that the case has not been made for further limiting the use of the fair value option. If, however, the Exposure Draft is approved by the IASB, we would consider paragraph 9(b)(i) to be appropriate.

IASB Question 5

Paragraph 103A proposes that an entity that adopted early the December 2003 version of IAS 39 may change the financial assets and financial liabilities designated as at fair value through profit or loss at the beginning of the first period for which it adopts the amendments set out in this Exposure Draft. It also proposes that in the case of a financial asset or financial liability that was previously designated as at fair value through profit or loss but is no longer so designated as at fair value through profit or loss but is no longer so designated:

(a) if the financial asset or financial liability is subsequently measured at cost or amortised cost, its fair value at the beginning of the period for which it ceases to be designated as at fair value through profit or loss is deemed to be its cost or amortised cost.

(b) if the financial asset is subsequently classified as available for sale, any amounts previously recognised in profit or loss shall not be reclassified into the separate component of equity in which gains and losses on available-for-sale assets are recognised.

However, in the case of a financial asset or financial liability that was not previously designated as at fair value through profit or loss, the entity shall restate the financial assets or financial liability using the new designation in the comparative financial statements.

Finally, this paragraph proposes that the entity shall disclose:

(a) for financial assets and financial liabilities newly designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the previous financial statements.

(b) for financial assets and financial liabilities no longer designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the current financial statements

Are these proposed transitional requirements appropriate? If not, what changes do you propose and why? Specifically, should all changes to the measurement basis of a financial asset or financial liability that result from adopting the amendments proposed in this Exposure Draft be applied retrospectively by restating the comparative financial statements?

Response

The IASB proposes that the amendments be effective for periods beginning on or after 1 January 2005. This is contrary to its commitment to provide a stable platform by 31 March 2004 for entities transitioning to IFRS in 2005. It is unfortunate that an issue as significant as fair value adoption is being re-litigated at this late stage. However, if the Exposure Draft is approved then, on balance, it is understandable that it should be made effective as soon as possible in order to avoid further confusion and changes for reporting entities.

IASB Question 6

Do you have any other comments on the proposals?

Response

Some of the concerns regarding the fair value option could be addressed if the income statement were to differentiate between transactions and remeasurements. We are aware that the Reporting Comprehensive Income project is examining this issue. We encourage the IASB to give priority to progressing this project given the potential benefits of adopting a comprehensive income approach.

We understand that the IMF will require countries to use fair values when reporting in accordance with its Government Financial Statistics (GFS) Framework. Adopting the proposed Exposure Draft will remove the option for the New Zealand Government to more closely align its reporting under GFS and GAAP.

FRSB NEW ZEALAND SPECIFIC QUESTIONS

Question One

Whether the ED: The Fair Value Option should contain any additional material to allow public-benefit entities to comply with the proposed requirements

In our view, no additional information is required to enable public sector entities to comply with the proposed amendments.

Question Two

Whether there are any regulatory issues or other issues arising in the New Zealand environment that may affect the implementation of the proposals, particularly any issues relating to:

a. public-benefit entities;

b. public sector profit-oriented entities;

c. the Privacy Act 1993

As discussed in response to IASB Question 6, the proposed amendments would remove the option for the New Zealand Government to more closely align its reporting requirements under GFS and GAAP. Dual records may well need to be kept for financial instruments if GFS requires fair value reporting while another measurement base is required by IAS 39.

Question Three

Whether adoption of the proposed amendments, in the IASB's ED The Fair Value Option, to NZ IAS 39 is in the best interests of users of general purpose financial reports in New Zealand?

We do not support the proposed amendments. If, however, they are adopted by the IASB then, as is the rationale for IAS adoption generally, on balance the changes should be applied to NZ IAS 39 in order that entities can comply with international accounting standards by complying with NZ IFRS.