

Explanatory Statement

AASB 2005-4 Amendments to Australian Accounting Standards

June 2005



Australian Government

**Australian Accounting
Standards Board**

EXPLANATORY STATEMENT

Adoption of Australian equivalents to IFRSs

The Australian Accounting Standards Board (AASB) is implementing the directive of the Financial Reporting Council (FRC) to adopt the Standards of the International Accounting Standards Board (IASB), for application to reporting periods beginning on or after 1 January 2005.

The IASB defines International Financial Reporting Standards (IFRSs) as comprising:

- (a) International Financial Reporting Standards;
- (b) International Accounting Standards (IAS); and
- (c) Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

The Australian equivalents to IFRSs are:

- (a) Accounting Standards issued by the AASB that are equivalent to Standards issued by the IASB, being AASBs 1 – 99 corresponding to the IFRS series and AASBs 101 – 199 corresponding to the IAS series; and
- (b) Urgent Issues Group (UIG) Interpretations issued by the AASB corresponding to the Interpretations adopted by the IASB, as listed in AASB 1048 *Interpretation and Application of Standards*.

In implementing the FRC's directive, the AASB is replacing relevant existing AASB Standards with Australian Standards equivalent to those of the IASB. The AASB has decided it will continue to issue sector-neutral Standards, that is, Standards applicable to both for-profit and not-for-profit entities, including public sector entities. Except for Standards that are specific to the not-for-profit or public sectors or that are of a purely domestic nature, the AASB uses the IASB Standards as the "foundation" Standards to which it adds material detailing the scope and applicability of a Standard in the Australian environment. Additions are made, where necessary, to broaden the content to cover sectors not addressed by an IASB Standard and domestic, regulatory or other issues.

On 15 July 2004, the AASB made the set of Australian Standards equivalent to IFRSs, together with several associated Australian Standards, effective for annual reporting periods beginning on or after 1 January 2005.

AASB 139 *Financial Instruments: Recognition and Measurement* was issued at this time and is the Australian equivalent of IAS 39 *Financial Instruments: Recognition and Measurement*.

Reasons for Issuing AASB 2005-4

AASB 2005-4 makes amendments to AASB 139 as well as consequential amendments to:

1. AASB 132 *Financial Instruments: Disclosure and Presentation*;
2. AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards*;
3. AASB 1023 *General Insurance Contracts*; and
4. AASB 1038 *Life Insurance Contracts*.

After the issue of IAS 39 the IASB became aware that some constituents, including some prudential supervisors of banks, securities companies and insurers, were concerned that the fair value option might be used inappropriately. These constituents were concerned that:

- (a) entities might apply the fair value option to financial assets or financial liabilities whose fair value is not verifiable. If so, because the valuation of these financial assets and financial liabilities is subjective, entities might determine their fair value in a way that inappropriately affects profit or loss;
- (b) the use of the option might increase, rather than decrease, volatility in profit or loss, for example if an entity applied the option to only one part of a matched position; and
- (c) if an entity applied the fair value option to financial liabilities, it might result in an entity recognising gains or losses in profit or loss associated with changes in its own creditworthiness.

In response to those concerns, the IASB published in April 2004 an Exposure Draft of proposed restrictions to the fair value option. In March 2005 the IASB held a series of round-table meetings to discuss proposals with invited constituents. Australian constituents from the banking and insurance industry and from the Australian Prudential Regulatory Authority participated in these meetings. As a result of this process, the IASB issued an amendment to IAS 39 in June 2005 relating to the fair value option.

Main Features of this Standard

This Standard was made by the AASB on 9 June 2005 under section 334 of the *Corporations Act 2001*.

Application Date

This Standard is applicable to annual reporting periods beginning on or after 1 January 2006 with early adoption permitted for annual reporting periods beginning on or after 1 January 2005.

Main Changes from AASB 139 (July 2004)

AASB 139 (issued July 2004) included a free choice option to designate financial instruments at fair value through profit or loss. Under this Standard the ability to designate financial assets and financial liabilities is restricted.

The amendment restricts the designation of financial assets and financial liabilities as “at fair value through profit or loss”, such that designation is only where permitted under paragraph 11A of AASB 139, or when doing so results in more relevant information because either:

- (i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or
- (ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in AASB 124 *Related Party Disclosures*), for example the entity’s board of directors and chief executive officer.

The AASB supports the availability of a free choice fair value option, on the basis that this provides the AASB with the ability to require the use of fair values in measuring financial assets and liabilities in appropriate circumstances without jeopardising compliance with IFRSs. However, in the interests of having Australian Accounting Standards that result in IFRS compliance, the AASB decided to amend AASB 139 as outlined above. This necessitates consequential amendments to AASB 132, AASB 1, AASB 1023 and AASB 1038. The more substantive consequential amendments are to AASB 1023 and AASB 1038.

Main Changes from AASB 1023 (July 2004)

Under AASB 1023, issued in July 2004, all financial assets that back insurance liabilities must be designated as “at fair value through profit or loss” in accordance with AASB 139.

Given the amendments to AASB 139 outlined in this statement, financial assets may only be designated as “at fair value through profit or loss”, using the restricted fair value option.

AASB 1023 is amended to require financial assets that back insurance liabilities to be measured as “at fair value through profit or loss”, where they are permitted to be measured as “at fair value through profit or loss” under AASB 139.

Main Changes from AASB 1038 (July 2004)

Under AASB 1038, issued in July 2004, all financial assets that back life insurance liabilities or life investment contract liabilities must be designated as “at fair value through profit or loss” under AASB 139.

Given the amendments to AASB 139 outlined in this statement, financial assets may only be designated as “at fair value through profit or loss”, using the restricted fair value option.

AASB 1038 is amended to require financial assets that back life insurance liabilities or life investment contract liabilities to be measured as “at fair value through profit or loss”, where they are permitted to be measured as “at fair value through profit or loss” under AASB 139.

Similarly, under AASB 1038, issued in July 2004, life investment contract liabilities must be designated as “at fair value through profit or loss” under AASB 139.

Given the amendments to AASB 139 outlined in this statement, life investment contract liabilities may only be designated as “at fair value through profit or loss”, using the restricted fair value option.

AASB 1038 is amended to require life investment contract liabilities be measured as “at fair value through profit or loss”, where they are permitted to be measured as “at fair value through profit or loss” under AASB 139.

Consultation prior to Issuing this Standard

Public consultation was part of the process undertaken by the AASB prior to its decision to issue this Standard, amending the existing version of AASB 139 (issued July 2004). An Exposure Draft (ED) containing proposed

revisions, ED 132 Request for Comment on IASB ED Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* – The Fair Value Option was issued for public comment in May 2004, with a comment period ending on 21 July 2004.

Ten submissions to ED 132 were received and the AASB considered these submissions in the process of developing this Standard.

A Regulatory Impact Statement has been prepared in connection with the revision of the Standards.