

Regulation Impact Statement
AASB 2005-4
Amendments to Australian Accounting Standards

Background

The Australian Accounting Standards Board (AASB) is implementing the Financial Reporting Council's (FRC) strategic directives to adopt International Financial Reporting Standards [the Standards and Interpretations of the International Accounting Standards Board (IASB)] for application to reporting periods beginning on or after 1 January 2005 and to harmonise the requirements applicable to general purpose financial reports of public sector entities and those applicable to Government Finance Statistics. To put the first of the FRC directives into effect the AASB is issuing Australian equivalents to IASB Standards and has undertaken a separate project in respect of harmonising financial reporting requirements and Government Finance Statistics. Implementation of the FRC's Year 2005 strategic directive does not, of itself, cause a change in the underlying economic circumstances of an entity but at times results in events and transactions being portrayed differently so as to achieve improvements in the transparency and quality of Australian financial reports.

The AASB has decided to continue to issue one series of sector-neutral Standards, that is, Standards applicable to both for-profit and not-for-profit entities, including public sector entities. The AASB has regard to the Standards of the International Public Sector Accounting Standards Board of the International Federation of Accountants (IPSASB) in respect of issues affecting not-for-profit entities. The IPSASB is using the IASB's Standards, to the extent possible, as the basis for International Public Sector Accounting Standard (IPSAS). Accordingly, adopting IASB Standards simultaneously helps convergence with existing and future IPSASs. Except for Standards that are specific to the not-for-profit or public sectors or that are purely of a domestic nature, the AASB is using 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, broadening the content to cover sectors not addressed by an IASB Standard and domestic, regulatory or other issues. The AASB also retains guidance from superseded AASB Standards in an Appendix to the new Standards where it considers that guidance to be important to facilitate implementation and compliance with a Standard. In addition, in respect of optional treatments included in IASB Standards, the AASB decided it would generally require only one treatment in order to facilitate comparability of financial reports in Australia.

AASB 139 *Financial Instruments: Recognition and Measurement* is part of the set of Australian equivalents to IASB Standards, and is the Australian equivalent of the IASB's IAS 39 *Financial Instruments: Recognition and Measurement*.

1. Problem

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 proposing restrictions on the circumstances in which the fair value option could be used. In March 2005 the IASB held a series of meetings to discuss proposals with invited constituents. Australian constituents from the banking and insurance industries 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 restricting the use of the fair value option.

AASB 2005-4 makes amendments to AASB 139, and consequential amendments to AASB 132 *Financial Instruments: Disclosure and Presentation*, AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards*, AASB 1023 *General Insurance Contracts* and AASB 1038 *Life Insurance Contracts*. The more substantial consequential amendments are to AASB 1023 and AASB 1038.

2. Objectives

The AASB's objectives in addressing the problem are to improve the quality and usefulness of financial reporting in Australia in respect of both for-profit and not-for-profit reporting entities in the private and public sectors and to implement the FRC's directives.

3. Options

Option 1

Adopt the IASB's amendment to IAS 39 restricting the fair value option.

Option 2

Not adopt the IASB's amendment to IAS 39 restricting the fair value option.

Option 3

Adopt the IASB's amendment to IAS 39 restricting the fair value option – with application limited to for-profit entities.

Option 1 enables compliance with the FRC directive. Option 2 would mean that there would not be an Australian Standard equivalent to IAS 39 and this would be inconsistent with the FRC's policy directive relating to adoption of IASB Standards. Option 3 enables compliance with the FRC directive and would involve the AASB retaining the free-choice fair value option in the July 2004 version of AASB 139 as an Aus paragraph, with application limited to not-for-profit entities. However, option 3 would be inconsistent with the notion of sector-neutral standards.

4. Impact Analysis

When issuing Exposure Drafts of Australian equivalents of IASB Standards, the AASB specifically sought comment from constituents on whether the proposals are in the best interests of the Australian economy and on whether there are regulatory or other issues that may affect the implementation of the proposals. The AASB assesses from a public interest perspective whether the costs of providing certain financial information exceed the benefits to be derived from its provision. There is no universally accepted methodology for quantitatively measuring costs and benefits of information presented in financial reports. The costs of providing financial information are incurred, in the main, by reporting entities, but extend in various direct and indirect ways to the users of general purpose financial reports. There is no guarantee that the costs are borne ultimately by those who derive the benefits. The AASB considers the benefits and costs for individual Standards in the context of the Year 2005 strategic directive as a whole.

Under section 227(1) of the *Australian Securities and Investments Commission Act 2001* (ASIC Act), the functions of the AASB are to:

- develop a conceptual framework, not having the force of an accounting standard, for the purpose of evaluating proposed accounting standards and international standards;
- make accounting standards under section 334 of the *Corporations Act* for the purposes of the corporations legislation;
- formulate accounting standards for other purposes; and
- participate in and contribute to the development of a single set of accounting standards for world-wide use having regard to the interests of Australian corporations that raise or propose to raise capital in major international financial centres.

Functions of the FRC include determining the AASB's broad strategic direction, monitoring the development of international standards and the accounting standards that apply in major international financial centres, to further the development of a single set of standards for world-wide use with appropriate regard to international developments and to promote the adoption of international best practice in the Australian accounting standard-setting process.

Both the AASB and the FRC are required to advance the main objects of Part 12 of ASIC Act:

- facilitate the development of accounting standards that require the provision of financial information that allows users to make and evaluate decisions about allocating scarce resources, assists directors to discharge their obligations in relation to financial reporting, is relevant to assessing performance, financial position, financing and investment, is relevant and reliable, facilitates comparability and is readily understandable;
- facilitate the Australian economy by reducing the cost of capital, enabling Australian entities to compete effectively overseas and having accounting standards that are clearly stated and easy to understand; and
- maintain investor confidence in the Australian economy (including its capital markets).

It is in this context that the FRC has decided to direct the AASB to:

- adopt IASB Standards with effect from 1 January 2005; and

- harmonise the requirements applicable to general purpose financial reports of public sector entities and those applicable to Government Finance Statistics.

AASB 139 (issued July 2004) included a free choice option to designate financial instruments at fair value through profit or loss. Under AASB 2005-4 the ability to designate financial assets and financial liabilities is restricted.

The amendment restricts to two situations the designation of financial assets and financial liabilities as “at fair value through profit or loss”, being:

- (a) if a contract contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss unless:
 - (i) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or
 - (ii) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost; or
- (b) 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.

AASB 1023 (issued July 2004) and AASB 1038 (issued July 2004) both require all financial assets that back insurance liabilities to be measured as “at fair value through profit or loss” in accordance with AASB 139 (issued July 2004).

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 and AASB 1038 are 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.

AASB 1023 and AASB 1038 have also been amended to incorporate commentary explaining that, in all but rare cases, financial assets would be permitted to be measured at fair value through profit or loss because of the circumstances of general and life insurers and the methods applied in measuring their liabilities.

5. Consultation

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 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 with respondents expressing concern about the potential impact of limiting the availability of the fair value option. The AASB considered these submissions in the process of developing this Standard.

The AASB also expressed its dissatisfaction to the IASB over the proposals because the AASB considers that the full fair value option offers the best opportunities for Australian reporting entities to be required to continue employing accounting policies that produce useful information. The AASB emphasised to the IASB that any restriction on the use of the fair value option could detract from the AASB’s ability to require such policies.

6. Conclusion and Recommendation

Notwithstanding the AASB’s support for the availability of a free choice fair value option, in order to comply with the FRC directive in relation to IASB Standards the AASB decided to follow Option 1 and issue AASB 2005-4. Failure by the AASB to make the amendments to AASB 139, AASB 132, AASB 1, AASB 1023 and AASB 1038 would be inconsistent with the FRC’s directive on IASB Standards.

In forming this conclusion, the AASB considered that, on balance, the benefits of facilitating the Australian economy by reducing the cost of capital, enabling entities to compete effectively overseas and the provision of information that is relevant, reliable and facilitates comparability outweighed the costs to individual entities of adopting Australian equivalents to IASB Standards.

7 Implementation and Review

AASB 139, AASB 132, AASB 1, AASB 1023 and AASB 1038 as amended by AASB 2005-4 will be subject to review and revision taking account of international developments, particularly the processes for review and revision undertaken by the IASB, and of the experience of constituents in implementing the Standards.