**Submission of Comments by the AASB to the IASB**

AUSTRALIAN ACCOUNTING STANDARDS BOARD

**CL 94**

# IASB

International Accounting Standards Board

## Exposure Draft

## IASB ED *PROPOSED AMENDMENTS TO IAS 39* FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT – *THE FAIR VALUE OPTION*

*Comments to be received by 21 July 2004*

## INVITATION TO COMMENT

***In response to the IASB Invitation to comment, the Australian Accounting Standards Board has prepared the following submission addressing the specific questions asked and commenting on the proposals in the IASB ED.***

The AASB supports the retention of the fair value option as articulated in the December 2003 version of IAS 39. Further, the AASB supports extending the opportunity available to entities to make use of the fair value option, and encourages the IASB to remove the current prohibition on reclassifying a financial instrument into fair value through profit or loss while it is held or issued (while retaining the current prohibition on reclassifying a financial instrument out of fair value through profit or loss while it is held or issued).

The AASB does not support the proposed amendments to IAS 39. The AASB's most significant concerns regarding the IASB ED relate to:

- limiting the fair value principle through the proposed addition of rules;
- the proposal that the fair value option can only be used where fair value is verifiable implies that verifiability is not required when an entity classifies a financial asset or financial liability as held for trading, or when an entity classifies a financial asset as available for sale and the gain or loss is recognised directly in equity;

- the proposal for loans or receivables would mean that many insurers would not be able to apply the fair value option to non-quoted fixed interest assets held to back many of their insurance liabilities, as well as some annuity and investment contract business;
- the notions "contractual link" and "substantially offset" are not clearly articulated;
- compromising financial reporting outcomes as a response to the concerns of a prudential supervisor; and
- the proposed effective date not being consistent with the IASB's commitment to maintaining a 'stable platform' of unchanged Standards during the period to 2005 when many companies adopt IFRSs for the first time;

**IASB ED *PROPOSED AMENDMENTS TO IAS 39* FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT – *THE FAIR VALUE OPTION***

# INVITATION TO COMMENT

The International Accounting Standards Board invites comments on the changes to IAS 39 proposed in this Exposure Draft. It would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, when applicable, provide a suggestion for alternative wording.

The Board is not requesting comments on matters other than those set out in this Exposure Draft.

Comments should be submitted in writing so as to be received no later than 21 July 2004.

**Question 1 – Proposals in this Exposure Draft**

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

The AASB supports the retention of the fair value option as articulated in the December 2003 version of IAS 39. Further, the AASB supports extending the opportunity available to entities to make use of the fair value option, and encourages the IASB to remove the current prohibition on reclassifying a financial instrument into fair value through profit or loss while it is held or issued (while retaining the current prohibition on reclassifying a financial instrument out of fair value through profit or loss while it is held or issued). The AASB does not support the proposed amendments to IAS 39 for the following reasons.

- Principles v Rules. The AASB understands that the IASB has a long-term strategic commitment to developing principles-based standards. The AASB notes that the revised 2000 version of IAS 39 significantly increased the use of fair value in accounting for financial instruments, and that the December 2003 version of IAS 39 continues this approach. Paragraph BC74(e) comments that one of the reasons for introducing the fair value option was that it "de-emphasises interpretive issues around what constitutes trading". The AASB has always considered fair value to be an important principle in IAS 39. The AASB considers that the IASB's proposal to limit the fair value principle through the proposed addition of many rules is not consistent with the IASB's commitment to developing principles-based standards. In addition, limiting the fair value option reopens the very question that the inclusion of the fair value option in December 2003 version of IAS 39 was intended to resolve – what constitutes trading?

- Verifiability: The AASB has always understood the reliability of a measure to rest on three attributes: representational faithfulness, neutrality and verifiability. The AASB considers that the IASB's proposal that the fair value option can only be used where fair value is verifiable means that the IASB does not share the AASB's view that verifiability is one of the attributes of reliable measurement.

  However, the AASB notes that the ED does not propose that verifiability operate in addition to the principle of reliable measurement when an entity classifies a financial asset or financial liability as held for trading (even when the financial instrument's market is not liquid), or when an entity classifies a financial asset as available for sale and the gain or loss is recognised directly in equity. The AASB considers that the IASB's proposal may give rise to the unfortunate implication that verifiability is not required when an entity classifies a financial asset or financial liability as held for trading, or when an entity classifies a financial asset as available for sale and the gain or loss is recognised directly in equity, or alternatively, the attributes of reliable measurement vary depending on the item being measured (and for some specified financial instruments the proposal introduces a new recognition criterion – verifiability – in addition to the recognition criteria that are currently articulated in IAS 39).

  The AASB considers that the attributes of reliable measurement are the same for each item being measured, and include the attribute of verifiability. Put another way, the AASB considers that the principle of reliable measurement should be consistently applied to any financial asset or financial liability remeasured at fair value.

  In addition, the AASB considers that the expression "verifiability" is problematic, because the expression is used in auditing to refer to information that is auditable, and whether information is auditable should not be a determining factor for an accounting standard setter.

- Loans or receivables: Many insurers hold non-quoted fixed interest assets to back many of their insurance liabilities, as well as some annuity and investment contract business. The AASB understands that many insurers would categorise non-quoted fixed interest assets as loans and receivables. The ED's proposals mean that these insurers would not be able to apply the fair value option to these assets unless they meet the requirement of the proposed paragraph 9(b)(ii). For non-quoted fixed interest assets backing general insurance liabilities it is very unlikely that the requirement of paragraph 9(b)(ii) can be satisfied. For non-quoted fixed interest assets backing life insurance liabilities the requirement of paragraph 9(b)(ii) will only be sometimes met. The AASB notes this limitation on insurers applying the fair value option to assets continues even when a non-quoted fixed interest asset is measurable using a valuation technique whose variables include primarily observable market transactions in the same instrument (i.e. without modification or repackaging) or to other observable current market data, because the non-quoted fixed interest asset is held to back certain products not covered by paragraphs 9(b)(ii) and (iii).

- Contractual link: The AASB considers that the expression "contractual link" is problematic (because the expression describes a potentially wide range of arrangements, including for example, debentures secured through a floating charge). In addition, the ED is not clear on whether the link between "a financial liability whose amount is contractually linked to the performance of assets measured at fair value" must be a link to a specific asset or a specific pool of assets, or could be to a pool of assets when some or all of the assets that comprise the pool can be varied.

  The AASB notes that, if the link must be to a specific asset or a specific pool of assets that cannot be varied, when a financial liability is linked to a pool of assets that may be sold or replaced with other assets as occurs with managed investments, an entity could not apply the fair value option to the financial liability.

- Substantial offset: The AASB notes that the ED does not propose guidance on how to implement the principle of substantial offset. The AASB considers that some economic variables will be common to a matched financial asset and financial liability. The AASB considers that other economic variables will not be common to a matched financial asset and financial liability (for example, a change in the credit-worthiness of the issuer will affect the fair value of its financial liability but will not affect the fair value of its financial asset). Accordingly, the AASB expects that for some matched financial assets and financial liabilities an entity will not be able to apply the fair value option because there is no substantial offset.

- Regulatory problem: Paragraph 3 of the Background to the ED comments that

"…prudential supervisors of banks, securities companies and insurers, expressed concerns that the fair value option might be used inappropriately". The IASB is responsible for setting accounting standards for financial reporting. The AASB has sympathy with the IASB's goal of developing an accounting standard that on the matter of reliable measurement is in harmony with the requirements of a prudential supervisor. However, the AASB considers it inappropriate for the IASB to compromise financial reporting outcomes as a response to the concerns of a prudential supervisor. The AASB note that the problem that the IASB is seeking to address is not an international problem, but a national or regional problem. In Australia's case, constraining the fair value option has the affect of inhibiting the harmony between the AASB's requirements (including the requirements of the Australian equivalent to the December 2003 version of IAS 39) and those of the Australian prudential supervisor. Accordingly, the AASB considers that the supervisor concerned with the December 2003 version of IAS 39 change its prudential reporting requirements to meet its concern that some financial instruments should not be fair valued.

- Stable platform: The IASB has previously articulated its commitment to providing, by 31 March 2004, a "stable platform" for the transition to IASB Standards in 2005. Stable platform means issuing all of the new and revised Standards that will be required for entities adopting IASB Standards in 2005. The AASB considers that the proposal in the ED to amend the revised IAS 39 that was issued in December 2003 and is effective for financial years beginning on or after 1 January 2005 is not consistent with the IASB's commitment to a stable platform. The AASB considers that to enable the IASB to remain consistent with its stable platform policy, requires any of the proposed amendments to IAS 39 that are approved by the IASB to be applicable from the first annual reporting period beginning on or after 1 January 2006, with an entity able to elect to early adopt the revised Standard. The AASB note that its proposal is consistent with the approach proposed by the IASB in ED *Proposed Amendments to IAS 39* Financial Instruments: Recognition and Measurement – *Cash Flow Hedge Accounting of Forecast Intragroup Transactions*. Paragraph BC16 to that ED comments "..the Board considered what should be the effective date of the proposed clarification. The Board is committed to maintaining a 'stable platform' of unchanged Standards during the period to 2005 when many companies adopt IFRSs for the first time. Accordingly, it decided that the effective date of the proposed amendment would be accounting periods beginning on or after 1 January 2006. However, given the widespread and practical relevance of the issue, it also decided to permit early application".

Should the IASB amend the fair value option as articulated in the December 2003 version of IAS 39, the AASB suggests that the proposed paragraph 9(b) references to fair value be expanded to encompass references to market-based measurement approaches, for example the margin on service (MoS) approach to measuring insurance liabilities. The AASB considers that such a change would enable insurers that use MoS to measure their insurance liabilities to fair value their financial assets.

**Question 2 – Financial instruments no longer eligible for the fair value option**

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?

For close to a decade, Australia has effectively had universal application of market value for all assets of life insurers and all investment assets of general insurers (which encompasses a very diverse range of asset types). The AASB understands that the proposed amendment will impact on the measurement of some of these assets.

Non-quoted fixed interest assets: The AASB understands that the requirement for verifiability has particular implications for life insurers investing in non-quoted fixed interest assets that are commonly offered on the Australian market. Most of these financial instruments are externally credit rated at inception, and life insurers would typically have an internal process for establishing a credit rating for ongoing valuation purposes. Further, the AASB understands that the various valuation techniques used in Australia are consistent with the valuation techniques set out in paragraphs AG69-AG72 of the Appendix to IAS 39. The AASB understands that the verifiability test would make it difficult for life insurers to apply the fair value option to these types of instruments, especially those that are long dated (e.g. an instrument to match the long tail of an annuity portfolio) or have significant levels of subordination. In Australia there is a scarcity of long-duration rated corporate and government bonds (in excess of 20 years). Accordingly, it is quite common for life insurers to purchase part of the top tranche of infrastructure bonds to back the long tail of an annuity portfolio as they provide long-duration fixed interest returns which makes this type of instrument a well suited match to the annuity portfolio. The AASB understands that, in the situation described, verifiability is problematic.

Annuity portfolios: The AASB understands that life insurers' annuity portfolios (after allowing for expected default/credit risk) are typically matched with non-quoted fixed interest assets and prima-facie this would seem to allow a substantial offset to be established. However, the substantial offset condition requires both sides then to be fair valued (and be subject to the verifiability test). The substantial offset condition precludes an entity designating a financial instrument as at fair value through profit or loss when one side of the offset cannot be fair valued, for example:

- Non-quoted fixed interest assets due to verifiability; and
- liabilities measured using MoS (in those situations when MoS is not fair value. Although the AASB considers MoS to be a market-based measurement approach, and one of the best currently available, however, the AASB acknowledges that it would be difficult to maintain that MoS gives a fair value for insurance liabilities).

Accordingly, the AASB considers that the substantial offset condition is not likely to be an effective means of enabling an entity to make use of the fair value option in respect of an annuity portfolio with non-quoted fixed interest assets on either:

- the asset side in respect of non-quoted fixed interest assets; or
- the liability side in respect of term annuities (which qualify as investments contracts and not insurance contracts).

Investment asset pools containing non-quoted investments: The AASB understands that non-quoted fixed interest assets are often held by life insurers in a pool that may back a combination of participating business, non-participating business and shareholder capital and retained profits. Establishing a substantial offset would appear to require segregation of the pool into specific assets backing participating business and policyholder retained profits. Non-quoted fixed interest assets backing shareholder retained profits would not qualify for the fair value option which could cause significant problems, given that Australian life insurance legislation treats investment returns on policyholder and shareholder retained profits as co-mingled and requires the total income to be split in accordance with agreed profit shares.

Assets backing insurance contracts: The AASB understands one potential problem arising from the identification of a substantial offset, is when the offsetting liability is an insurance contract or an investment contract with discretionary participating features. IFRS 4 *Insurance Contracts* grandfathers existing local practice. In Australia, this means that a life insurer will measure the liability using MoS (and in those situations when MoS is not fair value, or when it is fair value but not verifiable), it is not possible to fair value the assets backing participating business or lifetime annuities.

This substantially detracts from the benefits that may have arisen from having insurance contract accounting (MoS) grandfathered under IFRS 4.

Own debt: Some Australian entities that are not insurers presently fair value most or all of their financial instruments for which a fair value can be reliably measured. This would include applying the fair value option to their issued debt (which is a material amount). The AASB understands that issued debt would not be eligible to be measured at fair value as it does not fall within the specified instances where fair value measurement is allowed (and it is not held for trading).

**Question 3 – Concerns set out in paragraph BC9**

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?

The AASB considers the concerns set out in paragraph BC9 to be unfounded and is concerned that the proposed amendments will compromise financial reporting outcomes, be that by creating the illusion of a matched position when a matched position does not exist, or, in the case of life insurers, artificially increasing income statement volatility (given that IFRS 4 will require Australian life insurers to measure the liability using MoS when it might be not possible to fair value the assets backing participating business or lifetime annuities). The AASB notes that the IASB's concern about the level of income statement volatility that would result from widespread use of the fair value option might be more appropriately addressed by advancing the "Reporting Comprehensive Income Project" (as the current proposal to reformat the income statement to separate the remeasurement of assets and liabilities from other income and expense items may significantly reduce concerns about income statement volatility).

**Question 4 – Embedded derivatives**

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 Board 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 Board 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?

The AASB supports the retention of the fair value option as articulated in the December 2003 version of IAS 39. Accordingly, the AASB supports the proposal 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.

**Question 5 – Transitional requirements**

Paragraph 103A proposes that an entity that adopts 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 from the beginning of the first period for which it adopts the amendments 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:

(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 asset 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?

Australian entities will be adopting the Australian equivalents to IFRSs from 1 January 2005 and transition will be governed by the Australian equivalent to IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Accordingly, if the IASB approved the proposed amendments to IAS 39 with an effective date of 1 January 2005, no Australian entity is able to apply the transitional requirements in IAS 39. However, if the IASB approved the proposed amendments with an effective date of 1 January 2006 with early application, an Australian entity could elect to early apply the Standard. In this scenario, the Australian entity would need to make use of transitional requirements. The AASB considers the transitional requirements to be practical.

**Question 6 – Other comments**

Do you have any other comments on the proposals?

The AASB understands that one of the likely outcomes of the proposal is increased volatility in the results of life insurers and a reduction in the relevance and understandability of financial reporting, which could:

- adversely impact on the cost of shareholder capital (e.g. to make the information more understandable, Australian listed life insurers may feel the need to publish supplementary financial information, whereas other life insurers competing for capital in an international market will not be affected in the same way by these issues);
- create further divisions between financial and regulatory reporting in some jurisdictions, for example Australia, where the prudential supervisor has clearly articulated a policy for regulatory reporting based on market values; and
- result in a move to more conservative business approach – for example, matching annuities using only quoted fixed interest assets, and life funds not participating in non-quoted ventures, and consequent adverse implications for:
  - cost of private funding for infrastructure; and

- supply and attractiveness of annuities offered to retirees.

The AASB notes that IFRS 4.45 comments that a change in accounting policy will allow an insurer to reclassify some or all of its financial assets as at fair value through profit or loss. Under the revised insurance standards in Australia, that will take effect from 1 January 2005, insurers will be required to use a "risk-free" discount rate in measuring their insurance liabilities. This represents a change in accounting policy that appears to be contemplated by IFRS 4.45. Proposed paragraph 9((b)(v) is consistent with IFRS 4.45. However, the AASB notes that paragraph 9(b) requires that the fair value of the reclassified financial asset be verifiable. Accordingly, to the extent that the test of verifiability is satisfied, Australian insurers will presumably be able to apply the fair value option to non-quoted fixed interest assets. However, the AASB remains concerned about the verifiability criterion.

Alternative solution

In the process of adopting IASB Standards in Australia, the AASB has been removing options from Standards that it considers inappropriate in the Australian environment. The AASB considers that, if in the European environment the fair value option is considered inappropriate, the European Commission could adopt IAS 39 without the fair value option. In doing so the European Standard would still be IFRS compliant.