

Accounting alert

Analysis of the latest accounting developments delivered to you via e-mail

Financial instruments: Recognition and measurement

Pending AASB 139 can be obtained from the AASB's web site: www.aasb.com.au

Applicable for annual reporting periods beginning on or after 1 January 2005. Early adoption is not permitted

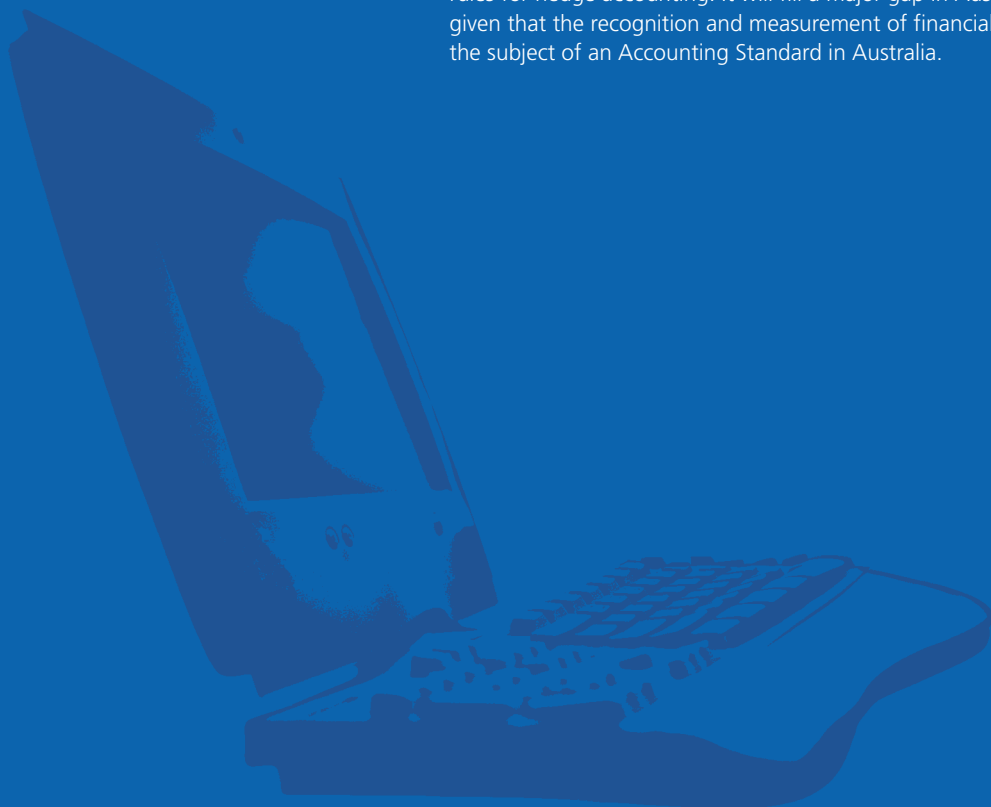
The Australian Accounting Standards Board (AASB) has made available Pending Accounting Standard AASB 139 'Financial Instruments: Recognition and Measurement'.

This *Accounting Alert* provides an overview of AASB 139 and some analysis of the issues arising. Refer *Accounting Alert* 2004/02 for an analysis of issues related to the disclosure and presentation of financial instruments.

Overview

As noted in *Accounting Alert* 2004/19 the AASB is issuing Pending AASB Standards prior to their finalisation in April/May 2004, to be effective for annual reporting periods beginning on or after 1 January 2005. Early adoption will not be permitted.

Pending AASB 139 addresses the recognition, derecognition and measurement of financial assets and financial liabilities, including derivatives and embedded derivatives, with special rules for hedge accounting. It will fill a major gap in Australia's current reporting framework, given that the recognition and measurement of financial instruments has not previously been the subject of an Accounting Standard in Australia.



Accounting alert

Financial instruments: Recognition and measurement

Key aspects of the standard

Pending AASB 139 establishes principles for recognising and measuring financial assets and financial liabilities, including derivatives and embedded derivatives.

The key aspects of the Standard are:

All financial assets and liabilities recognised on balance sheet

Mixed measurement basis (cost and fair value) and mixed profit recognition (through net profit and reserves)

Hedge accounting more prescriptive

Embedded derivatives accounted for separately from host contract

- requires financial assets and liabilities including derivatives to be recognised on the balance sheet
- there is a mixed measurement basis (cost and fair value are used) and mixed profit recognition (through net profit or through reserves). The measurement and recognition requirements are often applied based on management intent
- greater documentation is required. Because measurement and recognition criteria can vary depending on intent, documentation must be prepared upfront and retrospective adjustments are not permitted
- there is greater use of fair value
- criteria are established for derecognition of financial assets and liabilities
- hedge accounting is permitted in limited circumstances. There are three types of hedging relationships:
 - fair value hedges
 - cash flow hedges
 - hedge of a net investment in a foreign entity.
- changes in fair value of cashflow hedges are initially reported in equity and then transferred to profit or loss to match offsetting gains and losses on the hedged transactions
- hedge effectiveness must be measured and any ineffectiveness is recognised in net profit. Documentary requirements are very strict and failure to comply will disqualify the hedge
- requires certain derivatives embedded in other contracts such as leases, supply/sales contracts and loan agreements to be accounted for separately.

Application

Pending AASB 139 applies to all types of financial instruments except:

A number of financial instruments are exempt from Pending AASB 139

- those covered by another more specific standard such as interests in subsidiaries, associates and joint ventures and post-employment benefits (eg. pensions)
- insurance contracts
- contracts for contingent consideration in a business combination as they relate to the acquirer
- lease contracts. However, derecognition and impairment requirements do apply for lease receivables recognised on the lessor's balance sheet, and this Standard applies to derivatives embedded in leases
- contracts that require a payment based on climatic, geological or other physical variables
- equity instruments of the issuer
- financial guarantee contracts (including letters of credit) are excluded to the extent that they provide for payments as a result of the failure of the debtor
- loan commitments that cannot be settled net and the entity does not designate as 'at fair value through profit or loss' or does not have a practice of selling the assets arising from the loan commitment shortly after origination
- commodity contracts that are settled by physical delivery unless they are physically settled with the intention of selling the non-financial items within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin.

Accounting alert

Financial instruments: Recognition and measurement

There are five categories of financial instruments:

- financial asset or financial liability at fair value through profit or loss
- held-to-maturity investments
- loans and receivables
- available-for-sale financial asset
- financial liability at amortised cost.

Categories of financial Instruments and measurement principles

Categories of financial instruments

Financial asset or financial liability at fair value through profit or loss is a financial asset or liability that is either classified as held for trading or is designated by the entity as 'at fair value through profit or loss' on initial recognition. A financial asset or financial liability is classified as held for trading if it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term, is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short term profit-taking, or a derivative that is not a designated or effective hedging instrument.

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity, other than those that the entity designates as 'at fair value through profit or loss' or available for sale, or those that meet the definition of loans and receivables. If an entity sells or reclassifies more than an insignificant amount of held-to-maturity securities, other than in exceptional circumstances, the entity is prohibited from using the held-to-maturity classification for two financial years and all held-to-maturity investments are reclassified as available-for-sale and measured at fair value. These investments are described as 'tainted'.

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market other than those that the entity intends to sell immediately or in the near term, which are classified as held for trading, those that the entity designates at fair value through profit or loss or as available for sale; or those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which are classified as available for sale.

Available-for-sale financial assets are all other non-derivative financial assets that are not classified as one of the above.

Financial liability at amortised cost are all financial liabilities except financial liabilities that are held for trading or are designated by the entity as 'at fair value through profit or loss'.

Measurement of financial instruments

Measured at fair value with changes in fair value recognised in profit or loss.

Measured at amortised cost, subject to impairment.

Measured at amortised cost, subject to impairment.

Measured at fair value with changes in fair value recognised directly in equity subject to impairment until the financial asset is derecognised at which time it is transferred out of equity and recognised in the profit or loss. The impairment rules are such that depending on the type of asset, most losses will be brought to account in the profit or loss immediately.

Measured at amortised cost

Accounting alert

Financial instruments: Recognition and measurement

3 kinds of hedges:

- cashflow
- fair value
- hedge of net investment

Strict criteria for hedge accounting. Transactions previously classified as hedges may no longer qualify for hedge accounting. Existing hedge documentation will not be sufficient for Pending AASB 139 purposes

Some limitations on risks and exposures that can be hedged

Lack of appropriate documentation will increase earnings volatility

Hedge accounting

Hedge accounting is not mandatory, if an entity does not want to hedge account, it simply does not designate a hedging relationship.

Pending AASB 139 describes 3 kinds of hedging relationship and their accounting treatment:

- a fair value hedge – a hedge of the exposure to changes in fair value of a recognised asset, liability or firm commitment. Changes in fair value of both the hedging instrument and the hedged item are reported in the profit or loss
- a cash flow hedge – a hedge of its variability in cash flows attributable to a recognised asset or liability or a highly probable forecasted transaction. Changes in the fair value of the hedging instrument are initially reported in equity and transferred to profit or loss to match the recognition of the offsetting gains and losses on the hedged transactions. Entities have the option to use the 'basis adjustment' method for hedges of forecast transactions that will result in the recognition of a non-financial asset or non-financial liability. Under this method, deferred gains and losses on the hedging instrument are treated as an adjustment to the cost of the acquired asset or liability
- it also specifies that a hedge of a net investment in a foreign operation is accounted for in the same way as a cash flow hedge.

There are strict criteria for qualification for hedge accounting, which include:

- at the inception of the hedge there is formal documentation of the hedging relationship and the entity's risk management objective and strategy for taking the hedge, including identifying the hedged item, hedging instrument, hedged risk and how effectiveness will be assessed
- the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk
- for cash flow hedges, a forecasted transaction that is the subject of the hedge must be highly probably of occurring
- the effectiveness of the hedge can be reliably measured
- the hedge was assessed and determined actually to have been effective throughout the financial reporting period.

There are also limitations on the risks and exposures that can be hedged.

Examples of items that may be hedged include:

- a single asset, liability, firm commitment or forecast transaction
- a group of assets, liabilities, firm commitments or forecast transactions with similar risk characteristics
- a held-to-maturity investment for either foreign currency or credit risk (but not interest rate risk)
- a portion of the risk or cash flows of any financial asset or liability
- a net investment in a foreign operation.

Pending AASB 139 does not restrict the circumstances in which a derivative may be designated as a hedging instrument provided the conditions described above are met, except for some written options. However, a non-derivative financial asset or liability may be designated as a hedging instrument only for a hedge of foreign exchange risk.

Accounting alert

Financial instruments: Recognition and measurement

Hedging issues arising

Designation requirements under Pending AASB 139 may result in transactions previously classified as hedges no longer qualifying for hedge accounting.

The following issues arise in respect of documentation:

- documentation requirements under Pending AASB 139 are significant and existing documentation will not be sufficient for Pending AASB 139 purposes
- without adequate documentation, transactions will not qualify for hedge accounting. This in turn will increase earnings volatility
- documentation must be consistent with risk management objectives and strategy
- maintaining information on more sophisticated hedges across multiple platforms and between different areas of business will be challenging.

The following issues arise in respect of effectiveness:

- the requirement for hedge effectiveness to be assessed prospectively and retrospectively at least every reporting period end will lead to additional process and system requirements
- The recognition of the ineffective portion of derivatives used in any hedging relationship in the income statement will have the effect of increasing volatility in earnings

Embedded derivatives

The standard defines a derivative as a financial instrument with the following characteristics:

- its value changes in response to changes in an 'underlying' price or index
- it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors
- it is settled at a future date.

A derivative which is not a designated or effective hedging instrument is required to be carried at fair value through profit or loss.

Although derivatives may be stand-alone instruments, they may be embedded in another instrument, including a non-derivative host contract, eg. lease, sales contract or insurance contract. An embedded derivative causes some or all the cash flows that would otherwise be required by the contract to be modified according to a specified variable, eg. interest rate, commodity price or foreign exchange contract. Separate recognition of derivatives embedded in host contracts is required where:

- the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative
- the entire contract is not measured at fair value through profit or loss.

Embedded derivatives may need to be recognised separately

Accounting alert

Financial instruments: Recognition and measurement

Pending AASB 139 sets out criteria for the derecognition of financial assets and liabilities

Derecognition of financial assets

A financial asset (or a portion of a financial asset) is derecognised when the contractual rights to the cash flows from that financial asset expire or the entity transfers the financial asset and the transfer qualifies for derecognition.

An entity has transferred a financial asset when:

- it transfers the contractual rights to receive the cash flows of the financial asset
- retains the contractual rights to receive the cash flows but assumes a contractual obligation to pay those cash flows to one or more recipients in an arrangement that meets various conditions.

Where an entity has transferred a financial asset, it must evaluate the extent to which it retains the risks and rewards of ownership.

- if the entity retains substantially all the risks and rewards of ownership, it continues to recognise the asset
- if the entity has transferred substantially all the risks and rewards of ownership, it derecognises the asset.

If the entity has neither transferred nor retained substantially all the risks and rewards of ownership, the entity determines whether it has retained control of the financial asset.

- if the entity has retained control, it continues to recognise the financial asset to the extent of its continuing involvement in the asset
- if the entity has not retained control, it derecognises the financial asset and recognises as assets or liabilities any rights or obligations created or retained in the transfer.

Issues arising from these requirements include:

- there is a lack of guidance available to Australian entities in this area
- there are a number of different interpretations of the current Australian derecognition requirements
- in applying the derecognition requirements of Pending AASB 139, entities are still required to comply with SIC 12 'Consolidation of Special Purpose Entities' which may cause entities to consolidate assets derecognised at the parent entity level.

In-substance defeasance of liabilities not permitted

Derecognition of financial liabilities

A financial liability (or portion of a financial liability) is removed from the balance sheet when it is extinguished, that is when the obligation is discharged, cancelled or expires. A financial liability is extinguished when the debtor either discharges the liability by paying the creditor or is legally released from primary responsibility for the liability either by process of law or by the creditor. In-substance defeasance is not permitted.

Proposed amendments

The IASB is currently considering responses to Exposure Drafts that contain proposals for further amendments to IAS 39:

- ED 2 'Share-Based Payment' proposes the addition of a scope exclusion for financial instruments, contracts and obligations within the scope of ED 2
- ED 5 'Insurance Contracts' proposes to amend the scope of IAS 39:
 - (i) by amending the definition of insurance contracts (insurance contracts are outside the scope of IAS 39)
 - (ii) to delete the scope exclusion for derivatives based on climatic, geological or other physical variables
 - (iii) to clarify which financial guarantee contracts are within the scope of IAS 39 and which are within the scope of ED 5.

Amendments to accommodate portfolio hedging of interest rate risk being considered

The Exposure Draft of 'Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement – Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk' proposes:

- to amend IAS 39 to facilitate fair value hedge accounting for a portfolio hedge of interest rate risk
- to add related Application Guidance and an Illustrative Example.

Accounting alert

Financial instruments: Recognition and measurement

Comparative information is not required to be restated in which case adjustments are made at beginning of first IFRS reporting period

Pending AASB 139 will have a significant impact on systems, processes and documentation

First-time adoption of AASB 139

The most significant transitional arrangements are as follows:

- comparative information in the first year of adoption does not need to be restated and therefore the date of transition for Pending AASB 139 purposes may be the beginning of the first IFRS reporting period
- adjustments are made to the opening balance sheet (including retained earnings) at the date of first compliance in order to measure all recognised financial assets and financial liabilities in accordance with Pending AASB 139
- non-derivative financial assets and financial liabilities that were derecognised prior to 1 January 2004 may remain derecognised. This may give a 'safe harbour' to some securitisation and other transactions that have led to derecognition in the past, however where the transaction resulted in a special purpose entity (SPE), they must be consolidated in accordance with SIC 12 'Consolidation – Special Purposes Entities', regardless of when the SPE was established
- in arriving at the appropriate classification of financial assets and financial liabilities on transition, the following arrangements apply:
 - held-to-maturity (HTM) investments should reflect the entity's intent at the date of transition, with sales or transfers prior to this date having no impact on the 'tainting' rules;
 - loans and receivables should reflect the circumstances at origination not at the date of transition;
 - selective designation as 'at fair value through profit or loss' or 'available for sale' of most financial assets may be done at the date of transition rather than the normal requirement of date of initial recognition.
- the provisions in relation to hedging should be applied prospectively from the date of transition to IFRS. However, for hedge accounting to continue in respect of gains and losses on derivatives arising post-transition, the designation and other criteria in IAS 39 must be met at the date of transition and ongoing.

Action points

Entities should consider the need to address the following points in relation to Pending AASB 139:

Overview

- establish process to identify all financial instruments, including embedded derivatives
- consider classification of financial instruments and potential volatility in statements of financial performance and position.

Scope

- consider which transactions are in or out of the scope of Pending AASB 139
- perform full inventory of all transactions and contracts
- insurance companies may need to classify contracts as financial instruments which were previously accounted for as insurance.

Initial recognition and classification

- consider whether the entity intends to voluntarily designate financial assets and financial liabilities on initial recognition as 'at fair value through profit or loss' or financial assets as available for sale. There is some flexibility on the classification of financial assets and financial liabilities and hence the associated accounting outcome. Entities should carefully consider the classification of financial assets and financial liabilities.

Subsequent measurement

- consider whether the entity has a system to monitor the classification of financial assets and financial liabilities
- consider whether the entity has the resources and knowledge to calculate fair value of financial assets and financial liabilities.

Accounting alert

Financial instruments: Recognition and measurement

Derecognition

- assess current derecognition policy for financial assets and liabilities
- consider whether the entity previously had in-substance defeasance.

Special purpose entities

- consider the impact on current derivatives and structured finance products and whether they will still remain off- balance sheet under Pending AASB 139. Note, SIC 12 may still require such structures to be consolidated and this interpretation is generally applied more stringently than the Australian equivalent interpretation UIG 28 'Consolidation – Special Purpose Entities'.

Hedging

- assess the impact on the current hedging strategy. Formulate revised hedging and risk management strategy. Formally implement qualifying documentation and monitoring arrangements for hedges
- consider necessary changes to information systems to address the hedge documentation requirements from transition date. Develop ongoing monitoring process.

Feedback and assistance

We welcome your feedback on the matters covered in this *Accounting Alert* – please email your comments to accounting_alerts@deloitte.com.au.

For assistance in applying the requirements outlined above in your organisation, please contact your local Deloitte office or contact our Lead National Technical Partner, Bruce Porter on (03) 9208 7490, or by email to bruporter@deloitte.com.au.

This and other Deloitte publications are available on the Deloitte website at www.deloitte.com.au. This Accounting alert is of a general nature only and is not intended to be relied upon as, nor to be a substitute for, specific professional advice. No responsibility for loss occasioned to any person acting on or refraining from action as a result of any material in this publication can be accepted.

The liability of Deloitte Touche Tohmatsu is limited by, and to the extent of, the Accountants' Scheme under the Professional Standards Act 1994 (NSW).

© 2004 Deloitte Touche Tohmatsu. All rights reserved.
Produced in Australia.

A member of
Deloitte Touche Tohmatsu