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Accounting Alert

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Financial instruments update

A copy of revised Pending AASB 139 and ED 132 can be downloaded from the AASB's web site: ***www.aasb.com.au***

The Australian Accounting Standards Board (AASB) has recently updated Pending AASB 139 'Financial Instruments: Recognition and Measurement' to incorporate the finalisation by the International Accounting Standards Board (IASB) of amendments to IAS 39 'Fair Value Hedge Accounting for a Portfolio of Interest Rate Risk'.

The AASB has also recently issued a further exposure draft ED 132 'Request for Comment on IASB ED Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement – The Fair Value Option'.

This *Accounting Alert* provides an overview of the actual and proposed amendments to AASB 139 and some analysis of the issues arising.

Overview

Pending AASB 139 was first issued in December 2003 but at the time of issue it was expected that the Standard would be modified as other exposure drafts were finalised. The following actual and proposed amendments do not change the basic principles of the Standard, as discussed in *Accounting Alert 2004/03*.

Interest rate macro hedging more easily achieved

The finalised amendments enable fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk, a macro hedge, than under the previous version of AASB 139. In addition, the effectiveness test requirements have been modified, such that an entity now only needs to prove an expectation of high effectiveness rather than expecting changes in the fair value of the hedged item and hedging instrument to almost fully offset.

Limitation on the option to designate items at fair value through profit or loss

The proposed amendments intend to limit the option in AASB 139 to designate and measure individual financial assets and financial liabilities at fair value, with changes recognised through profit or loss. The proposed amendments have arisen due to concerns expressed by overseas prudential supervisors that the option may be used inappropriately. However similar concerns have not been raised with the AASB. The AASB believes that the fair value option is important, particularly for life insurers, and accordingly it is unlikely to support this proposal. Comments on the AASB exposure draft close on 30 June 2004, in time for IASB comment by 21 July 2004.

Further amendments to AASB 139 can be expected, covering an additional hedging methodology and the balance sheet presentation of certain hedges. However, these amendments are only likely to be effective in Australia after 2005.

Macro hedging

Implementation and compliance costs should be reduced

The revisions to AASB 139 permit fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk. Macro hedging can be achieved by:

- designating, as the hedged item, an amount of a currency (for instance, an amount of dollars, euro, or pounds) rather than individual assets (or liabilities)
- presenting the gain or loss attributable to the hedged item either in a single separate line item within:
  - assets, for those repricing time periods for which the hedged item is an asset, or
  - liabilities, for those repricing time periods for which the hedged item is a liability.
- incorporating prepayment risk by scheduling prepayable items into repricing time periods based on expected, rather than contractual, repricing dates, under certain conditions.

The amendment should result in a reduction in implementation and compliance costs, because previously entities would have had to set up systems to track the relationship between individual assets and liabilities and the hedging derivative.

Effectiveness Tests

Prospective hedging effectiveness test relaxed

Qualification for hedge accounting is based on an expectation of future hedge effectiveness (prospective) and an evaluation of actual effectiveness (retrospective). The prospective test had previously been based on the expectation that changes in the fair value of the hedged item almost fully offset the changes in the hedging instrument. This 'almost fully offset' test was quite onerous and has been replaced with a 'highly effective' test.

Highly effective is not defined and the Standard allows an expectation of effectives to be demonstrated in a variety of ways. However, an entity cannot deliberately hedge less than 100% of the exposure of an item and designate the hedge as a hedge of 100% of the exposure, in order to achieve effectiveness.

Entities should ensure that these amendments are incorporated into their risk management strategy and documentation of hedging relationships.

The Fair Value Option

Comment period closes 30 June 2004

Currently, under AAS 139, any financial asset or financial liability may be designated and measured at fair value through profit or loss. The AASB is proposing to limit the types of financial assets and financial liabilities which may be designated to items that meet one of the following criteria:

- financial assets and financial liabilities that contain embedded derivatives, whether or not required to be separated
- financial liabilities whose cash flows are contractually linked to the performance of assets that are measured at fair value
- cases when the exposure to changes in the fair value of the financial asset or financial liability is substantially offset by the (recognised) exposure to the changes in the fair value of another financial asset or financial liability, including a derivative
- financial assets other than loans and receivables, or
- items that other Standards allow or require to be designated as fair value through profit or loss.

However, such financial assets or liabilities may only be designated as fair value through profit or loss where fair value is verifiable; that is, the variability in the range of reasonable fair value estimates is low. This is a stricter test than the reliable measurement test required for items classified as held for trading, derivatives or available-for-sale and also measured at fair value.

It is expected that, through designation, volatility reduction can still be achieved and an entity may effectively be able to achieve hedge accounting without needing to meet the restrictive conditions of the Standard.

The exposure draft proposes mixed transitional requirements:

- retrospective application for newly designated financial assets and liabilities, therefore comparatives should be restated
- prospective application for items that are no longer designated, with no restatement of comparatives.

Impact of exposure draft may vary depending on whether option to early adopt in Australia

Although the IASB proposes that the amendments would be effective for annual periods beginning on or after 1 January 2005, the AASB has indicated that further amendments to IFRS will not be mandatory at that point and proposes a 1 January 2006 application date. However if the amendments are finalised at the time of an entities first financial report under Australian equivalents to IFRS it may be possible to early adopt the requirements, which may result in a different outcome due to the above prospective rules.

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 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**

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