

Accounting alert

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AASB 139 amended to limit the designation of any financial assets or financial liabilities as 'at fair value through profit or loss'

The Australian Accounting Standards Board (AASB) has released AASB 2005-4 'Amendments to Australian Accounting Standards' which amends AASB 139 'Financial Instruments Recognition and Measurement' in accordance with the recent amendments released by the International Accounting Standards Board (IASB). The amendment restricts entities from designating any financial asset or financial liability as 'at fair value through profit or loss' to specific financial assets and financial liabilities.

This Accounting Alert provides an overview of this change.

Fair value option

AASB 139 (July 2004) permitted an entity to designate any financial asset or financial liability at fair value with gains or losses recognised in profit or loss with the exception of equity instruments that did not have a quoted market price in an active market, and whose price could not be reliably measured.

As a result of concerns raised by the prudential regulators in Europe, the IASB and thus the AASB have limited the use of this option. This amendment is effective for annual periods commencing on or after 1 January 2006 and may be early adopted as part of the first time adoption of all Australian Equivalents to International Financial Reporting Standards (A-IFRS).

In terms of the amendment, an entity may only designate a financial asset or financial liability as 'at fair value through profit or loss' when doing so results in more relevant information, because either:

- it eliminates or significantly reduces an accounting mismatch i.e. a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases, or
- a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis in accordance with the documented risk management or investment strategy.

AASB 2005-4 provides further guidance to assist preparers determine if they would qualify under either of these categories.

In addition, an entity may designate any contract that contains one or more embedded derivatives as at fair value through profit or loss unless:

- the embedded derivative does not significantly modify the cash flows that would otherwise be required by the contract, or
- the embedded derivative would be considered closely related to the host contract after little or no analysis.

The ability to designate any financial asset or financial liability as at fair value through profit or loss has been limited to specific categories.

Contracts that contain embedded derivatives that are neither obviously closely related nor insignificant to the contract may be designated as at fair value through profit or loss.

Amendment provides some examples of where an entity would qualify on the grounds that it eliminates or reduces accounting mismatch.

Amendment provides guidance on where assets and liabilities are managed on a fair value basis.

Transitional provisions for the amendment are dependant on whether it is adopted on transition to A-IFRS or in a subsequent reporting period.

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Eliminates or significantly reduces an accounting mismatch

AASB 2005-4 includes examples of when this condition may be met. These include when an entity:

- has liabilities whose cash flows are contractually based on the performance of assets which otherwise would be classified as available for sale
- has liabilities under insurance contracts whose measurement incorporates current information and financial assets it considers related would otherwise be classified as available for sale or measured at amortised cost
- has financial assets or financial liabilities or both that share a similar risk that gives rise to opposite changes in fair value that tend to offset each other however:
 - only some of the instruments are measured at fair value through profit or loss, or
 - the entity does not qualify for hedge accounting because none of the instruments is a derivative.

Managed and performance evaluated on a fair value basis

This condition focuses on the way an entity manages and evaluates performance rather than on the nature of the financial instrument. Thus to qualify for this category it is important that the group of financial assets, financial liabilities or both is managed and evaluated on a fair value basis in accordance with the documented management or investment strategy and this information is provided internally on this basis to key management personnel.

Transitional provisions

The amendment is effective for all annual reporting periods commencing on or after 1 January 2006. An entity is entitled to early adopt the amendment as a part of the adoption of A-IFRS.

Different transitional provisions apply depending on whether the amendment is adopted as a part of the first time adoption of A-IFRS; or adopted for reporting periods commencing on or after 1 January 2006 (after having previously adopted A-IFRS).

For those entities that are adopting A-IFRS for the first time for an annual period beginning before 1 January 2006 (as is the case for most Australian entities that are required to apply A-IFRS), and elect to adopt the amendment on first time adoption of A-IFRS; then:

- at the start of the first A-IFRS financial reporting period, an entity is permitted to designate any financial asset or financial liability as 'at fair value through profit or loss' provided that it qualifies in terms of the amendment and was designated as such at or before the date of transition to A-IFRS
- in addition to those financial assets and financial liabilities designated at the start of the first A-IFRS financial reporting period, where the first A-IFRS financial reporting period begins before 1 September 2005 and ends before 1 September 2006, which would include most December 2005 and June 2006 reporters, this designation needs only take place at or before 1 September 2005 and may include financial assets and financial liabilities acquired up to 1 September 2005
- An entity shall apply this amendment to its comparative information unless it elects, in terms of AASB 1 'First-time Adoption of Australian Equivalents to International Financial Reporting Standards', not to restate comparative information for AASB 139.

Entities that adopt A-IFRS for the first time for an annual period beginning on or after 1 January 2006 should refer to the specific transitional provisions set out in the amendment.

If the amendment is adopted after first time adoption of A-IFRS then:

- de-designate any financial asset or financial liability previously designated as at fair value through profit or loss only if it no longer qualifies for such designation
- not designate as 'at fair value through profit or loss' any previously recognised financial assets or financial liabilities
- disclose the fair value of any financial asset or financial liability de-designated at the date of de-designation and their new classification
- restate comparative information as applicable.

Feedback and assistance

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