

TREASURY ANALYSIS – AASB 139 & AASB 2005-4

AASB 139 *Financial Instruments: Recognition and Measurement* and AASB 2005-4 regarding the *Fair Value Option*

Major impact of changes

- Recognition of many financial instruments that were previously “off-balance sheet” (e.g. derivatives) and only disclosed in the notes to accounts under AASB 1033 *Presentation and Disclosure of Financial Instruments*.
- Provides a mixed measurement model. Held for trading and available for sale financial instruments are measured at fair value and changes are recognised in profit or loss, or equity, respectively. Other financial instruments are measured at amortised cost.
- Hedge accounting treatment is available only if strict conditions are met.
- Fair value methodologies may be a significant issue where there is no liquid market for the relevant financial instrument.
- Major changes may be required to the contracts management and accounting system in order to satisfy valuation and hedge accounting requirements.
- Requires that all financial assets, except those measured at fair value through profit and loss, be subject to review for impairment.
- Potential increased volatility in operating profit and possible capital structure implications.
- Comparative information for 2004/05 need not comply with AASB 139 (refer AASB 1). This defers the AASB 139 date of transition by 12 months to 1 July 2005, rather than 1 July 2004.
- Treasury has mandated a number of different options under AASB 139 which are included in TPP 06-4 and summarised in Attachment B to this Analysis.

Key features of Standard

Measurement

- *Initial measurement* - Financial assets and liabilities must be recognised at cost, which is the fair value of consideration given plus, in the case of a financial instrument not at fair value through profit or loss, direct transaction costs (para 43). The fair value on initial recognition is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arms length transaction, which is normally the transaction price (para AG64).
- *Fair value measurement considerations* - Incorporates observable market data and factors such as time value of money, credit risk, foreign exchange prices, commodity prices, equity prices, volatility, prepayment risk, surrender risk and servicing costs (para AG82). AASB 139 distinguishes between instruments quoted on “active markets” and those where there is “no active market” (paras AG71-AG81). Where there is no active market, fair value may be established using valuation methodologies such as recent comparable transactions, discounted cash flow analysis and option pricing models (paras AG74-AG79).
- *Subsequent measurement* - Financial instruments must be classified into one of five categories and measured as follows (paras 45-47, 55-58):

<u>Category</u>	<u>Description</u>	<u>Measurement</u>
Financial asset or liability at fair value through profit or loss	Held for trading financial instruments and instruments designated at fair value through profit or loss on initial recognition. Held for trading financial instruments are acquired or incurred principally for the purpose of selling or repurchasing in the near term. This includes derivatives (except for designated and effective hedging instruments which are subject to hedge accounting).	Recognised at fair value. Changes in fair value recognised through profit or loss.

Category	Description	Measurement
Continued - Financial asset or liability at fair value through profit or loss	A derivative is a financial instrument with the following three characteristics (para 9): <ul style="list-style-type: none"> • Its value changes in response to a change in price of, or index on, a specific underlying financial or non-financial item or other variable; • It requires no or comparatively little initial net investment; • It is to be settled at a future date. 	Hedge accounting provides an alternative accounting treatment (where strict conditions are met) – see further below.
Held to maturity investments	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.	Amortised cost. Changes are accounted for in the profit or loss when impaired, derecognised or through amortisation process.
Loans and receivables	Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market.	Amortised cost. Changes are accounted for in the profit or loss when impaired, derecognised or through amortisation process.
Available for sale financial assets	Residual category including non-derivative financial assets designated as available for sale or not classified as any of the other categories.	Fair value with changes in fair value recognised in equity, except for impairment losses, until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity is recognised in profit or loss. But, interest calculated using the effective interest method is recognised in profit or loss, along with any dividends.
Non-trading financial liabilities	Liabilities that are not financial liabilities at fair value through profit or loss (see above).	Amortised cost. Changes are accounted for in the profit or loss or through amortisation process.

- *Embedded derivatives* - An embedded derivative is a component of a hybrid instrument that includes both a derivative and a host contract (paras 10-13 and AG27-33). An embedded derivative is required to be separated and recorded at fair value (subject to fair value option amendments – refer AASB 2005-4, below), with gains and losses taken through the profit or loss, if:
 - the hybrid instrument is not already recorded at fair value with gains and losses taken to profit or loss;
 - as a separate instrument, has terms which would meet the definition of a derivative;
 - the economic characteristics and risks of the embedded derivative are not ‘closely related’ to the economic characteristics and risks of the host instrument. AASB 139 does not provide much guidance on how to make the ‘closely related’ judgement but provide examples which suggest that an embedded derivative exists where it changes the nature of the contract risk.
- “*Own use*” exemption - AASB 139 does not apply where the purpose of the contractual arrangement is to meet the entity’s expected purchase/sale or usage requirements and it is expected to be settled by delivery (para 5).
- *Reclassification* (para 50-54):
 - An entity cannot reclassify a financial instrument into or out of fair value through profit or loss while it is held or issued.
 - Tainting rules - An entity cannot classify any financial assets as held to maturity if the entity has during the current annual reporting period or during the two preceding annual reporting periods, sold or reclassified more than an insignificant amount of held to maturity investments before maturity (other than certain sales or reclassifications).
- *Impairment testing* (para 58-62) - All financial assets except those measured at fair value through profit or loss are subject to review for impairment. This means that entities can no longer raise general provisions for doubtful debts. The Standard requires a specific impairment test which needs to be supported by objective evidence that the group of assets is impaired or uncollectible.

De-recognition – financial assets

- *Risks and rewards test* (para 20(a) and (b)) – When an entity transfers a financial asset it must evaluate the extent to which it retains the risks and rewards of ownership. If an entity transfers substantially all the risks and rewards then the entity must derecognise the financial asset.
- *Control test (secondary test)* (para 20(c)) - If an entity neither transfers nor retains substantially all the risks and rewards the entity must determine whether the entity has retained control. If the transferor has transferred some (but not substantially all) of the risks and rewards but retains control, the asset must be recorded to the extent of the transferor’s continuing involvement.

De-recognition – financial liabilities

- A liability is only extinguished when the obligation specified in the contract is discharged or cancelled or expires (para 39).
- AASB 132 also prohibits offsetting a financial asset and financial liability when financial assets are set aside in trust by a debtor for the purposes of discharging an obligation, without assets having been accepted by the creditor in settlement of the obligation (AASB 132, para 49(d)).
- This represents a change from AAS 23/ AASB 1014 “Set-Off and Extinguishment of Debt” which allowed debt to be accounted for as having been extinguished when it has been subject to an in-substance defeasance.

Hedging

- A hedging relationship qualifies for hedge accounting only if certain strict conditions are met including designation, documentation and hedge effectiveness requirements (para 88). There are three types of hedging relationships, as follows (para 86, paras 89-102).

Type of hedge	Description	Accounting treatment
Fair value hedge (see also “fair value hedge accounting for portfolio hedge of interest rate risk” below)	A hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.	Gain or loss is recognised through the operating statement for both the hedged item and hedging instrument.
Cash flow hedge	A hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction and could affect profit or loss.	Gain or loss on the effective portion of the hedging instrument is recognised directly in equity and any ineffective portion through profit or loss.
Hedge of a net investment in a foreign operation	Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment.	Accounted for similarly to cash flow hedges.

- *Fair Value Hedge Accounting for a Portfolio of Hedge of Interest Rate Risk* – The April 2004 amendment of AASB 139 permits fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk than previous versions of AAS 139 ((IAS 39.IN24A)). In a hedge of interest rate risk, the entity could designate individual assets (or liabilities) or an amount of a currency as the hedged item. Designation of a net amount including assets and liabilities is not permitted (paras (77, 78, 81A)).

AASB 1 First time adoption – Exemptions from retrospective application

- On first time adoption, there are numerous optional exemptions from retrospective application of certain AASB 139 requirements. The optional exemptions and Treasury’s mandates are discussed in ‘Policy and implementation issues’ and Attachment B, below.
- AASB 1 provides a mandatory exemption from retrospective application of the hedge accounting requirements (AASB 1, para 28-30). That is, an entity must apply the AASB 139 hedging requirements prospectively. However, hedge accounting can only be applied at 1 July 2005 when the hedge meets the AASB 139 criteria and the transactions were previously designated as a hedge under Australian Standards.

Main differences compared to previous Australian requirements

- There was no Australian Accounting Standard on the recognition of financial instruments. Australian Accounting Standard AASB 1033 / AAS 33 only addressed disclosure issues.
- Australian Accounting Standard AASB 1041 *Revaluation of Non-Current Assets* only addressed non-current financial assets (and non-current physical assets).

Impact on the public sector

- *GFS Convergence* – In principle, to converge with the Government Finance Statistics (GFS) Framework, all financial instruments should be designated at fair value through profit or loss. However, the GFS/GAAP convergence Standard (AASB 1049) is not applicable to the general government sector until 2008/09. Accordingly, Treasury has mandated that agencies use the existing AASB 139 categories, subject to certain restrictions (refer TPP 06-4).
- *Volatility concerns* – As part of the GFS/GAAP convergence project, the AASB has adopted a single comprehensive income statement for the general government sector, which distinguishes between “transactions” and “re-measurements”. If this is applied at the entity level in the future, this may help address volatility concerns.

- *Embedded derivatives* – While in practice, there is unlikely to be a significant number of embedded derivatives, agencies will have to undertake an evaluation to confirm this assessment.

Policy and Implementation issues (refer Attachment A and B and also Treasury’s Financial Instruments Policy (TPP 06-4))

Mandating Options

- *Date of transition / comparative information* (AASB 1, para 36A) - Comparative information in the first AEIFRS report need not comply with AASB 139. Treasury has mandated this optional exemption. This means that the ‘date of transition’ to AEIFRS for AASB 139 is 1 July 2005 (for 30 June entities).
- Other Treasury mandates are included in TPP 06-4 and are summarised in Attachment B.

Other implementation issues

- *Off-balance sheet items* – Entities will need to identify and recognise financial instruments previously not recognised, including derivatives. This may also require entities to review existing contracts to determine whether there are any embedded derivatives that are required to be separated and recorded at fair value.
- *Impairment testing* – Entities must assess at the date of transition (and each reporting date) whether there is any objective evidence that a financial asset or group of financial assets is impaired. Entities will need to review any allowances for doubtful debts i.e. must be supported by objective evidence of impairment and be subject to a specific impairment calculation.
- *Fair value of certain complex financial instruments* – For complex financial instruments entities may need to obtain external advice regarding fair value measurement.
- *Hedge accounting* – For entities with hedges, initial designation, documentation and system issues are likely to be significant and may require external advice.
- *De-recognition of financial instruments* – From 1 January 2004 entities will only be able to derecognise financial assets and liabilities when certain conditions are met.

AASB 2005-4 Fair Value Option

- AASB 2005-4 limits the designation of financial instruments at fair value through profit or loss (referred to as the fair value option) to a number of prescribed circumstances. AASB 2005-4 applies to annual reporting periods beginning on or after 1 January 2006, but may be early adopted. Treasury has mandated early adoption (refer Attachment B).
- The AASB 2005-4 amended fair value option may be used only when doing so results in more relevant information because either (AASB 139, para 9):
 - It eliminates or significantly reduces an accounting mismatch that would otherwise arise from measuring assets or liabilities or recognising gains or losses on them on different bases; or
 - A group of financial assets, financial liabilities or both is managed and performance evaluated on a fair value basis, in accordance with a documented risk management/investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel.
- Further, if a contract contains one or more embedded derivatives, an entity *may* designate the entire contract as a financial asset or financial liability at fair value through profit or loss, unless (AASB 139, para 11A):
 - The embedded derivative doesn’t significantly modify the cash flows that would otherwise be required by the contract; or
 - It is clear with little or no analysis that separation of the embedded derivative would be prohibited.

If an entity is required to separate the embedded derivative, but is unable to measure the derivative separately, it *must* designate the entire combined contract at fair value through profit or loss (AASB 139, para 12).

- Treasury has imposed additional obligations and restrictions regarding the use of the fair value option (refer TPP 06-4). With the exception of NSW Treasury Corporation Hour-Glass Investment facilities (which are mandated at fair value through profit or loss), the fair value option can be used only in limited circumstances:
 - where an agency satisfies the fair value criteria;
 - where it is appropriate to an agency's operations (e.g. NSW Treasury Corporation); and
 - where it is approved by Treasury.
- AASB 2005-4 also requires an agency that designates financial instruments at 'fair value through profit or loss' to disclose and demonstrate the basis for the designation, including how the agency satisfied the particular conditions in AASB 139 for such designation (AASB 132, para 66 and paras 94(e)-(i)).

This summary has been written in general terms and is intended for reference only. Agencies should review the contents of the AASB Standard to determine its application in particular circumstances.

**SUMMARY OF POLICY, IMPLEMENTATION & SYSTEM ISSUES
AASB 139 “FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT”
TREASURY & AGENCIES**

	Issue	Treasury Policy		System/ Implementation Issue	Mandate Options for GFS Harmonisation	Budget / Total State Sector Issue
		Mandate Option	Additional Guidance			
1	Identification and recognition of financial instruments previously not recognised e.g embedded derivatives			✓		✓
2	Impairment and Doubtful debts – can no longer raise general provisions for doubtful debts; a specific impairment test is required. Needs to be supported by objective evidence that the group of assets is impaired or uncollectible.			✓		✓
3	Fair value of certain complex financial instruments – particularly for electricity businesses			✓		✓
4	Hedge accounting – designation; documentation and system requirements			✓		✓
5	De-recognition of financial instruments (including in-substance defeasance)			✓		
6	First time adoption and other mandates – refer next page	✓				

**TREASURY MANDATES –
FIRST TIME ADOPTION AND OTHER MANDATES (REFER TPP 06-4)**

OPTIONS	TREASURY MANDATE
AASB 139 <i>Financial Instruments: Recognition and Measurement</i>	
AASB 1 First-time adoption – comparative information need not comply with AASB 139 (para 36A)	Mandate exemption - i.e. delay date of transition of AASB 139 by one year to 1 July 2005 (for 30 June entities) and do not restate comparative information for 2004/05. This means that the entity must apply its previous GAAP in the comparative information, including the opening AEIFRS balance sheet. However, this needs to be explained in accordance with AASB 1 (refer section 2.3 of TPP 06-4, AASB 1.36A & AASB 1.43A).
AASB 1 First time adoption - Designation as fair value through profit or loss or available for sale – i.e. any financial instrument may be designated into these categories at the date of transition (para 9).	<p>No mandate, except for designation of Hour-Glass Investment facilities at fair value through profit or loss (refer section 5.4 of TPP 06-4).</p> <p>Apart from Hour-Glass Investment facilities, an agency may only designate at fair value through profit or loss where (refer section 5 of TPP 06-4):</p> <ul style="list-style-type: none"> • it satisfies the fair value option criteria, • it determines it is appropriate for its operations (e.g. NSW TCorp); and • it is approved by Treasury. <p>An agency may only designate as available for sale, where it is approved by Treasury (refer section 6 of TPP 06-4).</p> <p>Further, an agency can only use the ‘held to maturity’ classification, where it is approved by Treasury (section 4 of TPP 06-4).</p>
AASB 1 First time adoption – designation of previously recognised financial instruments (para 25A) i.e. an entity is permitted to designate a financial instrument at fair value through profit or loss or as available for sale at the date of transition rather than on initial recognition.	As above.
AASB 1 First time adoption – First-time adopter may apply the de-recognition requirements in AASB 139 retrospectively from a date of an entity’s choosing (provided information obtained at time of initially accounting for those transactions) or prospectively for transactions occurring on or after 1 January 2004 (paras 27 and 27A).	Mandate the AASB 139 de-recognition requirements to apply prospectively from 1 January 2004. However, as discussed above, the date of transition to AASB 139 has been deferred to 1 July 2005 (for 30 June entities).

OPTIONS	TREASURY MANDATE
<p>AASB 1 First time adoption (para 25G) – Recognition of ‘day 1’ gains or losses. An entity may apply the requirements in the last sentence of AASB 139 para AG76, and para AG76A, in either of the following ways:</p> <p>(a) Prospectively to transactions entered into after 25 October 2002; or</p> <p>(b) Prospectively to transactions entered into after 1 January 2004.</p>	<p>Mandate option (b) i.e. prospectively to transactions entered into after 1 January 2004. However, as discussed above, the date of transition to AASB 139 has been deferred to 1 July 2005 (for 30 June entities).</p>
<p>Regular way contracts – AASB 139 provides the option of using either trade date or settlement date accounting for purchases or sales of financial assets under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned (para 38 and paras AG53-56).</p>	<p>Mandate trade date accounting i.e. date on which the entity commits itself to purchase or sell the asset (refer AASB 139.AG55).</p>
<p>Basis for establishing fair value in an active market – Current bid price or mid market price (para AG 72)</p>	<p>No mandate – AASB 139.AG72 suggests that the appropriate quoted market price is usually the current bid / asking price, although the mid market price may be appropriate in some circumstances.</p> <p>The TCorp Medium and Long Term Hour-Glass growth facilities use the bid price (from 1 July 2005).</p>
<p>Hedges of firm commitments – a hedge of foreign currency risk of a firm commitment may be accounted for as either a fair value hedge or cash flow hedge (para 87).</p>	<p>No mandate – this should not be a material issue for most NSW public sector agencies.</p>
<p>Hedging – where a hedge of a forecast transaction results in recognition of a non-financial asset or liability; or a forecast transaction becomes a firm commitment for which fair value hedge accounting is applied, the entity must either reclassify gains and losses recognised in equity to match the depreciation expense; OR include in initial cost of asset or liability (para 98).</p>	<p>Mandate inclusion in the initial cost of asset or liability. This reduces the record-keeping burden involved in transferring amounts progressively from equity to profit/loss.</p>

OPTIONS	TREASURY MANDATE
Early adoption decisions	
<p>Whether or not to early adopt the following Standards¹:</p> <ul style="list-style-type: none"> • AASB 2005-1 regarding cash flow hedge accounting of forecast intra group transactions; • AASB 2005-4 regarding AASB 139 fair value option; • AASB 2005-9 regarding financial guarantees; • AASB 7 regarding financial instrument disclosures; • AASB 2005-10 regarding AASB 7. • UIG 9 regarding reassessment of embedded derivatives. 	<ul style="list-style-type: none"> • Mandate early adoption of AASB 2005-4 from 1 July 2005 (for 30 June entities) regarding the revised AASB 139 fair value option (refer section 5 of TPP 06-4). • Mandate early adoption of UIG 9 from 1 July 2005 (for 30 June entities) regarding the reassessment of embedded derivatives (refer section 8 of TPP 06-4). • Encourage AASB 7 disclosures regarding separate disclosure of the carrying amounts for each AASB 139 category of financial instrument (refer section 2.3 of TPP 06-4). • Except for the above, mandate not to early adopt the other amending Standards.

¹ Where an entity does not early adopt a Standard (i.e. a Standard that has been issued but is not yet effective), in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* the entity must disclose this fact and known or reasonably estimable information relevant to assessing the possible impact that application of the new Standard will have on the entity's financial report in the period of initial application.