Australian Government

Australian Accounting Standards Board

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Dear Andrea

IASB ED *Proposed Amendments to IAS 39* Financial Instruments: Recognition and Measurement and *IFRS 4* Insurance Contracts – *Financial Guarantee Contracts and Credit Insurance*

In response to the IASB's Invitation to comment on its Exposure Draft *Proposed Amendments to IAS 39* Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts – *Financial Guarantee Contracts and Credit Insurance*, the Australian Accounting Standards Board has prepared the attached submission addressing the specific questions asked and commenting on the proposals in the IASB ED.

The AASB issued the IASB ED in Australia with an Australian Preface as ED 134 "Request for Comment on IASB ED *Proposed Amendments to IAS 39* Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts– *Financial Guarantee Contracts and Credit Insurance*" concurrently with the release of the IASB ED. The Preface identified the key impact of the proposed changes to IAS 39 and IFRS 4 – that credit insurers would be required to change their accounting policy for some credit insurance contracts. This is in contrast to the position for other insurance contracts for which the accounting policies (under Phase 1 of the IASB's Insurance Project) are largely grandfathered and can continue to be accounted for under a jurisdiction's current GAAP. The AASB encouraged Australian constituents to respond to the IASB on the proposals in the IASB ED, with copies of those responses to the AASB. The AASB has prepared its comments after having considered Australian constituents' comments on ED 134.

The AASB considers that the proposals represent an unnecessary complication in what, for many entities, is already a complex transition to IFRS. The objective of phase 1 of the Insurance project was to introduce certain limited improvements to the accounting for insurance contracts, whilst avoiding major changes until finalising phase II. Under the proposed amendments to IAS 39 and IFRS 4, some entities will be required to change their accounting policies for contracts that expose the issuer to insurance risk that is significant and are within the scope of the current IFRS 4. The AASB does not support the proposal to prescribe the recognition and measurement of financial guarantee contracts in isolation of the work on phase II of the Insurance project.

The Board hopes that its comments in the attached submission, explaining its concerns and those of its constituents, will assist the IASB when reconsidering the proposals in the ED.

Yours sincerely

David Boymal

David Boymal
Chairman

Submission of Comments by the AASB to the IASB

Australian Government

Australian Accounting Standards Board

IASB

International Accounting Standards Board

Exposure Draft

IASB ED *PROPOSED AMENDMENTS TO IAS 39* FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT *AND IFRS 4 INSURANCE CONTRACTS – FINANCIAL GUARANTEE CONTRACTS AND CREDIT INSURANCE*

Comments to be received by 8 October 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 considers that the proposals represent an unnecessary complication in what, for many entities, is already a complex transition to IFRS. The objective of phase 1 of the Insurance project was to introduce certain limited improvements to the accounting for insurance contracts, whilst avoiding major changes until finalising phase II. Under the proposed amendments to IAS 39 and IFRS 4, some entities will be required to change their accounting policies for contracts that expose the issuer to insurance risk that is significant and are within the scope of the current IFRS 4, especially with respect to the adjustment of their insurance liabilities for risk margins, discounting, and the treatment of deferred acquisition costs. An international consensus over these issues will not be reached until the final outcome of phase II. The AASB does not support the proposal to prescribe the recognition and measurement of financial guarantee contracts in isolation of the work on phase II of the Insurance project.

IASB ED *PROPOSED AMENDMENTS TO IAS 39* FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT IFRS 4 INSURANCE CONTRACTS – FINANCIAL GUARANTEE CONTRACTS AND CREDIT INSURANCE

INVITATION TO COMMENT

The International Accounting Standards Board invites comments on the changes 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.

Comments should be submitted in writing so as to be received no later than 8 October 2004.

Question 1 – Form of contract

The Exposure Draft deals with contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs if a specified debtor fails to make payment when due under the original or modified terms of a debt instrument (financial guarantee contracts). These contracts can have various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract. Under the proposals in the Exposure Draft the legal form of such contracts would not affect their accounting treatment (see paragraphs BC2 and BC3).

Do you agree that the legal form of such contracts should not affect their accounting treatment?

If not, what differences in legal form justify differences in accounting treatments? Please be specific about the nature of the differences and explain clearly how they influence the selection of appropriate accounting requirements.

IAS 39 Appendix A paragraph AG4A comments that the accounting treatment of financial guarantee contracts does not depend on their legal form. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* paragraph 10 comments that in the absence of an accounting standard that specifically applies to a transaction, judgement is used in developing and applying an accounting policy that reflects the economic substance of transactions, other events and conditions, and not merely the legal form. Accordingly, the AASB supports the proposal that the legal form of such contracts should not affect their accounting treatment on the basis that it is consistent with the principle articulated in IAS 39 and IAS 8.

Question 2 – Scope

The Exposure Draft proposes that all financial guarantee contracts should be within the scope of IAS 39 (see paragraph 2 of IAS 39 and paragraph 4 of IFRS 4), and defines a financial guarantee contract as “a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument” (see paragraph 9 of IAS 39).

Is the proposed scope appropriate?

If not, what changes do you propose, and why?

IAS 39 and IFRS 4 are not industry-based standards; rather, both are transaction-based standards (except that IFRS 4 does not address the accounting by policyholders). IFRS 4 articulates a principle that an insurance contract exposes the issuer to insurance risk that is significant. A contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract. Accordingly, the AASB consider that conceptually it is appropriate that the substance of a financial guarantee transaction is assessed according to the risk that the issuer is exposed to. In contrast, the Exposure Draft proposes that a financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. The proposal is that a contract that guarantees only the shortfall that may exist between the debt outstanding on a mortgaged property and the market value of the underlying security (at present, an insurance contract under IFRS 4) is brought within the scope of IAS 39, notwithstanding that an assessment of the substance of the transaction indicates that it is the potential shortfall in the value of the mortgaged asset against the defaulted loan that is the risk (as opposed to the default of the borrower).

Generally, IAS 39 excludes insurance contracts from its scope. Their exclusion from the scope of IAS 39 is consistent with having undertaken an assessment of the substance of the transaction and reaching a conclusion that the transaction exposes the issuer to insurance risk that is significant (as opposed to financial risk without significant insurance risk).

At present IAS 39 compromises the principle that the substance of the transaction is assessed according to the risk that the issuer is exposed to because it scopes in the following:

- an insurance contract that is a financial guarantee contract entered into, or retained, on transferring to another party financial assets or financial liabilities within the scope of IAS 39; or
- a financial guarantee contract that requires payments to be made in response to changes in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.[1]

The IASB's Exposure Draft of proposed amendments to IAS 32 and IAS 39 issued in June 2002 did not reflect a reconsideration of the fundamental approach to accounting for financial instruments. However, it proposed to further compromise the principle that the substance of the transaction is assessed according to the risk that the issuer is exposed to, by its proposal that financial guarantee contracts that provide for specified payments to be made to reimburse the holder for a loss it has incurred because a debtor fails to make payment when due should

1 Conceptually, the AASB consider that the methodology for assessing the substance of transaction articulated in IFRS 4 superior. While the definition of financial risk in IFRS 4 includes the same list of financial and non-financial variables described in IAS 39 paragraph 3, IFRS 4 requires that the substance of the transaction is assessed according to the risk that the issuer is exposed to (and accordingly, only when the quantum of the of financial risk present in the financial guarantee contract described in IAS 39 paragraph 3 is such that the contract does not expose the issuer to insurance risk that is significant, would IAS 39 apply).

be initially recognised and measured by the issuer in accordance with IAS 39. Subsequently, they should be measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* at the amount an entity would rationally be expected to pay to settle the obligation or to transfer it to a third party. One objective of that proposal was to clarify that an issued financial guarantee contract meets the definition of a liability and should be recognised as such, rather than await the outcome of the IASB's work on the recognition and measurement of insurance contracts.

The objective of phase 1 of the Insurance project was to introduce certain limited improvements to the accounting for insurance contracts, whilst avoiding major changes until finalising phase II. The AASB considers that under the Exposure Draft's proposals the liability determined for a financial guarantee contract would be different from that determined under the recognition and measurement requirements articulated in Australia in AASB 1023 *General Insurance Contracts* (which the AASB has revised to incorporate the limited improvements to accounting for insurance contracts required by IFRS 4). For example:

- there is a difference in the treatment of deferred acquisition costs under AASB 1023 and transactions costs in IAS 39. Under AASB 1023 these costs are recognised as an asset whereas under the proposed accounting treatment, paragraph 43 of IAS 39 appears to require transaction costs to be deducted from the liability. Further, the quantum of acquisition costs capitalised under the proposal is likely to differ from that capitalised under AASB 1023. Under IAS 39, transaction costs are defined as the incremental costs of the transaction. The AASB has been told that some constituents consider that the application of the criteria in IAS 39 will cause acquisition costs to be interpreted more narrowly than the definition of acquisition costs under AASB 1023. If so, the profit will emerge later under the proposals, as higher initial costs are recognised immediately; and
- the manner in which risk is incorporated into the treatments is also different. Under the current AASB 1023 risk is incorporated through the inclusion of a prudential margin to which is then applied a risk-free discount rate. Under the proposed accounting treatment, risk would be incorporated through the application of a risk-adjusted discount rate. Constituents have told the AASB that, in practice, this is likely to result in different outcomes.

At present, the AASB does not support any proposed expansion of the exceptions to the principle that the substance of the transaction is assessed according to the risk that the issuer is exposed to. Further, the AASB does not support a proposal that compromises the objective of phase 1 of the Insurance project. Instead, the AASB proposes that:

- the IASB should wait for phase II of the Insurance project to establish the principle underlying the recognition and measurement of a financial guarantee contract; and
- the mandate of the IASB's international working group on financial instruments should include an examination of the scope of financial instruments accounting, and in particular why a financial guarantee contract that in substance exposes the issuer to insurance risk that is significant should be within the scope of IAS 39 (and not within the scope of IFRS 4). Although we understand that any major revisions of existing standards on financial instruments may involve a long period of consultation, the IASB has announced its willingness to revise IAS 39 in the short term in the light of

any immediate solutions arising from the working group's discussions.

Question 3 – Subsequent measurement

The Exposure Draft proposes that financial guarantee contracts, other than those that were entered into or retained on transferring financial assets or financial liabilities within the scope of IAS 39 to another party, should be measured subsequently at the higher of:

(a) the amount recognised in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets; and

(b) the amount initially recognised (i.e. fair value) less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 Revenue (see paragraph 47(c) of IAS 39).

Is this proposal appropriate? If not, what changes do you propose, and why?

The AASB considers that in concept, when the substance of a financial guarantee contract is that the contract exposes the issuer to substantial insurance risk, then IFRS 4 should apply. Under this approach an issuer of an insurance contract applies a consistent set of accounting policies to all insurance contracts. However, the AASB acknowledges that the application of the current version of IAS 39 might prevent an issuer of an insurance contract from applying a consistent set of accounting policies to all insurance contracts.

The AASB considers that the practical purpose of the proposal is to require an issuer of a financial guarantee contract to measure a liability component that is not reflected in the measurement of the amortised initial fair value of the liability and assign the measure of that liability component to the remeasured liability. IFRS 4 requires a liability adequacy test to be applied to all insurance contracts. Unless the issuer applies a liability adequacy test that meets the minimum requirements in paragraph 16 of IFRS 4, it must perform a comparison with IAS 37 that is similar to the comparison proposed for the subsequent measurement of financial guarantee contracts, other than those that were entered into or retained on transferring financial assets or financial liabilities within the scope of IAS 39 to another party. The AASB added a liability adequacy test to the Australian equivalents of IFRSs for application to all insurance contracts. The consequence of the IASB's proposal is to complicate the testing for some contracts that at present are insurance contracts. Accordingly, the AASB does not support the replacement of the liability adequacy test by the requirements of IAS 37.

Question 4 – Effective date and transition

The proposals would apply to periods beginning on or after 1 January 2006, with earlier application encouraged (see paragraph BC27). The proposals would be applied retrospectively.

Are the proposed effective date and transition appropriate? If not, what do you propose, and why?

The IASB's work on the recognition and measurement of insurance contracts is now underway. The AASB considers that the application date for any amendments to IFRS 4 should be deferred until the principle underlying the recognition and measurement of a financial guarantee contract is agreed.

While the AASB disagrees with these proposals, it acknowledges that if the IASB does implement them, the proposed effective date and transition are appropriate.

Question 5 – Other comments

Do you have any other comments on the proposals?

Under IFRS 4, entities are required to present a ten-year claims development table (CDT) in respect of their insurance contracts. Insurance contracts that are scoped out of IFRS 4 would also be required to be excluded from the CDT. The requirement to disaggregate this information for preparation of the CDT would impose further practical issues in aggregating data for presentation in the CDT and increase the compliance burden on insurers. Changes to the scope of IFRS 4 should be rare and carefully considered, and preferably should not be made until the principles underlying phase II are agreed.