CONFIDENTIAL SUBMISSION

30th June 2004

Professor David Boymal,
Chairman
Australian Accounting Standards Board
PO Box 204, Collins Street West Vic 8807
AUSTRALIA

RE: Submission on ED 132 "Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* - The Fair Value Option."

Dear Professor Boymal,

The Australian Prudential Regulatory Authority (APRA) has reviewed the proposals in ED 132 "**Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* - The Fair Value Option."** Our general and specific comments in relation to these proposals are set out below.

General Comments

1. Ongoing Amendments to IFRSs

APRA agrees with the AASB's preliminary view that this amendment to the Fair Value measurement option, along with possible amendments to other IASs, is not consistent with the IASB stated commitment that the "stable platform" exists as of the 31st March 2004.

However, some APRA regulated entities will be forced to early adopt this amendment to IAS 39 and possibly other amendments including future IFRIC interpretations, to ensure that the audit reports of these entities unequivocally state that there is compliance with IFRS in accordance with AGS 1066 *"Reporting by Auditors on Compliance with International Financial Reporting Standards".*

The ongoing amendments to IFRSs with the option to early adopt some standards and interpretations and not others has the potential to confuse the Australian marketplace. Furthermore, the 31st March 2004 "cut-off" with the "stable platform", as the mandatory accounting framework in Australia has two unintended consequences. First, there is a risk that should an APRA regulated entity choose not to early adopt some IFRSs in the first year of IFRS adoption, the entity will be unable to unequivocally state that it is in full compliance with IFRS. This could reduce the entity's ability to raise capital in another jurisdiction. Second, the adoption of a potentially different earlier version of IAS/IFRS in Australia compared to another jurisdiction such as the European Union could also impact on the flow of funds from overseas investors into the Australian market who will be seeking IAS/IFRS compliant financial statements to be prepared on a comparable basis to other jurisdictions. This could impact the international flow of funds required for capital raisings of some of our domestic entities.

We believe the option to early adopt some IAS/IFRS standards and associated interpretations could contribute to an increase in the level of operational risk at some APRA regulated entities that already have significant challenges in terms of understanding and implementing IFRS requirements.

2. Fair Value measurement should be unrestricted for insurers and be applied consistently for assets and liabilities

APRA understands the reasons for restricting the application of fair value measurement to the banking sector given that the application of fair value measurement, without an underpinning in a rigorous fair value measurement model could lead to inconsistent application and volatility in the accounts of major financial institutions. However, the decision to adopt a restricted fair value measurement basis with Loans and Receivables, for example, is likely to be problematic in an insurance context. Australia is unique when compared to other jurisdictions as its insurance entities already adopt a full fair value measurement basis for insurance assets and at least a market consistent basis for liabilities. APRA believes that the Fair Value Measurement basis should be unrestricted for insurers. APRA agrees with the AASB that a restriction on the fair value measurement basis to loans and receivables assets will impact on the consistency of measurement between insurance assets and liabilities and will potentially enhance the mismatch between assets and liabilities for insurers in Australia. The amendment to IAS 39 should ideally allow all insurers to measure all of their assets and liabilities on an unrestricted fair value measurement basis which is consistent with current Australian best practice. APRA recommends that the proposed amendment to IAS 39 retain enough flexibility to allow an insurer's assets and liabilities to be measured on an unrestricted fair value measurement basis.

3. Need further explanation of terms

APRA believes that the concepts and clarity underpinning the usage of the terms "verifiability", "contractual link" and "substantial offset" needs to be explicitly defined to enable consistent understanding and application by readers, preparers, auditors and regulators alike. While we recognise that the IASB standards are principles based standards, we still believe that the proposals for amending the fair value measurement option in IAS 39 should be specific and directive to enable consistent application. The AASB may consider the use of explanatory guidance to facilitate readers in this regard.

3.1 Clarification of "Verifiability"

There is also a need to consider how the concept of "verifiability" relates to the IASB *Framework*. The requirements presently in SAC 3 "*Qualitative Characteristics of Financial Information*" specifically relates "verifiable" to the concept of "reliability". The IASB *Framework* does not specifically define the term "verifiable". However, paragraph BC 25 in the exposure draft defines verifiable as *"meaning that the variability in the range of reasonable fair value estimates made in accordance with IAS 39 is low."*

BC 25 goes on to state that:

"Accordingly, if this proposal is adopted, fewer items will qualify for the fair value option that are measured at fair value if classified as held for trading or available for sale in accordance with IAS 39 requirements."

While we can understand the need for reducing the variability in the range of reasonable fair value estimates, we believe there is likely to be practical difficulties in applying this test. A more robust fair value measurement model may be needed than what is presently available in IAS 39. We also note that as in section 2 above that any restriction on the application of fair value principles is likely to be problematic for Australian insurers. Furthermore, It is unclear whether the IASB is introducing a new accounting concept with this term, and how this term should relate to auditing concept of "verifiability" that forms part of the reliable measurement characteristic in SAC 3. Specific directive guidance is required to ensure that comparability and understandability is not compromised as a result of the introduction of the term "verifiable" in the exposure draft.

The requirements in the IASB *Framework* (as amended for Australia) in relation to the qualitative characteristics of financial information should govern the application of fair value measurement. Reliable measurement has an element of verifiability but not at the expense of relevance (see SAC 3 *Qualitative Characteristics of Financial Information,* paragraph 23). As in current Australian practice, there needs to be a balance between the qualitative characteristics of financial information to enable general purpose financial reports to be useful for users.

3.2 Clarification of "Substantially Offset"

We feel that more guidance should be provided to the application of the "substantial offset" test. Asset and liability management within the insurance industry tends to match annuity products with corporate debt assets. Although the effect on assets and liabilities of movement in interest rates effectively offset each other, there are instances where the offset is not perfect. In such circumstances, this may lead to the recognition of a profit or loss. Similarly, there may be circumstances where assets and liabilities are matched for changes in economic variables, but where changes to non-economic assumptions (such as expense assumptions) affecting the value of liabilities do not result in a similar change in the value of assets. Conversely, re-rating or defaults on the asset side may not result in similar offsetting change in liabilities.

3.3 Clarification of "Contractual Link"

We agree with the AASB's position on the use expression of "contractual link" and its potential problems whenever liability cash flows are linked to "specified" assets. The manner in which this term is used in this exposure draft, does not adequately reflect the way in which many contracts operate, and as such the category may not capture the full extent of circumstances that it is appropriate to include. In practice, linkage is more commonly applied to a pool of assets, the composition of which may change from time to time. Also, for practical purposes, the linkage may not be perfect at all times (e.g. from time to time a proxy value, such as a market index, may be used to derive unit prices between formal asset valuations). Furthermore, the category only covers the liability side of such "contractual linkages". It is conceivable that there may be liabilities that are already fair valued, but where not all the assets can be fair valued. We also believe that the notion of "contractually linked" should specifically address circumstances (such as those that may arise with some linked life insurance business) where liabilities are measured on a market consistent basis, but not necessarily at fair value.

We believe that using an unrestricted fair value measurement basis for the assets and liabilities of insurers with movements being taken through profit and loss and which is consistent with the IASB *Framework*, would better reflect economic reality and prudential outcomes.

4. APRA will change accounting standard principles used in prudential standards to achieve a better prudential outcome

The AASB also needs to recognise that our comments are made in the context that APRA generally seeks to ensure that our prudential reporting requirements are broadly consistent with accounting standards. Accounting standards are used as the starting point for prudential reporting standards in order to reduce the reporting burden on preparers.

However, APRA recognises that protecting the interests of policyholders and depositors may require prudential rules and reporting that may differ from rules designed for shareholder disclosure. As a special purpose user of financial information, APRA will alter the application of the principles in accounting standards required for general purpose financial reports for its own reporting purposes, whenever an alteration of these principles is likely to lead to a better reflection of the economic reality that underpins sound prudential management practices.

Specific Matters for Comment

APRA's response to the specific matters for comment in relation to the ED 132 exposure draft is included as a separate attachment (***Attachment A***).

Should you have any questions in relation to this submission please contact me directly on (02) 9210 3408.

Yours sincerely

Robert Sharma
Senior Accounting Advisor, APRA

Attachment A: Specific Matters for Comment

(a) We note that the AASB is constrained by its stated policy of adopting IFRS, and the Financial Reporting Council (FRC) "in principle" decision to adopt all international financial reporting standards on the IASB website as at the 31st March 2004.We recognise that the AASB proposal of early adoption may be an effective compromise with this exposure draft. However, early adoption may not be practically feasible in the Australian jurisdiction given:

- The insufficient time for preparers in Australia to fully understand and adopt the final version of the "fair value" standard once it is issued by the AASB;

- The flow on effects that an amendment to this standard is likely to have on the Australian specific insurance standards (AASB 1023 "General Insurance Contracts" and AASB 1038 "Life Insurance Contracts").

There is an added complication in terms of what compliance with IFRS means in the Australian jurisdiction as a result Australia adopting the "stable platform" as at 31st March 2004 on the IASB website. The requirements of AGS 1066 *"Reporting by Auditors on Compliance with International Financial Reporting Standards"* would suggest that auditors would need to state that Australia has complied with IFRS as at the 31st March, as this is the National Accounting framework applicable for the purposes of the audit. If an unequivocal statement of compliance with IFRS is required in an audit report, AGS 1066 would force APRA regulated entities to "early adopt" all IFRS and IFRIC requirements applicable at balance date or risk qualification. This could have unintended consequences in terms of capital raisings (please refer general comments section 1 above).

(b) APRA supports the preliminary views of the AASB in not supporting the proposed changes in the IASB ED with respect to Australian insurers. The proposed approach is inconsistent with regulatory requirements and best practice for Australian insurers.

(c) APRA supports the AASB's understanding of the implications for entities that might result from these proposals. Please refer to section 2 of the General Comments section above.

(d) As a consequence of the proposed amendments to IAS 39, Loans and receivables issued by the entity to back financial products, are not covered by paragraphs 9 (b) (ii) and 9 b (iii). These are currently reliably measured at fair value, however they would be excluded (under paragraph 9(b)(iv)) under the proposed amendments to IAS 39. In addition, the non-insurance debt liabilities of insurers would also be excluded from fair value measurement. The financial instrument portion of certain investment contracts are also excluded as the movements in assets and liabilities do not substantially offset one another, and would not satisfy paragraphs 9 b (iii). Under the proposals, unlisted equity assets that do not have a quoted price and that support policyholder liabilities may also fail the verifiability test.

(e) Refer to point (d) above.

(f) Prudential regulation for Australian insurers is built upon assets that are effectively fair valued and liabilities that are at least valued on a market consistent basis. In order to avoid distortion in the reported capital position of Australian insurers dual measurement requirements will need to be imposed on any assets that are no longer able to be measured on a fair value basis. We note that the insurance accounting requirements apply to insurance contracts rather than insurers which is a potentially narrower application.

(g) Given the impact on Australian insurance entities, we do not believe the proposals in this exposure draft are in the best interests of the Australian economy.