The South African Institute of Chartered Accountants

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**CL 66**

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Dear Ms Thompson

**EXPOSURE DRAFT OF PROPOSED *AMENDMENTS TO IAS 39 - FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT, THE FAIR VALUE OPTION***

In response to your request for comments on the exposure draft on the proposed *amendments to IAS 39 - Financial Instruments: Recognition and Measurement, The Fair Value Option*, please find attached the comment letter prepared by the South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but also secretariat for the Accounting Practices Board (APB), which is the official accounting standard setting body in South Africa.

We draw your attention to the fact that this comment letter was compiled using the comments from the SAICA Banking Interest Group and the SAICA Life Insurance Interest Group. Both of these groups are represented by preparers from these industries, regulators and auditors.

We thank you for the opportunity to provide comments on this document. Please do not hesitate to contact me should you wish to discuss any of our comments.

Yours sincerely

**Sue Ludolph**
**Project Director – Accounting**

cc: Doug Brooking (Chairman of the Accounting Practices Board)
Geoff Everingham (Chairman of the Accounting Practices Committee)

## GENERAL COMMENTS

South Africa has adopted International Financial Reporting Standards (IFRS) and issued the original IAS 39 as a South African Statement of Generally Accepted Accounting Practice (GAAP), AC 133, with an effective date for periods commencing on or after 1 July 2002. Prior to issuing AC 133, the South African accounting standards body, The Accounting Practices Board, early adopted the fair value option, as currently contained in IAS 39 (revised and issued in December 2003). The reasons for the inclusion of the option permitting entities to designate irrevocably on initial recognition any financial asset or financial liability as held for trading and thus to be measured at fair value with gains and losses recognised in profit or loss, was for the same reasons expressed by the IASB. South African companies have therefore been applying the fair value option in their application of AC 133. In our experience, we have not found the fair value option being used inappropriately. As such, we do not support the proposed amendments to limit the application of the fair value option as set out in this exposure draft.

Our reasons for not supporting the proposed amendments to limit the application of the fair value option, as set out in this exposure draft, are listed below:

1. We consider that the requirement to classify financial assets and liabilities under the fair value option only on initial recognition and the prohibition on transfers into and out of this classification (subject to our comments under Question 6) are sufficient to prevent abuse. The introduction of further limitations on the use of the fair value option so as to combat the potential abuse and manipulation by preparers of financial statements is, in our opinion, unfounded.

2. The introduction of the fair value option has in fact resolved some of the inconsistencies inherent in the mixed measurement model of IAS 39 and we propose that it remains unchanged in IAS 39 (revised). This is especially relevant for the financial services sector, including banks and insurers.

3. An entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value, with changes in fair value recognised in profit or loss. This reduces companies need for complex hedging documentation where there is a natural hedge as well as permits consistent accounting where non-derivative assets and liabilities have offsetting risks. The use of the fair value option to recognise the economic effects of natural hedges is applied widely by corporates and, in particular, by the banking and insurance sectors.

4. Imposing a set of rules to limit the use of the fair value option is inconsistent with the Framework (for example, the concept of verifiability is inconsistent with the qualitative characteristic of reliability) and the objectives of the Improvements Project. We do not consider the arguments in the Basis of Conclusions to be sufficiently strong or persuasive to justify this proposed amendment to IAS 39. The arguments seem to be based on concerns around auditability rather than on sound accounting principles.

5. The exposure draft proposes rules and terminology which cannot be traced back to IAS 39 (revised). We specifically refer you to the following:

- Substantially offset: What will qualify as being substantial? Is 51%, 80% or 90% regarded as substantial? IAS 39 AG 40 attempts to clarify the meaning of the word *"substantially"*. The paragraph refers to examples where an entity has retained substantially all the risks and rewards of ownership. Substantially offset does not have the same meaning as that described in IAS 39 AG 40. If the term were to be retained in the standard, it would need to be clarified.

- Verifiable: We believe that the requirement for the verification of fair value should be removed from the exposure draft as it is contradictory to the requirements for measuring the fair value of other financial instruments in terms of IAS 39 (revised). We are concerned as to why the Board has decided to place more onerous requirements for measuring fair value on financial instruments which are designated to be carried at fair value, where this requirement is not imposed on the determination of the fair value of available-for-sale securities, whose fair values may differ substantially depending on the valuation model used. This creates an unacceptable two-tier threshold for reliable measurement.

6. The definition of a verifiable fair value as defined in paragraph 48B is framed with financial assets in mind, rather than financial liabilities. The long-term insurance industry incurs financial liabilities on investment contracts. The cash flows of these financial liabilities are contractually linked to the performance of the assets that are measured at fair value, and therefore qualify under paragraph 9b(ii) for designation at fair value through profit and loss. The fair value of these liabilities equates to the fair value of the assets to which they are contractually linked. If the fair value of the financial liability or linked assets is not considered verifiable then there is a mismatch in accounting treatment. We believe that the verifiable test should not be required if the requirements of 9b(ii) are met.

7. Paragraph 9b(iii) permits the use of the fair value option if the exposure to changes in the fair value of the financial asset or financial liability is substantially offset by the exposure to the changes in fair value of another financial asset or liability. For the insurance industry, permitting the fair value designation without restriction allows insurers to match the accounting treatment for the majority of their financial assets and insurance liabilities, which are carried at fair value. At the very least, the option should be extended to include financial assets offsetting insurance liabilities (for example, insurance policies backed by mortgage or policy loans).

8. The exposure draft also seems to be trying to address the requirements of regulators or prudential supervisors rather than dealing with accounting principles. The statement in paragraph BC 11 (b) *"the powers of the relevant prudential supervisor may include oversight of the application of the requirements in IAS 39"* is, in our opinion, overstepping into prudential supervisors' affairs and is misplaced within an accounting standard. We firmly believe that accounting standards should not in any way prescribe or give powers to regulators.

9. This exposure draft will unnecessarily complicate the applicability of the fair value option and may undermine the objectives and reasons for the inclusion of the fair value

option in IAS 39 (revised) in the first place. As IAS 39 is already a complex standard, adding further levels of complexity to the standard will impede its implementation.

10. The exposure draft is not consistent in its definition of fair value. Fair value should be defined consistently in all accounting standards and for all financial instruments.

In summary, the exposure draft represents a step backwards in the accounting of financial instruments and we believe IAS 39 (revised) should remain unchanged in so far as the fair value option is concerned. However, additional disclosure relating to the selection and use of the fair value option may be included in IAS 32 to clarify, justify and explain the use of the fair value option by preparers of financial statements.

## SPECIFIC COMMENTS

### *Question 1*

*Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?*

We do not agree with the proposals in this exposure draft for the reasons noted in the General Comments above and are of the view that the exposure draft should be withdrawn. We are not aware of the widespread abuse suggested by the Board and the concerns now raised by the Board were in existence when the fair value option was first exposed in 2002. The exposure draft proposes a series of rules and introduces new terminology and a stricter test of *"verifiability"* for fair value that is not required for available-for-sale securities or for the disclosures of fair value. As such, IAS 39 (revised) should remain unchanged. However, should the Board continue with these proposals, our responses to the questions below indicate areas where we believe changes should be made.

### *Question 2*

*Are you aware of any financial instruments to which entities are applying, or are intending to apply, the fair value option that would not be eligible for the option if it were revised as set out in this Exposure Draft? If so:*

*(a) please give details of the instrument(s) and why it (they) would not be eligible.*
*(b) is the fair value of the instrument(s) verifiable (see paragraph 48B) and if not, why not?*
*(c) how would applying the fair value option to the instrument(s) simplify the practical application of IAS 39?*

*(a) & (b) Examples of instruments which would not be eligible and is the fair value verifiable*

1. **Fixed rate commercial property finance (CPF) or other structured finance transactions, as well as interest rate swaps to hedge its interest rate risk in respect of these transactions**

   Due to the long-term nature of these transactions and various other reasons, it is not feasible to meet all hedge accounting requirements (e.g. demonstrate hedge effectiveness over the full term) and hedge accounting cannot be applied. The fair value option is therefore utilised to recognise the economic hedge that has been entered into for the transaction. The option to fair value these types of transactions will no longer be allowed under this exposure draft due to the credit component of the fair value adjustment not being verifiable.

2. **A money market instrument for which quoted prices are not available, but whose price is reliably determined with reference to quoted rates from active markets**

   Such instruments would consequently be classified as loans and receivables and potentially not meet the other criteria in 9(b), thereby precluding entities from measuring these instruments at fair value.

3. **Private equity investments, private placement debt, guaranteed insurance contracts and structure products that contain embedded derivatives (e.g. credit linked notes)**

   The requirement for verifiability makes it difficult to apply fair value to prepayable loans and these financial instruments are not quoted in an active market.

4. **The requirement for a contractual link between movements in the fair value of loans and receivables and financial liabilities creates problems for insurance companies**

   The linked liabilities in these cases may be insurance contracts or discretionary participating contracts which are excluded from the scope of the IAS 39 definition of financial liabilities and which are not yet capable of fair valuation under IFRS. Therefore, such entities will be unable to apply the fair value option to such loans and receivables, even if they are capable of passing the test of verifiability as the insurance contracts are not permitted to be fair valued.

5. **Liabilities under insurance contracts or contracts with discretionary participation features linked**

   Where an insurer has liabilities under insurance contracts or contracts with discretionary participation features linked to the performance of specific assets, it is unclear whether these assets can continue to be designated at fair value through profit or loss. The reason for this is that the liabilities under these contracts cannot currently be fair valued (as accepted by the IASB in IFRS 4(AC 141) – *Insurance Contracts)* and therefore it is uncertain if the related assets can continue to be fair valued through profit and loss.

6. **Valuation of a term certain annuity contract in the insurance industry**

   In such an instance, the insurance industry attempts to match the cash flows of the annuity payments as closely as possible with fixed interest stock. A weighted average current yield of the stock is used as the basis of valuation of the liability, therefore the movement in the valuation of the assets is substantially offset by the movement in the valuation of the liabilities (and vice versa). The value of the assets is clearly verifiable, since the stock is traded, but what proof is now needed or how does one prove that the value of the liabilities is verifiable? Further clarification is required.

7. **Financial liabilities in respect of investment contracts issued by insurers**

   The amendment may result in the fair value option not being available for these financial liabilities and they will have to be valued at amortised cost with the resulting inconsistent measurement and disclosure between the movement in the fair value of the liabilities and the investment return earned on the underlying investments. The mismatch in the valuation of the investment contract liability and the underlying assets will constitute a profit or loss, resulting in artificial volatility in earnings despite the fact that the assets and liabilities may be fully matched.

8. **The proposals limit the December 2003 improvement to IAS 28 – *Investments in Associates,* as regards the option to measure investments in associates at fair value, with changes in fair value recognised in profit or loss**

   Such a limitation seems to conflict with the underlying reason for the IAS 28 option that fair value information is considered by the Board to be often readily available because fair value measurements are a well-established practice in venture capital entities, mutual funds and unit trusts.

9. **Investment fund industry**

   The investment fund industry is able, under the existing IAS 39, to adopt the fair value option in measuring both its fund liabilities and it its fund assets. In the case of investment funds, the cash flows of the fund's liability, on a unit-by-unit basis, will not necessarily be contractually linked to the performance of a particular asset, which could be identified with that liability and specified as required by IAS 39. This is the case, as within many investment industries there is a contractual obligation to redeem the unit at the net asset value of the funds measured at mid-prices. However, the requirement within the exposure draft currently is that designation of the fund liability as at fair value through profit or loss on a portfolio basis would not be appropriate.

(c) *Practical simplification of applying the fair value option in IAS 39*

In South Africa we have been applying the fair value option since July 2002, as noted in our General Comments above. We have noted during this period that the onerous requirements for hedge accounting have been simplified, especially with regards to the designation and effectiveness testing required by IAS 39. In addition, the fair value option has provided the opportunity for preparers of the financial statements to carry embedded derivatives at fair value and not to bifurcate the embedded derivative out of the host contract.

With specific reference to points made in (a) and (b) above, although it is possible to hedge some of the fair value risk inherent in mortgages for example, it is not always possible to meet the stringent hedge effectiveness testing required in IAS 39. Applying the fair value option in these circumstances has in fact decreased, rather than increased the volatility within the income statement.

***Question 3***

*Do the proposals contained in this Exposure Draft appropriately limit the use of the fair value option so as to address adequately the concerns set out in paragraph BC9? If not, how would you further limit the use of the option and why?*

In our view the proposals contained in this exposure draft inappropriately limit the use of the fair value option and in fact contradict the concerns set out in paragraph BC 9 and the objective of the exposure draft.

Concerns expressed regarding the increase in volatility within the income statement due to application of the fair value option to only one part of a matched position are unfounded. Preparers of financial statements do not seek volatility within their financial statements any more than do the regulators.

***Question 4***

*Paragraph 9(b)(i) proposes that the fair value option could be used for a financial asset or financial liability that contains one or more embedded derivatives, whether or not paragraph 11 of IAS 39 requires the embedded derivative to be separated. The Board proposes this category for the reasons set out in paragraphs BC6(a) and BC16-BC18 of the Basis for Conclusions on this Exposure Draft. However, the Board recognises that a substantial number of financial assets and financial liabilities contain embedded derivatives and, accordingly, a substantial number of financial assets and financial liabilities would qualify for the fair value option under this proposal.*

*Is the proposal in paragraph 9(b)(i) appropriate? If not, should this category be limited to a financial asset or financial liability containing one or more embedded derivatives that paragraph 11 of IAS 39 requires to be separated?*

Whilst we support the use of the fair value option to measure the entire instrument at fair value rather than attempting to separately measure the embedded derivatives, it is worth noting that paragraph 9(b)(i) could encourage artificial financial engineering to overcome the restrictions on usage of the fair value option. Despite this concern, we nevertheless believe the verifiability criterion would limit the extent of such abuse.

***Question 5***

*Paragraph 103A proposes that an entity that adopts early the December 2003 version of IAS 39 may change the financial assets and financial liabilities designated as at fair value through profit or loss from the beginning of the first period for which it adopts the amendments in this Exposure Draft. It also proposes that in the case of a financial asset or financial liability that was previously designated as at fair value through profit or loss but is no longer so designated:*

*(a) if the financial asset or financial liability is subsequently measured at cost or amortised cost, its fair value at the beginning of the period for which it ceases to be designated as at fair value through profit or loss is deemed to be its cost or amortised cost.*
*(b) if the financial asset is subsequently classified as available for sale, any amounts previously recognised in profit or loss shall not be reclassified into the separate component of equity in which gains and losses on available for-sale assets are recognised.*

*However, in the case of a financial asset or financial liability that was not previously designated as at fair value through profit or loss, the entity shall restate the financial asset or financial liability using the new designation in the comparative financial statements.*

*Finally, this paragraph proposes that the entity shall disclose:*

*(a) for financial assets and financial liabilities newly designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the previous financial statements.*
*(b) for financial assets and financial liabilities no longer designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the current financial statements.*

*Are these proposed transitional requirements appropriate? If not, what changes do you propose and why? Specifically, should all changes to the measurement basis of a financial asset or financial liability that result from adopting the amendments proposed in this Exposure Draft be applied retrospectively by restating the comparative financial statements?*

Although we are of the opinion that the transitional provisions are appropriate in that they are consistent with IAS 8, they are in contradiction to some of the transitional provisions of IAS 39.

***Question 6***

*Do you have any other comments on the proposals?*

**Disclosure of risk management policies**

As indicated throughout this comment letter, we are of the opinion that the concerns expressed around potential abuse of the fair value option are, unfounded and the proposals in this exposure draft are therefore unnecessary. We believe the IASB should rather consider requiring additional disclosure of the entity's risk management policies and management intentions in this regard. Specifically, the assumptions and reasons behind the decision to designate instruments at fair value should be disclosed.

From our experience in South Africa we have found that those financial instruments which had been designated to be fair valued through the income statement are not clearly disclosed in the financial statements. We believe that the IASB should require a split of financial instruments which are fair valued through the income statement into those held for trading in terms of the definition in IAS 39 (revised) and those designated to be fair valued through the income statement. Further disclosure for those instruments classified as designated to be fair valued should be included.

**Reclassifications into and out of fair value**

According to the IAS 39 (revised), reclassifications are prohibited into and out of the fair value through profit of loss category, but according to the previous IAS 39 reclassifications out of the trading category are prohibited, but reclassifications into the trading category are allowed. South African banks proposed that entities be allowed to reclassify financial assets into the trading category (effectively a sub-category of the fair value through profit or loss category), if there is evidence of a recent actual pattern of short-term profit taking that justifies such reclassifications. Placing such restrictions on the reclassifications into the trading category could lead to distorted presentation of the true nature of, and management's intention with respect to, financial assets.

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