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Dear Madam,

The Fair Value Option: Amendments to IAS 39 Financial Instruments, Recognition and Measurement

The Association of Corporate Treasurers (ACT) welcomes the opportunity to submit views on the important issue of amending IAS 39. This standard, and the accounting treatment of financial instruments is highly relevant to corporate treasurers. The ACT usually comments from the corporate and not the financial services sector standpoint

General

In the existing IAS 39 the availability of the fair value option provided a welcome degree of flexibility for entities as a form of hedge accounting outside of the strict rules on classifications of hedges. By recording both financial assets and liabilities at fair value through the P&L, which accords with the general principles of IAS39 of fair valuing financial instruments, there is a degree of natural offsetting even if the movements in the value of asset and liability are only partially correlated. Additionally if entities did not wish to spend the time and effort in meeting the extensive requirements for documenting and testing hedge accounting they could simply apply fair value. We note that the circumstances when this flexibility is available have been severely restricted under the proposed amendments in your April 2004 consultation, and therefore we do not support your Exposure Draft.

We believe that the criteria required to be satisfied in order to use the fair value option (para 9(b)) are unnecessary and that the standard should remain in its original form.

Responses to specific questions

Question 1

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

Your rationale for the proposed amendments is given in BC9.

If one of the purposes for the changes is to avoid banks, securities companies and insurers inappropriately using the old provisions we wonder why these new provisions are not limited to those entities.

The concern in BC9(a) about use of the option when the valuation is not verifiable is a valid one, which we accept. However we take issue with the terminology used between verifiable and reliably measurable. We also believe the need to satisfy yet more tests on verifiability and whether items substantially offset are further burdens on reporting entities which will cause more expense and confusion.

In BC9(b) your concern is over increased volatility and that its removal is an objective in this Exposure Draft whereas the potential volatility introduced in IAS 39 through the very strict criteria to achieve hedge accounting was not seemingly a concern for you. We accept that the fair value option may cause volatility but we find it surprising that you do not leave that to the reporting entities involved to resolve themselves, through deciding whether or not to make use of the fair value option.

In BC9(c) the concern was expressed over the recognition of gains or losses arising from changes in the credit worthiness of the reporting entity and we note in BC13 your decision to leave matters unchanged. In respect of this concern, we think there should be an option for issuers to fair value their liabilities whilst being able to exclude credit revaluations where there is no expectation to repurchase or to negotiate early termination of or to defease those liabilities. In such a case the decisions concerning the liability are historical and the P&L impact will continue to accrue over the life of the liability in the normal way.

The Exposure Draft allows the designation "at fair value through the P&L" only if the fair value is verifiable. Although the concept of verifiable is explained in 48B as being a tighter definition than measurable or reliably measurable (terms used elsewhere in IAS 39), in everyday language verifiable is not associated with any particular degree of accuracy or reliability and confusions could be introduced. Our particular concern about the introduction of the verifiable requirement on any valuations for this purpose is that it imposes a different criterion than found elsewhere in IAS39. We do not see the logic of having different degrees of reliability on fair value depending on particular uses within the same set of financial statements.

Para 9 (b) (iii) allows the use of the fair value through P&L option where the fair value of a financial asset or liability is *substantially offset* by the exposure to changes in the fair value of another financial asset or liability. This seems to be creating an effectiveness test similar to that already included in IAS 39, so that this sub paragraph is providing nothing new or extra other than being confusing. Indeed the test *substantially offset* is different from the normal wording of *highly effective* but does it introduce a more stringent test than required under hedge accounting?

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.

Yes. One of our members, who is the Treasurer of a large multinational, has explained that his organisation owns a financial asset in the form of cumulative redeemable fixed rate preference shares issued by an independent holding company which owns an operating company which the multinational sold. Although the dividend has a fixed rate coupon the timing of payment on the preference shares depends on the dividends paid by the operating company to the holding company. The multinational's treasury policy is to have floating rate investments. Hence the owner of the financial asset has taken out an interest rate hedge which estimates timing of flows. It appears that the more stringent verifiable test allied with the need to prove 'substantially offset' (which is not clear and would need testing) may prevent this instrument being allowed to be fair valued with consequent creation of P&L volatility. Since the actual timing of coupon flows simply cannot be predicted then it seems impossible to prove whether it 'substantially offsets' as in some situations it will and in others it will not.

(b)Is the fair value of the instrument(s) verifiable (see paragraph 48B) and if not, why not?

This is not clear as the lengthy new rules in 48A and 48B need considering with auditors and will need proving. It would be helpful if 48A and 48B could be written to only include matters which are additional to AG69 – A82.

(c)How would applying the fair value option to the instrument(s) simplify the practical application of IAS 39?

As both instrument and derivative could be fair valued under the previous IAS39 with any timing differences on payment dates and changes in the credit worthiness of the issuer being recorded in the P&L then the multinational was comfortable with the volatility impact and, in particular, that it did not need to test potential outcomes.

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?

On the premise that the concerns set out in paragraph BC9 are all valid, then the Exposure Draft does adequately cover the first concern, but not always the second, as noted by example in Question 2. In respect of the third concern please see question 1.

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?

We welcome the fact that the fair value option may be applied to assets or liabilities containing embedded derivatives whether or not the embedded derivative was required to be separated. This is a good use of the fair value option, and we point out that it demonstrates that your proposed treatment of assets or liabilities which do not contain embedded derivatives (see question 2), and which need to satisfy other criteria such as 'substantially offset', is inconsistent.

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?

For entities that have adopted IAS 39 early your proposed transition process is helpful in that there will be no need for backdated changes

We would like to draw your attention to the requirement for use of the fair value option that it is designated “upon initial recognition”. This is in the original IAS39, but on reflection it appears to us to be too restrictive. An entity may have a long standing financial liability held at amortised cost, and may subsequently take on a derivative asset which is fair valued and forms a partial hedge against that liability, but not sufficiently correlated to achieve hedge accounting. In BC6(c)(ii) you give reasons as to why it is fair to permit this sort of “natural offset” but it seems illogical and inconsistent to restrict it to circumstances where the financial liability is first recognised after the inception of offsetting asset rather than to pre-existing liabilities. On the basis of your requirements two identical liabilities will end up with different allowed treatments depending on the timing of initial recognition.

It is one thing to have rules which *allow* different treatment of identical assets or liabilities since the entity can do what is appropriate (as you accept in BC18), but it seems perverse to have rules which *force* different treatments without the entity having the choice as to what is appropriate.

In a similar fashion there may be occasions where the fair value option is quite properly in use to achieve a natural offset and then there is a major business change so that the asset is disposed of or the liability extinguished. It should then be possible for the entity to opt back to an amortised cost valuation of the offsetting liability or asset. To avoid abuse this option could be limited to major business changes. By “major business change” we would mean, for example, a merger / takeover / new acquisition / business sale or closure, etc. This would mirror the normal IAS hedging rules where it is possible to cease designating a particular hedge relationship.

Question 6

Do you have any other comments on the proposals?

No.

These comments are on the record and may be freely quoted and made available for public inspection.

We hope these responses are helpful for your deliberations and if you need any further information or clarifications please contact any of the people listed below.

Yours faithfully,

Martin O’Donovan
Technical Officer

The Association

The Association of Corporate Treasurers was formed in 1979 to encourage and promote the study and practice of corporate finance and treasury management and to educate those involved in the field. Today, it is an organisation of professionals in corporate finance, risk and cash management operating internationally. A professional body and not a trade association, it has over 3,000 Fellows, Members and Associate Members. With more than 1,200 students in more than 40 countries, its education and examination syllabuses are recognised as the global standard setters for treasury education. Members of the Association work in many fields. The majority of Fellows work in large UK public companies, responsible for the treasury and corporate finance functions.

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