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SPANISH ACCOUNTING AND AUDITING INSTITUTE (ICAC) COMMENTS ON ED AMMENDMENTS TO IAS 39 *FINNANCIAL INSTRUMENTS RECOGNITION AND MEASUREMENT*: THE FAIR VALUE OPTION

The IASB introduced in December 2003 the fair value option with the objective of simplifying the practical application of IAS 39. Prudential supervisors were concerned of the inappropriately use of the fair value option. This situation led to the launch of an exposure draft to restrain the use of this option just to certain instruments. We consider the exposure draft an improvement to the fair value option definition of the IAS 39 launched in December 2003.

This exposure draft has taken into account "natural offsets", avoiding the use of the fair value criteria to only one part of a matched position. Therefore, the proposed definition of the fair value option allows a decrease in the volatility in profit or loss covering more cases than the hedge accounting strategy. However, there are some concerns about the artificial volatility that can be introduced by the fair value option exposure draft.

Question 1

The main objective of the exposure draft shall be to reduce volatility in profit or loss and equity. From our point of view, paragraph 9.b.ii) and 9.b.iii) tackle this issue allowing the use of "natural offsets". Hence, paragraphs 9.b.i) and 9.b).iv) seem to be unnecessary. One could argue that the term "substantially offset" introduced by paragraph 9.b).iii) could limit the use of "natural hedges". We share that point of view and we think that this paragraph shall be redrafted in order to point out that

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"natural offsets" shall be used for sound risk management practices for reducing artificial volatility in profit or loss and equity.

We also have the perception that paragraph 9.b).iii) is broader than paragraph 9.b).ii), but both of them deal with the same issue. Therefore, paragraph 9.b.ii) could be deleted.

It shall not be possible to use the fair value option to recognize in profit or loss gain or losses arising from changes in an entity's own creditworthiness. We would like to remark the following comment:

- Paragraph 9.b.iii) (and also paragraph 9.b).ii) if it is not deleted) shall excluded the possibility of using "natural offsets" to hedge the entity's own creditworthiness. We also fear hat paragraph 9.b.i) (see comment 3) could be used to measured liabilities with embedded derivatives at fair value through profit or loss.

From our point of view Paragraph 9.b).i) could be deleted since the aim of the fair value option shall be to reduce volatility in profit or loss what is achieved by paragraph 9.b).iii). Paragraph 9.b).i) opens the possibility to a potential misuse of the fair value option in different ways. From the liability side, many liabilities could be measured at fair value through profit of loss, recognizing gains and losses arising from changes in an entity's own credit risk. From the asset side, the use of embedded derivatives is largely extended in many banking products (almost every loan has a prepayment option); therefore there can be a potential misuse of the fair value option if every asset with an embedded derivative is measured at fair value through profit or loss.

The reason for paragraph 9.b).i) is set out in BC6(a), where the Board explains that, in situations where IAS39 requires an embedded derivative that is not closely related to their "host contract" to be separated and measured at fair value, such separation an measurement can be both difficult and subjective. However, it is not explained why financial instruments with embedded derivatives that do not have to be

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separated could be eligible also to the fair value option. In our view, if not deleted it would be necessary to restrict the use of the fair value option only to embedded derivatives that shall be separated following the paragraph 11 of IAS 39. Also, to avoid the use of separated embedded derivatives with no value, i.e., created to take advantage of the possibilities offered by this paragraph but not to be exercised, it would be necessary to require that the embedded derivative will have economic substance. For example, it should not be possible to admit the designation of a financial asset or liability that contains an embedded option as at fair value through profit or loss when the option is deeply out of the money.

Relating to the verifiability concept, we consider necessary to extent the verifiability requirement to all financial instruments. It would be essential at least to extent this requirement to financial instruments designated in the available for sale category because in this category it would be possible to include financial instruments with no active markets.

Our last comment brings the question of the power of the prudential supervisor. We support the comments made by the IASB about the role of the supervisor in overseeing the application of the requirements for the application of the fair value and of relevant risk management systems and policies. We are aware that the statement made by the IASB does not give any power to supervisors to amend or overrule accounting standards. The statement of the IASB is also more essential if paragraph 9.b.i) and 9.b.iv) are maintained.

Question 2

No additional comments

Question 3

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See question 1

Question 4

See question 1 regarding financial asset or liability that contains embedded derivatives

Question 5

No additional comments

Question 6

No additional comments

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