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PROPOSED AMENDMENTS TO IAS 39 - THE FAIR VALUE OPTION

Memorandum of comment submitted in July 2004 to the International Accounting Standards Board in respect of the Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement - *The Fair Value Option, published in April 2004.*

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to respond to the Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* - The Fair Value Option, published by the International Accounting Standards Board in April 2004.

2. We have reviewed the Exposure Draft and set out below a number of comments. We deal first with our disagreement with the proposed change, before commenting on the specific questions raised in the Exposure Draft.

DISAGREEMENT WITH THE PROPOSALS

3. We agree with those Board members whose views are set out in the Alternate Views appendix to the Exposure Draft.

4. We support the current fair value option in the March 2004 version of IAS 39. We do not agree with the amendments set out in the Exposure Draft and, in particular, we disagree with the reason that has prompted the Board to propose making the changes. The fair value option is what it implies – a choice. If prudential supervisors and regulators do not wish their constituents to exercise the choice they have the power to prevent its use in returns made for regulatory purposes. To make changes to the standard to accommodate prudential supervisors' and regulators' concerns in matters where they have the remedy to address them would set an unfortunate precedent.

5. The proposals are complicated and would add an unnecessary degree of complexity to a standard that is already difficult to use. The reasons for change provided in the Basis of Conclusions are insufficiently robust and do not adequately address the concerns expressed in paragraph BC 9; financial engineers will undoubtedly be able to apply the criteria in paragraph 9(b) in a manner that would still allow some entities significant flexibility. Neither do we believe that the cost / benefit analysis of the proposed changes has been properly evaluated. The application of the proposed criteria and the transitional rules unnecessarily complicate 2005 IFRS transition as they would impose additional systems and operational changes and are more likely to hamper the use of the fair value option where it is required for a true and fair presentation of an entity's financial position.

6. We consider the current version of the fair value option to be robust and to meet the objectives for which it was introduced. It is robust because of the requirement to designate a financial asset or liability at inception and the prohibition on subsequent reclassification impose stringent conditions on the selection of the option. We do not consider that the present fair value option lends itself to abuse and a manipulation of earnings.

7. The present fair value option meets its objectives because it eases the application of the standard, particularly for many entities in the financial sector. It helps mitigate some of the anomalies inherent in the mixed accounting model

in IAS 39 which cause artificial volatility but without the cost and difficulties of achieving hedge accounting. In particular, it enables entities to avoid the need for complex hedging documentation where there is a natural hedge, as well as permitting consistent accounting where non-derivative assets and liabilities have offsetting risks.

8. We urge the Board not to implement the proposed changes. All our comments should be read on that basis. If the Board does press ahead with these changes, then our specific reservations, which are set out below, will need to be addressed before the changes can be made operational.

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?

9. We do not agree with the proposals in the Exposure Draft. We previously welcomed the introduction of the fair value option in IAS 39 as a necessary improvement: we would not wish to see it further restricted. The proposals will create difficulties of interpretation and complexity without meeting the objectives implied in paragraph BC 9. Further, restricting the use of the fair value option may have unintended consequences in the future by dictating the behaviour of entities and influencing the development of products. We concur with the Alternative Views expressed by certain members of the Board.

10. We are strongly opposed to the introduction of a new test for 'verifiability', for the following reasons.

(a) The verifiability test leads to a two-tier classification for fair valued items, distinguishing those that must be fair valued through profit or loss as trading instruments (such as complex derivatives) from those that are optionally fair valued (such as prepayable loans) and which are subject to the verifiability test. There is no justification for having two standards for fair value depending on the nature of the instrument or the reasons for holding it. To introduce such a distinction undermines the usefulness of fair values in the accounts, appears to be inconsistent with the Framework and is inconsistent with aspects of the fair value hierarchy under IAS 39, such as the use of observable data in valuation techniques.

(b) The definition of verifiable is circular as drafted, because it relates back to the existing criteria in IAS 39. Proposed paragraph 48B is seemingly little different from the criteria in paragraph AG 80. It is not clear what the difference is between "low" variability and "not significant" variability.

(c) The IAS 32 *Financial Instruments: Disclosure and Presentation* disclosure requirements regarding assumptions, methodologies and sensitivities are sufficient together with the requirements in

IAS39.AG76 that the best evidence of fair value at initial recognition is the transaction price unless the fair value can be evidenced by other market transactions or by a valuation technique with observable market inputs.

11. At a conceptual level, the Exposure Draft appears to suggest that verifiability is a subset of reliability, whereas we believe that verifiability is more correctly an attribute of reliability. The new distinction is not clear and can only lead to confusion. If there is a weakness in the test for reliability of measurement, then this should be addressed for general application in the Framework.

12. Paragraph 9(b)(iii) introduces a "substantial offset" test. We are concerned that the test will increase the problems of implementation of the option. Either the term is intended to be so wide that no testing is required and the restriction becomes meaningless, or only a qualitative acknowledgement of a reasonable expectation of offset is needed, or it is the Board's intention that it should require a demonstration (with quantitative testing) of offset. If the latter is intended, as the subsequent paragraph following 9(b)(i) – (v) suggests, it would seemingly fail one of the objectives of the fair value option, which is to mitigate the burden of achieving hedge accounting. In other contexts, IFRS uses the word 'substantial' to mean 'almost fully' or, at least, in excess of 90%. Such interpretation is highly likely to be attached to its use here. This is more restrictive than the 'highly effective' range of 80-125% used for hedge effectiveness testing and consequently would be more demanding rather than less. Any restriction that involves extensive testing would be contrary to the objective of introducing the option. We suggest that, if such a test is necessary, there should merely be an expectation that the items will offset in most reasonably expected economic circumstances.

13. We are in particular agreement with the view expressed in paragraph AV 7 that financial reporting standards should deal only with general purpose financial statements. Prudential supervisors and regulators are free to ask for modified reporting or other information that meets their specific requirements and this should not affect the setting of accounting standards.

14. The proposed revision to paragraph 9 refers to the powers of prudential supervisors. As paragraph BC 11 notes, 'the statement merely notes powers that supervisors may already have and does not confer any additional powers on them.' We therefore question why it is necessary to make any reference at all to prudential supervisors and regulators in the standard. Inclusion of the statement could encourage prudential supervisors to interfere in general purpose reporting, which is likely to lead to inconsistency between different jurisdictions. Prudential supervisors and regulators are able to use their powers to require information outside the framework of general purpose financial statements, and we believe that this is the correct course for them to take.

15. We assume from proposed paragraph 9(b)(iv) that it is the Board's intention to restrict the ability of entities to fair value loans and receivables. However, we believe that as drafted the 'loans or receivables' exclusion fails, as an item could simply be classified as available-for-sale on initial recognition, thus taking it

outside of the definition of loans and receivables in IAS 39. As such, the quality of the 'fair value' would only have to meet the apparent lower threshold of reliability rather than that of the higher hurdle of 'verifiability' and the volatility issue and how it affects profit would be transferred to a question of fluctuations in equity. Furthermore, it is most likely that some form of embedded derivative could be identified in many loans and thus entities can avail themselves of proposed paragraph 9(b)(i). We suggest that the Board should revisit whether it is really sensible and practical to introduce such a restriction.

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?

16. We understand that any change to the fair value option will jeopardise its planned use by a number of insurance companies and banks. The following examples illustrate the issues.

(a) Insurance companies will find problematical the requirement for a contractual link between the performance of assets (such as loans and receivables) measured at fair value and the cash flows of the associated financial liabilities. In many cases the associated or linked liabilities will be ones that fall outside the scope of IAS 39's definition of financial liabilities. Such liabilities include insurance contracts or discretionary participating contracts under IFRS 4 'Insurance Contracts'. Even if an insurer can fair value the loans and receivables, assuming that such fair values are verifiable, use of the revised fair value option would be precluded as the associated liabilities will not necessarily be measured at fair value, which has yet to be defined in this context.

(b) As already set out above, the requirement for verifiability in proposed paragraph 48B is unwelcome. In particular, it will cause problems in fair valuing such items as private equities, private placement debt, guaranteed insurance contracts and other financial instruments not quoted in an active market. Other examples include credit-linked notes and other structured products containing embedded derivatives. Furthermore, the 'verifiability' requirement will adversely impact those organisations that wish to apply the scope exemption in IASs 28 'Investments in Associates' and 31 'Interests in Joint Ventures', that requires designation of such investments and interests at 'fair value through profit or loss'. The lack of current market transactions would preclude use of the fair value option / scope exemption and force these organisations to equity account for their investments in associates and interests in joint ventures, thus directly cutting across the Board's rationale for introducing the exemption.

(c) In respect of prepayble loans, such as mortgages, the verifiability constraint becomes oppressive, particularly in regions of the world where there is no market or ones where the market lacks depth and there are only a limited number of transactions in such loans, for example, Europe. As a consequence, under the IAS 39 fair value hierarchy, valuation techniques would be used but the data input would not meet the observability requirements. Similarly, long-term life insurance products with savings components will be difficult to value within the narrow confines of the verifiability test.

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?

17. The proposals are unlikely to overcome the concerns set out in paragraph BC9. In any event, we consider some of these concerns to be ill-founded and we would not seek to further limit use of the fair value option. There should be consistent application of accounting policies, based on an economic hedging strategy or management intent, as a bar to cherry-picking.

18. In particular, we question concerns that entities will inappropriately apply the fair value option to financial assets and financial liabilities whose fair value is not verifiable in a manner intended to manipulate earnings. If this is the case, the prudential supervisors should be more concerned about the subjectivity of the fair values of those trading instruments, such as complex derivatives, that must be fair valued through profit or loss. This is mitigated by the IAS 32 disclosures about assumptions, methodologies and sensitivities where values are determined in the absence of active markets in the instruments concerned.

19. We view with considerable scepticism the concern that entities would deliberately introduce greater volatility into their profit or loss by misuse of the fair value option. Anecdotal evidence is quite the reverse, with vast efforts being made to reduce volatility by the appropriate, but costly, use of the rules to achieve effective hedge accounting.

20. We acknowledge that we had previously voiced concerns about the appropriateness of fair valuing financial liabilities and thus introducing volatility due to changes in own creditworthiness into profit or loss. However, we are content that the Board debated the issue when revising IAS 39 and accept that our concerns can be addressed through disclosure of the change in fair value due to credit risk. Consequently, we do not agree with those that have

opened the issue again at this late stage and jeopardise the stability of the Board's suite of standards for 2005.

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?

21. We support the fair value option as set out in the March 2004 version of IAS 39, and so do not favour any restriction. If the proposed revision is implemented by the Board, we consider the proposal in paragraph 9(b)(i) is appropriate. The proposals allow the revised fair value option to be applied to any debt instrument that contains an embedded derivative. We do not believe that this should be further restricted, as it avoids:

- costly and time-consuming procedures to determine which embedded derivatives are or are not closely related; and
- the subjectivity in any value for the separated embedded derivative that arises from using complex models.

Indeed, we consider that the ability to fair value the whole instrument is superior accounting to US GAAP in this area.

22. We note that finding an embedded derivative of some description in a contract is the art of the possible. Therefore, those that are inclined to use the revised fair value option selectively will be more likely to indulge in financial engineering to give the result that is most advantageous to them.

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?

23. The transitional rules are complex and do nothing to remove the view that IAS 39 is a difficult standard to understand. However, if the proposals were to be implemented, we can see that there are practical advantages from those that are designed to minimise the burden of adoption, in particular, not requiring retrospective application when an entity changes its measurement basis to amortised cost.

24. We do not agree with the proposed transitional rule that would allow those entities that use IAS 39 (March 2004) to classify additional financial instruments at 'fair value through profit or loss', as this could potentially allow manipulation of earnings after inception of a financial instrument and does not seem to give rise to any particular relief from burden.

Question 6

Do you have any other comments on the proposals?

25. We agree with the sentiments of paragraph BC17 and would wish that these thoughts are included in IAS 39. They are useful interpretation and application guidance in general. In particular, paragraph BC17(b) addresses the situation already caused by the scope exemption in IASs 28 and 31 and means that banks can have different accounting policies in their consolidated accounts for investments in associates or interests in joint ventures that are held through venture capital subsidiaries from those that are held directly by the bank or other subsidiaries where the intention for the investment is different.

26. We have no further comments.

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