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Your ref Fair value option ED

Our ref EL/813

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21 July 2004

Dear Sir David

Exposure Draft of Amendments to IAS 39 – The Fair Value Option

We appreciate the opportunity to respond to the invitation to comment on the International Accounting Standards Board's exposure draft of its proposed amendments to IAS 39 *The Fair Value Option.* This letter expresses the views of KPMG International on behalf of KPMG's member firms.

Question 1: Agreement with proposals

We believe that the fair value option should be allowed in respect of any financial asset or financial liability that has a fair value, which is either reliably measurable or verifiable (refer comments below). We are concerned that by limiting the circumstances in which the fair value option may be applied, in the manner proposed by the ED, IAS 39 is made to be rules-based. Consequently, we continue to support the unrestricted fair value option as it was included in amended version of IAS 39 published in December 2003 and refer to our comment letter dated 14 October 2002.

We do not share the view that the usage of the fair value option should be limited to avoid any increase in earnings volatility. Earnings volatility arises mainly due to the 'mixed measurement' approach within IAS 39, and can therefore only be eliminated if only one measurement basis is used for all financial instruments. Since this is not the case, management should be free to decide how best to limit the entity's exposure to earnings volatility arising from the 'mixed measurement' of financial instruments. Under the hedging concept, the IASB already allows for different earnings measurement based on whether management decides to apply hedge accounting or not. It is our understanding that with the implementation of the fair value option the IASB was seeking a pragmatic solution for applying IAS 39, in particular, a solution that can be implemented without significant modifications to an entity's current IT environment. We believe that, with the fair value option as it currently appears in IAS 39, the IASB has achieved its objective and we therefore cannot support limiting the usage of the option. In particular, we would like to draw attention to the following issues:

Reliable fair value versus verifiable fair value

In order to narrow the use of the fair value option even further, the ED allows its application only if the fair value of the relevant financial asset or financial liability is verifiable. We are concerned about the introduction of this further level of 'fair value'. We believe there should be one definition of fair value, which is consistently applied. IAS 39 indicates that only unquoted equity instruments and derivatives that are linked to and must be settled in such unquoted instruments can fail to be measured at fair value on grounds that fair value is not 'reliably measurable'. Consequently, despite the fact that the fair value of some financial instruments and embedded derivatives may not be verifiable (as required in the context of application of the fair value option), these are required in terms of the existing requirements of IAS 39 to be remeasured to fair value.

Having made the distinction between two levels of fair value, it would appear that, whether the entity wishes to recognise fair value gains and losses in profit or loss, or equity, determines how 'strong' the estimate of fair value must be. In order to designate a financial asset or financial liability as at fair value through profit or loss, an entity is required to meet the stricter, verifiable, fair value requirement. However, should that entity wish to designate the financial asset as available for sale, it can do so having only a reliable measure of fair value. Consequently, misleading information may result, especially if voluntary designation as available for sale is allowed.

We find it difficult to support an argument that relevant and reliable information is provided in financial statements by measuring at fair value some financial assets and financial liabilities whose fair value is reliably measurable but not verifiable, while others whose fair value is similarly reliable but not verifiable must be measured at cost. In other words, if the Board wishes to *prohibit* fair value measurement in some cases for instruments whose fair value is not verifiable, why would it *require* fair value measurement in other similar cases?

The addition of a further level of 'fair value' also results in inconsistent fair value measurement within the 'at fair value through profit or loss' category, since the verifiable requirement is not required to be met in respect of held-for-trading financial assets or financial liabilities.

The requirement for fair value to be verifiable may significantly limit the circumstances in which financial liabilities may be designated as at fair value through profit or loss. This is evident from the discussion in paragraphs AG 74 to AG 79 of the Appendix to IAS 39, dealing with the use of valuation techniques for instruments that are not traded in an active market. While initially it would appear that it is possible to determine a verifiable measure of fair value for financial liabilities, paragraphs AG 77 and AG 78 make it appear unlikely that this will be the case since it is difficult to make an accurate estimate of movements in liquidity spreads and credit spreads, for example, in order for the range of possible fair values for financial liabilities to be low.

The discussion in paragraphs AG 74 to AG 79 of the Appendix to IAS 39 (as noted above) further lays doubt on whether the fair value of debt instruments, such as loans and receivables, as well as unlisted securities may be verifiable, and thus indicates that these instruments would probably also be precluded from application of the fair value option. While it is possible to reliably measure the fair value of these financial instruments, it may not be possible to limit the range of reasonable fair value estimates to an acceptable level.

It is our understanding that a verifiable fair value is a fair value which is substantiated by market observations while a reliable fair value is one that uses current valuation techniques, which cannot necessarily all be substantiated by market observations due to a lack of instrument-specific information such as liquidity spreads. If the Board intends to change the fair value definition by implementing an additional verifiability criterion, then this would lead to a situation where hardly any fair values can even be disclosed in the financial statements. As such, we propose that the current fair value definition, requiring reliable measurement, be retained. However, the Board might reconsider its conclusion that a reliable fair value can be determined for any financial instrument with the exception of unquoted equity instruments and derivatives that are linked to and must be settled in such unquoted equity instruments. We believe that for some financial instruments with contingent clauses (e.g., a forward purchase of an output such as a crop harvest) it is quite difficult to determine the instrument's fair value.

In addition, we are concerned that it may be impracticable, given the guidance in the ED, to distinguish adequately between reliable measurement and verifiability. Besides the statement that verifiability is more restrictive, paragraph 48(b) simply requires that the variability in the range of reasonable estimates is 'low'. The examples that follow are based on valuations that are in turn based primarily on market data or market-accepted models. It is unclear whether this would extend to some or most unquoted equities or to some or many or most loans or borrowings where the range of estimates is 'low' but where valuations are based on reasonable estimates and assumptions that cannot be validated by reference to markets or other market participants. We believe the proposal serves to introduce a further degree of uncertainty into what is already a very judgemental area.

Linked performance

The ED determines that the matching financial asset and financial liability may both be measured at fair value through profit or loss if there is a contractual linkage between the performance of the asset and the liability. Due to a lack of implementation guidance it is currently not clear whether paragraph 9(b)(ii) of the ED should be interpreted in the same manner as the current linkage requirement in AG72 and BC100. The current requirements state that there is an offsetting risk position only if a) the cash flows from the asset and liability are locked in, and b) the matched position can be sold without incurring the bid-ask spread. We understand that the current requirement should be analysed on an asset by asset basis (confirmed by BC 16(a) of the ED) while often this criterion is only met on portfolio basis (refer investment funds below).

It is also unclear in the insurance industry whether contracts with discretionary participation feature would qualify for the 'linkage' criteria.

We believe that guidance is necessary regarding the manner in which an entity is required to indicate the contractual linkage between a financial liability and an associated asset. Should the Board impose any formal requirements on the entity in order to prove compliance with this condition, e.g., documentation of the relationship demonstrating the contractual linkage, this would in fact create an enlarged administrative load for entities wishing to apply this option. The benefit of the fair value option, as a pragmatic solution to implementing IAS 39, would be somewhat limited by such requirements.

Substantial offset

Furthermore, the ED indicates that the fair value option may be applied where the exposure to changes in the fair value of the financial asset or financial liability is substantially offset by the exposure to changes in the fair value of another financial asset or financial liability, including a derivative.

With respect to the above limitation we believe that it is necessary to clarify what is meant by 'substantially offset'. Should this be interpreted in the same way as hedge effectiveness, i.e. 80% to 125%? In addition, there is no guidance whether the substantial offset has to be achieved considering the total risk of assets and liabilities, including derivatives, or only specific risk elements such as interest rate risk. The assets and liabilities may have significantly different *total* risk exposures, e.g. credit risk will differ where the respective counterparties are different and yet the foreign currency risk exposures of the respective items may substantially offset one another. Although BC 14 indicates that it is the Board's intention not to limit the usage if there is a natural offset of some of the risks (BC 6(c)(ii)), the suggestion in BC 6(c)(ii) that only 'some protection' is required seems inconsistent with a notion of 'substantial offset'.

In clarifying the measurement of 'substantial offset' we believe the Board should indicate whether it would be necessary to demonstrate, upon initial recognition, that the substantial offset is expected to continue throughout the life of the respective financial assets and financial liabilities. For example, if the financial asset is an investment with a maturity of ten years, and the offsetting financial liability has a maturity of only six months, can the requirement be met on day one, knowing that the substantial offset will only be in place for a small proportion of the period until maturity of the investment.

Also, we understand that once designated as at fair value through profit or loss, a financial instrument may not be reclassified out of this category. However, we believe that it would be useful for the Board to clarify that this is the case. Especially in the context of where, upon initial designation, the 'substantial offset' criterium was met and subsequently this is no longer achieved.

We would also like to emphasise again that the fair value option was implemented as a pragmatic solution to implementing IAS 39. Should the Board impose any formal requirements on the entity in order to prove compliance with this condition, e.g., documentation of the relationship demonstrating the substantial offset, this would in fact create an enlarged administrative load for entities wishing to apply this option. We would therefore not see the benefit to applying the fair value option rather than hedge accounting the relationship, with the exception that by using the fair value option neither the financial asset nor the financial liability need 'qualify' as a hedging instrument / hedged item. We understand that this condition is included to accommodate the 'natural offsets', and presents an alternative to hedge accounting. We do not agree with the inclusion of this limitation since it appears to represent an income statement focused approach and attempts to achieve 'matching', a concept which has been removed from IFRSs. However, if implemented there is a need for more clarification and guidance about what constitutes substantial offset.

Treatment of own credit spread

While one of the concerns raised was that entities applying the fair value option to financial liabilities might result in the entity recognising gains or losses in profit or loss for changes in its own creditworthiness, we support the IASB's view that the fair value of a financial liability should include the credit risk relating to that liability. It is important, using the balance sheet approach, that the fair value of the liability incorporate all factors influencing its value of which credit risk is one.

Proposals to address constituents' concerns

While we oppose limiting the use of the fair value option, we understand the IASB's need to respond to concerns raised by its constituents, in particular regarding application of the fair value option to loans and receivables. If the Board believes a change is necessary, then we believe the concerns would be better addressed simply by prohibiting the use of the option for loans and receivables.

We have noted above our opposition to the introduction of a further level of fair value, i.e. the verifiability requirement. It seems that the primary reason for introducing this particular requirement is also to deal with the regulators' concerns about the use of fair values for loans and receivables. As an alternative to the approach suggested in the above paragraph, we believe an appropriate way of dealing with this issue in the short-term is to remove the verifiability requirement and to amend paragraph 9(b)(i) to restrict this category to embedded derivatives that would otherwise need to be separated under paragraph 11. This would have the practical effect of prohibiting the use of the fair value option for most loans and receivables containing common caps, collars, floors and prepayment options. However, we note that this would complicate use of the fair value option since, before being able to apply the fair value option, an entity would have to analyse each financial asset or financial liability to determine whether it contains a separable embedded derivative thus negating some of the benefit of applying the option in the first place.

In paragraph BC 11 the Board notes the two ways in which it decided to meet the constituents concerns (as set out in BC 9(a)). The second of these (BC 11(b)) makes reference to the Board's inclusion of the statement in the Standard relating to prudential supervision. We do not believe that the description of this statement as a means of addressing constituents concerns is consistent with the Board's aim of including this statement, as indicated further along in paragraph BC 11(b), namely to alert entities subject to prudential supervision to the possibility that their supervisor may be concerned to ensure they do not use inappropriate estimates of fair value.

Question 2: Financial instruments which will be affected

A particular situation in which application of the fair value option would be beneficial is that encountered in the investment fund industry, where the amount paid on the fund liability directly reflects the performance of a pool of specified assets. The fair value option would allow the investment fund to measure both its fund liabilities and its fund assets at fair value, achieving an almost perfect offset.

The ED indicates that the fair value option may be applied to a financial liability whose cash flows are contractually linked to the performance of assets that are measured at fair value. 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 where there is a contractual obligation to redeem the unit at the net asset value of the funds measured at mid prices. The requirement within the ED may be met on a *portfolio* basis, i.e. the fund's liability in respect of a particular portfolio could be identified with a *particular pool* of assets. However, our understanding of the ED currently, is that designation of the fund liability as at fair value through profit or loss on a *portfolio* basis would not be appropriate. We believe that more guidance should be provided in this regard.

Furthermore, we believe that the objective of enabling insurers to fair value financial assets that fund certain insurance liabilities as mentioned in BC17(c) cannot be achieved if the insurance companies hold loans and receivables as financial assets, which are excluded from the fair value option in accordance with 9(b)(iv). For example, many insurance companies invest in mortgage loan portfolios to offset their obligations arising from life insurance contracts entered into: as there is no offset between financial assets and financial liabilities as described in paragraph 9(b)(iii), the loans and receivables are prohibited from being measured at fair value through profit and loss to offset insurance liabilities.

Similar issues may arise within other industries, which do not meet the offsetting risk position criteria described in IAS 39.BC100.

A further situation where application of the fair value option is beneficial is noted in BC 7(b), namely in respect of investments in associates and joint ventures held by venture capital organisations, mutual funds, unit trusts and similar entities, which are excluded from the scope of IAS 28 and IAS 31 respectively provided that the fair value option is used (or they meet the IAS 39 definition of held for trading). Would the 'verifiable' fair value requirement apply equally to these investments in so far as the entity wished to apply the fair value option? BC 7(b) notes that fair value information in respect of such investments is often readily available. However, we are concerned that this fair value information would not necessarily be verifiable (given the requirements of 48B) since the process nonetheless involves the valuation of unquoted securities. Consequently, limiting the application of the fair value option in this manner would limit the identified benefits to be obtained by venture capital organisations, mutual funds, unit trusts and similar entities.

We note that paragraphs 9(b)(ii) and (iii), dealing with the 'linkage' and 'substantial offset' requirements, refer only to financial assets and financial liabilities. We believe both requirements should apply when there is linkage or substantial offset between financial assets and contracts with discretionary participation features or insurance contracts or derivatives or deposit components embedded within such contracts. Technically, of course, some insurance contracts, many contracts with discretionary participation features and most non-separable embedded derivatives will meet the definitions of financial assets and financial liabilities in IAS 32 (but are scoped out of the financial instruments standards). It could therefore be argued that no change is required. Nevertheless, we would suggest this is clarified.

Also in respect of insurance entities, IFRS 4, paragraph 45 determines that when an insurer changes its accounting policies for insurance liabilities, it is permitted, but not required, to reclassify some or all of its financial assets as 'at fair value through profit or loss'. Do the restrictions on use of the fair value option apply equally to insurance companies in these instances?

Question 3: Adequacy of the limitation on use of the fair value option

As described above we believe that the limitations contradict the objective to ease the implementation of IAS 39. For both conceptual and practical reasons, we do not believe the 'verifiability' test should be introduced at this time.

Question 4: Adequacy of the embedded derivative limitation

This limitation opens the door to financial engineering, whereby entities may structure transactions in such a way as to purposely include terms resulting in embedded derivatives in the financial assets and financial liabilities to which it wishes to apply the fair value option. This results in greater emphasis being placed on the form of a contract rather than its substance. We believe that this would be the case, whether the condition is limited to a financial asset or financial liability containing one or more embedded derivatives that are required to be separated, or not.

We note that a large proportion of loans will incorporate embedded derivatives including prepayment options, caps, etc. even though in most cases these derivatives will not be separated. We are doubtful whether the proposals, as drafted, would achieve the objective of limiting the fair value option for loans.

Question 5: Transitional provisions

Within the transitional provision it is necessary to differentiate two different scenarios. Firstly, there is the transition for a first time adopter; and secondly, the transition for an existing IFRS preparer needs to be addressed.

First Time Adopters

For first time adopters IFRS 1.8 provides precise guidance that the amended IAS 39 has to be implemented retrospectively. As such, no additional transition rules are required.

We believe that even if the entity is an early adopter or does prepare comparative financial statements in accordance with IAS 39 that the retrospective application of these amendments should not have a material impact on the preparation of the financial statements in accordance with IFRS.

Existing IFRS Preparers

Existing IFRS preparers could face two scenarios if they early adopted IAS 39 (rev. 2003). This depends on whether a preparer (i) already applied the fair value option as stated in IAS 39 (rev. 2003) or (ii) did not use this fair value option but, intends to use the new fair value option as discussed in the ED. Based on that the following issues arise:

Retrospective Designation of the Fair Value Option

Upon application of the amendments, an entity may reconsider whether it wishes to continue the designation of a financial asset or financial liability as at fair value through profit or loss, i.e. it has the opportunity to reclassify the item out of this category. In addition, the entity is given the ability to designate some financial instruments as carried at fair value through profit and loss even if those have previously not been designated to this category. We do not agree with this free choice to re-designate instruments. Where a financial asset or financial liability previously designated as at fair value through profit or loss meets the stricter conditions proposed by the ED, the entity should not be permitted to reclassify such financial asset or financial liability out of this category. Furthermore, any early adopter of IAS 39 (rev. 2003), which did not previously use the fair value option should be prohibited from implementing the amended Standard to retrospectively designate financial instruments to this category. Only newly acquired financial instruments should be allowed to be designated as at fair value through profit and loss.

Date of Transition

In our view, the proposed transitional rules are unnecessarily complex. We would require that if an entity adopts the December 2003 amendments to IAS 39 in a period that ends on or after 1 October 2004, it should also adopt these amendments. This would ensure that the vast majority of financial statements at year-end would incorporate the same standard.

One of the arguments noted by the IASB against retrospective application of the amendment was that entities may have used the existing version of the option as a simplification to fair value hedge accounting. Had the option not been available to them, these entities might have gone to the effort of meeting the hedge accounting requirements. However, hedge accounting cannot be applied retrospectively and a requirement to apply the amendment retrospectively would therefore be disadvantageous to such entities. To overcome this problem, the IASB could consider offering a one-off exemption to the restriction on retrospective designation of a hedging relationship.

We generally agree with the IASB to require retrospective application of new standards. The IASB decided to require stricter eligibility criteria for the fair value option compared with IAS 39 (rev. 2003) and therefore we do support your view for not applying retrospective application. However, we believe it will be confusing that at the year-end of 2004 two different fair value options can be applied. Therefore we recommend requiring all preparers that intend to implement IAS 39 (rev. 2003) to use the amended version.

Drafting comments

Paragraph 9(b)(ii) states as follows 'The item is a financial liability whose cash flows are contractually linked to the performance of assets that are measured at fair value'. We believe that it should be clarified whether a financial liability that is contractually linked to the performance of an asset can be designated as at fair value through profit or loss only if the asset is measured at fair value through profit or loss – under another Standard or because it meets one of the other designation criteria – or whether it is possible to designate both the liability and the asset that are contractually linked as measured at fair value through profit or loss. For example, if a loan asset, which does not meet any of the other criteria for fair value designation, is contractually linked to a loan liability can both be designated as at fair value through profit or loss, even though the loan asset would normally be measured at amortised cost.

The second last paragraph of the fair value option section of paragraph 9 states as follows 'Equity instruments that do not have a quoted price in an active market and whose fair value cannot be reliably measured shall not be designated as at fair value through profit or loss'. Since the concept of 'verifiability' is associated with this option, we believe that the above reference to 'reliably measured' should be replaced with 'verifiable'. The current wording implies a different threshold of reliability for unquoted equity instruments.

Please contact Mark Vaessen at 020 7694 8089 if you wish to discuss any of the issues raised in this letter.

Yours faithfully

KPMG International

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