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Ms Sandra Thompson
International Accounting Standards Board
30 Cannon Street
London

Dear Ms Thompson

Exposure Draft: The Fair Value Option

The global organisation of Ernst & Young is pleased to submit its comments on the Exposure Draft: ("the ED") *Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement, The Fair Value Option* ("the FV option"). In summary, we do not support the proposals set out in the ED, which we consider to be a retrograde step, in relation to in the move towards the most meaningful accounting framework for financial instruments. We have particular concerns about the introduction of the notions of "verifiability" and "substantially offset", both of which should in our view be rejected by the Board.

Ernst & Young supports the ability 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. As we have stated previously, in our comment letter response to the ED, *Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement* dated 23 October 2002, we view this ability as a solution to various accounting anomalies encountered in a "mixed measurement model" approach, particularly those encountered by entities in the financial services industry.

For example, non-derivative liabilities that are generally regarded as part of a bank's trading book and are managed as such could be accounted for consistently with the associated assets. Similarly, an insurer could legitimately designate part of its portfolio, such as assets related to its linked, variable annuity or "separate account" insurance liabilities, as financial assets held at fair value and account for those assets consistently with the liabilities. The restriction of the FV option would make it far more difficult to obtain the appropriate accounting treatment and its proposals should not be adopted.

The fair value designation would also reduce the administrative burden on companies that would otherwise be required to use fair value hedge accounting for hedges of financial instruments, by allowing the hedged items to be accounted for in the same way as the hedging instrument.

Additionally, since the issue of IAS 39 (Revised 2003), many entities have begun to make enhancements to information technology systems to make use of the FV option. Amendments to the FV option, such as those described in the ED, would result in an undue burden of cost for entities to reverse any system changes already completed without, in our view stated above, a commensurate benefit. We are also concerned that the Board has not fully taken into account the implications for those entities that are planning for early adoption during 2004, or who have already published quarterly information using the revised IAS 39.

The Basis for Conclusions, states that some constituents have argued that the FV option would increase the volatility of an entity's reported earnings. We believe that this is generally not the case and that the FV option will usually be used to *reduce* the amount of volatility. The FV option permits an entity to account for financial instruments that are entered into as a natural hedge (ie, when a financial instrument has been entered into as a natural hedge of another financial asset or financial liability) on a consistent basis. We believe that it is important to present financial information in a manner consistent with the way such financial instruments are managed and that fair value often provides the most useful and relevant measurement for financial instruments.

In Our view the majority of entities will not seek to use the FV option to increase the volatility of their reported earnings, since volatility will normally lead to a reduction in the quoted price of their shares.

We understand that certain constituents are concerned with applying fair value measurement to financial instruments where fair value is not verifiable. Aside from introducing another concept that will require interpretation in addition to that of "observable data," we are perplexed as to why there should be a higher standard for voluntary application of fair value measurement then where its application is mandatory. We believe that the IAS 32 disclosure requirements should help readers understand the extent of use of fair value measurement and that such disclosures could be expanded if necessary to better emphasise where an entity has voluntarily applied fair value in situations where there are less than transparent markets.

We are also concerned that by introducing the concept of "verifiable", the implication is that there are instruments that are *required* to be held at fair value whose fair values are *not* "verifiable". A number in a set of accounts cannot be relevant if not reliable and we believe it is not reliable if not verifiable and hence auditable. Fair value is either reliably measured or it is not. Reliability of measurement and verifiability cannot be mutually exclusive. Consequently, for accounts to be credible there should only be one reliable/verifiable criterion and all financial instruments recorded at fair value, whether by designation or otherwise, should be required to meet it.

We also note that constituents are concerned with the application of fair value measurement to an entity's own financial liabilities, with the consequence of it recording gains when its creditworthiness declines. We understand this concern but believe that it is symptomatic of a larger issue that we believe has yet to be adequately addressed by either the IASB or the FASB. As the IASB is aware, when the JWG first mooted the idea of including own credit risk in the fair valuation of liabilities, this proposal received little support through the consultative process. Consequently, it was generally agreed at the time that this is an issue that required further detailed research. However, this research has yet to be carried out, and we therefore believe that the IASB's proposals in this regard are premature.

We do not believe that an entity should be prohibited from fair valuing its own debt if it has the ability to repurchase this at market value. However, we do not believe an entity should record a gain on its own debt resulting from a deteriorating credit quality when the entity is unlikely to be able to repurchase the debt at the resulting "fair value." As the FASB has issued an ED on fair value measurements, we believe that both the IASB and the FASB should better articulate the concept of fair value and its relevance to the users of financial statements. It is not clear that the price at which two willing third parties trade an entity's debt should be used to measure such debt in the entity's financial statements.

Further, we do not believe that the majority of entities will choose to fair value their own debt unless it contains an embedded derivative or acts as an offset to a natural hedge, as to do so would introduce unwelcome volatility in earnings. The introduction of a requirement that the fair value of an entity's own debt be "verifiable" does not address this concern.

We believe that the ED proposals should be rejected. However, if the concerns about fair valuing an entity's own credit risk are too widely held, rather than accepting the proposals contained in the ED, the Board should, as an interim measure, prohibit the recognition of a gain or loss arising from revaluation of own credit risk on instruments designated as held at fair value through profit or loss until such time as the full implications of this are properly researched. In the meantime, users of financial statements would be better served by the footnote disclosure of the gains/losses attributable to changes in credit spread, rather than including this in the determination of the fair value.

We therefore believe that the ED represents a backward step in the move to the most meaningful accounting framework for financial instruments. We are also worried that such a major change in the principles of IAS 39 is being made, in a hurry, at a late stage, with a potential for significant unintended side effects. For instance, it is not in our opinion appropriate to restrict the FV option without, also, re-examining the definition of "held for trading". We outline some of the unintended consequences in this letter but are concerned that there could be others that would only emerge on the application of the new rules.

Our responses to your detailed questions are included in the appendix to this letter.

Should you wish to discuss any aspect of this letter, please contact David Lindsell on 020 7980 0106 or Anthony Clifford on 020 7951 2250.

Yours faithfully

Ernst & Young

Appendix: 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?

Ernst & Young does not agree with the proposals in the ED, as currently drafted. As noted in our main letter, we supported the FV option when it was first included in IAS 39 (Revised 2003). We continue to do so and therefore believe that the ED should be rescinded in its entirety. As stated in our letter, we do not believe that the voluntary use of the FV option as originally contemplated will usually increase the volatility of an entity's financial statements. It is our understanding that management generally is rewarded for the lack of volatility in reported earnings. The use of the voluntary FV option by management to increase volatility in today's environment is counterintuitive and should not be such a cause for concern as to drive the constraints proposed by the ED.

Second, we do not understand why the use of less than transparent fair values should be limited to financial instruments where FV measurement is mandatory as opposed to optional. In many cases, an entity may want to apply the FV option in a situation where the instrument in question is a natural FV offset to an instrument that is *required to* be measured at fair value but whose fair value is not "verifiable".

Finally, while we believe that concern over recording fair value gains and losses on an entity's own debt due to creditworthiness changes is valid, we believe that the issue would be better addressed by prohibiting the recognition of gain or loss due to changes in fair value where designated as held at fair value through profit or loss. This would most easily be achieved by excluding the effect of revaluing the credit risk from the fair value of the instrument, and so recording debt at an adjusted fair value.

As well as disagreeing with the proposal restrictions on the FV option, we have majorconcerns about the introduction of new qualitative terms in the ED, in particular the term "substantially offset" and the requirement for fair value to be "verifiable". Both of these should be addressed by the IASB.

Substantially offset

The ED proposals permit the use of the FV option when the "exposures to changes in the fair value of the financial asset or financial liability (or portfolio of financial assets or financial liabilities) is substantially offset by the exposure to changes in the fair value of another financial asset or financial liability (or portfolio of financial assets or financial liabilities), including a derivative (or portfolio of derivatives)".

The term "substantially offset" is not further defined or clarified within the ED and is not necessarily used in the English language as a measure of relative size in the same way as "the majority" or "partially". "Substantial" is often used to convey a sense of absolute as much as relative size so that (for instance) a contribution to a charity can be "substantial" without being a large proportion of the donations given. Hence, "substantially offset" could just mean that there is an offset that is large and important, even if less than, say, 25%. It is not clear if the Board intended that the term be applied in this manner.

The basis for conclusions to the ED indicates that the Board believes "substantially offset" to be a lower threshold than that required for hedge accounting, where "highly effective" is defined as between 80% and 125%. However, the ED does not provide any guidance on how this concept should be applied in practice and in the absence of such guidance there exists the possibility of inconsistent application.

We consider that the term "substantially offset" should be replaced by a term which conveys more precisely what the Board had in mind: such as "majority" or "to a significant degree". Whatever term is used, it is likely that there will also need to be guidance to help explain how it should be applied. However, we believe that this is not the best route to follow – see "Alternative Approach" below.

Alternative approach

The current definition of held for trading is based on a financial asset or liability being designated at inception as acquired principally for the purpose of selling or repurchasing it in the near term. However, this does not reflect the way in which many entities manage their business. For example, financial institutions' trading books include derivative and non-derivative instruments, which are held for arbitrage and risk management purposes. The risk management strategy is a dynamic process and will include instruments held for both short-term and longer-term periods.

The definition does not especially matter if the FV option is available, but it will matter if the ED proposals are adopted. The definition should be altered to be closer to how financial instruments are used and managed, in practice. We believe the definition should include any item that forms part of a portfolio that is actively managed on a fair value or similar basis. However, it would be inappropriate to change a key definition without exposing the change in an ED. A sensible result will most easily be achieved if the FV option is made available for any item held in this manner. One possibility would be to include this as *the* criterion for the FV option (and remove the five criteria set out in the ED), but the easiest change would be to make it a sixth category to which the FV option can be applied.

In general, since the FV option has to be applied at inception it is not possible to "cherry pick" so that profits can somehow be "created". However, we recognise concerns that there could be selection of the instruments to be classified as held at fair value upon first-time adoption of IAS 39. To avoid this, the criterion would need to be worded so that the FV option would only be applied to situations where the entity has actively managed the instrument on a fair value basis *since inception*.

Verifiable

The ED would permit the use of the FV option only when the fair value of the financial instrument is "verifiable". The ED proposes an amendment to IAS 39, paragraph 48B, to indicate that fair value is verifiable only if the variability in the range of reasonable fair value estimates is low. Additionally, the Basis for Conclusions indicates that the Board believes that "verifiable" is a stricter test than "reliably measured" and that this would be met if several independent and knowledgeable observers were to estimate the fair value of a particular instrument in accordance with IAS 39, and would all arrive at approximately the same amount.

As a result, the ED creates a second regime for fair value measurement, as financial instruments held for trading or available-for-sale are not required to meet the "verifiable" criteria to be carried at fair value. The only restriction for such items is for unquoted equities and associated derivatives, where the item may not be held at fair value if the fair value cannot be measured reliably.

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We believe there should exist one fair value measurement regime and that this should be applied to measurement of all financial instruments including those where the FV option is used. First, it would be inappropriate for the same financial instrument to be subject to two different measurement regimes depending on its classification as held for trading/available for sale or held at fair value through profit or loss. Second, we are concerned that the existing reliable measurement constraint is only deemed to be applicable to unquoted equities because the same principle should, in theory, be equally applicable to any other financial instrument including certain debt instruments and embedded derivatives. It may be more appropriate to broaden this rule for all financial instruments rather than institute a new rule for items under the FV option, as we believe that fair value can either be reliably measured or it cannot. Third, if fair value is not "verifiable" then arguably it is not "auditable". We believe that the fair value of all financial instruments should meet a single test of reliability and verifiability if recognised in the accounts.

One of the difficulties with the "verifiable" constraint is illustrated by the anomaly in the ED, as drafted, that it will frequently not be possible to treat, as verifiable, the fair value of an instrument containing an embedded derivative, because of the difficulty in valuing the embedded derivative itself. However, IAS 39 *requires* the embedded derivative to be recorded at fair value. Paragraph 12 of IAS 39 goes on to state that if the embedded derivative cannot be measured separately then the entire instrument must be treated as held for trading, in a direct contradiction of the ED's proposals.

At the very least, the ED needs to be amended to make it clear that the verifiability criterion only needs to be applied to the host instrument, otherwise there will be a conflict in the Standard. More generally, we believe that the majority of instruments to which entities will wish to apply the FV option will be easier to value than many of the embedded derivatives that they are currently required to fair value.

BC 25 explains that the verifiable concept has been borrowed from US usage, but in our view the FASB definition of the term would not result in a stricter test than the concept of reliability.

Additionally, we are concerned that the ED only permits the fair value designation to be made at inception, which does not consider that in developing markets the level of verifiability may develop over a period of time.

In our response of 22 June 2001 to the JWG, we did not support the concept that the fair value of financial liabilities should include movements in own credit spread, except in the trading book. This is not because we believe the credit component is not verifiable, but because we do not believe that a profit should be recorded unless it is capable of being *realised,* which may often not be the case (for instance) if an entity's debt declines in value due to financial difficulties. As stated previously, we believe that the IASB should endeavor to better define the concept of fair value and to whom it is relevant. While we believe that fair value as determined by changing credit spreads may be relevant to an investor/trader of an entity's financial liabilities, we question its relevance to the users of the entity's financial statements.
We do not believe verifiability is the real issue of concern when determining the fair value of an entity's own financial liabilities, rather it is the practical ability to realise the mark-to-market profit. Introducing a verifiability test does not remove this problem. We would support the introduction of a new principle that profit should only be recognised where the entity has the practical ability to realise it, but not the inclusion of a new concept of verifiability.

In summary, we believe that the "verifiable" requirement should be rejected,

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?

Substantially offset

We have set out a number of practical issues with the ED's proposals in response to question 1, above. One of the problems of giving further examples is that (as already set out) the concept of "substantially offset" is too vague.

Take an example where an entity makes a loan of 100 and chooses to hedge this with a derivative of a notional value of 50. Has the risk been "substantially offset"? The offset is relatively substantial. Assuming that the Board clarifies the concept to mean that, for example, the majority of the risk must be offset, would it be possible for an entity to hedge 51% of the risks at inception and then to unwind 1% of the hedge the day after?

Also, if an asset has a longer term than the hedging instrument, it is possible that it may meet the "substantially offset" criterion at the outset, so that the asset might be held at fair value. But is it still possible to hold the asset at fair value if there is no offsetting exposure at all, once the hedge matures?

One of the problems highlighted by the above examples is that an entity that tries to adopt an inappropriate accounting treatment will probably do so however the Standard is worded. The underlying problem identified by the regulators is probably one of potential accounting abuse rather than the wording of the Standard. The correct solution is strong corporate governance rather than the introduction of new "rules" into IAS 39.

Subsequent offset

Conversely, there are situations in which an entity may purchase a financial asset and hedge the risk associated with this asset only at a subsequent date (such as the following day). In this instance, the "substantially offset" criterion will not be met at inception and the entity would not be able to account for the financial asset at fair value through profit or loss, even if the entity intends to manage the asset on a fair value basis. An example of the latter problem is where a bank purchases loans or other assets over a period of time (up to a year) with the intention of securitising them. While the portfolio is being assembled, the bank will normally manage it on a fair value basis, perhaps using derivatives to hedge interest rate or credit exposure. Eventually the assets will be sold to an SPE that issues bonds. While it is possible that the loans will be hedged, the decision whether to hedge or not will normally be a trading decision and they may only be hedged subsequent to their purchase.

Alternatively, bonds may be issued by an SPE, which purchases government bonds as collateral, and the bank enters into a credit default swap with the SPE referenced on certain loan assets. Yet the loan assets need not be acquired immediately and the bank may take months fully to hedge the bonds issued by the SPE.

In each of these cases, the FV option is needed to enable the transaction to be accounted for meaningfully, but the ED seems to prohibit its use, since the loans, or the bonds, are not "substantially offset" at the outset.

Embedded derivatives
Again, as set out above, the verifiability concept will appear to preclude many investments from being fair valued just because of an embedded derivative that would, otherwise, be required to be fair valued. Take for example credit-linked notes. These typically have embedded put options, which are usually unique and their values derived from complex models. The inputs to such models are not normally "observable" or "verifiable," yet, if the options meet the definition of embedded derivatives that must be separated from the host contract, an entity must ascribe fair value to the put options and separate them from the notes at inception and account for them at fair value thereafter. However, as a result of the restrictions contained in the ED, an entity would be unable to fair value the entire credit-linked note, simply because it contained a put option whose fair value would not be verifiable.

Venture capital investments
IAS 28 does not apply to investments in associates held by: (a) venture capital entities, or (b) mutual funds and similar entities, that upon initial recognition are designated as at fair value through profit or loss and measured at fair value in accordance with IAS 39. However, frequently the valuation of these instruments will not meet the "verifiable" criterion. Does this mean that they will have to be accounted for on an equity basis? We do not believe that it was the Board's intention, or should have been its intention, to prohibit such investments from being fair valued, but this will be the case if the ED proposals are incorporated into IAS 39. Assuming the Board does not rescind the ED altogether, there either needs to be a scope exemption for venture capital and similar investments, or (better) the verifiability criterion should be removed.

Money market books
Financial institutions may maintain money market books that are actively traded rather than used for liquidity management. While the financial assets in such books may meet the definition of a trading asset, the naturally offsetting financial liabilities are not normally eligible for trading classification and must be accounted for at amortised cost. The fair value option would permit an entity to account for financial liabilities that are entered into as a natural hedge on a consistent basis. The proposals in the ED would eliminate the ability to report the money market liabilities at fair value through profit or loss.

Insurance offsets
Certain insurers may hold unlisted securities to offset insurance liabilities, which, while not carried at fair value may move in value with market changes. However the unlisted securities are unlikely to meet the verifiability criteria.

Under IFRS 4, an entity is allowed to change the value of a liability if the fair value of the asset it is linked to has changed. Therefore, if an asset is not designated to be held at fair value at inception, there will be no need to adjust the value of the corresponding liability. However, if the entity's existing insurance accounting model requires the liability to be adjusted for changes in fair value, the ability of an entity to designate the corresponding financial asset and achieve the natural offset will be precluded.

QUESTION 3
Do the proposals contained in the 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?

We do not accept the premise that the concerns set out in paragraph BC9 justify limiting the use of the fair value option and we therefore believe that the ED should be rescinded in its entirety. If the Board nevertheless proceeds to limit the FV option, then we do not believe that it should be limited any further than as proposed in the ED.

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 of 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 believe that the ED should be rescinded in its entirety. However, if use of the fair value option is nevertheless to be limited we support the proposal to permit all financial instruments that contain an embedded derivative to qualify for the FV option. A cap or floor, or an exotic interest formula in a bond, for instance, will often meet the requirements to be closely related, but nevertheless are features which may need to be hedged or could act as a hedge of another financial instrument. This is achieved through the application of the FV option, but may not be possible if the embedded derivative category is limited to where they are not closely related. Also, separation of an embedded derivative from a structured instrument and its measurement can be highly subjective and difficult. Additionally, the issuer and investor often manage a structured instrument in its entirety, not based on the components, and fair value measurement provides a meaningful presentation for this type of instrument, in a manner consistent with the way the entity manages its risk.

However, we do believe that the embedded derivative should have economic substance. For example, according to the ED, a floating rate debt instrument could be issued with a cap of 100% or a floor of 0.001% and could be fair valued. Any number of exotic deeply out of the money derivatives could be devised and embedded in financial instruments to allow them to be fair valued. Therefore, if the ED is adopted in its present form, the guidance should be revised to state that any embedded derivative identified solely to enable an entity to use the FV option and which has no likelihood of ever having commercial effect, has no substance and therefore the entire instrument would not qualify for the FV option.

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 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?

We understand that it is intended to include the transition provisions set out in the ED within IAS 39, whether or not the other components of the ED are accepted.
We believe that the transition provisions are appropriate, since they:

i) will reduce the administrative burden for entities that are required to adjust their accounting treatment; and

ii) will retain consistency of treatment, where gains or losses on financial instruments that were previously held at fair value through profit or loss were previously offset by gains or losses on other financial instruments required to be held at fair value and which provided a natural hedge.

QUESTION 6
Do you have any other comments on the proposals?

1. **Entities subject to prudential supervision**
We understand the concerns of the regulators as discussed in the Basis for Conclusions, but financial reporting has never been intended as a basis for calculating regulatory capital. We would expect the prudential supervisors and other regulators to make adjustments to the financial reporting results where necessary, in order to determine regulatory capital or to measure performance. We do not believe that it is appropriate for prudential supervisors to have oversight of the application of accounting requirements, as set in paragraph 9 of the ED. This could lead to different solutions, depending on the regulator, and would not be conducive to comparable financial reporting.

2. **Paragraph 50**
While revising the FV option, the Board also needs to re-examine the wording of paragraph 50 of IAS 39. This allows no reclassification of a financial instrument into or out of the fair value through profit and loss category while it is held or issued. Since

the category includes items that are held for trading, this appears to mean that a financial instrument can never be reclassified as held for trading subsequent to its initial recognition. This has two consequences:

a) in the previous version of IAS 39 a loan or receivable (for instance) was *required* to be designated as held for trading if it became part of a portfolio of instruments which are managed together and for which there is evidence of short-term profit-taking. This appears no longer to be the case and we do not believe this to be an appropriate change; and

b) absurdly, according to paragraph 50 it is not possible to designate a derivate as a hedge after it is first held but, subsequently, not possible to remove the designation!