ISDA®

International Swaps and Derivatives Association, Inc.
One New Change
London EC4M 9QQ
United Kingdom
Telephone: 44 (20) 7330 3550
Facsimile: 44 (20) 7330 3555
email: isdaeurope@isda.org
website: www.isda.org

Peter Martin, CA
Director,
Accounting Standards
Canadian Accounting Standards Board
277 Wellington Street West
Toronto, Ontario
M5V 3H2, Canada
Telephone: +1 (416) 204-3276
Fax: +1 416 204 3412
ed.accounting@cica.ca

19th May, 2006

DISCUSSION PAPER - Measurement Bases for Financial Accounting – Measurement on Initial Recognition

Dear Mr Martin,

ISDA appreciates this opportunity to comment on the Discussion Paper entitled "Measurement Bases for Financial Accounting – Measurement on Initial Recognition" (the "Discussion Paper") prepared by staff of the Canadian Accounting Standards Board" (the "AcSB" or the "Board").

Our members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such we believe ISDA brings a unique and broad perspective to the IASB's work on accounting for financial instruments. We have therefore focused our response on those aspects of the Discussion Paper that would affect financial instrument accounting.

General observations

ISDA is supportive of the AcSB's project to undertake a preliminary investigation of measurement bases for financial accounting, exploring the objectives and alternative measurement bases for assets and liabilities. Furthermore, we welcome the IASB's willingness to work with existing national standard setters, and view the vast network of interested national accounting bodies as a valuable resource for the IASB to tap. However, we would ask the IASB to clarify how this project fits into its broader work on the conceptual framework and fair value measurement, with particular regard to the anticipated IASB Exposure Draft on the FASB Fair Value Measurement Standard.

We are also concerned with the approach that the AcSB has taken in this project. The AcSB is looking at this project in two phases, with the initial Discussion Paper focusing on the different measurement bases on initial measurement and a future Discussion Paper that will focus on subsequent measurement. In our opinion any discussion on the possible measurement bases for financial accounting should consider both initial and subsequent measurement concurrently as the subsequent measurement of a financial instrument may impact the treatment on initial measurement. Take, for example, a financial asset that is initially measured at the end of day price at fair value and the transaction results in an initial gain for the entity. If you conclude that, on subsequent measurement, this financial asset must be recorded at amortised cost then on day 2 this gain would immediately have to be reversed from the profit or loss account. We are unclear as to what useful information this would provide to a user of the financial statements. It is also worth noting that the point at which initial measurement ends is often the subject of much discussion and will therefore impact when the subsequent measurement of the financial instrument begins. If the AcSB continues to consider initial and subsequent measurement in isolation then it will be important that decisions made on initial measurement are tentative conclusions that are reviewed as the proposals on subsequent measurement are developed.

The Discussion Paper proposes that the measurement objective on initial recognition is fair value or the best estimate of fair value. ISDA supports this notion in many circumstances and has actively encouraged other standard setters to provide entities with the option to fair value where a financial instrument is managed on a fair value basis so that the financial statements better reflect the risks being taken. However, having reviewed the contents of the Discussion Paper, we do not believe that it contains persuasive arguments for full fair value on initial measurement for all financial instruments in all circumstances and would ask the Board to provide further information to support their conclusion.

We have therefore focused the remainder of our comments on the guidance in the paper on how, rather than when, an organisation should fair value a financial asset or liability. We would encourage the AcSB to consider our comments as they continue to develop the proposals in the Discussion Paper.

Fair value – measurement objectives

ISDA does not agree with the concept outlined in the Discussion Paper that market value measurement has important qualities that always make it superior to an entity specific measure. In practice, the fair value of financial instruments requires careful application of judgement to ascertain the assumptions and estimates in determining the most appropriate fair value. There are many situations where our member firms will use a valuation model rather than a third party market valuation to estimate the fair value of a financial instrument and manage the risks taken. These valuation models will have gone through a rigorous testing and approval process and will undergo daily risk and control procedures and are thus considered by the market to be a reliable, consistent and robust method for determining the fair value of an individual or portfolio of financial instruments.

It is also important to emphasise that markets are not perfect and it will often be the case that quoted bid and offer prices may not represent the most reliable evidence of the fair value of the instrument to the entity. Even in a liquid market, the bid and offer prices will merely indicate a range at which a financial instrument will trade. Take for example an over-the-counter equity option that is referenced on a basket of names. Whilst a dealer may provide a bid to offer spread, they will often trade within the range depending on the counterparty and the current risk positions held in their portfolio.

We are further concerned that the Discussion Paper comments that there may only be one fair value for a financial instrument on initial recognition. In particular, the paper states that it seems “fundamentally inconsistent with the premises of open market competition to expect that individual items could be bought and sold in different markets at different prices at the same time” and thus there is a “priori expectation” that there can be only one market fair value for an asset or liability on initial measurement. ISDA would not agree with this statement as we consider there are many situations where different investors will have access to different markets. For example, financial institutions buying and selling derivative positions will be able to operate in both the wholesale and retail derivatives markets and therefore we believe it is important that these institutions are able to price their positions in the most advantageous market to which they have access. We are pleased to see that the paper goes on to suggest that research by other accounting standard setters has demonstrated that multiple markets can exist for some assets and liabilities which are not related to value-effecting or entity specific differences and that it is proposed that further in-depth study is carried out in this area. ISDA would be pleased to support the AcSB with this work.

Unit of account

ISDA does not fully support the definition of unit of account in the Discussion Paper as we do not believe that the appropriate unit of account on initial recognition is generally the unit of account in which the reporting entity acquires an asset or incurs a liability. In assessing the appropriate unit of account for OTC derivatives, ISDA members will not consider the asset acquired or liability incurred in isolation, but rather consider the impact they have on the financial instruments currently held in their portfolios. Take a situation where a dealer has a large portfolio of interest rate swaps. As a fundamental principle, dealers manage the underlying risks of transactions on a portfolio basis, with some of the risks naturally offsetting each other. For example, assume the dealer has executed a one year, 2 million notional pay 5%, receive LIBOR interest rate swap with a counterparty and a two year, 2 million notional receive 5%, pay LIBOR interest rate swap with another counterparty. The dealer does not have an open interest rate position in year one but does have an open 2 million notional interest rate position in year two. To offset the interest rate position in year two, the dealer may decide to enter into a further transaction to reduce the open risk. In this situation, it would be important for the dealer to consider and agree the price of this new transaction in the context of the entire portfolio. The conceptual basis for determining fair value on the net portfolio is that this accurately aligns to the way a market place participant would price and manage risk. We would therefore encourage the authors to review the unit of account definition provided in the paper, with a view to better reflecting how portfolios of financial instruments are managed on a day to day basis.

Fair value hierarchy

ISDA does not support the proposed fair value hierarchy on initial recognition. The Discussion Paper currently proposes a four level hierarchy with Levels 1 and 2 defined as “estimates of fair values” and Levels 3 and 4 defined as “substitutes for fair values”. As noted above we are concerned that the proposals suggest that entity-derived fair values are always inferior to market fair values and should be used only as a last resort We would also stress that we do not consider entity fair values to be “substitutes’ for fair value. In practice, fair values estimated using a model with entity-specific information are often better estimates of actual amounts that would be received or paid to exit the risk position. In our view, what is most important is that an entity should determine and measure the financial instrument or portfolio of instruments, at its best estimate of the fair value using the most appropriate valuation inputs. Therefore, rather than provide a strict fair value hierarchy, the proposals should require that appropriate qualitative information be provided in the financial statements to enable a user to understand and assess the different basis used by an entity to estimate the fair value of its financial assets and liabilities. This may include additional disclosure where the fair values of the financial instruments have been determined using a model with significant entity specific inputs.

Transaction costs

The paper defines transaction costs as incremental costs that are directly attributable to the acquisition, issue or disposal of an asset or liability. In general, we agree with the definition of transaction costs and to the extent that transaction costs are not recoverable would concur that they should not be included in the definition of fair value. However, there are many situations, such as adjusting for transportation costs to access a particular reference market, where transaction costs will be an essential part of determining the fair value of the financial instrument. We therefore would encourage the AcSB to refine the definition of transaction costs to ensure entities are allowed to adjust or capitalise transaction costs where they are considered to be an intrinsic part of the value of the asset or liability and therefore more accurately reflect the underlying economics of the transaction.

It is also important to emphasise that there are different ways that a dealer may charge a counterparty to execute a transaction. In some markets the bid to offer spread for a financial instrument represents or includes the dealers profit margin and no further commission is payable whereas in other markets dealers may explicitly charge a commission. In a trading environment the objective is to profit from short term changes in market prices after taking into account transaction costs and the market convention is to adjust the fair value of a portfolio of the financial instruments to reflect the cost to close the underlying risk positions. ISDA believes that it is important for transaction costs to be treated consistently regardless of market convention and would encourage this to be factored into the AcSB's work.

We would be pleased to discuss our comments with the Board or staff. Please feel free to contact either Melissa Allen at Credit Suisse or Ed Duncan at ISDA.

Yours sincerely

Melissa Allen

Melissa Allen
Chair of the ISDA European Accounting Committee
Credit Suisse

Ed Duncan
Director
ISDA

cc.
Sir David Tweedie