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PROPOSED AMENDMENTS TO IAS 39:
TRANSITION AND INITIAL RECOGNITION OF
FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Memorandum of comment submitted in September 2004 to the International Accounting Standards Board in respect of the Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement - Transition and Initial Recognition of Financial Assets and Financial Liabilities**,** *published in July 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 - Transition and Initial Recognition of Financial Assets and Financial Liabilities,* published by the International Accounting Standards Board in July 2004.

2. We have reviewed the Exposure Draft and set out below a number of comments. We set out first our overall response to the Exposure Draft, and then respond to the specific questions it raises.

OVERALL RESPONSE

3. We welcome the Board's decision to address the concerns of constituents set out in paragraph 5 of the Background. However, we do not support the specification of a date for prospective application that is only relevant for SEC registrants. We recommend that the date should be set by reference to the appropriate transition dates for entities adopting IFRS, and, in particular, IAS 39, but allowing for use of an earlier date. Such a formula is already found in IFRS 1 in respect of the transition requirements for derecognition of financial assets and financial liabilities. We expand on this further in paragraphs 6 to 8 below.

4. We support the inclusion of material to assist preparers understand when a so called 'day 1' profit can be recognised in profit or loss in subsequent periods. However, the material in the Exposure Draft is unclear and ambiguous and is thus not helpful. Unless the ambiguity is resolved, the material adds to, rather than removes, the present confusion. In the appendix to this memorandum of comment, we have provided an example of how we believe the proposals in the Exposure Draft may be interpreted. However, our example may serve to illustrate that this is not the way the IASB intends 'day 1' profit to be recognised in subsequent periods and thus demonstrates that the final amendment to IAS 39 needs to be much clearer on how it is intended to work.

5. We understand that predominant current US practice is straight-line amortisation of 'day 1' profit, in the absence of a definitive statement in US GAAP. To ensure that there is conformity on this issue between IFRS and US GAAP, we suggest that the IASB should work with the US standard setter to find a common solution.

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?

6. We do not agree with the proposed date of 25 October 2002 from which an entity may prospectively apply the requirements of the last sentence of paragraph AG76. We do not agree in principle that the date should be chosen solely on the basis of its relevance to SEC registrants. We note further that the US Emerging Issues Task Force finalised EITF 02/03 on 21 November 2002, and this is the date (not 25

October) from which entities complying with US GAAP applied the guidance prospectively to new transactions.

7. We suggest that the requirements should be similar to those in paragraphs 27 and 27A of IFRS 1 in respect of the derecognition of financial assets and financial liabilities. This would mean that the requirements of the last sentence of paragraph AG76 would be applied prospectively to transactions entered into on or after I January 2005 (for those using the exemption in IFRS1.36A from restating comparatives), or from 1 January 2004 (for those not using the IFRS1.36A exemption) or from an earlier date of an entity's choosing. This would mean that entities that are not SEC registrants would not have to revisit transactions prior to their relevant transition date for IAS 39, with the attendant problems of observability of data. However, it would allow, for example, SEC registrants to use the date on which they adopted EITF 02/03.

8. We recommend that the consequential amendments to IFRS 1 should be inserted as additions to paragraphs 26 and 27 rather than as paragraphs 13(j) and 25E as these would seem to be the more logical positions. We note that there is no proposed amendment to the Implementation Guidance to IFRS 1 and presume that this is an oversight. If our recommendation is accepted, it would minimise the change necessary to paragraph IG52 and would facilitate the placement of a new paragraph to cover this issue under the heading of 'Recognition' above paragraph IG53.

Question 2
Do the proposals contained in this Exposure Draft appropriately address the concerns set out in paragraph 5 of the Background on this Exposure Draft? If not, why not and how would you address those concerns?

9. Please see our answers in paragraphs 6 and 7 above.

Question 3
Do you have any other comments on the proposals?

10. We agree that there is a need to clear away the confusion about how any gain (or loss) not recognised on 'day 1' should be recognised subsequently, and particularly to clarify that the entire gain (or loss) may not be recognised on 'day 2'. However, the phrase 'a change in a factor (including time) that market participants would consider in setting a price' in the last sentence of proposed paragraph AG76 could be interpreted as allowing amortisation on a straight-line basis, even in the absence of observable transaction data to support this treatment.

11. If it is the IASB's expressed intention that 'day 1' profit can be recognised on a straight-line amortisation basis, then the revised standard should be clear on this. Equally, if this is not the intention, then the revised standard should be precise that straight-line amortisation should be used only in respect of the elements of 'day 1' profit that can be shown to decay proportionately with time.

12. We note that an interpretation that allows straight-line amortisation of a 'day 1' profit would align with what we understand is predominant current US practice, in the absence of a definitive statement in US GAAP. Although the practice may not accord with finding observable data or economic reality, straight-line amortisation provides a

systematic and rational basis that in many cases provides an acceptable proxy and also has the benefit of a pragmatic approach to suppressing earnings manipulation that might arise through selective choices of what transaction data is available or the quality or source of such data. We suggest that the Board should work with the US standard setter in finding a common solution.

13. We have provided in the appendix to this memorandum of comment, an example of how we believe the proposals in the Exposure Draft may be interpreted. However, our example may serve to illustrate that this is not the way that the IASB intends 'day 1' profit to be recognised in subsequent periods and this demonstrates that the final amendment to IAS 39 needs to be much clearer on how it is intended to work. The inclusion of a worked example in the Implementation Guidance is, we believe, fundamental to giving the required clarity.

DW\8 October 2004

APPENDIX

1. We believe that there are strong grounds for the IASB to add an illustrative example in the Implementation Guidance on the manner of the recognition of 'day 1' profits in subsequent periods profit or loss: the so-called 'day 2' issue.

2. This is an issue particularly for corporates that are confused about what 'day 2' profit/loss recognition means for them for the derivatives that they have bought from banks. Some banks are also wondering how it applies to them in practice. We outline below an example of how we believe the proposals in the Exposure Draft should be interpreted, if we have understood the intentions behind the proposed paragraph AG76A. The example is constructed to show the outcome from the point of view of a bank and a corporate.

3. It is possible to interpret the proposed paragraphs AG76 and AG76A to mean that gains and losses are recognised after initial recognition only to the extent that they arise from a change in factor (including time) that market participants would consider in setting a price. Market participants have to use a valuation technique that incorporates all factors that market participants would consider in setting a price and which is consistent with accepted economic methodologies. Such an interpretation suggests that the proposals do not require all fair value movements after initial recognition to be deferred until they are measured using observable data only. Rather, if on initial measurement a day 1 profit/loss has to be deferred because it is not based on observable data or recent market transactions it can only subsequently be recognised as a result of changes in its valuation (e.g. due to the passage of time) or when it is measured entirely on observable data.

Example

Bank B sells derivative option X to Corporate A for £100 at arms length. X is a complex derivative which has been specifically tailored for the requirements of Corporate A for which there are no recent market transactions and which has not been valued by Bank B based solely on observable market data. Bank B has used its valuation model to value X. The valuation model used by Bank B consists of only two inputs into the valuation model. Bank B sets the price for Corporate A by adding a profit margin to the price derived from the valuation model. The two inputs for the valuation model are:

(a) £/$ foreign exchange rates observable in the market; and

(b) the volatility in the stock price of another entity which is currently not observable in the market.

The initial valuation of derivative X from the model used by Bank B is £80 to which it adds its initial profit margin of £20.

Initial recognition

Initial recognition by Bank B:

Bank B cannot recognise the £20 profit on initial recognition because it is not evidenced either by recent market transactions or only data from observable markets because the stock volatility is not observable. Bank B therefore has to record X at the transaction price with no 'day 1' profit and records:

Dr cash 100
Cr fair value of trading derivative 100

Initial recognition by Corporate A:

Corporate A recognises derivative X at the transaction price, being the best evidence from its point of view of the fair value of the arm's length transaction:

Dr fair value of trading derivative 100
Cr cash 100

Six months later

Six months later Bank B recalculates the price of the derivative that it would charge Corporate A by using the same valuation model to value X and it arrives at a price of £90 that consists of a valuation from the model of £75 and a profit margin of £15. The overall change in the price of £10 is due to:

(a) £/$ foreign exchange rates observable in the market = loss of £7

(b) the volatility in the stock price of another entity which is still currently not observable in the market = gain of £2

(c) due to the passage of time, Bank B would only charge a profit margin of £15 six months later. Bank B believes that between transaction date and maturity of the derivative its initial profit margin of £20 is earned straight-line over the life of the product as, in accordance with IAS 18, it earns the profit margin over the life of the provision of services; the service being provided to Corporate A is risk mitigation over the life of the derivative. Derivative X has a two year maturity and therefore in six months Bank B has earned £5 = (£20/2)x0.5 = £5 in an amortised cost model. (Bank B can not use the fair value model because the profit is not yet based solely on observable market data).

6 month later recognition by Bank B:

Bank B can therefore show that the change in value of £10 arises from changes in factors that market participants would consider in setting a price (i.e. foreign exchange rates, volatility estimates and the passage of time) and therefore it recognises a profit of £10 in the six month period:

Dr fair value of trading derivative £10
Cr P&L £10

6 month later recognition by Corporate A:

Corporate A is told by Bank B that if it wanted to buy derivative X today, six months, it would cost it £90. Corporate A therefore records:

Dr P&L £10
Cr fair value of trading derivative £10

A year later

A year later, Bank B uses the same valuation model to value derivative X and values it at a price of £65 that consists of a valuation from the model of £55 and a profit margin of £10. The overall change in the price of £25 in the last six months is due to:

(a) £/$ foreign exchange rates observable in the market = loss of £10

(b) the volatility in the stock price of another entity which is now observable in the market = loss of £10

(c) due to the passage of time Bank B would only charge a profit margin of £10 a year later. Bank B believes that between transaction date and maturity of the derivative its initial profit margin is earned straight-line over the life of the product as in accordance with IAS 18, it earns the profit margin over the life of the provision of services; the service being provided to Corporate A is risk mitigation over the life of the derivative. Derivative X has a two year maturity and therefore in this second six month period Bank B has earned £5 = (£20/2)x0.5 = £5

A year later recognition by Bank B:

Bank B can therefore show that the change in value of £25 arises from changes in factors that market participants would consider in setting a price (i.e. foreign exchange rates, volatility estimates and the passage of time) and in addition the deferred locked in profit of £10 in the valuation model is now based solely on observable market data because both the foreign exchange rates and the volatility are now observable in the market and therefore it will also recognise the £10 profit embedded in X and move back into a full fair value model. Bank B records:

Dr fair value of trading derivative £25
Cr P&L £25
Dr fair value of trading derivative £10
Cr P&L £10

Bank B will now be holding the derivative on balance sheet at its fair value of £55 and therefore on a cumulative basis it has recorded a credit of £45 in the P&L.

A year later recognition by Corporate A:

Corporate A is told by Bank B that if it wanted to buy derivative X today, a year later, it would cost them £65. Corporate A therefore records:

Dr P&L £25
Cr fair value of trading derivative £25

4. To re-emphasise our comments in paragraphs 4 and 13 above, and as this illustrative example shows, the IASB needs to clarify exactly what the subsequent recognition criteria are. We believe that the intention is that the trader's initial profit margin built into the price should be amortised on a straight-line basis over the life of the derivative, until it is valued solely using observable market data or based on recent market transactions. This would confirm that corporates and banks still have to book the underlying fair value movements in their derivatives, and that it is only excess profit margins for traders that need to be observable before they can be fully recognised. Otherwise, a corporate might try to defer 'day 2 losses' on derivatives on the basis that they are not observable.