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Contact Mark Vaessen
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Dear Sandra

Exposure draft of proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement – Transition and Initial Recognition of Financial Assets and Financial Liabilities*

We appreciate the opportunity to respond to the International Accounting Standards Board's exposure draft of its proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement – Transition and Initial Recognition of Financial Assets and Financial Liabilities*. This letter expresses the views of KPMG International[1].

We welcome the Board's decision to address the concerns of constituents as set out in paragraph 5 of the Background of the Exposure Draft. We support the objective of the proposal to allow entities that report under both IFRS and US GAAP to avoid complex and on-going reconciliation differences. However, we do not believe that the objective is achieved in all respects for the reasons set out below.

Specifically, for convergence, we believe proposed paragraph 107A should apply only to <u>derivative</u> transactions and that, for the reasons set out below, the accommodation should apply to transactions entered into on or after 21 November 2002. In addition, we believe the amendments should clarify, in respect of 'day 2' what is intended by the term 'including time' in paragraph AG76A. One interpretation is that this would permit the release of 'day 1 profit or loss' on a time proportionate basis irrespective of whether additional factors have become observable.

[1] KPMG International is a Swiss cooperative that provides no client services. All professional services are performed by its member firms. As used herein, "KPMG" refers to KPMG International and/or its member firms, as appropriate.

We note that our recommendations do not achieve full convergence with US GAAP in this particular area. However, we consider this acceptable in order to achieve a pragmatic solution on this issue. We suggest that the Board should work closely with the US Standard setters in finding a common solution to the problem and to avoid further divergence, including divergence resulting from deviating transitional requirements.

Question 1

Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

a) Convergence with US GAAP and transitional provisions

We understand that the intention of permitting prospective application of the 'day 1' gain or loss requirements in the last sentence of paragraph AG 76 of IAS 39 to transactions entered into after 25 October 2002 is to enable entities to eliminate any differences with US GAAP in order to allow entities to adopt a transition date that would mirror the effective date of EITF Issue 02-3 *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*. In particular, BC 11 of the Exposure Draft indicates that permitting prospective application of the 'day 1' gain or loss recognition requirements in paragraph AG 76 of IAS 39 to transactions entered into after 25 October 2002 would enable entities to eliminate any difference with US GAAP on the basis that EITF 02-03 requires prospective application from 25 October 2002. This would be especially relevant to entities that also prepare US GAAP financial information.

Assuming that the Board's intention is to introduce transition rules that mirror US-GAAP requirements, we believe that the desired intention is not achieved. By choosing the date 25 October 2002, IFRS will not have the same transition as EITF Issue 02-3. That date represents the date when the EITF reached its consensus to rescind EITF Issue 98-10. However the "transition date" (actually two separate dates depending on the type of transaction involved) relating to recognition of unrealized gains and losses at inception of a contract differs as follows:

- The FASB staff expressed a view regarding determination of fair value in respect of *energy trading contracts* in June 2002. The June 2002 FASB staff guidance should have been applied prospectively to all energy trading contracts originated after 20 June 2002 but did not apply to other derivative instruments.
- The FASB staff issued an observation on 21 November 2002 as part of the revised minutes of the October 2002 EITF meeting (refer to footnote 3 to EITF Issue 02-3) that applied prospectively to *all derivative transactions* entered into after that date.

Although these dates are not specifically noted in the EITF Abstract of Issue 02-3, we note that practice in the United States was to follow the above dates in terms of transition to the requirements of EITF Issue 02-3 and adoption of the FASB staff's guidance on fair value. The

FASB staff's views are stated in the final minutes of the EITF meetings of 19-20 June 2002 and 21 November 2002.

Assuming that the IASB intends not to propose any industry specific transition rules for energy trading contracts, but otherwise would like to allow a transition that is similar to that used for EITF Issue 02-3, we recommend that the proposed amendment be changed to specify a date of 21 November 2002 for all derivative contracts.

We note that the above US GAAP guidance relates to energy trading contracts and derivative contracts only. On the other hand, the measurement requirements in paragraph AG 76 of IAS 39 and the proposed transitional guidance in paragraphs 107A, 108A and AG 76A of IAS 39 apply to all financial instruments, including *nonderivative* financial instruments, e.g. investments in debt and equity securities.

Nevertheless, we support the Board's decision to address the concerns of constituents as set out in paragraph 5 of the Background of the Exposure Draft, in particular that full retrospective application of the 'day 1' gain or loss recognition will be difficult and expensive and may require subjective assumptions about what was observable and what was not. Thus, we support the proposals made as a pragmatic solution to address these concerns and to achieve convergence with US GAAP in the area of 'day 1' profit recognition on derivative instruments (other than energy trading contracts).

We therefore recommend that entities should apply the requirements of the last sentence of paragraph AG 76 of IAS 39 prospectively to transactions entered into after 21 November 2002, thus mainly converging with US GAAP in relation to 'day 1' profit recognition rules on derivatives.

In relation to energy trading contracts, since convergence is not achieved under the proposals as noted above, the Board may wish to consider to allow or require a different transition date for those contracts that would mirror US GAAP (i.e. prospectively to all energy trading contracts originated after 20 June 2002).

Alternatively, as another pragmatic solution that would simplify the issues surrounding 'day one' profit recognition, the Board may also wish to consider to require application of the 'day 1' profit recognition rules for *all* financial instruments *prospectively* from the same date as the date of transition for IAS 39, i.e. to transactions entered into on or after 1 January 2005 with an option for entities to apply the amendment prospectively as of any earlier date.

b) Subsequent treatment of gains and losses not recognised on 'day 1'

We agree that there is a need to address the confusion over 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'. In particular, there is a need to clarify when and how such gains should be recognised.

In our view, the proposals in the Exposure Draft do not clearly address these issues. In particular, the phrase "a gain or loss shall be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price" does not satisfactorily clarify when and how the gains should be recognised.

In particular, non-recognition of 'day 1' gains or losses in the absence of observable market data seems to imply that no gain or loss should be recognised subsequently until maturity or until such observable market data is available. On the other hand, if time is an observable input that should be taken into account, then recognising the gain or loss on an amortisation basis seems to be compliant with IAS 39 principles.

In our understanding, the phrase can be interpreted as meaning that the same valuation model used on initial recognition (which should reflect a price accepted by market participants) should be used for the purpose of determining subsequent gains or losses. In other words, any subsequent changes in the input variables of the valuation model used on initial recognition would lead to a subsequent gain or loss. Therefore, if interest rates and other input variables into the model do not change, then we would expect that interest would be recognised under the effective interest method.

However, it is not fully clear whether this interpretation is appropriate as the factors that market participants would consider may change over time.

An alternative interpretation of the phrase might be that it allows recognition on a straight-line basis or using the effective interest method. This would not be in line with the principle that recognition should be in line with observable transaction data. It is not clear whether, under what circumstances and to what extent gain (loss) recognition on a basis that is faster (or slower) than on a straight-line basis would be acceptable. It is not clear whether and to what extent application of the effective interest method would be required or acceptable.

Therefore, at the very least, the Board should explain what it means by "including time".

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?

We do not believe that the proposals fully address the concerns set out in paragraph 5 of the Background of the Exposure Draft for the reasons stated in the response to Question 1. In our view, these concerns should be addressed based on our recommendations provided under Question 1.

Question 3

Do you have any other comments on the proposals?

No.

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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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