Date

7 September 2004

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Sir David Tweedie
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Dear Sir David,

Re: Exposure draft of proposed amendments to IAS 39 Financial Instruments: Recognition and Measurement: The Fair Value Option

FEE (Fédération des Experts Comptables Européens – European Federation of Accountants) is pleased to submit its views on the Exposure Draft of Proposed Amendments to IAS 39, Financial Instruments: Recognition and Measurement. FEE as a founding organisation of EFRAG has contributed to the EFRAG commenting process by submitting our views to EFRAG on their preliminary comments. In general, we agree with the views expressed in EFRAG's comment letter to IASB of 23 July 2004.

General

FEE supported the introduction of the fair value option in the Exposure Draft for the proposed amendments to IAS 39, issued in 2002. We refer to our comment letter on the proposed amendments to IAS 39 dated 21 October 2002. We understand the IASB's intention to accommodate concerns raised by constituents, in this case certain prudential supervisors and the European Central Bank. However, in our view the proposals in this ED do not meet the objective the IASB has with this ED to limit inappropriate use of the fair value option while preserving the key benefits of the option. We do not consider that the proposals in the ED improve the standard as they are cumbersome and may further complicate the standard unnecessarily. The proposal even adds more difficulties for the implementation and may cause particular problems for the insurance industry. In this respect, we agree with the board members' alternative views, which are well elaborated.

In our view it is inappropriate, so shortly after the comments on the fair value option were first considered as part of the proposed amendments to IAS 39 and an amended IAS 39 standard was issued, to propose a revision, in particular since no new views have been expressed. Moreover the timing of the exposure draft is also significantly affecting the stable platform that was agreed and is necessary for many enterprises preparing for implementing IFRS in 2005 in Europe and elsewhere in the world. We also feel this is a negative signal to the market in respect of the IASB's due process: the IASB seems to admit that the process for the amendment of IAS 39 has not appropriately addressed all views expressed and it is therefore considered necessary to open up the standard within a few months after it has been issued. Also by agreeing to introduce the changes resulting from the concerns of certain supervisors of regulated industries and central banks, other non-regulated industries will also be affected. We question whether the IASB has sufficiently considered the extra-territorial effects on non-regulated industries.

Our key concerns from a technical perspective are the following:

- The proposals are rules-based, contrary to the objectives of IFRS. The rules proposed are very complex and add to the complexity of the standard and of its implementation. Whether or not the proposed rules will have a substantial effect in practice is currently not clear. However the rules-based proposals will very likely limit the use of the fair value option in future when further developments in financial markets lead to changes in situations where the use of the fair value option could be beneficial.

- The criteria proposed when to allow the use of the fair value option, such as 'contractually linked' and 'substantially offset' are not clear and will require further interpretation. Also the 'substantially offset' criterion could be interpreted as being similarly stringent as well as comparable to hedge accounting criteria. As a result the use of the fair value option would not be beneficial in practice compared to applying the hedge accounting criteria of IAS 39.

- We do not agree with the proposal to introduce verifiability as a criterion for the use of the fair value option. In our view there should only be one definition of reliability in IAS 39 and if the existing definition is considered inadequate, this definition should be strengthened rather than creating a two-tier approach. It is inconsistent to apply different requirements where fair value measurement is permitted rather than required. The main reason for introducing a new term seems to be that the requirement that fair values are reliable in IAS 32 and 39 has been restricted to the fair value of unlisted equity securities or derivatives based upon these. Furthermore, we are unconvinced that the proposed IAS 39 distinction between the terms reliable and verifiable is clear and expect the terminology used will require further interpretation. The dictionary definition of "verify" is to "establish truth or correctness of by examination or demonstration" which differs significantly from "rely", which is to "depend with confidence or assurance on or upon" (source: Oxford English Dictionary). While the extent to which something is verifiable will affect the degree of confidence or assurance attached to a value, verifiable is a far narrower term than reliable. The use of a new term lacks conceptual integrity and risks creating an expectation gap.

We feel it is not appropriate to refer to the powers of prudential supervisors or other regulators in an accounting standard. Any reference to supervisors might give the impression that these supervisors have authority to interpret IFRS and even have power to overrule or amend standards. The result may be a violation of the level playing field that is aimed at through the adoption of IFRS, as supervisors in different jurisdictions may interpret IFRS inconsistently. Supervisors' mandates in respect of reporting for regulatory purposes should not be extended in any way to interpretation of IFRS for general purpose financial reporting.

In summary, we support the concerns raised by EFRAG and share its advice to withdraw the current proposal. We recommend the IASB to reconsider its proposal to limit the fair value option. FEE continues to support the fair value option as a pragmatic solution to resolve difficulties in applying IAS 39 in certain circumstances and therefore does not support the proposed revisions. In our view the only limit to the application of the fair value option should be the unreliability of measurement. If the IASB feels that a revision is needed in order to meet concerns raised by prudential supervisors and other regulators in order to make IAS 39 acceptable to those regulatory organisations, we propose the following alternative approach:

1 We propose to reconsider the proposed two-tier approach of verifiability and reliability and develop one test. It seems the IASB does not feel sufficiently comfortable with the reliability test included in IAS 39, given that the test of verifiability is introduced in this ED. In our view there should be one reliability test in the standard and propose that the current reliability test is further developed for that purpose if necessary; and
2 We propose to require entities to disclose as a policy note when an entity uses the option to measure instruments at fair value.

The proposed alternative approach is further explained in our response to question 1.

Answers to the individual questions

Question 1
Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

No, as mentioned above in the general section we do not agree with the proposals, but agree with the alternative views included in the exposure draft:

- The proposals lead to a rules based approach to the fair value option.
- The proposals are complex and therefore difficult to understand and implement. The criteria mentioned in paragraph 9b will require further interpretation. The risk is that for example 'contractually linked' and 'substantially offset' may be interpreted in similar ways as the hedge accounting criteria in IAS 39 and there will as a result be little benefit in practice in the application of these criteria rather than the hedge accounting criteria.
- The proposals may lead to an increase in volatility in particular situations, while a decrease is intended with the fair value option. The reason is that loans and receivables can only be measured at fair value under the proposals in very limited circumstances. In situations where loans and receivables are used in the asset and liability management of, for example, an insurance company or a fund for (partially) matching certain liabilities, but the strict criteria proposed under (ii) and (iii) cannot be met, volatility will increase as a result of the restrictions. Given the requirement that the offsetting instrument should be measured at fair value, it may not be possible for insurers to utilise criteria (ii) or (iii) since fair value has yet to be defined for insurance liabilities and insurance liabilities will not necessarily be measured at fair value under IFRS 4.
- We expect that situations will later arise that were not now foreseen and where the use of the fair value option through income would be helpful.
- We do not agree with the proposal to introduce verifiability as a criterion. In our view there should only be one reliability test in the standard. There is insufficient conceptual basis for the introduction of the new term and in our view the use of verifiability is not appropriate in an accounting standard. Verifiability is a component of reliability. FEE proposes that the reliability test is further developed and used for (permitted and required) fair value measurement, as it seems the IASB does not feel that the reliability test included in IAS 39 is sufficient, given that the test of verifiability is introduced in this ED. In our view there is no reason to adapt different criteria for situations when fair value measurement is required compared to situations when fair value measurement is permitted (refer to our proposal below).
- We note that the examples included in paragraph 48B are redundant as they are a repetition of existing application guidance in IAS 39 (AG 74 and AG 76)

Rather than unnecessarily complicating the proposed standard, there is in our view a better way to achieve the objectives of this ED of the fair value option:

(1) We propose that the definition of reliable in IAS 39 is further developed in order to introduce only one test of reliability and ensure that financial instruments – whether resulting from a requirement or through designation - are only measured at fair value if these can be *measured reliably*. There is no reason to have a stricter test for the permitted (where at choice) application of fair value than for the situation that fair value measurement is required. The definition of reliable measurement included in AG 80 of IAS 39 is appropriate as a starting point for further development of such a test for application to all financial instruments. We note that not only would the fair values of unlisted equity securities and derivatives based on unlisted equity securities potentially fall into the category of unreliable fair values, but also other instruments' fair values. In practice in Europe, other situations have arisen where the fair values of instruments (for example some commodity derivatives or some interest bearing instruments with very long durations) could not be determined reliably when applying the criteria of IAS 39

paragraph AG 80, although in the revised IAS 39, this paragraph can only be applied to unlisted equity securities.

(2) Furthermore we propose to require that an entity *disclose in the policy notes* when it measures instruments at fair value by designation. Our comment letter dated 21 October 2002 made a similar point, when it stated: "*We [furthermore] propose in relation to the designation for fair value through the profit and loss account, that enterprises are required to demonstrate the business rationale for doing so and disclose the designation policy as part of the accounting policy note. This may include hedging relationships at an aggregated level or in cases of insurance companies, circumstances where asset values match certain insurance obligations.*" In this way, a consistent and disciplined application of the fair value option can be achieved, without unnecessarily taking a rules-based approach to the fair value option. We feel that disclosing the rationale for the use of the fair value option, as an accounting policy would enforce an accounting approach of IAS 39 based on the (risk management) policies and operations of the enterprise. It would show that the option is applied where this is the most appropriate accounting policy, for example where changes in the values of financial assets and liabilities naturally offset each other but the requirements for hedge accounting are not met.

In respect of the conditions included in the proposed paragraph 9b, we - in addition to the above proposal - note the following. The main criteria mentioned in paragraph 9b seem to be (ii) and (iii). These suggest some form of linkage with the underlying operations and the risk management of an entity. If any limitations are to be provided, we would prefer these criteria to more explicitly refer to operations and risk management and aimed to address mismatches in measurement. We also think that the other criteria would then be no more than sub-criteria of these more general criteria.

The proposals do not meet concerns on the measurement of own credit risk. In our comment letter of 21 October 2002 we mentioned that we were of the opinion that – if changes in own credit risk were to be reflected – the measurement effects would be better shown by an entirely separate movement in equity rather than as a component of profit/income. In the amendments the IASB has included a requirement to disclose the impact of other than interest changes on the fair value of financial liabilities. Notwithstanding our concern regarding the counterintuitive effect of measurement of own credit risk on profit/income, we do not think this issue can be resolved as part of this amendment. For that reason, we on balance propose no changes in this respect at this stage but would encourage the Board to address this as part of the ongoing project to improve IAS 39.

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?

We support the comments raised by EFRAG.

Generally, we feel that there may be further situations that are now not identified and that should be eligible for the fair value option. However, it is at this stage impossible to provide a comprehensive list of instruments that should be eligible, since new developments may lead to new transactions that should be included. The following are examples of industries where we expect that such situations could occur:

- The assets (and liabilities) of investment funds where assets only partially offset the liabilities or where loans are entered into an investment.
- It might be difficult to apply the fair value option for assets held to back insurance liabilities. Paragraph 9b (ii) and (iii) might be unavailable to insurers on the asset side, given the requirement that the related liability be measured at fair value and this has yet to be defined for insurance liabilities. This could be problematic for insurers, particularly when insurance liabilities are

measured using current value based estimation techniques, such as current interest rates, in accordance with the option in paragraph 24 of IFRS 4. The application of this paragraph does not necessarily lead to a fair value.

- A specific example of an instrument where the fair value option may be unavailable is a portfolio of mortgages used to match a long term insurance book, for the reasons noted above (unless embedded derivatives were artificially found in the mortgage contract). The restrictions might also inhibit product development if companies are unable to use the fair value option on assets backing and matching liabilities under new types of contract.
- Under paragraph 9 b(ii) liabilities are eligible for measurement at fair value if they are contractually linked to the performance of assets. We are unclear about how this option allowing financial instruments to be measured at fair value applies to financial liabilities.

Question 3
Do the proposals contained in this 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?

No, we prefer either not to change the standard again or to change the standard in a more principles based way as suggested in our response to question 1.

Condition 9b (v) refers to the option to measure venture capital activities that are under the scope of IAS 28 at fair value. Currently there are no further limitations to the application of fair value to these activities. This proposal introduces the verifiability restriction to the use of the fair value option in this situation. We agree that the option to fair value should not be applied if the fair value cannot be determined sufficiently reliably, but do not agree with the verifiability criterion as also noted above.

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 for 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?

Yes, given the fact that we do not agree with the proposed revision of the fair value option. We share EFRAG's view in this respect.

However we note that many financial instruments will have some embedded derivatives or could be engineered to include embedded derivatives. For that reason the criterion as currently drafted may provide a loophole allowing the fair value option in more situations than intended. On the other hand if the option were limited to financial instruments with separable embedded derivatives, little benefit would be gained in practice from the application of the criterion, since entities would first have to determine whether there is a separable embedded derivative. The result would be that it is hardly beneficial to apply the fair value option, since the evaluation of whether or not a separable embedded derivative is included in the instrument nevertheless has to be performed. We reiterate that we continue to favour not to limit the fair value option at all (apart from due to the unreliability of measurement).

Question 5 Transition requirements

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 so designated:

(a) if the financial asset or financial liability is subsequently measured at cost or amortized 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 amortized 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 agree with EFRAG. The proposed transition requirements are adequately flexible and pragmatic, given the fact that the current IAS 39 allows the unconditional application of a fair value option.

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

No. In our view, the fair value option should not be limited as proposed in this ED. If any changes are considered necessary, we propose that the IASB (1) introduces one reliability test and if needed further develops the current definition of reliable included in AG 80 for that purpose and (2) includes a requirement in the standard for a disclosure in the accounting policies to set out when the fair value option is applied.

We would be pleased to discuss any aspect of this letter you may wish to raise with us.

Yours sincerely,

David Devlin
President