CCDG
COUNCIL ON CORPORATE
DISCLOSURE & GOVERNANCE

3 August 2004

CL 111

Ms Sandra Thompson
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

(By email: CommentLetters@iasb.org)

Dear Ms Thompson,

RESPONSE TO EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT – THE FAIR VALUE OPTION

We are writing to provide our comments on the Exposure Draft of the proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement – The Fair Value Option* published by the International Accounting Standards Board (IASB) in April 2004. Our comments below address the specific questions set out in the "Invitation to Comment" section.

Question 1

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

In general, we support the IASB's proposals to limit the fair value option (FVO) to address the concerns raised by some constituents. However, we propose that certain changes be made to some of the proposals as set out below and in our responses to Questions 4, 5 and 6.

(1) Reclassification

We understand that the one of the reasons for the introduction of the fair value option is to make it possible for the entity to use the fair value option as an alternative to hedge accounting. Under hedge accounting, if the hedge no longer meets the criteria for hedge accounting, the hedged item would revert to the accounting treatment based on its original classification. We feel that the ED should similarly allow reclassification in this case.

The following are some examples of possible situations that would call for a reclassification:

a. **When the offsetting instrument is terminated early due to factors not within the entity's control, e.g., the counterparty is bankrupt or regulatory laws change and the entity is not able to get another offsetting instrument to replace it. Under the ED, the offset item will have to continue to be stated at fair value when the offsetting instrument is no longer in the books. This will result in a mismatch in the profit and loss. In addition, if the offset item is categorised as a "loan & receivable", to continue to state it at fair value will infringe the restriction in para 9(b)(iv) of the ED.**

b. **The tenor of the offsetting instrument may be longer or shorter than the tenor of the hedged item. Thus, if the offsetting instrument matures earlier than the hedged item, this will create a mismatch and increase volatility, as the FVO is irrevocable.**

c. **The offsetting instrument may be entered into after the initial recognition of the offset item. Thus, the FVO cannot be selected for the offset item, as the ED does not allow reclassification into the FVO. If the FVO is selected at the onset, there will be volatility in the profit and loss until the occurrence of the offsetting instrument transaction.**

Also, paragraph 50 on reclassifications appears to contradict paragraph 9 by restricting reclassification of a financial instrument into or out of the fair value category through profit or loss category while it is held or issued. For example, paragraph 50 would not allow available-for-sale assets that have a pattern of trading to be reclassified into the fair value category.

(2) <u>Emphasis on "verifiability" as opposed to "reliable measurement"</u>

It is difficult to distinguish between the terms and we ask that the IASB should either:

a. **provide further guidance on the terms "verifiability" and "reliable measurement"; or**

b. **consider merging or using standard terminology for both these terms.**

(3) The IASB may wish to incorporate the following point on disclosure in its deliberations on IAS 32 *Financial Instruments: Disclosure and Presentation*:

As the application of the FVO remains subjective across countries and/or entities, it may be useful to require more disclosures in the financial statements on entities' use of the FVO. Specifically, the IAS could require entities to disclose the types of assets/liabilities that are measured using the FVO and the respective gains or losses that have been reflected in the financial statements. This would help financial statement

users in better understanding the impact of the FVO on entities' financials and enhance financial comparability across institutions.

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 the revised IAS 39?

Other than as identified in the ED, we are not aware of any financial instruments to which entities are applying, or are intending to apply, the FVO that would not be eligible for the option if it were revised as set out in this Exposure Draft.

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?

We do not believe that the proposals contain criteria that are necessarily exhaustive and propose that the proposed standard delineate boundaries that are clearly set in order to limit the use of the FVO.

The five conditions may not be a complete list of all possible conditions that exist. New circumstances may arise that will render the list in-exhaustive. The five conditions are also not mutually exclusive and hence may appear haphazard. We therefore recommend that the proposed standard establish a general principle and present the five conditions as examples of the overriding principle. The principle may incorporate the following conditions that are implicit in the five examples:

a. the financial asset or financial liability must have an exposure to fair value changes; and
b. the fair value of the financial asset or financial liability is verifiable.

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 the revised 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 the revised IAS 39 requires to be separated?

Notwithstanding that some constituents had expressed their agreement with the proposal, we are of the view that the proposal in paragraph 9(b)(i) is not appropriate as it is relatively easy to structure a financial instrument with an embedded derivative if an enterprise wishes to take advantage of the proposal in paragraph 9(b)(i). Accordingly, we believe that the proposal in paragraph 9(b)(i) should be restricted to a financial asset or financial liability containing an embedded derivative that is required to be separated by paragraph 11 of IAS 39.

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 so 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 are of the view that the above proposed transitional requirements are not appropriate. Despite the views in the BC, all changes to the measurement basis of a financial asset or liability that result from adopting the amendments proposed in this ED should be applied retrospectively by restating the comparative financial statements. This is also consistent with paragraph 105 of revised IAS 39.

Question 6

Do you have any other comments on the proposals?

We are of the view that additional guidance for paragraph 9(b)(ii) and the term "substantially offset" in paragraph 9(b)(iii) would be useful for the avoidance of divergent application of these conditions.

Should you require any further clarification, please contact Mr Ramchand Jagtiani, Deputy Director, at the Institute of Certified Public Accountants of Singapore via email at jagtiani@icpas.org.sg. Thank you.

Yours sincerely,

Derek How
Secretary, CCDG