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Organización Internacional de Comisiones de Valores
International Organisation of Securities Commissions
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Organização Internacional das Comissões de Valore

21 July 2004

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear David:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (the Committee or SC1) thanks you for the opportunity to provide our thoughts regarding the ***Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement The Fair Value Option*** (the ED). IOSCO is committed to promoting the integrity of international markets through promotion of reliable high quality accounting standards, including rigorous application and enforcement.[1] Members of SC1 seek to further IOSCO's mission through thoughtful consideration of accounting and disclosure concerns and pursuit of improved transparency of global financial reporting. The comments we have provided herein reflect a general consensus among the members of SC1 and are not intended to include all the comments that might be provided by individual members on behalf of their respective jurisdictions.

SC1 Comments to Specific Questions in the ED

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

Response: The Committee is generally supportive of any proposal that promotes the consistent application of reliable high quality accounting standards. Keeping our previous comment letters[2] in mind, we believe this ED represents a pragmatic approach towards addressing the practical concerns of stakeholders. On this basis, SC1 supports the proposed changes to the fair value option. Notwithstanding this support and consistent with our previous International Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (IAS 39) comment letters we have provided additional specific comments in our responses to Questions 2 though 6.

[1] See IOSCO website, www.iosco.org

[2] In our comment letters dated November 6, 2002 and June 12, 2003, we expressed concerns about comparability as well as the counterintuitive financial statement results arising from fair value measurements that include an entity's own creditworthiness.

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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?

***Response*:** SC1 does not believe it is in the best position to provide a complete listing of financial instruments that would not be eligible for the option if the fair value option were revised. However, we would like to highlight the provisions of paragraph 18 of IAS 28 *Investments in Associates* that requires entities to discontinue the equity method of accounting "...from the date that it ceases to have significant influence over an associate and (shall) account for the investment in accordance with IAS 39..." It is possible these investments may no longer be eligible for classification as a *financial asset at fair value through profit or loss* if their fair value is not verifiably measurable, particularly if those investments are in entities whose shares are not publicly traded or are not traded on an exchange.

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?

***Response*:** While the ED does limit the potential for abuse of the fair value option, we still have overriding concerns regarding:

Verifiably Measurable: The impact that the introduction of the *verifiably measurable* limitation contained in this specific ED (versus being incorporated into a conceptual framework) will have on investors' ability to understand and compare individual components of financial statements; and

Creditworthiness: The counterintuitive financial statement results arising from fair value measurements that include an entity's own *creditworthiness.*

Verifiably Measurable: In response to concerns about abuse of the fair value option, the ED introduces the new notion of 'verifiably measurable' as a narrower definition than the Conceptual Framework's 'reliably measurable' definition. SC1 strongly supports consistency as a key objective of financial reporting. As such, we are concerned about how differing fair value measurement thresholds will impact consistency of fair value measurements for different types of items on the balance sheet.

We note that there are other standards that allow a fair value option, but do not rely on the notion of verifiably measurable (e.g. IAS 16 *Property Plant and Equipment* and IAS 40 *Investment Properties*). Presumably, determining the fair value of these items involves the same level of complexity and subjectivity as valuing a financial instrument. As a result, users of financial statements may assume, incorrectly, that all balance sheet items measured at fair value are subjected to the same general fair value guidance or fair value hierarchy. The diversity in measurement techniques reduces consistent application of fair value measurement provisions, and thus, may impede financial statement users' ability to know when or when not to compare data presented in financial statements.

We are aware of the Board's *Accounting Measurement* research project that intends to resolve "issues related to selection of the appropriate measurements of items recognized in the financial statements." Therefore, we suggest that the Board, as part of this project, assess the use of different fair value measurement criteria. To this end, we believe that the Board should avoid introducing new measurement notions (such as verifiable fair value measurement) into specific standards before this research project is complete.

<u>Creditworthiness</u>: SC1 continues to have concerns with how changes in an entity's credit standing affects the fair value measurement of its debt securities and how such changes are disclosed in the financial statements. These concerns were first expressed in our comment letter dated June 12, 2003, which is attached.

We continue to question whether fair value is the most relevant measurement of an entity's issued debt. In an environment focused on net income, reporting of gains from the deterioration in creditworthiness does not seem to provide the most useful information to investors, other than in situations where a specific release of obligations or a restructuring agreement is in place. Further, changes in fair value arising from changes in an entity's creditworthiness may not necessarily correspond to offsetting changes in the fair value of related assets.

Although we acknowledge that the existing disclosure requirements and the proposed option restrictions mitigate the risk that financial statement users may be misled if income increases as a result of deteriorating creditworthiness, our level of concern regarding this issue remains heightened. If the Board adopts the provisions in this ED, SC1 recommends that the final standard include appropriate revisions to the fair value calculation for issued debt instruments and related disclosure. Possible revisions could include:

- Describing techniques (or criteria of techniques) for estimating the impact of credit risk and therefore allowing for a more meaningful and understandable methodology to account for and/or disclose its impact; or
- Strengthening presentation and disclosure requirements to provide financial statement readers with adequate and understandable information regarding the financial impact from changes in the issuer's credit standing.

***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 recognizes 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?

Response: SC1 agrees that not bifurcating a financial instrument and its embedded derivative may reduce the risk of fair value calculation errors arising from the subjectivity of bifurcation. We also concur with the notion of utilizing the fair value option to measure a hybrid instrument that contains an embedded derivative that, pursuant to the provisions of paragraph 11 of IAS 39, would not require bifurcation and separate accounting as a derivative instrument.[3] However, certain financial instruments may contain embedded derivatives that, conceptually, should be bifurcated for the purpose of providing appropriate balance sheet classification. For example, the conversion option in a convertible debt security may be more appropriately classified as equity than as debt. Therefore, we believe the Board should consider including criteria similar to paragraph 15 of IAS 32 *Financial Instruments: Disclosure and Presentation* that requires classification of the components in instances where reclassifications of certain instrument components between major balance sheet classifications may be necessary.

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 and 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 amortised cost.***
- ***b) if the financial asset is subsequently classified as available for sale, any amounts previously recognized 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 recognized.***

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 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 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?

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[3] Under the proposal, the fair value of embedded derivatives, which would not otherwise be bifurcated from a host contract, may now be reflected in an entity's financial statements. Although we do not object to the result, the general concerns raised in this letter regarding the fair value option also apply to those instruments.

Response: SC1 believes that additional guidance is needed for the first-time adoption of the fair value option. Specifically, how should the "verifiable" notion be applied to prior year data, presented as comparative information, if the entity cannot verify the fair value measurement for prior year amounts but can in the current year of adoption? An inability to verifiably measure the prior year amount may cast doubt on the ability to measure in the current year. Therefore additional disclosure guidance may be useful for the preparer and user of the financial statements.

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

Response:

Prudential Supervisors: We note that paragraphs 9, BC 9 and BC 11(b) have reference to the prudential supervisors but do "... not confer additional powers on them." SC1 recommends that such references, if any, be restricted to the Basis for Conclusions only. Inclusion in the body of IAS 39, may give financial statement users the impression that information addressing the interests and risk assessments of regulators is sufficient to satisfy the objectives and risk assessments of investors. We note that the IASB staff, in paragraph BC53 of the near final *Exposure Draft for Financial Instruments: Disclosures,* used a line of reasoning similar to the latter argument to reject the inclusion of references to prudential supervisors.

Paragraph 9: SC1 believes that the presentation of subparagraphs 9(b)(i-v) should be revised to avoid confusion when determining the Board's intent. For example:

- Subparagraph 9(b)(ii) limits the use of the fair value option to contractually linked assets and liabilities. However, subparagraph 9(b)(iii) presents a similar arrangement that could be non-contractual and therefore the two limitations appear to conflict with one another;
- Subparagraph 9(b)(iv) prohibits loans and receivables from qualifying for the fair value option. However, a loan or receivable with an embedded derivative could, via subparagraph 9(b)(i), be afforded the fair value option; and
- It is unclear whether subparagraph 9(b)(v) stating that, "The item is one that this or another Standard allows or requires to be designated as at fair value through profit or loss" is necessary.

It is our understanding that each individual criterion should be considered separately, and not in contemplation of the contents of the other criteria. If that is true, the wording should be revised. We suggest the second sentence of paragraph 9(b) should read "...financial liability that meets ***any*** one of the following ***independent*** conditions."

Paragraph 50: *Prohibition from subsequent reclassifications in or out of the option:* SC1 has two primary concerns regarding paragraph 50:

- *Changing Market Conditions*: What impact does changing market conditions have on fair value through profit and loss measurement? For example, what if the fair value of an instrument no longer is readily verifiable? Would an entity continue to measure the item at fair value? In order to reduce future variations in practice, paragraph 50 should provide guidance for such situations. If the Board were to conclude that the item would continue to be measured at fair value, the Board may wish to expand the discussion in paragraph BC 18 (or its replacement) to more fully explain the rationale for its decision.

- *Discontinuation of Matched and Offsetting Positions*: We suggest that the Board considers limiting the fair value option to those financial liabilities that have similar offsetting financial assets or "matched books" that *continue* to exist. For example, if the original matched assets are sold and not replaced, than the previously matched long-term liabilities should no longer qualify for fair value through profit and loss accounting.

Paragraph BC 6: *Situations where the option might be used*: SC1 found this information very useful and recommends that it become incorporated in some fashion into the main body of the final standard.

If you have any questions or need additional information on the recommendations and comments that we have provided, please contact me at 1.202.942.4400.

Sincerely,

/s/ Scott Taub, Chair
IOSCO Standing Committee No. 1