Deutsches Rechnungslegungs Standards Committee e.V.
Accounting Standards Committee of Germany
® Der Standardisierungsrat

DRSC e. V. • Zimmerstr. 30 • 10969 Berlin

Telefon +49 (0)30 206412-12
Telefax +49 (0)30 206412-15
E-Mail info@drsc.de

European Commission
DG Market, Unit F-3
Mr. Jeroen Hooijer

Berlin, 20 October 2008

Commission Declaration 14284/08, expert round table 21 October

Dear Mr. Hooijer,

On 16 October 2008, the German Federal Ministry of Justice forwarded us the Commission Declaration 14284/08 and asked for any comments to be addressed directly to you, rather than to the German Federal Ministry. We appreciate the opportunity to comment on the declaration and provide input to the Commission.

First of all, we would like to refer to our comments expressed in our letter dated 13 October 2008 on the draft EU Commission Regulation regarding changes in IAS 39, i.e. a proposed carve-out concerning reclassification of financial instruments. In our letter, we mentioned various issues which are not addressed or resolved by the amendments as (at that time) proposed by the IASB. By mentioning those issues, we simply wanted to **highlight** the fact that these issues should be **considered further by the International Accounting Standards Board**. We certainly did not intend to express the opinion that the issues mentioned there should be **addressed** by the EU regardless of whether the IASB considers them or not.

As already emphasised in our earlier letter mentioned above, we retain our position that any further changes should be addressed by the standard-setter, i.e. the IASB and following its due process. We do not support any changes the European Union might make to the International Financial Reporting Standards (IFRS) on an EU-level. Any EU-specific solution

- will harm the common objectives of global financial reporting standards as well as l of achieving consistent application on a worldwide basis and will seriously undermine these objectives and the IASB's credibility,
- may harm investors' confidence in the financial reporting,
- may lead to corresponding amendments to US-GAAP, thus initiating an undesirable "race to the bottom".

To our knowledge, the round table scheduled for 21 October is intended to discuss amendments to IAS 39 that go significantly beyond the changes made by the IASB on 13 October 2008 and adopted by the commission on 15 October 2008 and focus on the treatment of (embedded) derivatives, instruments for which the fair value option has been exercised and how to determine fair value.

With regard to **derivatives**, we disagree with permitting reclassifications of derivatives. Although we acknowledge that some "toxic assets" do meet the definition of a derivative under IAS 39 and are thus not covered by the recent amendments to the reclassification requirements in IAS 39, we nevertheless do not think that suspending fair value measurement for derivatives is an appropriate solution. Rather, we think that derivatives should continue to be classified as held for trading and thus measured at fair value through profit or loss. We completely fail to see any suitable alternative measurement concept for derivatives: If derivatives were made subject to the "amortised cost" measurement concept, any derivatives with a negative fair value would still need to be recognized as liabilities, while derivatives with a positive fair value would be subject to IAS 39's impairment test, resulting in losses being recognized in profit or loss anyway.

There is one area where we would think that the current requirements for derivatives might be or need to be re-considered: If a **derivative** is **embedded** in another contract and the combined instrument is classified as "at fair value though profit or loss", but the host contract could be re-classified to another category in rare circumstances under the recent amendments to IAS 39, we think that entities should be permitted to reclassify the host contract, while "fair value though profit or loss" classification for the embedded derivative is retained, provided IAS 39 requires to account for it separately. We note that reclassification of host contracts that were previously classified as at fair value through profit or loss gives rise to the question how to account for the embedded derivative. This is because IFRIC 9 requires the assessment of whether an embedded derivative is required to be separated from the host contract to be made when the entity first becomes a party to the contract and prohibits subsequent re-assessments unless there is a change in the terms of the contract. If the host contract was classified as at fair value through profit or loss at inception, the entity did not assess whether or not to bifurcate the hybrid instrument, due to IAS 39.11(c). The question remains whether, on reclassifying the host contract in accordance with the latest amendment, the entity is required to make up for the omitted assessment.

With regard to the **fair value option**, we suggest the IASB considers allowing a re-assessment in cases in which an entity exercised the fair value option based on economic circumstances in order to eliminate or reduce accounting mismatches that existed on initial recognition, but changed significantly in the current market turmoil. It might be worthwhile to discuss a one-time option to re-assess prior exercises of the fair value option, to be applied as of 1 July 2008 accounted for prospectively.

We support the IASB's and the FASB's continued co-operation to ensure that **applying fair value in inactive markets** is dealt with consistently and their intent to issue guidance on any accounting questions. We do not support any deviating guidance on a national or EU-level.

Concluding, we would like to stress again that any changes to IAS 39 to mitigate the issues mentioned above should be discussed at the IASB, rather than solely on the level of the European Union.

Finally, we would like to address a matter which needs to be considered at the EU and national level. We think that focusing solely on changes of accounting standards falls short: If fair value accounting is deemed of having a pro-cyclical effect during the credit crunch, it needs to be kept in mind that this hinges on the fact that regulatory capital of financial institutions is based on equity according to IFRS, subject to additional prudential adjustments. A decrease in fair value of certain assets will reduce the entity's equity. Due to the link between accounting equity and regulatory equity, such reductions in accounting equity may force financial institutions to reduce their risky assets (and thus, regulatory capital). This might have put more pressure on the market. Against this background, we think that the regulatory requirements, and particularly the link between accounting equity and regulatory equity, should be subject to a thorough analysis.

We are pleased to further discuss any aspects of this letter.

Yours sincerely

Liesel Knorr