Deutsches Rechnungslegungs Standards Committee e. V.
German Accounting Standards Committee e. V.®
Der Standardisierungsrat

DRSC • Zimmerstr. 30 • 10969 Berlin

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

Sir David Tweedie
Chairman of the
International Accounting Standards Board
30 Cannon Street

London EC4M 6XH
United Kingdom

Berlin, 19 July 2004

Dear Sir David

ED Amendments to IAS 39 The Fair Value Option

We appreciate the opportunity to comment on the proposed amendments *to IAS 39 Financial Instruments: Recognition and Measurement, The Fair Value Option*.

As we have set out in our comment letter on the amendments to IAS 32 and IAS 39, dated 16 October 2002, we support the fair value option since it facilitates the application of IAS 39 and allows the consideration of natural hedges. We are still of the opinion that the introduction of the fair value option is a big step towards a fair value measurement of financial instruments. Noting the objections against a possible misuse raised by the ECB and other prudential supervisors, we understand the Board's intention limiting the option whilst trying to preserve the key benefits of the option. Nevertheless, from a conceptual point of view we regard a restriction of the fair value option as a step backwards. Furthermore, the proposed limitation of the fair value option introduces a set of rules that runs counter to a principle-based standard, which we would not support.

As regards the reference to prudential supervisors and regulators in paragraph 9, we believe that this could create a false impression of a supervisors' role in the standard setting process. Since the Board states clearly in paragraph BC11(b) of the Basis for

Conclusions on this Exposure Draft that the reference does not give supervisors the power to amend or overrule the requirements of IAS 39, we regard the related part of paragraph 9 as redundant and suggest deleting it.

Whilst we do not see material new arguments put forward by the ECB, which were not yet considered by the Board when it finalised IAS 39 in 2003, we are concerned that a limitation of the fair value option would result in a delay of the finalisation of IAS 39, which we perceive as contra-productive to both preparers and users. Insofar, we agree with the dissenting Board members.

Based on our points mentioned above we therefore suggest reverting to the current standard.

If you would like any clarification of these comments, please contact me.

Yours sincerely,

Prof. Dr. Klaus Pohle
President

Appendix

Question 1

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

GASB's comment:

As set out above, we generally welcome the fair value option as introduced in the December 2003 version of IAS 39. In our view, the concerns recently expressed by the ECB and other prudential supervisor were substantially considered in the Board's discussion when finalising IAS 39 in 2003. We agree with the Board's decision that the benefits of the fair value option outweigh these concerns, regarding a simpler application of IAS 39 particularly in those situations in which the mixed measurement model could result in reported volatility on positions that are economically matched. We therefore welcome the Board's intention to clarify that matched positions shall not be measured asymmetrically.

The ECB and other regulators have expressed their concerns that the use of the fair value option will increase the volatility of an entity's reported earnings. In contrast, it is our perception that the introduction of the fair value option as published in December 2003 is necessary to prevent or reduce accounting volatility stemming from the mixed measurement model. We believe that the fair value option enables entities to measure financial assets or financial liabilities that are considered natural hedges on a consistent basis, without having to apply hedge accounting. If application of the fair value option resulted in reported volatility and if that volatility was based on economic rather than accounting mismatches, we would regard this fact as being highly relevant information for users of financial statements. Therefore, we regard the introduction of the fair value option as enhancement of transparency, which is a key objective of standard setting.

Nevertheless, we are not convinced that there is a need for redrafting IAS 39 in order to retain discipline in the application of the fair value option. However, if the Board regards a limitation unavoidable, we would like to point out some issues that require clarification.

Substantial offset

The Exposure Draft proposes that the designation as at fair value through profit or loss shall be used only for a financial asset or financial liability that meets one of the criteria set out in paragraph 9(b). Paragraph 9(b) (iii) allows the use of the fair value option if the exposure to changes in the fair value of the financial asset or financial liability (or portfolio of financial assets or financial liabilities) is substantially offset by the exposure to the changes in the fair value of another financial asset or financial liability (or portfolio). Whilst the December 2003 version of IAS 39 allows for assets and liabilities being accounted for at fair value through profit or loss without further restrictions, the ED requires substantially offsetting positions.

As the ED does not give guidance on this issue, we wonder whether 'substantially offset'

- is to be understood as 'substantially all' as conveyed in connection with the derecognition requirements or the exemptions from the tainting provision of held-to-maturity items;
- requires an offset across all risk factors present in a portfolio of financial assets and liabilities;
- is to be proven throughout a reporting period or for reporting date only.

We are concerned that introducing a substantial offset criterion will create even stronger requirements than the existing qualification for hedge accounting that is based on a prospective effectiveness within a range of 80-125 per cent. Against the background that the Board intended to simplify the application of IAS 39 on matched positions reflecting the risk management adequately, we regard this criterion as very problematic. If positions were not substantially offset, any profit volatility would stem from economic mismatches. In that case, a fair value measurement of the entire position adequately reflects the economic exposure and therefore provides relevant information.

Verifiability

Acknowledging the concerns that the fair value option might be used for items whose fair value is subjective, the Board proposes that the designation of a financial asset or financial liability as at fair value through profit or loss shall be used only if the fair value of the financial asset or financial liability is *verifiable*. The Board decided introducing the notion of verifiability and considered that criterion a stricter test than 'reliably measured' contained in paragraphs 46(c) and 47(a) of IAS 39. The Board explains in the Basis for Conclusions that 'verifiable' means that the variability in the range of reasonable fair value estimates made in

accordance with IAS 39 is low and that the term is used in analogy to conceptual frameworks of other standard setters. We regard this as highly problematic.
The notion of verifiability derives from the FASB Statement of Concepts No. 2 (CON 2) and is defined as a degree of reliability. In contrast, the concept of verifiability does not exist in the IASB's literature. According to CON 2, 'verifiable' essentially means minimising the measurer's bias. According to the IASB's Framework, information has the quality of reliability when it is free from material error and bias. As we cannot see a qualitative difference between these two definitions, we wonder whether verifiability may at all result in a stricter test than 'reliably measured'. Consequently, we regard the proposed introduction of 'verifiable' as a linguistic variation rather than a stricter test for the application of the fair value option. Additionally we would like to point out, that the December 2003 version of IAS 39 already contains considerable guidance on the determination of fair values of non-marketable financial instruments. Whilst the fair value measurement considerations in paragraphs 48A and 48B of the Exposure Draft are nearly identical to the corresponding Application Guidance (AG80) of the December 2003 version of IAS 39, the latter provisions however refer to 'reliably measurable' instead of 'verifiable'. Regarding the link to paragraph AG80 we do not see the need for introducing yet another threshold for fair value measurement.
Furthermore, we are concerned that the introduction of a second threshold will result in an undesirable dual standard for fair value measurement of financial instruments. Since IAS 39 requires financial instruments classified as held-for-trading or available-for-sale to be measured at fair value without a verifiability test, the impression arises that the fair value of the two categories might be less reliable than the fair value of items designated as at fair value under the fair value option. We do not consider this appropriate. If the Standard was to be changed, we recommend reconsidering this issue and replace 'verifiable' by 'reliably measured' providing a consistent solution for items required as well as those permitted to be accounted for at fair value through profit or loss.
If the Board generally believes that regarding the controversial discussion about a fair value measurement of financial instruments a criterion 'reliably measurable' is not appropriate, we suggest discussing the introduction of a stricter test within the more conceptually context of the measurement project.

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?

GASB's comment:

Against the background of the substantial offset criterion, we have identified some cases in 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.

(a) Instruments that would not be eligible for being designated as at fair value under the new proposals:

- **Amortising loans:** Financial institutions often originate loans that are not being repaid in full at maturity but are being amortised over their term (either with constant or increasing principal portions). In order to fulfil the substantial offset criterion an entity would have to enter into an amortising swap to lay off the interest rate exposure. Financial institutions often hedge their loan portfolios on a macro basis with other non-amortising financial instruments. These entities would not be eligible for hedge accounting nor would they qualify for designation the loans as at fair value, because the loans do not contain embedded derivatives and the requirement to demonstrate a substantial offset on an ex ante basis may be difficult in practice.
- **Instruments hedged on a portfolio basis for which a substantial offset cannot be demonstrated at inception:** Financial institutions often sell several products to the same customer. For instance, a bank may have originated a ten-year Euro loan at a fixed rate, written a financial guarantee, entered in a loan commitment, and originated a two-year Dollar loan with a floating interest rate. The risks inherent in this portfolio are generally offset using a central treasury function. Since there is no direct link between the instruments that are contained in the baskets and the offsetting derivative and

non-derivative financial instruments, a substantial offset cannot be demonstrated. The same would apply if an entity does not close a risk position exactly at the time when it is entered into, but some time after. Since the option underlies the condition that it must be applied at initial recognition, a substantial offset cannot be demonstrated either.

Assets and liabilities of insurance companies:

- The Board intended to solve the insurers' mismatch problem by allowing insurers to discount insurance liabilities with a current market interest rate. In view of the 'substantially offset' criterion, problems might arise for insurers. Discounting insurance liabilities with current market interest rates does not necessarily result in a fair value measurement. Because of different durations of assets and liabilities a substantial offset often might not be demonstrated.
- Criterion (iv) of paragraph 9(b) proposes that the item shall be a financial asset other than one that meets the definition of loans and receivables, which may lead to another problem for the accounting of insurance contracts. Insurers may decide to apply the option of IFRS 4 to discount insurance liabilities with current market interest rates consistently to all their insurance liabilities. Furthermore, insurers may back insurance liabilities with investments in assets that meet the definition of loans and receivables, which are not eligible for being designated as at fair value under the new proposals. We are therefore concerned that a limitation of the fair value option would restrict the application of the option in IFRS 4, which has been introduced in order to avoid accounting mismatches. Thus, contrary to the Board's view expressed in BC15 of the Basis for conclusions, the condition of paragraph 9(b) (iv) is not broad enough in order to achieve the intended.

(b) Instruments without a verifiable fair value

In our comment letter on the amendments to IAS 39 we supported the Board's view for including an option to fair value any financial instrument. Meanwhile, we learned that several companies intend to use the fair value option for own debt to counter fair value measurements of financial assets. Although we acknowledge that a credit spread is generally available at the time the liability is entered into, it might be burdensome, in many cases virtually impossible to track the changes in fair value that relate to changes in the credit spread (both entity- and industry-specific and, narrowing and widening of spreads).

Given that the Board intends to apply an even stricter notion to the criterion of verifiability in relation to reliability, we are concerned that a huge number of financial instruments which otherwise would have passed the five conditions of draft IAS 39.9 would not qualify for use of the fair value option under the verifiability criterion.

As regards the accounting of own credit spreads in general we refer to question 6.

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?

GASB's comment:

As we have set out above, we agree with the Board's clarification that the fair value option shall be applied symmetrically on matched positions. However, we regard the requirements in the December 2003 version of IAS 39 as appropriate avoiding improper application of the fair value option. Therefore, we see no need for further restrictions.

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?

GASB's comment:

The proposal to retain the fair value option for hybrid instruments does not create a difference to the December 2003 version of IAS 39. The issue was brought forward by the Board in the Basis for Conclusions as one of the driving factors, which led to the introduction of the fair value option. We favour retaining the option in full without limitations to certain hybrid instruments. This would also allow entities to implicitly mark the embedded derivative to market in cases where IAS 39 prohibits separation of the embedded from the host contract.

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 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.

(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 a financial liability that result from adopting the amendments proposed in this Exposure Draft be applied retrospectively by restating the comparative financial statements?

GASB's comment:

As we have stated above, we do not favour a limitation of the fair value option, hence there would be no need for introduction additional transitional requirements. Nevertheless, if the standard was to be changed we would agree with the proposed transitional requirements.

Question 6

Do you have any other comments on the proposals?

GASB's comment:

Based on experiences of first-time adopters of the fair value option, which have been brought to our attention, we would like to take the opportunity and address the issue of accounting for changes in an entity's own credit spread.

Whilst we acknowledge the theoretical validity of a full fair value model, some have cast doubts about the appropriateness of accounting for changes in an entity's own credit spread in the income statement without recognising the offsetting effect. This would be the case if the credit deterioration related to "assets" that have not (yet) been recognised on the balance sheet, e.g. self-generated goodwill. In addition to that, some doubt that changes in the credit spread of an entity are always attributable to endogenous factors. Changes in the credit standing of a whole industry or changes relating to speculative actions taken by market participants would have to be treated the same way as entity-specific reasons, e.g. a sharp decline in sales of a highly profitable product following a legal action. We have concerns about the relevance of accounting for changes in credit spreads that relate to exogenous factors.

Furthermore, as we have said in our response to question 2, changes in credit spreads are hardly observable for non-listed instruments. We acknowledge that certain industries might appear on the market rather continuously (e.g. banks, insurance companies), other entities might not have issued any debt securities. Those entities would have to come up with a best estimate as regards changes in their credit spread. We regard this to be problematic especially in those cases where an entity refinances itself on an irregular basis only, e.g. by taking out long-term debt.

Based on the points mentioned above, we would like to suggest deviating from measuring financial liabilities at fair value by adjusting the book value for changes in the risk-free interest only. At initial recognition an entity would record the liability at fair value and compute the entity-specific credit spread inherent in that liability by comparing the rate negotiated with the risk-free rate. In subsequent periods the entity would add the credit spread to the risk-free interest rate at next reporting date and discount the future cash flows using that adjusted interest rate. The changes would be recorded in the income statement.