MINISTERIO
DE ECONOMÍA

INSTITUTO DE CONTABILIDAD
Y AUDITORÍA DE CUENTAS

CL 16

Dear EFRAG members,

The Spanish Accounting and Auditing Institute (ICAC) answers to the questions set out in the draft about the improvements to IAS 32 and 39 are the following:

IMPROVEMENTS TO IAS 32

We agree with EFRAG's answer.

Though, with regard to the EFRAG answer to Q2 we believe that the method proposed should be ameliorated taking into account the improvements of the IAS 32 of allocating the carrying amounts of a compound financial instrument. There could be another possibility, for example when there is market for derivatives based on an entity's own equity instruments, the prices of market can be used to value the derivatives and the residual amount of the issue could be assigned to the liability component. This method is simple and compatible with the fair value concept.

IMPROVEMENTS TO IAS 39

Q1. Scope: loan commitments (paragraph 1(i)). Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?

We support the idea behind this proposal. But we think that the appropriate solution should be to introduce the same solution for all transaction with similar characteristics, such regular way transactions and derivatives that only can be settled by conversion into an underlying instrument. For that reason, we suggest to

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introduce a principle expressing that the changes in the fair value of derivatives (including regular way transactions and loan commitments) that only can be settle by conversion into an underlying instrument are accounted for in a manner consistent with the accounting treatment that will be applied to that underlying instrument.

Other comments

The revised IAS 39, like the text in force, proposes a different treatment for regular way transactions from the one established for financial derivatives.

We agree that the change in the fair value of a financial asset bought in a regular way must be recognised, between the trade date and the settlement date, in the income statement or equity in the same way as it will be after the settlement date.

Nevertheless, we do not understand why the proposed regulation still gives entities a choice as to how to recognise these transactions between the trade day and the settlement day. The only argument used to justify the alternative treatment is the short period of time of these transactions. But for many banks this type of activity is very significant (spot exchange transactions, spot purchases of debt securities, etc.), and therefore the method used for the recognition of these transactions in the balance sheet is of great importance to them.

The financial assets bought in a regular way transaction should be recognised in the buyer's balance sheet on the day on which it becomes their true legal owner, because it has the unconditional right to them (a financial asset) and the unconditional obligation to pay for them (a financial liability). This date depends on the type of the regular way transaction (generally the settlement day) and is not determined at the entity's option.

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From the point of view of the seller, settlement date accounting and trade date accounting recognise the gains of these transactions in different days. This is an additional reason for the establishment of a compulsory treatment for regular way transactions.

Furthermore, the removal of this choice will improve the comparability of the financial statements of different entities, which is one of the IASB's main aims.

Q2. Derecognition: continuing involvement approach (paragraphs 35-57). Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?

The approach proposed for the treatment of transferred assets overcomes many of the inconsistencies of the current approach, but the following problems should be resolved:

- A "legal isolation" test should be required to be passed before a financial asset can be derecognised. The reason is that the financial statements must also reflect the legal and financial situation of an entity in case of bankruptcy. Otherwise, the financial statements would not show the true and fair view of the financial position.

- When the transferor retains substantially all of the credit risk (via the residual interest) and the right to service the financial assets, the gain of the transfer should be recognised in the profit and loss account over the remaining life of the assets, as the service is provided and the credit risk declines. Otherwise, the entity would recognise gains before they were accrued.

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- When residual interests retain substantially all of the credit risk of the transferred assets, they should be covered by provisions calculated on the basis of the expected cash flows of all the underlying financial assets. The reason is that the credit risk retained by the transferor is identical to the credit risk of the transferred financial assets. Consequently, the impairment loss must be equal.

- The transferor should only have to recognise financial liabilities relating to its continuing involvement in the transferred assets when it can be required to return to the transferee part of the amount received, as a result of losses on such assets.

  This amendment should be done because the proposed standard implies "double counting" when obligates to recognise a financial liability (and simultaneously a financial asset) when the entity does not transfer a percentage of the total assets that retains all the expected loss on the transferred assets (see paragraphs B.4-B17 in Appendix B). In fact, in this case the transferor has not any obligation to repay any amount to the transferee, consequently there is not a liability. Additionally, the transferor can only lose the amount of the financial assets that has not been transferred (that remains recognised on the balance sheet); therefore, the recognition of other financial asset for the same amount implies double counting.

- There is currently no market for subordinated assets, at least in most European countries. Thus, the recognition of residual interests should not be based on their fair values, because these are not reliable.

- When subordinated assets are held, this should be disclosed, specifying the underlying financial assets and the provision established for covering the estimated credit losses.

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- The criteria that financial assets cannot be derecognised when there are clauses that imply a continuing involvement of the transferor, even when those clauses are totally different from arm's length ones, does not seem logical (para. A.8). We are concerned that the existence of such a rule-based approach to derecognition will lead to the development of significant abuse driven by structures that achieve off balance sheet treatment solely as a result of their legal form.

- The measurement criteria for transferred assets classified as held for trading or available for sale that cannot be derecognised (see paragraphs A.8 and B18-B24) are not considered appropriate. The proposed treatment tries to ensure that the net carrying amount of the assets and the borrowing is the fair value of the put or call option. But the draft proposes that in some cases these financial assets should be valued at the option exercise price, even when the option is deeply out of the money. Therefore, the financial assets and the financial liabilities can be recognised on the balance sheet for totally arbitrary values.

Q3. Derecognition: pass-through arrangements (paragraph 41). Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?

We agree with EFRAG's proposal. In any case, it is necessary to highlight that a "legal isolation" test should be required to be passed before a financial asset can be derecognised

Q4. Measurement: fair value designation (paragraph 10). Do you agree that an entity should be permitted to designate any financial instrument irrevocably at

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initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?

The introduction of a new option for directors to be able to designate any financial instrument for inclusion in the trading portfolio, even if irrevocably, is not considered appropriate. The inclusion of primary financial assets and liabilities that are not managed to take advantage of short-term fluctuations in their prices or dealer's margin in this category would give managers an enormous amount of discretion and, necessarily, reduce the comparability of the financial data published by firms.

In our opinion, it should be compulsory to classify financial instruments, for the purposes of their valuation and the recognition of profits and losses, in a particular category according to the way in which they are managed by the entity. The proposed criteria should be complemented with an amendment of the hedge accounting rules to allow portfolio hedging, provided the hedge effectiveness and other general hedge accounting criteria are met.

To avoid the possibility of accounting arbitrage, it would be necessary to properly define the different categories in which the financial instruments should be classified for measurement. This would increase the comparability between the financial statements of entities, since two firms with the same financial instruments managed in the same way would present the same financial situation.

The differences in the primary statements of entities with different management criteria would be fully justified. In any case, users would always be able to compare the financial situation of all firms, irrespective of the way in which they manage and, therefore, record their financial instruments, since in accordance with the proposal for IAS 32, they must supply information on the fair values of each category of financial instrument. That said, it should be remembered that in order for this

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information to be useful it must be accompanied by data on its reliability for those financial instruments for which there is no active market.

In addition, the use of fair values to value any financial liability may generate undesired accounting asymmetries, as for example when the liabilities finance financial assets valued at cost.

Q5. Fair value measurement considerations (paragraphs 95-100D). Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95–100D of the Exposure Draft? Additional guidance is included in paragraphs A32–A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?

The values estimated by means of valuation techniques for certain financial instruments not traded on active markets (basically loans granted and deposits attracted by credit institutions) are very subjective. Estimating these values would necessarily involve a high degree of prejudgement, as well as the need to make certain hypotheses and use information that cannot be obtained from the market, so that it would be very difficult to verify. All of these factors reduce the neutrality of the values obtained, which could not be considered sufficiently reliable to be used in the primary statements. Moreover, the use of these values to record such instruments in the balance sheet at their fair value and to recognise their changes in value in the profit-and-loss account could mean that the results of two firms with identical financial instruments, even contracted on the same date, could vary considerably.

The proposed standard does not indicate how to treat the own risk of the entity when calculating the fair value of its financial liabilities. It may be concluded therefore that it should be taken into account when calculating such value. If this is so, the paradox may arise that an entity recording its financial liabilities at their fair value has to reduce their amount in the balance sheet, simultaneously recognising a profit

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in the income statement, simply because its credit rating deteriorates, i.e. because the market considers that the entity is more risky than previously.

In consequence, it should not be possible for financial instruments for which a fair value cannot be reliably estimated (by means of generally accepted valuation techniques whose most important variables are obtained from the market) to be recorded at a fair value in the balance sheet. And, with even greater reason, it should not be possible for the changes in the value of such instruments to be recognised in the profit and loss account.

Q6. Collective evaluation of impairment (paragraphs 112 and 113A–113D). Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A-113D?

We agree with EFRAG that the amendment is an improvement to the existing rules. Nevertheless, discounting, although it is conceptually attractive, raises some practical difficulties, such as estimating the amount and timing of cash flows and the discount rate to be used. For that reason, other methodologies should be admitted for the estimation of provisions for group of loans, provided that they imply similar amount of provisions. For instance, the use of provision matrixes, where the provision percentages are set in accordance with the past-due status. The provision percentages to be applied to each time bracket, which should be periodically revised, could be estimated using the accumulated experience for groups of similar assets of the entity itself or a group of entities that operate in the same market[1].

[1] Although this procedure is not included in the draft of the standard, it is indirectly admitted in the answer to question 111-3

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Regarding evaluation of impairment, the following criteria should also be included in IAS 39 and related IAS:

- Lease receivables should be subject to the impairment provisions of IAS 39, because they are in substance financial assets very similar to collateral loans.

- All financial assets and off-balance-sheet items (guarantees, credit derivatives, etc.) with the same credit risk should have the same provision for impairment losses (for instance, the provisions for a financial guarantee on a loan should be the same as the specific (instrument-by-instrument) and general (collective evaluation) provisions for the guaranteed loan; the provisions for a subordinated asset should be equal to the specific and general provisions necessary for the underlying financial assets, etc.).

Q7. Impairment of investments in available-for-sale financial assets (paragraphs 117–119). Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?

We agree with EFRAG's proposal.

Nevertheless, it should required the disclosure of the disappearance of the circumstances that originated the initial deterioration with rigorously and objective

of the IAS 39 Implementation Guidance. Under this scheme, for example, a provision percentage of 10 per cent would be set for loans with amounts 90 days overdue, if it is concluded from the historical data that this is the percentage that has been unpaid on all loans with the same risk characteristics that have had amounts 3 months past due.

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evidences, in order to avoid the risk of manipulations and practices of creative accounting.

Q8. Hedges of firm commitments (paragraphs 137 and 140). Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?

We agree with EFRAG's proposal.

Q9. 'Basis adjustments' (paragraph 160). Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?

We agree with EFRAG's proposal.

Q10. Prior derecognition transactions (paragraph 171B). Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (i.e. that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?

We agree that prior derecognition transactions should not be grandfathered.

OTHER COMMENTS

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1. Hedging

The treatment proposed by IASB for hedging is not considered appropriate, since it is limited to permitting adjustments in the valuation criteria for certain financial instruments, without requiring the elimination or reduction of the financial risk to which the entity is exposed.

Although the proposed standard works relatively well for most financial risks (price, exchange rate, etc), it does not in the case of interest rate risk hedges, since it classifies them artificially as fair value hedges (when the hedged items have a fixed rate of interest) or cash flow hedges (when they have a variable interest rate) and it does not take into account that, in practice, these hedges are used to reduce the risk of net interest losses arising from fluctuations in interest rates.

The definition of "accounting hedge" should be capable of encompassing "financial macrohedges", which are used by entities to reduce their exposure to interest rate risk through the management of primary financial instruments with different maturities or contractual rate revision dates. This would enable one of the main problems of the current proposal of the IASB for credit institutions to be eliminated.

The solution of widening the trading portfolio to enable any primary financial asset or liability to be included does not resolve the problem. First, because reliable values cannot be obtained for all these financial instruments, and second, because the more stable deposits of entities engaged in traditional banking ("banking book") are generally in the form of sight deposits or short time deposits ("core deposits"), whose fair value naturally coincides with, or is very close to, their nominal value.

In any event, to avoid abuses in the use of macrohedges, very restrictive requirements should be laid down for them to be admissible for accounting purposes

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(i.e. the hedged and hedging instruments are continuously subject to an integrated, prudent and consistent system for the management and control of risks and results, which enables the transactions to be perfectly monitored and identified at any moment).

Finally, the suggestion that appears in the EFRAG draft letter relating to accounting for all the changes in the fair value of the hedging items under an item to be included in equity until they are recognised in the profit and loss account, is considered appropriate, provided that a specific denomination for the item is used, since it would resolve the current inconsistencies and possibilities of arbitrage arising from treating each type of hedge differently.

2. Scope

The Standard should clarify whether it is possible to apply IAS 39 to the part of an interest in an associate held for trading for departments or entities of the group different that the departments or entities that held the strategic investment in the associate entity [para. 1 (a)].

3. Definitions of Four Categories of Financial Instruments

The standard should clarify whether it is possible to classify simultaneously different parts of exactly the same financial asset (e.g. a debt security issue for a Central Government) in more than a category for measurement purposes. For example, when an entity or department hold some amounts for trading because it is a market-maker and other department or entity hold the same financial asset to maturity or for available for sale.

4. The effective interest method

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The Standard establishes that in the calculation of the effective interest rate it is necessary to include all fees and points paid or received between parties. Consequently, in the case of financial instruments with a fee at the origination (in many cases an important percentage of the principal), the estimation of the original effective interest rate must take that fee into consideration. When the financial instrument has a fixed interest rate, the fee shall accrue over the remaining life of the asset (for instance 10 years); but when the financial instrument has a variable interest rate, the application of the standard seems to imply that the fee must be accrued up to the next repricing date (for instance, a month, a quarter, six months a year) and not to the maturity date (for instance 10 years).

Additionally, the wording of the proposed definition of effective interest rate does not take into consideration that there are many financial instruments with a variable interest rate that establish a fixed interest rate for the initial period lower than the variable one that should be applicable for that period (for instance, the fixed interest rate for the initial period is 2%, while the reference variable interest for that period is 5%). Consequently, the rate at which interest accrues in the first period (2%) is lower than the average yield to maturity.

For that reason, the definition of the original effective interest rate should be amended to solve these problems. The definition should establish that the initial fees and the discounts in the interest rate established in some periods in relation to the reference interest rate should be accrued during the remaining life of the financial instruments, including those with variable interest rates. In other words, these amounts should be accrued as premiums or discounts during the remaining life of the financial instruments. Also, it should be advisable to include some example of how to determine the "amortised cost" of financial instruments with variable interest rates to illustrate how to treat the fees and the discounts in the interest.

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The standard should also clarify that, for simplicity, in those financial instruments in which there are no fees, premiums or discounts, the contractual interest rate could be used as the effective interest rate when the interest payments are more than one for year (for instance, it the contractual interest rate is 10% and the interest payments are monthly or quarterly, the original effective interest rate could be 10%).

Finally, a different term should be used to distinguish between the original effective interest rate that is calculated on the basis of the contractual cash flows (for instance, original contractual effective interest rate) and the one that is calculated on the basis of the estimated cash flows (for instance, original estimated effective interest rate).

5. Gains and Losses

The way in which the gains and losses of a financial instrument are shown in the income statement is very important, because it allows its readers to understand the entity's performance (IAS 32.30 and IAS 39.103).

For that reason, it is desirable that the standard should establish clearly that the interest of an available for sale financial instrument accrued in accordance with the effective interest method should be accounted for as interest in the income statement and that only the changes in its fair value due to other reasons (fluctuation of the interest rate) should be recognised in equity.

The standard should also establish that the interest of a held for trading financial instrument accrued in accordance with the effective interest method should be accounted for as interest in the income statement and the changes in its fair value due to other reasons should be shown in a different item.

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The proposed treatment enables income accruing merely as a result of the passage of time to be distinguished from gains or losses due to fluctuations in the price of the financial instruments.

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