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Date : Amsterdam, 11 October 2002
Re : Exposure Draft of Proposed Amendments to IAS 32 Financial Instruments: Disclosure and Presentation, IAS 39 Financial Instruments: Recognition and Measurement

Dear Sirs,

We appreciate the opportunity to respond to your invitation to comment on the *"Exposure Draft of Proposed Amendments to IAS 32 Financial Instruments: Disclosure and Presentation, IAS 39 Financial Instruments: Recognition and Measurement" (Further referred to as ED)*. Our response consists of general comments and answers to the questions raised in the ED.

1 General comments

We welcome and appreciate the effort made by the IASB in creating an ED improving IAS 32 and IAS 39. While we agree with many of the amendments proposed to improve IAS 32 and 39, there are certain issues that in our view require further study, concepts that need to be more narrowly defined and areas where we prefer the proposed changes are not implemented. These issues are all addressed in the answers to the questions raised in the exposure draft.

IAS 39 includes many rules, for example in the area of hedge accounting, but also in other areas. The Council for Annual Reporting has always strongly supported a principle based rather than a rule based approach to standard setting. Although we appreciate that financial instruments accounting is a complex area that requires more interpretation and guidance than many other topics, we would like to urge the IASB to focus in the amendments of IAS 32 and IAS 39 on clarifying the principles of the standards, while at the same time providing sufficient guidance and interpretation rather than further rules to support the principles. In our letter we have provided an example of in our view unnecessary rules under hedge accounting.

Certain issues are not addressed in the ED while in our view improvements of IAS 32 and 39 are possible in these areas:

Insurance contracts that fall within the scope of IAS 32 and IAS 39 –

In IAS 32 a definition of insurance contracts is included to distinguish insurance contracts from financial instruments. The definition differs from the definition of insurance contracts included in the DSOP on insurance contract accounting and leads to interpretation issues in practice. The definition in the DSOP has resulted from a long debate in the insurance contracts accounting advisory committee.

We strongly recommend that the board considers an amendment of the definition in IAS 32 and considers the definition and the related guidance of the DSOP in that respect. It would be important that the definition chosen is not later changed so that insurance enterprises do not need to go through a conversion process twice. Irrespective of a change in definition, many in form insurance contracts will have to be accounted for under IAS 32 and 39. We therefore furthermore recommend that guidance is included in the standards on some measurement issues in respect of those contracts.

Hedge accounting for held-to-maturity instruments

Hedge accounting in respect of interest rate risk is not allowed for held-to-maturity instruments. The reason provided in the standard is that instruments classified as such are not exposed to interest rate risk since they will be held to maturity. However, IAS 32 and 39 define risk exposure in terms of fair value risk as well as cash flow risk. If exposure were only defined as a risk of changes in fair values, we would understand the rationale. Given however that:

- the standard allows for a change in risk profile for all other instruments by either applying cash flow hedge accounting or fair value hedge accounting,
- the standard does not prescribe risk reduction in terms of one type of exposure, and
- generally (especially in financial institutions) all instruments, including held-to-maturity instruments are part of a risk exposure analysis considering the total balance sheet,

we feel that the exclusion of held-to-maturity instruments from hedge accounting is not appropriate. We recommend that the requirements in this respect be reconsidered.

Hedge accounting principles

Hedge accounting is generally considered the most complex area of financial instruments accounting. Also the extensive rules and requirements regarding the application of hedge accounting add to the complexity. We would therefore have expected that other and more changes would have been proposed in this area. We recommend that the guidance provided in IAS 39 on when to apply hedge accounting and when this is not allowed is more clearly linked to the criteria for hedge accounting: designation, measurability and effectiveness. In relation to that we recommend to reconsider whether any unnecessary rules and exceptions to rules can be deleted. An example in our view is the prohibition of applying hedge accounting on components of non-financial instruments. With clear guidance on measurability and effectiveness such a requirement becomes superfluous.

Hedge accounting and internal contracts

Apart from the use of two models for hedge accounting and many requirements restricting the use of hedge accounting in specified circumstances, one of the most difficult issues to deal with in the application of hedge accounting is the interpretation in practice of the prohibition of the use of internal transactions as hedging instruments. All financial institutions and larger corporate treasuries generally use internal transactions. The interpretation guidance provided on the paragraphs IAS 39.134 & 121 describes how, under certain circumstances, a portfolio approach using internal derivative contracts is acceptable, and why and how it is determined that balance sheet and income statement effects of internal derivatives are effectively eliminated. We recommend that the principles of the implementation guidance included in the IGC Q&A's are further simplified and clarified in the standard. This will significantly ease the implementation of hedge accounting in practice, and also address many of the industry concerns that have been strongly expressed about the standard not reflecting current rational risk management practice.

Current paragraph 39.126B (previously 134) explains that only derivatives that involve a party external to the entity can be designated as hedging instruments and that internal transaction between group entities as well as gains and losses on those transactions need to be eliminated. Question and Answer 134-1 (a and b) explain that only if internal transactions are offset by derivatives with external parties, hedge accounting can be applied to those external derivatives. Also, several internal transactions that do not offset each other may be aggregated and offset by one single external transaction that would then qualify for hedge accounting assuming the other criteria for hedge accounting are met.

Positions denominated in foreign currencies are measured at spot rates under IAS 21 and monetary assets and liabilities denominated in foreign currency are eligible hedging instruments under IAS 39. Therefore it is possible that only the net exposure of a group is offset by entering into an external contract, if one and the same hedge accounting model (cash flow hedge or fair value hedge model) is used for all (internal and external) derivatives involved. In that case the income statement impact of the internal transactions would be zero (see Q&A 134-1-b). Hedge accounting can be applied using the internal derivatives and only basis adjustments recorded would need to be eliminated. The latter would no longer be required if the proposed change to the cash flow hedge model is accepted. The guidance implicitly, but not explicitly, indicates that the documentation would include:

- documentation for the hedge relationship at the level of the internal derivative and the hedged position, and

- evidence that on a net basis the internal derivatives are offset by an external derivative and that the same hedge accounting model is used for all hedge relationships and no basis adjustments are applied.

We propose that the IASB clarifies in the standard that the above documentation and evidence would be sufficient and that in this case the hedge relationship need not to be documented as a hedge of the external contract with a part of the gross positions that the enterprise has hedged as described in paragraph 39.133.

Q&A 134-1a explains that for interest rate positions a similar approach could not be applied as interest rate positions are generally measured at cost (and therefore require adjustments when included in a fair value hedge accounting relationship or basis adjustment when hedging forecasted acquisitions). However, in our view a similar approach could be acceptable, when applying the cash flow hedge accounting approach as explained in Q&A 39-121-2 and its appendix as well as when the proposed amendment to the cash flow hedge model is accepted. In that case hedged positions are not (basis) adjusted and similarly as in foreign currency hedging, the income statement effect of the internal transactions could be offset by a net external transaction. This would constitute an important simplification for interest rate hedging in financial institutions when applying cash flow hedge accounting. The documentation to be provided would be similar to the one described above for foreign currency hedging.

For the purpose of providing the evidence as described under (b) above, a further simplification could be made. Applying the above to financial institutions would require that the trading desk or department that is the counterparty to the external transactions offsets all internal transactions on a net basis. Often however in practice, banks require for risk management and internal control purposes that there is only one entity/department entering into transactions with an external party: the trading desk, that acts as the 'window' to the market for the whole entity. That department is furthermore the only department authorised to take trading risk positions, an activity that is generally performed by banks.

We propose to consider whether the evidence provided for testing the offsetting of the internal transactions for banks in interest rate risk hedging, but also for others with similar characteristics, could be based on the following:

- internal transactions are concluded on exactly the same terms and applying the same (tested and reviewed) pricing models as applied for external transactions and are all measured on a fair value basis;

- the trading department is separately managed and operates under strict (relatively small) limits;

- the trading department is active on external the financial markets it is authorised to deal on;

- internal controls ensure compliance with limits set; when the limits are reached, the department always enters into transactions with external parties;

- the trading department operates in the 'fair value' environment of the entity, functionally segregated from the 'banking/cost' environment and is separately managed and controlled.

When applying one hedge accounting model (the cash flow hedge model as described in Q&A 121-1 and 2) and under the above mentioned conditions gains and losses on internal contracts would – as in the examples provided in the Implementation Guidance on foreign currency contracts – be effectively eliminated, potentially except for (part of) the relatively small limit set for the trading department, while adhering to business and risk management objectives. The important advantage would be the significant simplification of hedge accounting substantially in line with the application of the standard's requirements for foreign currency risk hedge accounting.

2 Answers to questions raised in the ED

2.1 IAS 32

Question 1 - Probabilities of different manners of settlement (paragraphs 19, 22, and 22A)
Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).

Response:

Probabilities of different manners of settlement

We agree that the classification of a financial instrument as a liability or equity should be made without regard to the probability of settlement, as financial instruments are based on contracts.

We furthermore more note that the amendment of paragraph 19 "and without regards to the probabilities of the manners of settlement" is confusing in light of the proposal of the board to disregard probabilities and we propose to delete this addition.

Removal of economic compulsion

Economic compulsion can be part of the substance of an instrument's contractual terms and conditions. The current guidance in IAS 32, improved and clarified, is helpful and we propose not change the approach in IAS 32. However we note that the notion of economic compulsion and the need for guidance on the issue is closely linked with a clear definition of 'discretion', which in our view could be improved.

However, in our view the example previously provided in paragraph 22 is not sufficiently clear, as the instrument referred to is described as containing a documented obligation to pay dividends. When an entity is under the obligation to pay dividends this would already cause that instrument to be classified as a financial liability. In our view, therefore, the example on economic compulsion needs to be clarified.

Other

In our view the classification as either equity or liability should be changed when terms and conditions change such that the substance of the transaction is revised. The last sentence of paragraph 19, prohibiting reclassification contradicts the proposed guidance on derivatives on own equity, since an enterprise entering into a forward to buy or a written put option, results in a reclassification of equity to liability.

Question 2 -- Separation of liability and equity elements (paragraphs 28 and 29)
Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?

Response:

Yes we agree with the elimination of the option.

Question 3 -- Classification of derivatives that relate to an entity's own shares (paragraphs 29C -- 29G)
Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?

Response:

Yes, we agree with the proposals for derivatives on own equity shares, as they are consistent with the definition of financial assets and financial liabilities.

We furthermore note the following:

- In responding to question 1 we pointed out that an inconsistency exists between the treatment of certain derivatives on own shares and the prohibition to reclassify an instrument after initial recognition as either equity or liability.

- We agree with the accounting as proposed in the paragraphs 29D and 22C. However, the guidance provided in those paragraphs is not consistent with the definition of a financial liability included in IAS 32. Instruments that will be settled by delivering or receiving own equity do not strictly meet the definition of financial assets or financial liabilities as they are currently drafted. The view that an instrument settled in own equity is not a financial asset or financial liability is in fact currently supported in IAS 32 (pre-amendment) paragraph A7 and in Q&A 11-1. This inconsistency could be solved within the scope of the improvement project by clarifying the definition of financial liability, by including guidance that the aspect of the definition "to exchange financial instruments with another entity under conditions that are potentially unfavourable" includes situations where the obligation will be settled in own equity, if the number of equity instruments to be issued is variable, dependent on the value of the shares.

- The recognition of derivatives on own shares as derivatives or in equity is dependent upon the history of settlement. When derivatives on own shares are entered into for the first time, no history is available. In our view the intention of the issuer is then relevant in classifying the derivative. The IASB should clarify this.

Question 4 -- Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard
Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)

Response:

Yes, we believe it is useful to integrate IAS 32 and 39 into one standard. The structure and the transparency of the standard would benefit from such integration. However, if integrating the two standards would significantly delay the issuance of the amended standard, the amended standards should be issued without integrating them.

2.2 IAS 39

Question 1 -- 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?

Response:

Yes, we agree with the scope exclusion for practical reasons.

Question 2 -- 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?

Response:

No we do not agree with the change proposed. We fail to see that the continuing involvement approach is as an improvement of the current treatment under IAS 39. The approach lacks conceptual underpinning and would in our view raise many interpretation issues. The approach is in our view not easier to apply than the current approach and leads to the recognition of assets and liabilities and measurement issues that are difficult to understand and that do not meet the criteria of the Framework.

Although we see that the current approach in IAS 39 is complex and that many implementation issues have arisen in practice on the subject of derecognition, we propose not to change the approach, as the proposed change is in our view not an improvement. We rather recommend to clarify the current text on derecognition along the following lines:

- If there is no continuing involvement at all, the instrument is derecognised;
- If there is continuing involvement, it is considered whether significant risks and rewards have been transferred:
  - If no significant risks and rewards have been transferred, the instrument is not derecognised at all,
  - If significant risks and rewards have been transferred, a components approach is applied to derecognition.

We also do not agree with the minority views expressed that a full components approach is more appropriate. Such an approach would be adequate in a full fair value measurement model, but not in the current mixed measurement model The issue requires further study for a more appropriate approach to be developed.

Question 3 -- 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?

Response:

We agree with the proposal when an enterprise is only acting as an in substance agent, rather than as a principal to a transaction, and all cash flows are on a one-to-one basis, passing through the enterprise.

We think that the definition of “pass-through” has been broadened to include situations where the enterprise is a true principal by bringing certain Special Purpose Vehicles (SPE’s) – not being in substance agents - within the scope of a “pass-through” vehicle. We strongly disagree that such an SPE is a “pass-through” vehicle that would meet the criteria as proposed. This applies especially to situations where various classes of instruments are issued and most of the holders of securities issued by the SPV do not take risks other than those of lenders. In this case cash flows are not passing through the vehicle on a one to one basis, but the vehicle has positions and the beneficial interest holders have rights on the return from the investments in a varying degree. Those rights do not represent a proportionate share in the assets of the entity. We do not agree that an issue as fundamental as consolidation as interpreted in SIC-12, should be circumvented by including proposals for derecognition within the SPE in IAS 39 for vehicles that issue these types of beneficial interests.

We also feel that the current proposal could have more far reaching consequences than intended, for example for investment funds.

Question 4 -- Measurement: fair value designation (paragraph 10)
Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?

Response:

Yes we agree with the proposal and support the objective of this amendment, which is to avoid certain mis-matches that arose under IAS 39 because an entity was precluded from adopting a fair-value-through-income model for some financial assets and liabilities. We also expect that the proposals will provide more opportunity for real life testing of fair value accounting.

Question 5 -- 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?

Response:

Yes, we agree with the guidance proposed.

Question 6 -- 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?

Response:

We agree with a proposal to allow setting up an impairment provision on a portfolio basis. However in our view the calculation of such a provision on a portfolio basis should not be required, if an enterprise has set up adequate provisions by assessing the impairment on an individual basis. In particular for smaller portfolios of individually significant loans a portfolio assessment will be impossible as sufficient historical statistical information will not be available.

We agree that the proposed approach to the calculation of the impairment prevents that impairment provisions are set up when entering into the loan transaction. However, the calculations are rather complex and are different from the approach currently taken to inherent risk provisioning in practice as well as are different from the approach taken in the standards with respect to provi sioning. Generally only events that have occurred at balance sheet date are considered when setting up a provision. The calculation as described would be more a fair value approach, taking future events into consideration through their impact on estimated cash flows.

Question 7 -- 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?

Response:

We do not agree with the proposal to not reverse impairment losses:

- Not allowing reversals of impairment losses is not in line with other standards in IAS, for example IAS 36

- Not allowing reversals of debt securities in internally inconsistent with allowing reversals on impaired loans.

We rather propose to significantly simplify the recognition of gains and losses when an asset categorised as available for sale is impaired, by allowing to include all changes in the fair value of such an asset in the profit and loss account, until the fair value has reversed up to the amount that amortised cost would have been had no impairment been recognised.

Question 8 -- 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?

Response:

Yes, we agree with this proposal.

Question 9 -- '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 recognized 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?

Response:

We would prefer an option to either basis adjust or to release from equity consistently with the reporting of gains and losses on the hedged item, however do not fundamentally disagree with the proposal.

The arguments of the IASB in the Basis for Conclusions are not particularly strong as basis adjustment is now introduced for firm commitments. Therefore - and given the flexibility entities already have in applying either hedge accounting model - we do not think that including an option in this model would provide any more flexibility than is currently already available for hedge accounting.

We propose also that it is clarified that at inception of a hedge transaction, the model to be applied is determined and that this is not later changed. Otherwise enterprises would first have to apply a cash flow hedge model when hedging a forecasted transaction and then change to a fair value hedge model, once the forecasted transaction had become a firm commitment.

Question 10 -- 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 grand fathered)? Alternatively, should prior derecognition transactions be grand fathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?

Response:

Yes, we agree with this proposal.

If you have any queries regarding our comments and responses, please do not hesitate to contact us.

Yours sincerely,

Martin Hoogendoorn
(Chairman Dutch Council for Annual Reporting)