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**CL 12**

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

London EC4M 6XH
United Kingdom

Düsseldorf, 11 October 2002
524/520

Dear Sir David,

**Re.: Financial Instruments - Proposed Amendments to IAS 32 and IAS 39**

We appreciate the opportunity to comment on the aforementioned Exposure Draft and would like to submit our comments as follows:

## General Remarks

We agree with the IASB´s objective to improve the existing requirements in IAS 32 and IAS 39. In particular the complexity of IAS 39 requires amendments in order to clarify many issues and to reach more consistency. In some respects we recognize major improvements. However, in particular in the following areas we have major concerns:

In our view the proposed amended version of IAS 39 Financial Instruments lacks a clear and consistent concept for measurement of financial instruments through the implementation of the opportunity to designate any financial instrument as held for trading irrespective of whether management really intends to generate profits from short-term fluctuations in price or dealer´s margin. Whereas the measurement concept of IAS 39 (revised 2000) is to a great extent based on management intent to sell or hold the financial instruments, in particular with regard to the measurement of financial instruments within the categories “financial instruments held for trading” and “held to maturity investments”, the proposed new standard combines a measurement based on management intent with the approach proposed by the Joint Working Group of Standard setters, which requires a fair value measurement for almost all

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financial instruments and which refuses any influence of management intent on the measurement of financial instruments.

By means of introducing such a choice to designate each financial instrument as held for trading and thus to measure each financial instrument at fair value the standard will leave the accounting treatment to the arbitrariness of management, which seriously impedes comparability of financial statements of different entities.

In this context we are very much concerned that the important issue of reflecting changes in the entity´s own creditworthiness in the income statement is not addressed by the Board when allowing all financial liabilities to be measured at fair value through net income – which also would create an incompatibility with US GAAP. With regard to this major conceptual issue, which already has been raised in the context of the proposals of the Joint Working Group, we would have expected further discussions and field testing before IAS 39 would be changed.

It is stated in the basis of conclusions that permitting enterprises to designate any financial instrument as held for trading eliminates the need for hedge accounting when there are natural offsets or matched positions and thereby avoids the related burdens. In our view, and in order to resolve the critical issues raised above, the new opportunity for fair value measurement should be restricted to such cases (see our detailed comments to question 4 to IAS 39 ‘Measurement: Fair Value Designation’).

With regard to the continuing involvement approach as the principle for derecognition we share the dissenting view of the two Board members which is reflected in Appendix D ‘Alternative Views’. We have much sympathy for a “pure” components approach. For our detailed comments we refer to the answer of question 2 to IAS 39 ‘Derecognition: Continuing Involvement Approach’.

Further we would like to remind that neither the amended IAS 32 nor IAS 39 include detailed requirements for the presentation of financial instruments on the face of the balance sheet and profit and loss account. Regarding this we see an urgent need in practice. We expect that this issue will be considered in full as part of the Reporting Financial Performance Project.

Many of the proposed amendments to IAS 32 and IAS 39 give the impression that they are based primarily on the intended convergence towards US GAAP regardless of whether this would really cause an improvement to the current accounting of financial instruments. In particular we are concerned with regard to the proposed elimination of the reversal of impairment losses, the treatment of hedges of firm commitments and the elimination of basis adjustments in the context of cash flow hedges.

In general, we support examples in the appendices to IAS 32 and IAS 39 as an integral part of the standards in order to illustrate the rules of the standards. Therefore the examples should be simple and easy to understand. But the chosen examples in the Exposure Draft are in some cases (for example amendments to IAS 39, appendix B, B4.-B22.) very complicated. We recommend to revise the examples, especially in respect of explanation of figures and of the underlying provisions.

The IASB proposes that the improved standards become operative for financial statements covering periods beginning in 2003. In our opinion this date is not appropriate in consideration of the huge extent of adaptations being required. Therefore the earliest possible effective date could be 1. January 2004. In addition we believe that the IASB should include a clearly determined effective date in its Exposure Draft in order to give all interested parties a chance to appropriately assess the effective date and to comment on.

**Proposed amendments to IAS 32 Financial Instruments: Disclosure and Presentation**

**Probabilities of different manners of settlement (paragraphs 19, 22 and 22a)**

*Question 1*

*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 on 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).*

We agree. In our opinion the distinction between financial liabilities and equity should be based strictly on the definition of para. 49 (b) of the IASB Framework and IAS 32.5. Therefore the existence of a financial liability requires that the entity has a contractual obligation from which the entity can or could be required to suffer an outflow of resources embodying economic benefits by delivering cash or other

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financial assets. In case of a contingent liability the occurrence or non-occurrence of the future events or circumstances must be beyond the control of the entity. The probability of those events or circumstances is not relevant with regard to the question, whether a financial liability exists. However, it might be clarified in this context, that this probability is an important factor in determining the fair value of a financial liability.

The example of an accelerating dividend on a preferred share has been deleted from para 22. We do not favour the removal of the example because it demonstrates that a contractual agreement can create an economic compulsion and therefore a financial liability.

**Separation of liability and equity elements (paragraphs 28 and 29)**

*Question 2*

*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?*

We agree.

**Classification of derivatives that relate to an entity’s own shares (paragraphs 29c – 29g)**

*Question 3*

*Do you agree with the guidance proposed about the classification of derivatives that relate to an entity’s own shares?*

Para. 29D states that a derivative contract is classified as a financial liability if the contract requires net settlement in the entity´s own equity instruments because it will not result in the receipt or delivery of a fixed number of own equity instruments in exchange for a fixed amount of cash or other financial assets at the maturity date. Similarly para. 22C states that a contractual obligation of a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity´s own shares, which must or can be settled by delivery of the entity´s own equity instruments is a financial liability. We request the Board to check whether these classifications are compatible with the definition of a liability in the IASC-Framework. The settlement of a liability is expected to result in an outflow of economic resources of the entity (see F. 49 (b)). In the case of para. 22C and para. 29D the settlement of the contractual obligation does not result in an outflow of resources of the entity, but only in a dilution of the shares of the other shareholders.

In this connection we would like to ask the Board to check the sign of the fair value of the forward in the illustrative example 2 of Appendix A on December 31, 2002 and on January 31, 2003 (see A32.). In our opinion the fair value of the forward must be negative in the example according to the journal entries.

In addition, we do not agree with the proposals in IAS 32.29E. As a principle it is not our view that the accounting should be dependent upon past behavior and the intention to settle a contract by issuing own shares. If an entity has the right to settle a fixed obligation by issuing a fixed number of its own shares, then the instrument should be treated as equity.

**Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard**

*Question 4*

*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.)*

We would recommend the combination of both standards - although such a standard will inevitably be voluminous - since definitions, recognition, measurement, presentation and disclosure of financial instruments together are indispensable elements with regard to the accounting for financial instruments and therefore were originally intended to be included in one comprehensive standard. Also the clarity of the accounting standards would benefit from the integration, because the combined standard would include only one section for the scope and only one section for definitions. For example, IAS 39.10 defines a derivative, but the amended IAS 32 already uses the expression ‘derivative’ and ‘derivative contract’ (e.g. para. 22B, 29C ff.).

**Other comments with regard to IAS 32**

**Definition of an insurance contract**

We observe that there is a difference between the definition in IAS 32 and the definition included in the DSOP for insurance contracts. If this were not to be solved, there is the risk that insurance undertakings need to treat certain contracts as financial instruments and subsequently, after issuance of a final insurance standard, this treatment will have to be changed. We recommend therefore changing the definition of IAS 32 in the line with the definition in the insurance DSOP in order not to require insurance undertakings changing their system twice. There are other areas of IAS 32 and IAS 39 for which similar comments can be made, for example separation of embedded derivatives (IAS 39.1(d) and IAS 39.23) and participating contracts. In general we believe that IASB should do the maximum possible to avoid that companies have to change their systems twice within a relatively short period.

**Scope: interests in subsidiaries**

We recommend to amend the scope paragraph IAS 32.1 (a) in order to clarify whether this standard applies to all interests in subsidiaries, joint ventures and associates or just to direct equity investments in those entities. In our view also interests arising from derivatives on the equity interests already held by the reporting entity as well as call options on additional equity interests should be exempt from IAS 32 and IAS 39. These interests should be covered by IAS 27.

**Equity minority interests**

IAS 32.17 is already amended in accordance with the proposed revision of IAS 27.26. However, IASB´s project on business combinations is still in process. Therefore we propose to refrain from the proposed amendment to IAS 32.17 until this project is finalized. If IASB´s project on business combinations would result in the conclusion that consolidated financial statements should be prepared from an entity point of view, minority interests are part of equity of the group and, therefore, should be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity.

In this context the Board should give further guidance on whether the same treatment should be applied to derivatives on own shares and to derivatives on minority shares (IAS 32.22 to 22C and IAS 32.29A to 29G).

**Classification of partnership interests (IAS 32.20)**

More guidance with regard to the classification of interests in partnerships is required, where the individual partner has the right to cancel his partnership, without liquidation of the partnership, resulting in an obligation of the partnership to deliver cash or another financial asset in the amount of the partner´s share of the residual value at that time.

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**Transaction costs of equity transactions (IAS 32.31A)**

IAS 32.31A should also address the treatment of transaction costs in those cases in which the equity transaction is not finalized at the balance sheet date. Such transaction costs should be charged to income unless it is virtually certain at the balance sheet date that the transaction will occur.

**Classification of interest, dividends, losses and gains relating to financial instruments (IAS 32.31)**

It should be clarified whether the provision of IAS 32.31 deals with the accounting treatment for the issuer or the holder of the financial instrument. Further we propose to add guidance in respect of the treatment in consolidated financial statements.

**Proposed amendments to IAS 39 Financial Instruments: Recognition and measurement**

**Scope: loan commitments (paragraph 1(i))**

*Question 1*

*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?*

In general, we agree with this proposal. However, we do not agree that the standard shall apply to all loan commitments of an entity, if it has a past practice of selling the assets resulting from its loan commitments. In our opinion only those loan commitments, which can be settled net and which have been incurred principally for the purpose of net settlement in the near term should be included in the scope, if they are part of a portfolio of loan commitments being managed together and if there is evidence of a recent pattern of short term profit taking (see definition of “trading” in IAS 39.10).

Furthermore it is not clear whether the use of the word „entity” in IAS 39.1(i) applies to an entire group, an operating entity (e.g. a subsidiary), or even some smaller unit within the group, although we suspect the Board intended it to apply to an entire group which would not, in our opinion, be appropriate. For diversified groups operating in significantly different markets, we believe the differences between those markets can often justify adopting different treatments in different parts of the group. For example we do not believe that an international bank, which is able to dispose of assets arising from its retail loan commitments in the US, and has a past practice of doing so, should be required to treat its European commercial loan commitments as held for trading if there is no ready market to dispose of the resulting assets.

In case of trading activities as mentioned above not only loan commitments, but also 'financial guarantee contracts' (see para. 1(f)) and 'contracts that require a payment based on climatic, geological or other physical variables' (see para. 1(h)) should be included in the scope of IAS 39 by allowing to designate such contracts as held for trading.

Further we propose to add a definition of a loan commitment in the standard, which also clarifies that it includes long term banking facilities and credit lines. In this connection it also has to be clarified in IAS 32.1(i) that the standard applies both to holder and issuer of loan commitments.

**Other comments with regard to scope of IAS 39**

**Contracts to buy or sell non-financial items**

We strongly disagree with the conclusions taken in the Exposure Draft to include contracts to buy or sell non-financial items. This would extend significantly the scope of IAS 39 since the effect of the amendment is to extend the scope of Q&A 14-2 to all regular trading of non-financial assets.

The Exposure Draft proposes to include in the scope of the Standards those contracts to buy or sell a non-financial item that can be settled net in cash or by some other financial instrument as if they were financial instruments, with the exception of contracts that were entered into and continue to be for the purpose of delivery of a non-financial item in accordance with the entity´s expected purchase, sale, or usage requirements (see IAS 32.4A f. and IAS 39.6). In addition, the Exposure Draft proposes to also include such contracts in the scope, where there is no net settlement provision at all, but for which the entity has a past practice of settling net by taking delivery of the underlying and selling it within a short period after delivery. Furthermore servicing assets and servicing liabilities shall be recognised and measured at fair value under the proposed amendments, if an entity transfers all or portion of a financial asset and retains the right to service the financial asset for a fee (IAS 39.43).

In our opinion the rules of IAS 32 respectively IAS 39, in particular the measurement at fair value in certain circumstances, should be applicable only for financial instruments as defined in IAS 32.5, because there are significant differences between financial instruments and other items, which justify or even require different measurement considerations. Financial instruments are insofar different from other assets and liabilities as they represent contractual – i.e. legally enforceable – rights or obligations to receive or pay cash or other financial instruments or residual interests in the net assets of another enterprise, and, thus, are directly linked to future cash flows. That is, financial instruments are not recognised before the enterprise’s earnings process is completed (for example, receivables are not recognised before the enterprise has fulfilled its contractual obligation to deliver goods or to render services), or they are in some other form unrelated to the enterprise’s earnings process. In contrast, non-financial items have only an indirect, non-contractual relationship to future cash flows. They merely serve, in various forms, as inputs in the enterprise’s earnings process, and their risks and rewards depend on how effectively they are used in that process.

We see a strong need for putting emphasis on a strict distinction between financial instruments and non-financial assets and liabilities. The distinctive feature of financial instruments is that they are not exposed to operational risks of the reporting enterprise. Accordingly, it is our belief that the Exposure Draft inappropriately extends the scope of fair value measurement to servicing assets and liabilities and contracts to buy or sell non-financial items.

With regard to contracts to buy or sell non-financial items, only those contracts which meet the definition of financial instruments could be included in the scope. The inclusion of contracts for which the entity has a past practice of settling net by taking delivery of the underlying and selling it within a short period after delivery would create problems especially for retailers.

In our opinion, the contract must convey to the reporting enterprise a legally enforceable right or obligation to settle the contract by receiving or paying cash or some other financial instrument, rather than by physical delivery, in order to qualify as a financial instrument. However, even such contracts should not be included in the scope, if they (a) were entered into and continue to meet the entity´s expected purchase, sale, or usage requirement, (b) were designated for that purpose at their inception, and (c) are expected to be settled by delivery.

### Rights and obligation under leases

We see no reason why IAS 39.1(b) requires that lease receivables are subject to the derecognition provisions of IAS 39, but IAS 39.58 to IAS 39.65c should not be applicable for lease payables recognized by a lessee.

**Financial guarantee contracts**

IAS 39.1(f) outlines that financial guarantee contracts shall fall within the scope of IAS 39 for initial recognition and measurement, but fall within the scope of IAS 37 for subsequent measurement which is conceptually difficult to understand. Since the measurement criteria of the two standards are different, this might result in the immediate reversal of the initial recognition (based on fair value) when the criteria of IAS 37 (more likely than not) are not met, resulting in a gain to be recognized in net profit or loss. In order to avoid these inconsistencies it should be considered whether IAS 37 should be also applied for initial recognition and measurement.

**Derecognition: continuing involvement approach (paragraphs 35 – 57)**

*Question 2*

*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?*

As already stated above we do not agree because we believe that a “pure” components approach is superior when compared to the proposed approach although such an approach also needs to be substantial field-tested before its implementation.

In our view, the crucial (and only) factor for recognising or derecognising a financial instrument should be whether a legally enforceable right exists that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. Thus, all binding contracts in which the reporting entity has entered into at balance sheet date (including all arrangements that give rise to rights and obligations that are similarly enforceable as right and obligations under a binding contract) should be analysed with regard to the existence of financial assets and financial liabilities as defined in IAS 32.5. A pure components approach would look solely at the rights and obligations an entity actually has as a result of the transaction, rather than ask whether the transferor has no continuing involvement in all or a portion of the contractual rights, which have been existing before the transaction occurred. We support the argument of the alternative view that two companies that finally end up in the same economic position, though by different ways, should not result in different accounting, but should report the same assets and liabilities at the same amounts.

The proposed amendment results in recognising fictitious assets and liabilities which do not meet the definitions of those elements in the IASC-Framework, e.g. where there is no longer any access to future economic benefits. In this context the IASB proposes new measurement rules, i.e. curtailing fair value changes in certain situations, which result in deviations from the general principles simply as a result of the method of financing used.

On the other hand, derivative financial instruments arising under such arrangements (for example repayment options) and financial guarantee contracts are not recognised, even though they clearly represent financial assets or liabilities.

Overall, we are concerned that the IASB's rule-based continuing involvement approach will result in financial engineering in order to achieve an off balance sheet treatment merely driven by the legal form of the underlying transactions.

We are not aware of any sufficient evidence that the continuing involvement approach has been adequately field tested. We would have expected that such a new approach representing a major change to the current provisions for derecognition be fully tested in order to avoid any application issues. As it is already demonstrated in the Application Guidance (Appendix A), the proposed continuing involvement approach requires very complex accounting techniques, which differ in dependence on the individual type of transaction. With this background we would expect that a lot of additional guidance will be needed. This problem could be avoided by using the pure component approach.

**Derecognition: pass-through arrangements (paragraph 41)**

*Question 3*

*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 do not agree with the proposed treatment.

If the entity has rights with regard to future cash inflows based on a contractual agreement with one party and corresponding obligations with regard to future cash outflows based on a contractual agreement with another party, in our opinion both, a financial asset and a financial liability have to be recognised. It should be clarified that this case does not meet the definition of a “pass-through arrangement”. Otherwise the application of the proposed derecognition rules for “pass-through arrangements” would result in an offsetting of the financial asset and the financial liability, which is not compatible with the general offsetting rules. Furthermore it will be more meaningful to present a right to receive future cash flows and an obligation to pay future cash flows on a gross basis. As stated in IAS 32.5, the existence of financial assets or financial liabilities would be determined by contractual rights or contractual obligations to receive or deliver future cash flows. Consequently, we see no reason why netting of rights and obligations arising under a pass-through arrangement should be permitted on another than the legal basis. Therefore, IAS 32.33 should be applied. Under IAS 32.33 a financial asset and a financial liability shall be offset and the net amount reported in the balance sheet, when, and only when, the entity

- has a legally enforceable right to set off the recognized amounts and
- intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

The proposed amendment to IAS 32.33 emphasizes that in the accounting for a transfer of a financial asset that does not qualify for derecognition, the transferred asset and the associated liability shall not be offset. IAS 32.36 makes clear that the conditions establishing a right to set off may vary from one legal jurisdiction to another, and the relevant laws apply to the relationships between the parties involved in the contracts relating to the financial instruments affected. The application of IAS 32.33 would have the advantage that financial assets and financial liabilities would be presented on a net basis only if this reflects an entity's expected future cash flow from settling two or more separate financial instruments. When an entity has the right to receive or deliver a single net amount and intends to do so, or when an entity has a contractual netting obligation, it has, in effect, only a single financial asset or financial liability (see IAS 32.34). On the other hand, if gross cash flows are expected (that is, a cash inflow and a cash outflow), this should be reflected by presenting the financial instrument(s) on a gross basis (that is, by recognising both, a financial asset and a financial liability). It makes a significant difference, whether the entity would only receive or pay a (small) net amount or whether the entity receives a (large) amount at one future date and pays a (large) amount at another future date. Only in the latter case, there can be the possibility to reinvest the amount received for the meantime, even if this might not be permissible under a "pass-through arrangement".

If the IASB retains its proposal regarding "pass-through arrangement", we recommend to clarify and revise the wording of the respective paragraphs, because we are concerned that the present wording leads to varying interpretations. Further we ask the IASB to give guidance in which period the cash flow has to be transferred from the transferor to the transferee in order to be remitted "without material delay", the latter a term which is vague and which in practice will result in different interpretations.

**Measurement: fair value designation (paragraph 10)**

*Question 4*

*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?*

As we have mentioned in our general remarks we agree with the Basis of Conclusion in so far as under the rules of the new standard mismatches with regard to fair value exposures can be avoided, because a fair value hedging relationship can be reflected in the financial statements without the necessity to fulfil the strict requirements for hedge accounting as stated in IAS 39 (rev. 2000). In particular in view of these hedging relationships a new category of financial instruments, which can be measured at fair value will be consistent with the current concept of management intent. Therefore, in our opinion the new opportunity to measure financial instruments at fair value should be applicable only in cases, in which a reduction of measurement-mismatches can be demonstrated at least on an aggregated level. This means, that, in contrast to IAS 39.132 f., fair value measurement should be possible for groups of financial instruments within a fair value hedging relationship - even if they are not similar - or overall net positions, if the entity's risk management demonstrates the hedge effectiveness being sufficient. However, since the reduction of the risk of fair value changes is assessed on an aggregated level, the required degree of hedge effectiveness should be lower compared to the requirement of IAS 39.146 ff. In this case all financial instruments, which are designated as part of the hedging relationship might be measured at fair value and the fair value changes – except for effects of changes in own credit risk (see our comments below) – could be reflected in income. However, fair value measurement should not to be irrevocable under this concept since it requires the demonstration of a hedging relationship on an aggregated level.

With the implementation of a new category of hedging relationships whose elements will be measured at fair value as described above many practical problems in respect of the actual hedge accounting rules could be avoided, since the creation of artificial hedging relationships between individual hedging instruments and hedged items and the corresponding efforts with regard to the documentation and measurement of hedge effectiveness could be avoided.

Besides our comments above we do not agree with the opportunity to measure all financial liabilities at fair value through net income:

The fair value of a financial liability changes when the market's assessment of the risk that the liability will not be repaid changes. An enhancement and a deterioration of a debtor´s creditworthiness causes the observable market exit price of its traded debt to increase or to decrease. We question whether the change in fair value of liabilities caused by changes in the debtor's creditworthiness is relevant to users of the debtor's financial statements and are concerned, that the results rather may be perceived as confusing and counterintuitive. In particular, if an entity's creditworthiness deteriorates, the fair value of its liabilities declines and the entity records a gain. We do not believe that a decline in creditworthiness should result in recognising a gain.

Furthermore, the effects of changes in creditworthiness on the fair value of liabilities reflect changes in the internal operating conditions of the entity, rather than changes in external conditions of financial markets (see also our other comments on contracts to buy or sell non-financial items).

In addition, changes in the credit standing of an entity are usually accompanied by adverse changes in the value of the entity's internally generated intangible assets (in particular, internal goodwill). However, these adverse changes are generally not recorded under existing accounting standards. Thus, there is a fundamental inconsistency and "mis-matching" in reporting the effects of changes in credit standing on an entity's liabilities. While a deterioration of the creditworthiness causes a reportable gain from the decrease of the fair value of the entity's liabilities, a loss from the corresponding decline of internal goodwill is ignored.

If an enterprise is in financial difficulties, the fair value of the enterprise's debt may reflect the market's expectation that the enterprise probably will not continue as a going concern (in other words, the market may evaluate the enterprise on the basis of its expected break up value). That may create a discontinuity in accounting if the enterprise continues to account for its assets on a going concern assumption while the book values of liabilities and their changes are determined on the expectation that it may not continue as a going concern.

The risk that an enterprise will fail to repay its liabilities when due can be described as an implicit put option of the debtor to transfer its remaining (financial and non-financial) assets to the creditor in the case of insolvency instead of settling the liability according to the contractual terms. Theoretically, it would be possible to separate from a liability the value of that implicit put option (which does not meet the definition of a financial asset as far as it refers to non-financial assets). Separating the put option would result in the liability being valued at the present value of its contracted cash flows discounted at the current basic (risk-free) interest rate. The option could presumably be separately accounted for as a specific type of intangible asset of the enterprise to be amortised using the effective interest method, although one might also argue that it should directly be offset against equity. Separation of the option from the liability would result in measuring the liability at the amount that the enterprise is obligated to pay without any reduction for the market's evaluation of the statistical probability that the enterprise will not meet its obligation.

Alternatively, an approach might be considered that measures financial liabilities without taking into account changes of the reporting enterprise's own creditworthiness.

We do recognise the practical difficulties arising from the exclusion of the effects of changes in credit risk from fair value measurement of financial liabilities where a market price exists. However, on the other hand this approach would avoid the problems arising on the determination of changes in credit risk, if no market prices exist for financial liabilities.

**Other comments with regard to measurement:**

We agree, that equity investments should be excluded from fair value measurement, if it is not practical to reliably estimate their fair value. However, as it was stated in the previous version of IAS 39.71, it should be clarified that the exception is also applicable to investments that are in substance equity instruments, in particular special participation rights without a specified maturity whose return is linked to an entity´s performance.

**Fair value measurement considerations (paragraphs 95 – 100d)**

*Question 5*

*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?*

We agree with the proposed hierarchy of principles for determining fair values and the respective guidance. However, more guidance would be helpful, among others as to whether what is an active market and what is a non-active market in relation to IAS 39.101 since this constitutes a major distinction in determining fair value. In this connection the definition of an "active market" in IAS 39.99 should be adjusted to the definition of IAS 38.7.

At present the proposed application guidance includes only a very general description of how fair values of non-traded financial instruments should be calculated. Not only with regard to the practicability of fair value measurement, but also with regard to the comparability of financial statements, we have doubts whether implicit or explicit options should be permitted to reporting entities to choose between different types of valuation techniques and to determine, without detailed guidance, the appropriate parameters and inputs to be used in the specific valuation model. Comparability is a very important qualitative characteristic of financial statements and, based on past experience, it is doubtful whether guidance of a very general nature can be sufficient to achieve the comparability objective.

We welcome the proposed amendment of IAS 32.77B, which requires the disclosure of the methods and significant assumptions applied in determining fair values. In our opinion it would be even more helpful, if the methods to be applied for measurement of different types of financial instruments and the parameters to be used within the methods would be specified by the standard setter as far as possible. A certain degree of standardization can also be found in other areas of accounting (i.e. employee benefit obligations, construction contracts or impairment of assets), which contributes to significant practical facilitations. Though we acknowledge that a sufficiently detailed specification of acceptable valuation models might require the standard to be updated more frequently (that is, in principle, every time when major advances in valuation techniques occur), we believe that this problem can be eased by establishing a less complex and less costly due process for amendments of those parts of the standard that form the application guidance.

**Collective evaluation of impairment (paragraphs 112 and 113a – 113d)**

*Question 6*

*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 do not believe that the inclusion of loans that have already been found to be unimpaired in the overall pool has an adequate conceptual basis. However, the more important question is how to calculate the average default rate for the past, i.e. with or without the loan assets or other financial assets that have been individually assessed for impairment and found not to be individually impaired. If a company has the respective information it can do the calculation in either way.

We agree that the proposed approach of the calculation of the impairment prevents that impairment provisions are set up when entering into the loan transaction. However, we feel that the proposed calculations are rather complex. We doubt that the result of the proposed estimation of cash flows for each future period is closer to reality than a calculation which uses the same estimated cash flow loss rate for all future years if this rate is calculated based on past experience and the effects of current conditions. Both methods take into consideration the historical default rates and the current conditions. We agree that the methodology and assumptions used have to be reviewed regularly.

Further we would prefer that IASB uses identical terms in IAS 30 and IAS 39 (IAS 39.109ff.), i.e. specific loan loss provisions, general loan loss provisions and provision for general banking risks. Finally, in the banking industry there is a distinction between specific loan loss provisions calculated on a portfolio basis and general loan loss provision.

**Impairment of investments in available-for-sale-financial assets (paragraphs 117 – 119)**

*Question 7*

*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 do not support the proposed amendment since we do not see any conceptual reason for the proposed approach. We are unable to see any substantial difference to the situations described in IAS 2 paragraph 31 (reversal of any write-down of inventories), IAS 8 new paragraph 27 (recognition of the effect of a change in accounting estimate in profit or loss), IAS 16 paragraph 37 (Property, plant and equipment: the reversal of a revaluation decrease of the same asset previously recognised as an expense shall be recognised as income) and IAS 38 paragraph 76 (Intangible assets: a revaluation increase should be recognised as income to the extent it reverses a revaluation decrease of the same asset which was previously recognised as an expense) all of which require a consistent and reasonable treatment of reversals through income when the initial revaluation decrease was previously recognised as an expense. The only reason for the proposed treatment we can imagine is to eliminate a difference to US GAAP. Converting to unsound concepts just because these represent current US GAAP would be against the many times announced objectives of the IASB and, accordingly, as part of the convergence project the FASB should be convinced to amend its rules.

**Hedges of firm commitments (paragraphs 137 and 140)**

*Question 8*

*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?*

In general firm commitments are not recognized in the financial statements. If such firm commitments are hedged against financial risks (e. g. interest or exchange rate risks) with financial instruments, in our opinion this does not change the valid recognition and measurement rules for firm commitments. Consequently, the principle of not recognizing the gain from a net claim resulting from a firm commitment or the revenue recognition principle continue to be authoritative for firm commitments from operations. Therefore, we hold the classification of contracts for hedging such firm commitments as fair value hedges, with the consequence of a partial contravention of these recognition and measurement principles, as not being permissible.

Further the proposal results in practical problems: If an entity hedges a forecasted transaction against foreign exchange rate risks, this transaction is designated as cash flow hedge. At the time when a forecasted transaction converts to a firm commitment, this transaction would have to be re-designated as fair value hedge. If IASB retains its proposal, we expect that the standard provides guidance in respect of the treatment of the re-designation required.

It has been argued that the proposed change would remove an inconsistency between IAS and US-GAAP, however that is not entirely true – US-GAAP allows hedges of the foreign currency exposure from unrecognised firm commitments to be treated as a cash flow hedge whereas the amended IAS would not.

**„Basis adjustments“ (paragraph 160)**

*Question 9*

*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 do not agree with the arguments set out against basis adjustments in paragraph C 103 of the basis for conclusion, since the effects of basis adjustments on the book value of the hedged item are comparable to the effects of fair value hedges. Thus, as long as the Board advocates for the present accounting technique for fair value hedges, basis adjustments in case of cash flow hedges are consistent with the overall hedge accounting principles. Furthermore, a continuation of the presentation of measurement gains and losses as a separate item in equity and the reversal of this item affecting profit or loss according to the losses or gains originating from the hedged balance sheet item would not be practical in many cases (especially in the case of a hedge of long-term property, plant or equipment or investments) and would incur significant costs.

**Prior derecognition transactions (paragraph 171b)**

*Question 10*

*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 (ie 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?*

If the Board would follow our proposal to implement a pure components approach all contracts would have to be reviewed regularly at each balance sheet date with regard to the necessity of recognition or derecognition. Therefore, we would agree with a requirement that at the date of the first time application of the revised Standard all contracts should be recognised as a financial asset if this is required under the provisions of the revised Standard, although the asset was derecognised under the former Standard, since this would not cause any additional burdens for the preparers of financial statements.

However, if the continuing involvement approach would be included in the amended standard, a “grandfathering” of prior derecognition transactions, which took place before January 1, 2001 (this was the effective date of the present IAS 39) and where previous derecognitions were grandfathered, seems to be reasonable with regard to the complex derecognition rules in case of undue cost or effort.

**Other comments with regard to IAS 39**

**Appendices**

We are surprised that whilst the Board considers Appendix A – Application Guidance to IAS 39 to be an integral part of that Standard, Appendix A to IAS 32 is only considered illustrative. The differential approach causes confusion as to the authority of the appendices to the Standards and we recommend that the Board adopt a consistent approach to all new or revised Standards. We also wonder whether Appendix B to IAS 39 should be an integral part of that Standard.

There is a significant amount of the remaining Implementation Guidance that has not yet been rejected or incorporated into the proposals in exposure draft, not least those dealing with the detailed application of the hedge accounting rules. We believe that all remaining Implementation Guidance should either be incorporated into the revised standard, directly or indirectly (e.g. by giving them the status of an appendix), or be rejected as being incompatible or inconsistent with the revised standard. Otherwise users of the standards will be left confused as to the status of the individual Q&A.

**Embedded derivatives (IAS 39.22 to 26A)**

More disclosure requirements for embedded derivatives might be useful especially with respect to the large volumes at banks. These could include a breakdown of trading assets in stand-alone derivatives and (separated) embedded derivatives as well as disclosures about embedded derivatives not separated (short or long position, terms, notional amounts etc.).

Yours sincerely

Klaus-Peter Naumann

Chief Executive Officer