INDUSTRIE-HOLDING

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GROUPEMENT DE HOLDINGS INDUSTRIELLES SUISSES
FEDERATION OF SWISS INDUSTRIAL HOLDING COMPANIES

**CL 18**

International Accounting Standards Board
30 Cannon Street,
GB-London EC4M 6XH

October 14, 2002

## Exposure Draft, Proposed Amendments to IAS 32, Financial Instruments: Disclosure and Presentation IAS 39, Financial Instruments: Recognition and Measurement

Dear Sirs,

Please find below our comments on the above mentioned Exposure Draft. We would first like to give you our general thoughts on this important project, and then we will answer the specific questions of the Exposure Draft.

### 1. General Comments

1. We fully support the objective of the proposed amendments to improve the existing requirements in IAS 32 and IAS 39. As a matter of fact, recognition and measurement of financial instruments under IAS 39 have become extremely complex in practice. Therefore, complexity should be reduced wherever possible, especially in the following areas:
   a) Impractical limitation of 12 months for held-for-sale acquired subsidiaries (32.18 and 138).
   b) Disclosure of book values of financial instruments exposed to interest-rate risks (6 maturity periods instead of 3 at present, ED 32.49).
   c) Hedge accounting (reduction of required documentation).

2. Hedging plays a central role in risk management. Unfortunately, some amendments to the existing rules will not improve insight into preparers' risk management strategies as it further formalises the requirements for hedge accounting, especially regarding:
   a) Accounting treatment for firm commitments
   b) Cash flow hedges
   c) Basis adjustment.

3. As the Implementation Guidance is expected to be followed by preparers, it is necessary for the Board to develop a due process to formally consider the Q&A it will publish.

4. Due to the complexity of financial instrument recognition and measurement and based on the experience of implementing IAS 39 we cannot support the new standard becoming effective in 2003. Neither the Standard nor the Implementation Guidance can be published well in advance in order to allow preparers to properly adapt internal guidelines, procedures and systems to the envisaged amendments. Hence, this standard should become effective in 2004, under the assumption that the final standard and the Implementation Guidance are published well in advance.

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5. The Board intends that the new standard will be in place for a considerable period. We welcome this objective as it will allow the Board to work first on the project “performance reporting” which has to set the fundamental principles for measurement and recognition of the performance of financial instruments before related concepts are to be introduced in other IFRS.

## 2. Answers to specific Questions

## 2.1 IAS 32, Financial Instruments: Disclosure and Presentation

### Q. 1 - Probabilities of different manners of settlement

We disagree with the proposal to classify financial instruments without regard to probabilities of manner of settlement since the approach is inconsistent with the fundamental principal that financial instruments should be classified in accordance with the substance of their contractual relationships. We support the current conclusion in SIC 5 that contingent settlement provisions should not be considered if the probability that the issuer would be required to settle in cash or another financial asset is remote at the time of issuance. In the absence of such a provision, we believe that remote clauses will be inserted into financial instruments for the sole purpose of determining the accounting classification of the instrument.

We also recommend that consideration be given to introducing a similar remoteness provision elsewhere in the standard. For example, in circumstances where derivatives on own equity contain multiple settlement options, any whose exercise is remote should be excluded from the determination of the appropriate classification.

### Q. 2 – Separation of liability and equity elements

We agree that only one approach is necessary.

### Q. 3 – Classification of derivatives that relate to an entity’s own shares

Given the primary focus in paragraphs 18 and 19 of the exposure draft on classification following the substance of the contractual arrangements of the instrument, we believe it is essential that the requirements should not permit the development of instruments that, while sharing the same economic characteristics, are accounted for differently. This is particularly relevant when considering the proposals relating to derivatives on own equity.

This concern is best expressed by presenting an example: an issuer writes two options on its own equity: one a deep in the money written call and the other a deep in the money written put, both relating to the same fixed number of shares and maturing on the same day but with significantly different strike prices – the call would be exercised unless the share price fell significantly and the put would be exercised unless the share price rose significantly. The premium received for each would be largely intrinsic value but would also include some element of time value.

Assuming both instruments are separately tradable and are not regarded as linked, the accounting treatment of the options would depend on the manner of settlement. If both could only be exercised gross by physical delivery of shares, the premium received on both options would be taken to equity and a liability would be established under paragraph 29F for the discounted amount of the liability on the put. The cash receivable on exercise of the call, however, would not be recognized as a financial asset. The discount would then be charged to the income statement over the period to maturity as an interest charge. On maturity, assuming that both instruments remain in the money, the cash received on the exercise of the call will be taken to equity whereas the cash paid on the exercise of the put would be offset against the liability. Since the same number of shares will be issued under the call and bought back under the put on the same day, there will be no equity instrument outstanding at the end of the day.

Assume, however, that both written options are cash settled. Both will be treated as derivatives with gains/losses going through income. The gains and losses relating to the movement in the intrinsic value of the options would offset each other through the income statement, but the time value of each option would be credited to income (on a fluctuating fair value basis) over the period to maturity. When the options mature, the net cash paid by the issuer to settle them will be the difference between the strike price of each of them and the market value of the shares – effectively the difference between the two strike prices. In net terms, this is the same outcome as in the previous example but the accounting treatment is different. The time value on the options is taken as a credit to income and there will be no interest charge.

**Other points - Prospective Application of Measurement Standards**

We suggest that the IASB adopt a principle of prospective application of standards that result in re-measurement and retrospective application of standards that impact disclosure and presentation. The prospective approach will be consistent with what we understand the Board's thinking to be on business combinations and the share based payments projects. A prospective approach will avoid the potential dilution of public confidence that will arise from repeated restatements of financial statements as the IASB works to improve the standards. The extensive work programme of the IASB suggests that if a restatement approach is maintained as standards are improved and amended there will be few years without wholesale restatements by the users of IAS. The prospective approach will also enhance the credibility of the IASB with the preparer community and further acceptance of IAS by the large community of first time users and regulators across the European Union, Russia and Australia. The prospective approach will also avoid punishing the preparer community who applied the existing accounting standards as written in good faith and their advisors, creditors and shareholders who relied on such financial statements.

The amendments to IAS 32 and IAS 39 are particularly vulnerable to further change in the foreseeable future. The recently announced convergence project with FASB, especially the debt/equity question will almost certainly result in further fundamental changes. Restatement seems less and less appropriate in such circumstances. The IASB could either undertake a re-think of the current text in IAS 8 or simply provide specific transition requirements for each new standard.

**Convergence with US GAAP**

A prospective approach to new standards affecting measurement is also consistent with US GAAP. A review of the last six standards issued by FASB shows that four require prospective application (140, 141, 142 and 144), one (143) requires adoption in the current year through a cumulative catch up adjustment and one (145) affects the presentation only of gains and loss on extinguishments of debt and requires restatement of prior periods. Further, US GAAP, in APB 20 makes strong arguments that there are few, if any, changes in accounting principles that require the restatement of prior periods. We believe that the multiple regulatory environments in which IAS must be applied and enforced make a restatement bias even less comprehensible than under US GAAP.

**First time application of IAS**

There is a distinct difference between an ongoing user of IAS and an entity adopting IAS for the first time. Our view is that the measurement standards should be applied prospectively for changes in accounting policy of those entities already applying IAS. The adoption of a new set of accounting principles and the first publication of IAS financial statements does require the retroactive application of the standards to produce results that are comparable with existing preparers and with other entities applying IAS for the first time.

**Q. 4 – Consolidation of the text of IAS 32/39 into one comprehensive standard**

We agree that this would be desirable. We consider that the presentation of a financial instrument especially as to whether it is of a liability or equity nature is of more significance than disclosure and presentation of other assets and liabilities and in certain circumstances determines the appropriate measurement rules to apply. The allocation of the guidance in this area between IAS 32 and IAS 39 is therefore somewhat artificial.

Furthermore, we consider that amalgamation of the text into one standard may lead to an elimination of duplication in some areas. An advantage would also be derived from achieving a compatible register for the combined standard - orienting the recognition and measurement aspects to the principle-based register of IAS 32 and eschewing the rule-based, cookbook approach of the present IAS 39.

Such a combined standard will be long, so care will need to be given to producing a good index and structure. We believe re-exposure of any combined standard would be necessary.

**Other points**

Para. 1(a): We have already negatively commented on the limitation of 12 months for held-for-sale acquired subsidiaries in our response on the other “Improvements” draft (q.v.).

Para. 32.29C (bold print) and para. 32.29F (plain print): It should be noted that there is an overlap between 32.29C and 32.29F in that 32.29C refers to both rights and obligations to acquire and deliver own equity instruments, whereas 32.29F only includes the obligation to acquire own equity instruments. The question therefore arises as to whether 32.29F overrides 32.29C, and according to the examples in Appendix B, 32.29F does indeed override 32.29C. We suggest that the wording in para. 32.29C be rephrased so as to avoid any confusion.

Para. 64: The disclosure of the book value of financial instruments exposed to interest-rate risk broken down into 6 maturity periods would be excessive. We recommend staying with the present, quite adequate analysis (< 1 year, 1-5 years and > 5 years).

We find the table in B27 very helpful and recommend that such a table, amended in respect of our comments on question 3 above, should be incorporated into the standard itself.

## 2.2 IAS 39, Financial Instruments: Recognition and Measurement

### Q. 1 – Scope: loan commitments

We agree.

### Q. 2 – Derecognition: continuing involvement approach

A few concrete examples from the commercial as well as the banking sector would make clearer what is meant here, eg. we suggest covering factoring and forfeiting, where one might pass on receivables subject to recourse due to inadequate documentation (veritas risk) affecting, on the basis of experience, some 2% of receivables. Does the continuing involvement approach prevent derecognition of all of the receivables – which seems rather far from the economic reality of the situation – or does it still permit derecognition with a 2% provision for recourse?

Further, as we understand it, certain measurement aspects of the approach need more study as they appear to result in some circumstances in the recognition of assets and liabilities that do not meet Framework definitions. For instance, a transfer of receivables might contain a credit guarantee for default of 20% of the principal amount, though actual expectations are that default losses should not exceed 10% on the basis of experience. It seems that the proposal would derecognise 80% but leave 20% as an asset through the continuing involvement. Where values can be reliably measured (e.g. based on experience), it would clearly make more practical sense to derecognise 100% of the receivables and set up a provision for impairments due to likely losses on the guarantee. This would also be more consistent with IAS 18 recognition conditions and avoids meaningless assets being shown in the balance sheet.

Para. 42-43: We consider that the concept of practical derecognition whilst theoretically acceptable is not particularly concrete. We suggest that the Appendix gives examples as to how to calculate the amount to be derecognised.

We note also that, despite the elimination of the control concept, it still surfaces in para. 37 and 38 in "re-acquiring control", so the change does not appear to be a clean one. Moreover, in para. 42, it would be desirable to cover whether or not the retention of voting rights in an asset is a substantial factor to consider in determining whether it can be de-recognised.

In general, we find that this proposal on de-recognition clearly "needs more work" to make it practicable if it is to replace current rules and would certainly benefit from concrete examples of what should and should not be recognised, perhaps in the Appendix.

### Q. 3 – Derecognition: pass-through arrangements

We agree.

**Q. 4 – Measurement: fair value designation**

We agree.

**Q. 5 – Fair value measurement considerations**

We agree.

**Q. 6 – Collective evaluation of impairment**

While broadly satisfied with the proposal, we consider that it should be made clear that the preferred valuation approach is individual assessment. We consider that the present wording places too much emphasis on a collective approach and that there is a danger that this will be interpreted as allowing the creation of general doubtful debt provisions. There may be certain industries, eg. banking, retailing of consumer goods, where this is an acceptable approach. However, generally we would encourage the use of a specific approach.

**Q. 7 – Impairment of investments in available-for-sale financial assets**

No, we do not agree. The IASB does not appear to have a consistent criterion for deciding what impairments can be reversed: It is proposed to permit it for inventories and for intangibles under certain circumstances but not for goodwill and – now – AFS financial assets. Why not? Particularly if based on demonstrable market prices, the validity of the reversal may even be more clearly evidenced than with inventories. Permitting reversal where there is adequate supporting evidence would also be much more consistent with IAS 2, IAS 8 (changes in estimate), IAS 16, para. 37, and IAS 38 , para. 76.

**Q. 8 – Hedges of firm commitments**

No, we do not agree. While the proposed accounting treatment for firm commitments has the same effect as the basis adjustment, it results in recognising the fair value of hedged firm commitments while unhedged commitments are currently not recognised and would presumably continue to stay off balance sheet, which results in a conceptual inconsistency between economically similar situations. The dangling "commitment" to be recorded in the balance sheet does not readily represent anything: such a meaningless position does not fit with the IASB's reluctance to recognise timing accruals and deferrals in the balance sheet. The proposed treatment is also more complicated from a practical standpoint since it duplicates the entries whereas, with the current treatment as a cash flow hedge, the opposite entry of the derivative simply goes to the hedging reserve.

Furthermore, the IASB proposals do not address the issue of hedged transactions that are still cash flows hedges such as future export sales. Also the problem remains when a forecasted transaction is hedged before it is committed. For example, an enterprise may want to hedge its raw material needs for a given period but firm orders have not yet been placed with the suppliers. So the hedge effectiveness would not be guaranteed when the company places the firm commitment later on. It would make much more practical and conceptual sense to leave the definition of fair value hedges in consistent terms related to accepted recognised assets and liabilities and treat firm commitments and forecasted transactions in the same way, as cash flow hedges as now. They are economically identical. The proposal is an excellent example of where converging to US GAAP would result in a lower-quality solution than IAS currently offers, as is the proposal to eliminate the "basis adjustment" (see Q. 9 below).

**Q. 9 – “Basis adjustments”**

No, we do not agree. The basis adjustment approach properly reflects the economic reality of the hedge, namely that the entity has protected the expected value of the cost or revenue. Furthermore, the recording of the value changes in equity and especially their transfer to income over a period of time are much more complicated from a practical book-keeping viewpoint.

If it is decided to proceed with this unfortunate idea, some guidance should be given on where the transfers to income should appear in the income statement. Might they for instance reduce the related operating expense (depreciation, cost of goods sold?)

**Q. 10 – Prior derecognition transactions**

No, we believe this will be very cumbersome and costly of effort without any major benefit in most cases. Grandfathering should apply.

**Other points**

Para. 1(a): We have already negatively commented on the limitation of 12 months for held-for-sale acquired subsidiaries in our response on the other “Improvements” draft (q.v.).

According to IAS 39, para. 122, a non-derivative financial asset or liability cannot be used for hedge accounting purposes, except for hedges of foreign currency risks. This restriction appears to be quite arbitrary, without any conceptual foundation. To consider an example with the current issue of accounting for $CO_2$ trading rights, we believe that the restriction could have negative consequences if $CO_2$ trading rights do not meet the definition of derivatives. Para. 129 (b) also imposes arbitrary restrictions which can lead to nonsensical exclusions from hedge accounting (e.g. hedging exposures to price risks in specific coffee qualities with derivatives on the generic quality, with separate treatment of the differential).

We strongly recommend the Board to seriously reconsider broadening the hedging base for non-derivative financial assets and liabilities before issuing an amended IAS 39.

Para. 160: We assume that the last sentence added to this paragraph relates to impairment in respect of the hedged item. However, this is not at all clear from the wording. We suggest some explanation is given of the intention behind the rule.

Yours sincerely,

**Federation of Swiss Industrial**
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