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Dear Sir David

ED - Proposed Amendments to IAS 39

Attached to this letter is my response to the Exposure Draft, Proposed Amendments to IAS 39.

My response is divided into 3 parts. In part A, I outline my response to the Invitation to Comment Questions. Part B raises additional issues. Part C provides some editorial suggestions.

Sincerely

Michael Bradbury
October 11, 2002

Comments on IAS 39
Section A: Invitation to Comment Questions

Question 1 – Scope: loan commitments
No.

I see no conceptual reason to exempt loan commitments from the scope as they meet the definition of a financial instrument. However, I agree with Q30-1 of the IAS 39 Implementation Guidance that non-recognition may be reasonable, if based on application of trade date and settlement date rules.

The application of trade date/settlement date accounting is also likely to be appropriate in other areas and should therefore be retained as a practical application guidance. Consider, for example, an entity offering to buy-back its own shares within a normal (short) time frame. The firm has effectively written an option that (conceptually) would need to be recognised if the offer period straddled a reporting date. Applying the trade date/settlement date principle (supplemented with appropriate disclosure) this option would not have to be recognised. There may well be other examples in which the application of a trade date/settlement date exemption will be appropriate.

Question 2 – Derecognition: continuing involvement
No.

I appreciate that the IASB is trying to provide a short-term compromise between FAS 140 and FRS 5. However, I do not think the continuing involvement approach contained in the proposed IAS 39 is effective.

The example in 39.B1 to 39.B3 results in "debt arising in failed sale" of 20. The 20 obligation of Coy A is at best contingent and is clearly not the fair value of the actual liability. Similarly, the example in 39.B18 to 39.B22 results in fictitious assets and liabilities that do not meet conceptual framework definitions. Remeasuring the debt to the option exercise price of 120 (when the fair value is 100) is arbitrary. What if the option exercise price was set at 200? Or 500? Under the IAS 39 proposals history matters and thus financial statements will not be comparable.

To summarise, the continuing involvement approach in IAS 39 results in:

- Recognised assets and liabilities that do not meet conceptual framework definitions.
- Financial assets and liabilities that are not initially measured at fair value.
- Non-comparable information.

I concur with the alternative views expressed in Appendix 39.D1 to D5.

Given the short time frame, to introduce the improvements, there are three possible solutions:

1. Accept either IAS 140 or FRS 5 and establish a longer term reserach project to resolve this issue. My personal preference would be to adopt FAS 140. It seems to be a workable solution in New Zealand. Although FRS-5 has also found acceptance in New Zealand.

2. Adopt the JWG proposals for derecognition. Although a review of the international submissions on the JWG's proposals will provide some indication of the acceptability of this approach, it will require re-exposure. The New Zealand constituents were reasonably accepting of this part of the JWG's proposals.
3. Delete derecognition requirements from IAS 39. This would leave users to adopt either FAS 140 or FRS 5 until the issue is resolved.

Question 3 – Derecognition: pass-through arrangements
Yes

The "pass through arrangements" in 39.41 appear to be reasonable where all risk flows through to the sub-participant and the "collector" does not have to earn the income. However, there is a concern that entities might use the principles in this section as a precedent to take non-recourse loans off balance sheet. For example, a three-year Government research grant payable to a university could be collateralised against borrowings and if treated as a pass-through arrangement the loan would be off-balance sheet. The grey-letter paragraph (39.42) needs to be strengthened. This could be done by stating that pass-through arrangements <u>only</u> relate to <u>recognised</u> financial assets.

Question 4 – Measurement: fair value designation
Yes.

Being able to designate any financial instrument to be measured at fair value is very appropriate, if fair value is a strategic objective of future financial instrument reporting. However, the question of whether this designation should be "irrevocable" and only at initial recognition is not quite so clear. In principle I disagree because the entity can achieve re-designation by selling a held-to-maturity financial instrument (previously designated at fair value) and buy it back (and recognise it as an held-to-maturity).

A possible solution would be to require designation (not irrevocably) of a class of financial instruments to be measured at fair value. IAS 32.77 requires fair valuation by class rather than by individual financial asset or financial liability. Any change in designation would have to relate to the whole class and would therefore be a change in accounting policy.

Question 5 – Fair value measurement considerations
No – as a rule. Yes – as guidelines.

Valuation Hierarchy
I do not agree with the hierarchical approach in 39.99 to 30.101. My preference would be to establish the objective of estimating fair value and then leave it up to financial statement preparers to decide the best practical way of measuring fair value. In most cases, it would be difficult to support a basis other than a price from an active market if one was available. However, in other cases a valuation technique would provide a practical (cost benefit) way of reliably measuring fair value.

As part of their internal management reporting, some financial institutions in New Zealand firms use a generic yield curve (e.g., swap curve) as input to valuation models for a multitude of financial assets and financial liabilities. The models are back-tested and are considered reliable when compared with actual exchange transactions that take place. Furthermore, the fair values generated are audited and are currently being reported in the notes to the financial statements. Why should these firms have to use a recent market transaction in an inactive market in preference to their own reliable valuation technique? In this case the valuation hierarchy in IAS 39 will add costs to firms with very little benefit. If part of the strategic objective of IAS 39 is to get entities into a position where they will eventually accept comprehensive fair value for financial instruments then some flexibility is appropriate.

However, I think the hierarchy should be retained as "guidelines" rather than "rules". I would add an additional guideline to the hierarchy in cases where more than one market exists. The JWG's proposal on this aspect is appropriate.

Transaction Costs
For subsequent measurement I prefer fair value to be measured net of transaction costs. However, I realise that constituents might not generally support this approach and that current amendments to IAS 39 relate to "immediately acceptable improvements". On this basis, I accept the retention of pre-transaction cost approach to fair value.

Thus, while I personally agree with using bid-ask prices (39.99) this is not consistent with the principle in 39.69 for subsequent measurement to be at "… fair value, without any deduction for transaction costs". The bid-ask spread is a transaction cost – it is what a broker makes on a round trip deal. Assume a market of 1 security and with two brokers. Broker A quotes on a bid-ask spread basis ($95 - $105), while Broker B quotes $100 less 5% commission (which may be reduced for large transactions). Fair value would differ depending on which broker was used or depending on the size of the holdings. One solution is to allow entities to use mid-spread price.

Given that (1) the "jury is still out" with regard to accounting for transaction costs, (2) IAS 39 does not have a robust conceptual approach, (3) for most financial instruments the impact of transaction costs will not be significant or material, I recommend that some flexibility in the treatment of transaction costs is appropriate as long as there is clear disclosure of the policy adopted.

Amendments to Appendix A
A21. Delete the following phrase from the first sentence. "…and adjusted to reflect the market's evaluation of the non-diversifiable risk relating to the uncertainty of those cash flows". This phrase is incorrect, as the cash flows are not adjusted for this factor. It is the denominator (i.e., the discount rate) that reflects non-diversifiable risk.

A23. Delete this example. I have never come across this example in either a textbook or a financial instrument. I fail to see it's relevance. I am not sure that it is technically correct. It mentions that the 200 is certain (except for timing). This means that it should be converted into a certainty equivalent and discounted at the risk-free rate. Deleting A23 would also require deletion of A24.

Question 6 – Collective evaluation of impairment
No.

I consider this part of IAS 39 is too rigid. The assessment of impairment of a portfolio of financial assets with similar credit risk characteristics should be undertaken on the same basis as the evidence of impairment losses are collected. That is, if the evidence collected on impairment losses does not include financial assets that have been individually assessed then individually assessed financial assets should be excluded from the portfolio to be assessed. Financial assets assessed individually for impairment should be included in the portfolio if the evidence on impairment has been collected on that basis. This is similar to the issue of whether to adjust the cash flows or the discount rate. Both are correct as long as the application does not double-count or omit elements of risk.

Question 7 – Impairment
No.

It is difficult to conceptually justify the category of available-for-sale financial assets (because changes in fair value are either gains or losses and should be recognised in income). This means accounting for the fair value change arising from impairment is problematic. It seems to me that the distinction between a decline in value and impairment is artificial. On balance, I think it is probably best to treat impairment losses on available-for-sale the same as declines in fair value.

I note that 39.119 does not allow impairment reversals through income, which is inconsistent with IAS 36.104.

(I also note that if we can assess impairment from other fair value changes for financial assets we should be able to do this for financial liabilities. Therefore we could separate own-credit risk changes from market changes in fair value of liabilities and account for them separately. In which case all liabilities could be reported at fair value).

Question 8 - Hedges of firm commitments
Yes.

While I agree that hedges of firm commitments should be accounted for as fair value hedges I consider the reasoning in 39.C94 to 39.C99 is weak. In my view, the whole of the firm commitment should be accounted for as a financial instrument (i.e., at fair value).

First, the argument in 39.C97 (that current GAAP is to recognised executory contracts but that the historical cost is zero) is simply wrong. The accounting literature on executory contracts <u>is</u> concerned with the conditions for recognition rather than whether to measure at fair value or historic cost. Second, the adoption of FASB Statement 133 to “promote convergence” is only appropriate if the FASB method is "of higher quality". Hence, this needs to be established. Third, it is inconsistent with the removal of "basis accounting".

If it <u>is</u> appropriate to recognise at fair value the component of the hedged item that is part of an effective hedge then it is also be appropriate to fair value and record in income that component of the hedged item that is an ineffective part of a hedge. IAS 39 should require the whole of the firm commitment to be recorded at fair value. Thus both the hedged item firm commitment and hedging item should be fair valued and the gain or loss reported in income. This would then extend the scope of IAS 39 to include commodity-based contracts that require delivery. While this may seem a major extension of IAS 39, several constituents in New Zealand have indicated to me that this extension is logical and appropriate (irrespective of any hedge accounting issues).

Question 9 – Basis adjustment
Yes

This is a difficult issue. Let me say at the outset that I do not support hedge accounting nor do I support reserve accounting.

One of the problems of IAS 39 is that although there are underlying principles involved, they are not very obvious (or the reader gets no sense in IAS 39 of which principles might be paramount over others). This makes IAS 39 look like a collection of rules and makes choices between conflicting principles difficult. Basis adjustment is one of the issues that involve conflicting principles. For example eliminating basis adjustment can be justified if the dominating principle is that fair value is the appropriate basis for initial measurement.

However, if the decision is to allow hedge accounting (i.e. to allow "offset" gains and losses on hedged items and hedging instruments in income) is paramount then I support basis accounting as it is a lower cost method of hedge accounting (relative to accumulating and tracking amounts in reserves to be released to income over the life of a non-current asset or inventory). Accounting is a means not an end and basis adjustment makes practical sense.

However, I believe that recording "initial measurement" at fair value is a core principle in accounting for financial instruments, which ought to "trump" any hedge accounting rules. If no basis accounting is retained in IAS 39, then the logic needs to be clearly stated in the Basis for Conclusions.

Question 10 – Prior derecognition transactions
Yes.

I support "grand fathering" existing derecognition transactions, providing there is a sunset clause. I have no recommendations as to what the sunset period would be, but I would take advice from the securitisation industry.

Comments on IAS 39
Section B: Additional Issues

Hedge Designations

In my opinion the paragraphs relating to designation of hedged items and hedging instruments are confusing.

The definitions of "hedged item" and "hedging instruments" are not satisfactory because they include the requirement to be designated. This causes logical (and readability) problems in later sections (39.122 to 39.135). For example, 39.128 states "If the <u>hedged item</u> is a financial asset or financial liability, it may be a <u>hedged item</u> with respect to the …"[emphasis added]. This allows a portion of cash flows or fair value of a hedged item to be designated as a hedged item, but the whole of the hedged item (by definition 39.10) has already been designated. In addition 39.126A, B & C relate to designation issues rather than hedged items *per se*. Furthermore, it is clear that the designation of hedging instruments and hedged items are not completely independent (see 39.126D and 39.133), even though they are written up in different sections.

I suggest the following:

First, drop the definitions of hedged item, hedging instrument and hedge effectiveness from 39.10. They are not definitions. In most standards the definitions assist a reader who wants a more precise understanding of a word or phrase. In this case the definitions of hedged item and hedging instrument are less than useless because they do not clarify anything. In fact the reader has to go back to the text to find out what the definitions mean! Additional confusion arises because the definitions are <u>almost</u> repeated in the text. However, typically the wording is not quite the same (compare first sentence of 39.127 and 39.10) leaving the reader to wonder if black or grey letter prevails. My point is, if the definitions are not complete (stand alone) definitions and are repeated in the text – why have them?

Second, if it is appropriate to have definitions of hedged items and hedged instruments then exclude "designation" from the definition. Then refer to the designation of the "risk exposure" of a hedged item, rather than the designation of a hedge item. Similarly, I would refer to the designation of the "risk exposure" of the hedging instrument. This might overcome the problem of referring to hedged items and hedging instruments (which are already designated in terms of the definition) when it is fact a proportion or element of the exposure that may be designated.

Third, the standard mentions designation many times but I could not find any paragraph that says what this means! (I realise I may have missed it but I have only been through the document 100 times). My understanding is that designation means the 39.142(a) formal documentation. I recommend the re-arranging of paragraphs. 39.142(a) should precede a separate section in the standard that deals with designation of both hedged items and hedging instruments. In this section I would keep designation of hedging instruments and hedged items together because often they are not independent decisions – both parts are designated simultaneously.

As a consequential amendment arising from the above suggestion I suggest that a summary version of paragraph 39.142 appear near or is combined with 39.121. This would state that hedging relationship require designation (with references to the appropriate paragraphs) and effectiveness (with references to the appropriate paragraphs).

Measurement

I disagree with how 39.66 states the measurement principle. Specifically I disagree with the reference to "cost". I think 39.66 should be re-worded:

> When a financial asset or financial liability is recognised initially, an entity should measure it at its ~~cost, which is the~~ fair value ~~of the consideration given (in the case of an asset) or received (in the case of a liability).~~

The reference to cost is unfortunate. "Cost" may or may not be "fair value of consideration given", but "fair value" is not the "fair value of consideration given". Fair value is an arms-length market concept – therefore fair value given and received will be the same. However, in any specific situation one side of the transaction may be more reliably measured than the other. Furthermore, the "willing buyer/willing seller" concept of market value will not include any special value attributed by the purchaser (i.e., over-payment), which may be included in cost.

Regardless of whether the Board agrees with my logic there is no need to include the reference to cost in 39.66. Financial instruments should be initially measured at fair value. While this may not seem an important issue for financial instruments, in later standards (e.g., business combinations) this may have a significant effect on interpretation of fair value.

Comments on IAS 39
Section C: Drafting Suggestions

1. It might be worth considering amending the definition in 39.10 to have five categories of financial instruments by adding a further category – financial instruments (not held for trading but) designated and reported at fair value.

2. In 39.10 the definitions of held-to-maturity investments and originated loans and receivable refer to fixed or determinable "payments", as these are assets it would be preferable to refer to these as "receipts". Similar adjustments should be made elsewhere in the text.

3. Reverse the positions of paragraphs 39.22 and 39.23, as 39.22 is commentary material and should follow black letter.

4. In 39.100D I recommend that "or loan asset" be deleted. It is difficult to explain how an asset can be debt.

5. I suggest that 39.103A (i.e., hedge accounting over-ride) should be written in more general terms – not just for amortised cost financial assets and liabilities. For example, 39.103B does not include guidance on equity instruments carried at cost (because the fair value cannot be reliably measured). In such cases IAS21.11 requires the non-monetary item to be translated at the transaction date. However, IAS 39.128 would appear to allow for the foreign currency risk to be hedged (providing the effectiveness can be measured). Adjusting the carrying amount of the hedged item (IAS 39.152(b)) conflicts with IAS 21.11. Hence the need for an hedge accounting over-ride. [It would also be appropriate to ban the use of hedge accounting for the foreign currency component of equity instruments carried at cost, if the reason that the fair value cannot be reliably measured is the foreign currency component. This might be too complicated to draft. A simple solution (and my preference) would be not to allow any hedge accounting for items, or components, carried at cost].

6. The latter part of paragraph 39.103B refers to the change in fair value of an equity instruments. A commentary paragraph on financial assets and liabilities carried at amortised cost might not be the obvious place to look for guidance on a cash flow hedge of an equity instrument.

7. The document uses the terms "proportion" and "proportional" interchangeably, especially paragraphs 39.122 to 39.134. In 39.128 the "proportion thereof or a percent" is used. My understanding is that "proportion" is a part of the whole , whereas "proportional" expresses the strength of a relation (fraction or percentage). Thus, 200% can be a proportion, but a portion cannot be greater than 100%. Also a portion can be an amount of (but less than) the whole (e.g., $200) whereas a proportion must be a fraction or percentage. It is not clear that we should allow entities to designate more than 100% of a hedged item (i.e., they can only hedge a portion). However, effectiveness can be measured in proportion terms (i.e., the 80/125% effectiveness test). I recommend the terminology be reviewed.

8. 39.126C. Delete "~~and the spot price~~". This does not make sense. Suggestion: "…interest element ~~and the spot rate~~ on a forward contract, which is the difference between the forward rate and the spot rate at acquisition date."

9. 39.126C. In the last sentence consider "…can qualify ~~for hedge accounting~~ as a hedging instrument." I note this sentence only allows a dynamic hedging strategy for an option. Is there any reason why a dynamic hedging strategy cannot also apply to a forward contract or must the interest element of a forward contract always be separately identified?

10. 39.126E. I fail to see what part (c) adds. If necessary the first sentence could be re-worded: "A single hedge instrument may be designated specifically as a hedge…."

11. The second sentence in 39.127 should become the first sentence in 39.132. Because 39.132 is an explanation of "similar risk".

12. The emphasis in 39.127A could be improved. He second sentence is the general rule (i.e., cannot hedge general business risk) and should be stated first. Whereas the first sentence is an application of the rule.

13. Standardise 39.137 (a) and (b):
    A fair value hedges is a hedge of the exposure to the variability in fair value of a recognised asset or liability or unrecognized firm commitment to particular risk that could affect reported income.
    A cash flow hedge is hedge of the exposure to variability of cash flows that is (i) attributable to a particular risk associated with a particular asset or liability or forecast transaction and (ii) could affect reported income.

14. I think 39.142 (a) should explicitly state that the type of hedge (fair value, cash flow or net investment) needs to be documented.

15. I recommend the following change to the last sentence of 39.142(a): ..the entity will assess the ~~hedging instrument's~~ hedge effectiveness. ~~in offsetting the exposure to changes in the hedged item's fair value or the hedged transaction's cash flows that is attributable the hedged risk;"~~ This last part is unnecessary because hedge effectiveness is already defined in 39.10. Definitions should be relied upon as much as possible because the use of different words in the text may lead to conflicting interpretations. As both black letter and grey letter carry the same weight the reader is in doubt as to which has more authority.

16. 39.142(c) seems out of place with the other sub-parts of this paragraph, which deal with effectiveness or documentation. This sub-part deals with the criteria for a hedged item (namely cash flows related to a forecast transaction) and should therefore be placed somewhere between 39.127 and 39.133.

17. I suggest "..~~in one of the two ways set out in~~" (39.155) is deleted and replace with "..in accordance with paragraph 103". 39.103 no longer has two ways and consistency with 39.158.

18. Heading: "Fair Value Hedge~~s~~" (between 39.152 and 39.153) and "Cash Flow Hedge~~s~~" (between 39.157 and 39.158) should be singular to be consistent with the text. Also "Hedge~~s~~ of a Net Investment" (between 39.163 and 39.164) should also be singular but the text here is plural. Some consistency would be desirable.

19. The last sentence in 39.160 is really an impairment rule and should be transferred to the appropriate section.

20. 39.162 refers to a "forecast transaction". However, cash flow hedges cover more than just forecast transactions because they also include future cash flows on variable rate debt. Hence, I recommend the following wording "…the risk being hedged ~~forecast transaction~~ affects …". Or "…the hedged item affects future profit …" A similar issues arises with 39.163 (a) and (b).

21. I recommend the placing 39.162 before 39.160 because this is the main principle. 39.160 is merely to eliminate basis accounting.

22. Can an item be recognised twice (as implied in 39.163)? That is can an item be recognised in equity and then recognised in income? Or, should amounts recognised in equity be reclassified to income (as in 39.160)? I prefer reclassification. Similar correction is required for 39.164.

23. It is not clear to me why paragraph 39.164 refers the reader to IAS 21, when the hedging requirements relating to a net investment to be removed from IAS 21 as a consequential amendment.

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Dear Sir David

ED - Proposed Amendments to IAS 32

Attached to this letter is my response to the Exposure Draft, Proposed Amendments to IAS 32.

My response is divided into 3 parts. In part A I outline my response to the invitation to Comment Questions. Part B provides additional comments on 32.22C&D and 32.29D&G. Part C includes a few editorial suggestions.

Sincerely

Michael Bradbury
October 11, 2002

Comments on IAS 32
Section A: Invitation to Comment Questions

Question 1 – Probabilities of different manners of settlement (paragraphs 19, 22, and 22A)

I agree with the proposition that classification between debt and equity should not be based on the probability of settlement. This is consistent with the recognition of a financial instrument, which only requires a contract to be written rather than an assessment of whether the economic benefits are probable and measurable.

This section needs an example of "substance over form". I thought the accelerating dividend example in 32.22 was a good example of substance over form and I would like to see it retained (or another example provided). "Economic compulsion" means the instrument should, in substance, be viewed as a mandatory convertible. The issuer has the option of the timing (of when) to convert but conversion is near 100% certain.

I disagree with 32.22C and 32.22D. See comment in section B.

Question 2 – Separation of liability and equity elements

I disagree with the arguments presented in 32.28. Simply because equity is defined as a residual interest it does not necessarily follow that it should be the last element to be is measured. The argument should be based on practical grounds rather than conceptual. For example:

- The last two sentences in 39.28 establish the basic concepts.
- That allocation of joint measurement error is arbitrary.
- Typically debt is more reliable to measure than equity.
- Therefore, to promote consistency debt is to be measured first.

Question 3 – Classification of derivatives that relate to an entity's own shares

I disagree with 32.29D and 32.29G. See comment in section B.

Question 4 – Consolidation of the text in IAS 32 and IAS 39 into one comprehensive standard

In principle I favour having one document. However, for the improvements project retention of the two standards would be preferable as it is the least disruptive approach.

Comments on IAS 32
Section B: Additional Issues

Classifying obligations to issue a fixed amount of equity or an amount that fluctuates in response to variables other than market price of the entity's own equity instruments as a liability.

I fail to understand how the settlement of an obligation by an entity that can only be made by the delivery of its own equity can meet the conceptual framework definition of a financial liability.

I disagree with 32.22D that "the counterparty does not hold a residual in the entity". Subsequent paragraphs also employ a similar rule (e.g., 32.29D, 32.29G). In my opinion the entity does have a residual interest. Common sense indicates that where there is a 100% probability that equity will be issued then it must be an equity instrument. What is uncertain is the exact amount of equity to be issued. Based on this logic all employee option schemes will be liabilities because the exact amount of shares to be issued is unknown.

The problem with 32.22C is that it merely states a rule. Unfortunately 32.22D merely reiterates the rule but does not provide any underlying logic or conceptual basis. These paragraphs employ an implicit interpretation of "residual interest" which is not well articulated. 32.B10 states that "..the obligation exposes the entity to a favourable or unfavourable change in a variable other than the market price of its own equity". A further insight is seen from 32.B22, which states that derivatives on an entity's own equity instruments are not equity because "..they do not evidence a residual interest in the entity".

The problem with these paragraphs is that they classify equity by imposing a further interpretation of "residual interest". I disagree with this approach for two reasons:
First, this approach is inconsistent with the conceptual framework definition of "equity". Equity is determined under the conceptual framework (and 32.20) by first defining liability and then assuming equity is the residual, rather than defining equity directly.
Second, the approach in 32.22C &D views "equity risk" as evidence of a residual interest. If a holder of a share also has a put option (i.e., has no downside equity risk), why should the issuer reclassify the shares as a liability? I disagree that having no equity risk is evidence of a liability. This appears to be viewing equity from the point of view of the holder rather than the issuer. From the point of view of the issuer there is a 100% probability of issuing equity (although the exact amount is unknown).

Comments on IAS 32
Section C: Drafting Suggestions

24. If the first sentence in 32.20 is a <u>critical</u> factor it should be black letter.

25. 32.A18 refers to “writer”, “issuer” and the “entity”. Some consistency would be desirable.

26. I would delete 32.A26 to 32.A56. It is an accounting standard not a “bookkeeping 101” text.