Organización Internacional de Comisiones de Valores

International Organization of Securities Commissions

Organisation internationale des commissions de valeurs

Organização Internacional das Comissões de Valores

OICU-IOSCO

June 12, 2003

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (Standing Committee No. 1) wishes to express its concern over the IASB's proposed amendments to IAS 39, *Financial Instruments: Recognition and Measurement*, specifically as they relate to the ability for any financial instrument to be designated as held for trading when it is initially recognized.

The Board has tentatively concluded to proceed with the fair value measurement option in the final standard. Although we have concerns about the discretionary nature of the designation, we understand the conceptual merits for allowing an entity to designate any financial instrument as held for trading, allowing the change in fair value to be recorded as profit or loss. This may become especially important to certain entities, such as banks and insurance companies, where specific economic hedging relationships may exist between certain assets and liabilities but where hedge accounting may not be possible (depending on the IASB's final conclusions on hedge accounting).

However, as reported in the April 2003 "IASB Update":

> Furthermore, the Board tentatively confirmed that changes in the credit risk of a liability should be included in its fair value measurement when the fair value option is used (i.e., the fair value of financial liabilities is not adjusted to exclude the effect of changes in the liability's creditworthiness). It also tentatively agreed that no disclosure should be required of the effect of changes in a liability's creditworthiness on the fair value of its liabilities.

Counterintuitive Financial Reporting Results

The members of Standing Committee No. 1 have concerns about the tentative conclusion discussed above. Those concerns relate to our belief that investors and other users of the financial statements will misinterpret the reported effects of changes in credit risk, especially in the absence of any disclosures. We are concerned about situations where the fair value measurement option would be applied to long-term debt issued by reporting entities lacking the "matched book" operations of a financial institution. In these situations, the results could be arbitrary and potentially misleading to the users of the financial statements. On the most basic level, in the period that an entity experienced a decline in its credit standing (likely resulting from

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negative business developments), the income statement would reflect a gain (a positive financial reporting result). We believe investors would have difficulty understanding this accounting result. The following represent example situations in which we believe financial statement users are likely to be misled by the proposed ability to have changes in an entity's own creditworthiness affect profit and loss.

- Consider an entity with a potentially valuable, but unrecognized, intangible asset that becomes impaired. Assume this results in a significantly diminished economic outlook for the entity, and thus results in the downgrade of the entity's outstanding long-term debt. Under the IASB's proposal, if the entity had designated that long-term debt as a financial instrument to be accounted for at "fair value through profit and loss," the gain would be reflected in the income statement without an offsetting loss from the now-impaired but unrecognized intangible asset. We are concerned that users of the financial statements, seeing a decrease in debt, an increase in income, and an increase in equity, would take the wrong message from the financial statements.

- Consider also a company that issues debt during a distressed period in its history. If the company elected the "fair value through profit and loss" classification, it would subsequently reflect a loss as a result of considering its improved credit standing as it worked through its problems and turned around its business. Again, reflecting losses in the income statement as the company improved would be counterintuitive or illogical to many.

- Consider also an entity that has recently committed itself to a significant amount of cash expenditures for capital investments, research and development, settlement of litigation, or even repurchase of stock. Such an entity might face credit rating downgrades due to the potential for a short-term liquidity crunch. The fair value of the company's assets would likely be unaffected by this potential liquidity crunch. The gain in the statement of profit and loss would therefore not be offset by any loss. Similarly, such an entity would subsequently report a loss if the liquidity issues pass without significant effect. Again, such a loss would not be offset by any gain in asset values.

While it is clear that fair value information about liabilities is useful information, these examples raise the question of whether fair value is the most relevant measurement characteristic for long-term debt and similar liabilities at any time between incurrence and settlement of the liability. Many regulators believe that an entity should profit from changes in the value of its long-term debt only when there is a discrete transaction with independent parties, such as a restructuring or extinguishment. They would also note that marking long-term debt to market could be considered to contradict a going-concern notion. An entity would only realize a "gain" from changes in its credit standing if it were to cease operations.

Furthermore, Standing Committee No. 1 notes that it is not necessary to include changes in own credit risk in the profit and loss statement to effectively address the "matched book" issue. This is because there are no assets that respond in the opposite manner to changes in the entity's credit risk. Such assets would respond only to changes in the credit risk of their issuers.

Potential Additional Considerations

On Monday, May 19, Tom Jones, Mary Barth, and Warren MacGregor were kind enough to speak by phone with several members of Standing Committee No. 1 about these concerns. Both the IASB and Standing Committee No. 1 members seemed to agree that additional discussion on this issue could be helpful in, at the very least, identifying presentation or disclosure options in an attempt to reduce the potential for misunderstanding. Looking at the development of the issue as part of this project, we wonder if discussion with interested parties on issues associated with the "own credit risk" might not result in constructive suggestions that could help the Board devise either an accounting or presentation solution that better informs financial statement users. Questions that might be considered include:

- If a fair value option for long-term debt is allowed, should the changes be reflected in shareholders' equity rather than through income?
- Is there a method that can be used to isolate the change in fair value related to credit standing, similar to the Financial Accounting Standard Board's approach to isolating the effect of the change in benchmark interest rates as described in paragraphs 120C-D of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (as amended)? There may also be other alternative approaches to identify the change in fair value related to credit standing, such as market data reflecting the "cost" of a credit downgrade or a comparison of various cash flow projections with the fair value of the debt to indirectly determine the impact of a credit downgrade.
- Should any decisions related to this issue be conditioned on decisions in the IASB's project on Reporting Performance?
- Should a change in the fair value of a liability due to changes in an entity's own credit risk receive different presentation in the statement of profit and loss, if it is to appear there at all?

We believe that financial reporting might be improved by additional consideration of the effect of an issuer's credit standing in determining the fair value of its outstanding debt with these specific questions, and perhaps others the IASB might identify, in mind.

Potential Action Steps

As we indicated we would during the May 19 conference call, the members of Standing Committee No. 1 have attempted to identify action steps that could be taken to resolve or allay our concerns about the potential detrimental effects to investors of reflecting changes in an entity's own credit risk in the statement of profit and loss. The following were identified as actions that could improve the situation over the current tentative conclusion. Note that some members of Standing Committee No. 1 consider some of the actions below to be insufficient, except in concert with other actions, to address the issue at hand.

1. Defer consideration of whether and how changes in an entity's own credit risk should affect its financial statements until completion of the project on Reporting Performance. We believe it is possible that the Reporting Performance project will result in a presentation framework that allows for a more meaningful and understandable way to take changes in an entity's own credit risk into account. In the interim, require companies to disclose whether they reflect changes in the value of liabilities due to changes in their own credit risk in the statement of profit or loss, and, if so, estimate the effects in each period presented. As discussed below, we believe that the change in fair value due to the change in credit risk can be isolated and calculated.

2. Solicit comment both on the decision to include changes in an entity's own credit risk in the periodic mark to fair value, and on ways to present or disclose the effects of such changes.

3. Limit the option to mark liabilities to fair value through profit and loss to situations in which a "matched book" or similar situation exists. Although this would not necessarily allay our concerns, it would at least ensure the option is only used in the situations that caused the IASB to include it in the first place.

4. At a minimum, require specific disclosure of the nature and effects of a change in the issuer's credit standing on the financial statements both in the footnotes and on the income statement. As banks and other lenders continually evaluate the effects of changes in borrowers' credit risk on the carrying value of loans, we find arguments that the effects of a change in credit risk cannot be isolated to be hollow ones.

5. If a decision is made to issue the standard which allows changes in a entity's own credit risk to affect the statement of profit and loss, describe in significant detail the basis for such conclusion. The discussion should be sufficiently detailed such that readers would understand, at least, 1) why changes in an entity's credit risk should be thought of as creating gains and losses, despite no change to the contractual obligation, 2) why the potential for counterintuitive results, such those in the examples above, was not considered strong enough to cause the IASB to reach a different conclusion, 3) what other solutions were considered and what shortcoming such solutions had that caused them to be rejected, and 4) the fact that IASB members themselves have some of the concerns as those expressed in this letter, and how they were able to overcome such concerns.

We appreciate the opportunity to provide our thoughts to the IASB. If the Board or staff should have any questions regarding the comments in this letter, please call me on 202-942-4400.

Sincerely,

Scott A. Taub

Scott A. Taub
Chairman
IOSCO Standing Committee No. 1