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CL 142

16 December 2002

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

RE: Exposure Draft of Proposed Improvements to IAS 32 and IAS 39

Dear Sir David:

The Global Financial Reporting Advocacy Committee (GFRAC) of the Association for Investment Management and Research (AIMR)[1] is responding to the International Accounting Standards Board (IASB) *Exposure Draft of Proposed Improvements to IAS 32 and IAS 39.*

The GFRAC is a standing committee of AIMR charged with representing the views of investors to and maintaining a liaison with bodies that set financial accounting and reporting standards in a global context, particularly the IASB. The committee is also charged with responding to requests for comment from national standard setters and regulators on international financial reporting issues.

General Comments

We view the current proposals to amend IAS 32 and IAS 39 as an interim step towards the completion of a comprehensive financial reporting standard that would require (1) all financial instruments to be measured and recognized at fair value with changes in valuation reported in profit and loss and (2) adequate disclosures explaining methods and assumptions used to determine these values, including correlation and sensitivity analysis of key assumptions. Earlier this year, the Financial Instruments Task Force (FITF) of AIMR, issued a comment letter responding to the Joint Working Group's Draft Standard and Basic Conclusions, *Financial Instruments and Similar Items.*[2] We concur with the FITF's view that fair value principles of accounting and reporting, once applied, will greatly improve the transparency of essential financial and non-financial information. Users of this information will be better able to predict with reliability the amounts, timing, and uncertainty of an enterprise's expected future cash flows. Moreover, such information improves the

[1] The Association for Investment Management and Research (AIMR) is a global, not-for-profit organization of over 60,000 investment professionals in more than 100 countries. Through its offices in Charlottesville, VA, Hong Kong, and London, as well as more than 118 Member Societies and Chapters throughout the world, AIMR provides global leadership in investment education, professional standards, and advocacy programs.

[2] The comment letter issued by the FITF on 18 January 2002 is available on AIMR's web site at following link - http://www.aimr.org/advocacy/02commltr/02jwgdraft.html.

degree of relevancy and understandability with respect to current historical cost-based measurements and recognition of financial instruments.

The quality of this information hinges on the adequacy and completeness of the disclosures and supporting analysis provided to explain and discuss the fair values recognized in the financial statements. Given our past experience with the standard setting process, we have observed that proposed disclosures, which we supported and believed to be essential for transparency, are too often removed in the final drafting of a financial reporting standard. The following general comments focus on the need for disclosures and sensitivity analysis.

Disclosures

We support strongly the Board's proposed modification to current IAS 32 disclosure requirements, in particular, those pertaining to fair value as provided in paragraph 77 of the ED, which include the following[3]:

- The extent to which fair values are estimated using a valuation technique;
- The extent to which valuations using valuation techniques are based on assumptions that are not supported by observable market prices;
- The sensitivity of the estimated fair values to changes in those assumptions based on a range of reasonably possible alternative assumptions;
- The change in fair values estimated using valuation techniques recognized in profit or loss during the reporting period;
- The nature and extent of transfers of financial assets that do not qualify for derecognition;
- The risks inherent in any component that continues to be recognized after a transfer of financial assets that does not qualify for derecognition.
- The difference between the carrying amount and settlement amount of non-derivative financial liabilities that are carried at fair value; and
- Defaults in the payment of principal or interest and breaches of sinking fund or redemption provisions on loans payable, and any other breaches of loans agreements when those breaches can permit the lender to demand repayment.

Generally, the objectives of financial analysis, in the context of IAS 32 and IAS 39, are to discern and assess the effects on an enterprise's financial performance and financial condition, resulting

[3] Provided in the Summary of Main Changes to the Exposure Draft of Revised IAS 32.

from its risk management policies and decisions involving financial instruments. In addition, financial statement users want to assess how well an enterprise effectively applies these policies in managing the risks of the enterprise. Consequently, we believe that accounting and disclosure requirements related to financial instruments must be designed to explain the following items: (1) risks inherent in a given business; (2) hedging strategies employed; and (3) the outcome(s) of such hedging activities.

In other words, financial and non-financial disclosures must provide sufficient information for users of this information to discern and answer questions, such as these:

- What are management's policies and procedures for using certain financial instruments?
- How extensively does the enterprise use these financial instruments as part of its risk management?
- What are the timing and the magnitude of the effects of the instruments on fair values in the balance sheet and changes in these values reflected in the income statement?
- How effective, or ineffective, are the positions in these financial instruments as hedges in managing the risk exposure of the enterprise?
- What portion of the gains and losses reported in the balance sheet and income statement is realized and unrealized?
- What methods are used to determine fair value when market values are not readily available?
- What key assumptions are used to calculate these fair values?
- How sensitive are these fair values to certain assumptions, such as changes in interest rate or foreign currency exchange rates?
- What are the effects on operating segments?

Sensitivity Analysis

We firmly believe that sensitivity analysis should be a required disclosure rather than an *encouraged* disclosure. Historically, it has been our experience that encouraged disclosures are rarely provided or are often inadequate and incomplete when provided. All market participants, including preparers as well as users, would benefit from such analyses. Therefore, we recommend strongly that the Board include sensitivity analysis as a required disclosure as part of the final standard issued for accounting and reporting of financial instruments and similar items.

Current principles of accounting and reporting require that material items should be disclosed. Therefore, we believe that sensitivity analysis is an integral and essential component of fair value accounting and reporting because it provides an essential element needed for estimating an enterprise's future expected cash flows. Such cash flows are essential for the calculation of an enterprise's value. Additionally, many derivative instruments have "tails" that affect future cash flows. Unless those potential effects are transparent in disclosures and analyses, such as sensitivity analyses or stress tests, the balance sheet representation of fair values for financial instruments is incomplete and cannot be used properly to assess risk-return relationships and analyze management's performance.

Moreover, the importance of sensitivity analysis is evident in that a primary purpose of derivatives is to modify future cash flows either by minimizing the exposure to risks, or increasing risk exposure, and/or deriving benefits from these instruments. Also, an enterprise can readily adjust its positions in financial instruments to align its financing activities with operating activities and, thereby, improve its allocation of capital to accommodate changes in the business environment. All such activities, or their possible occurrence, should be transparent to the users of financial statements. For example, we believe that not reporting significant interest rate or foreign currency swap transactions would be as inappropriate as not consolidating a significant subsidiary.

IAS 32 – Financial Instruments: Disclosure and Presentation

Question 1 – Probabilities of Different Manners of Settlement

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?

Yes. We believe that the classification of a financial instrument (either as a liability or equity) should not be based on the manner of settlement. Whether a company agrees to settle a contractual agreement with shares of its stock or with cash, should not change the fact that the agreement is a liability. Additionally, the contract agreement is also a liability if the company is compelled to redeem the agreement. (Please refer to our response to **Question 3** for more elaboration of our view.)

Question 2 – Separation of Liability and Equity Elements

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 that there should be only one method. But, we disagree with the elimination of the relative-fair-value method because this method makes it more difficult to manipulate or game the calculation. Therefore, the relative-fair-value method, rather than the residual method, is the most appropriate method for determining the values of each component of the financial instrument. If two methods are permitted, the residual or with-and-without method should only be used when one or more components cannot be reliably measured.

Question 3 – Classification of Derivatives that Relate to an Entity's Own Shares

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

We believe that the proper way to reflect a classification of derivatives, relating to a company's own shares of stock, is to report a receivable or liability until the shares are actually issued. In addition, this receivable or liability, representing the equity derivative, should be adjusted for changes in fair value with those adjustments flowing through the comprehensive income statement. When the shares of stock are issued, the receivable or liability would be reversed, and the corresponding value of the recently issued shares would be recorded in appropriate equity accounts of the company. Furthermore, we believe that this treatment supports the accounting of equity share-based payments as a liability on the date they are granted.

We realize that our proposed accounting treatment of equity derivatives, such as equity share-based payments, does not currently conform with the IASB's Framework with respect to the definition of a liability. However, we believe that our proposed treatment would result in similar accounting for financial instruments, which are economically similar in nature, e.g., employee stock options and stock appreciation rights.

Question 4 – Consolidation of the Text in IAS 32 and IAS 39 into One Comprehensive Standard

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

Yes. We believe that the two standards should be integrated into one comprehensive standard on the accounting and reporting of financial instruments. Such an integration will better align the scopes of the current standard into one cohesive scope for all financial instruments. In addition, we recommend that the Board consider integrating parts of IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions,* which pertain to financial instruments and related activities.

IAS 39 – Financial Instruments: Recognition and Measurement

Question 1 – Scope: Loan Commitments

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?

We disagree that such loan commitments should be excluded from the scope of IAS 39. These commitments have a fair value and therefore, should be measured and reported on a company's balance sheet. For example, a company makes a commitment to make a loan at a rate of 5% six months from now, which is equivalent to making a commitment to make a loan at the spot rate plus issuing a put option, representing the derivative of the interest rate. If these commitments were done as two separate transactions, the interest rate put option would be marked to market.

Question 2 – Derecognition: Continuing Involvement Approach

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?

We support strongly the notion of continuing involvement as the determining factor for whether a transfer of financial assets should result in derecognition. This continuing involvement would be evident by the risks and awards retained by the company after the financial assets are transferred to a special purpose entity. Furthermore, this approach is less arbitrary and thus, less likely to be manipulated than an approach that uses a bright-line test to determine effective control.

However, we do have concerns about the proposed application of continuing involvement given a controlling interest versus a non-controlling interest. Also, we do not believe that the components approach for recognizing gain on sale is appropriate because of the continuing involvement with the assets through related activities, such as servicing arrangements. Therefore, we recommend that the Board continue the review the technical issues regarding the application of continuing involvement.

Question 3 – Derecognition: Pass-Through Arrangements

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?

Generally, we agree that this type of pass-through arrangement would qualify for derecognition. However, some of these arrangements have a "trigger" or stipulation that if something happens, generally an unfavorable event, then the company may be required to buy back the financial assets. In essence, the company is guaranteeing a level of asset quality and therefore, still retains some risk in the financial assets. Consequently, we agree strongly with the definition stated in paragraph 41 that **no** continuing involvement (i.e., risks and rewards related to the financial assets rather than the service provided) should be permitted in pass-through arrangements. In addition, we suggest that the Board reexamine the "right of offset" noted in Paragraph 33 to assure consistency with the application of derecognition principles.

Question 4 – Measurement: Fair Value Designation

Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as on instrument that is measured at fair value with changes in fair value recognized in profit or loss?

Generally, we do not support choices in the accounting treatment of financial items or transactions with similar economic results. The overarching principle of accounting should be to reflect the economic substance rather than the legal form of the financial item or transaction. However, we understand the current measurement issue that the Board is remedying and, therefore, support the acceleration of the ultimate objective, which is to recognize and report all financial instruments at fair value.

Question 5 – Fair Value Measurement Considerations

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 are not comfortable with maintaining a constant credit spread for a financial instrument, which is thinly traded on a generally illiquid market. Generally, we believe that the credit spread for these instruments will fluctuate over time due to changes in the issuer's credit standing and changes in interest rates.

Question 6 – Collective Evaluation of Impairment

Do you agree that a loan asset or other financial asset measured at amortized 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?

Generally, we **do not** agree with the proposed grouping of financial assets into a "portfolio" for purposes of impairment testing even though the assets have similar credit risk characteristics when some of those loans can be individually assessed for impairment. Such groupings could distort the actual impairment of a firm's financial assets given the weight, or significance, of individual loans to the aggregate value for the group of loans. For example, a loan portfolio comprised of similar risk characteristics may have a few large loans and several small loans. In the aggregate, the group of loans is not impaired, but if each loan is tested individually for impairment, several smaller loans are determined to be impaired. As a result, these impaired loans, in total, represent a material impairment, which is obfuscated by the weight of larger unimpaired loans. Additionally, based on our understanding of the proposed impairment test for this Standard, it appears that this test is not consistent with the impairment test of IAS 36, which requires two impairment tests rather than one.

Question 7 – Impairment of Investments in Available-for-Sale Financial Assets

Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?

Although, this proposed amendment results in a convergence between IAS 39 and SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, we do not believe, and thus disagree strongly, that this is the *best* accounting treatment for impaired losses. This proposed treatment is inconsistent with the principles of fair value accounting. All changes (i.e., gains or losses) in fair value carrying amounts should flow through the profit and loss statement. Consequently, we believe that there should be no distinction made, which separates financial instruments between available for sale and trading securities.

Question 8 – Hedges of Firm Commitments (paragraphs 137 and 140)

Do you agree that a hedge of an unrecognized 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?

We agree with the proposed change that an unrecognized firm commitment would be accounted for as a fair value hedge instead of a cash flow hedge. This proposed treatment is consistent with the application of the fair value model and provides more transparency, regarding the change in the value of the firm commitment. This accounting treatment is moving towards our ultimate goal, which is to have all executory contracts measured and recognized in the financial statements rather than off the balance sheet.

Question 9 – 'Basis Adjustments'

Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognized directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?

We agree with this proposal **only if** sufficient disclosure is provided for the basis adjustment. This disclosure must provide information that enables analysts to discern the operating and financing costs related to the commitment. Such information is needed to reflect the adjustment correctly in financial ratios because the numerator and the denominator are not related since the adjustment flows through equity.

Question 10 – Prior Derecognition Transactions

Do you agree that a financial asset that was derecognized under the previous derecognition requirements in IAS 39 should be recognized as a financial asset on transition to the revised Standard if the asset would not have been derecognized under the revised derecognition requirements (i.e. that prior derecognition transactions should not be grandfathered)?

Yes. We support strongly this proposed accounting treatment (to disallow grandfathering) for financial assets previously derecognized that would not currently qualify for such treatment. We believe the proposed treatment corrects prior accounting that did not present the true economic substance of the transaction.

Closing Remarks

The GFRAC appreciate the opportunity to comment on the IASB' proposed improvements to IAS 32 and IAS 39. If you have any questions or seek elaboration of our views, please do not hesitate to contact Georgene Palacky at 1.434.951.5334 or georgene.palacky@aimr.org.

Sincerely,

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