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GESELLSCHAFT FÜR FINANZWIRTSCHAFT
IN DER UNTERNEHMENSFÜHRUNG E.V.

"Financial Accounting Working Group"

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

Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement

Dear Sir David,

The Members of the GEFIU Financial Accounting Working Group are pleased to comment on the Exposure Draft of Proposed *Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement.*

The GEFIU (Gesellschaft für Finanzwirtschaft in der Unternehmensführung e. V.) is the German Financial Executives Institute. It has some 160 members who are chief financial officers or finance directors of German industrial and trading companies as well as insurance companies, banks, and other financial services. GEFIU is a member of the International Association of Financial Executives Institutes (IAFEI). As a member of the International Group of Treasury Associations (IGTA), GEFIU also cooperates with other treasury associations.

We, the members of the GEFIU Financial Accounting Working Group, have reviewed the drafts whilst considering the experience of German companies with the existing Standards. We begin our commentary with a few initial remarks.

General Comments

1. We applaud the fact that following extensive criticism of the existing Standards for accounting for Financial Instruments, the IASB has initiated a review. This review offers the opportunity to correct the main weaknesses of the standard and enable entities to prepare financial statements without significant distortions of profitability.

However, in reviewing the intended amendments, it is clear that the Board has unfortunately not used this opportunity for reviewing and correcting material issues. Industrial companies together with German banks have repeatedly called attention to the main weaknesses of the current Standards for Financial Instruments. These lie in the restrictive and economically nonsensical rules for hedge accounting, particularly the inadmissibility of macro hedges, as well as the rules for the treatment of internal contracts. These rules blatantly contradict an entity's risk management goal of hedging its net risk position.
We refuse to abandon modern and efficient risk management methods in order to solely fulfil accounting rules. Accounting should reflect risk management and not the other way around.

Whether companies or other interest groups, we do not know of one single opinion which endorses these unsystematic and impractical rules, especially for hedge accounting. In fact, German industry, European bank associations, the German Federal Authority for Financial Services Supervision, the Basel Committee for bank regulation and even national standard setters such as the British Accounting Standards Board share our opinion that the rules for hedge accounting distort the profitability of an entity and make it extremely difficult to gain an understanding of the financial position of the entity. The critics are not worrying about earnings management but are wanting to ensure that transactions are accounted for in line with the economic intentions (substance over form). The capital markets and users of financial statements are not well served by inefficient, complicated rules for Financial Instruments and the resulting confusing economic picture communicated. We therefore propose that the basic structure of the rules for hedge accounting be revised in a further project.

We would also like to mention at this point that we are disappointed with the rigid stance of the IASB, especially in the way that it often overrides, without discussion, the justified criticism of many parties.

2. Clear, precise and consistent Standards are required to provide meaningful company information. We see this principle jeopardised by the principles underlying ED IAS 32 and ED IAS 39. By addressing several individual cases in relatively high detail, the amendments to the Standards, as well as the Standards themselves, come across as commentaries and not as accounting guidelines. The structure and basic message of the guidelines are therefore, in many parts, neither recognisable nor understandable.

3. During our review, we have repeatedly seen that guidelines are to be changed without any obvious reason and sometimes contrary to existing views, even though these changes provide no added information for the user of the financial statements (e.g. the treatment of equity instruments according to ED IAS 32.29C-G). This type of approach was also followed in the Improvement Project and leads to high implementation costs for those preparing financial statements. We therefore request that the IASB put more emphasis on a cost-benefit analysis.

4. Disclosure requirements are important for corporate governance. This is however relevant only if the published information truly provides the users with an understanding of the risk position of the entity. The disclosure requirements of ED IAS 32 fulfil this requirement only to some extent. The required explanatory notes are in some areas so detailed that the users are no longer able to filter out the information necessary to make their investment

decisions (i.e. information overkill). In this context, we would ask that the principle of materiality be given more importance.

5. We would also like to point out the fact that the timeframe between when the Standards are issued and the initial application is too short. Generally, the implementation of a new standard requires a lead time of one year. This is necessary for the IT technical changes, programming, and implementation of new processes. In large firms, the communication of the changes throughout the group involves many staff and takes up much time. With this in mind, and given the complexity of the amendments proposed, we recommend postponing the date with which the Standards should take effect from 2003 to 2004 at the earliest.

ED IAS 32 „Financial Instruments: Disclosure and Presentation"

1. 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 of 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).

According to ED IAS 32.19, the classification of a financial instrument as an equity instrument or liability is based not on the legal but on the economic form at the time of first application. We agree with this basic principle. The addition of „and without regard to probabilities of the manners of settlement" is however confusing, and should be deleted. The principle of substance over form implies that the probabilities of the various settlement forms should be taken into account.

We agree with paragraphs ED IAS 32.22 and 22A.

2. Separation of liability and equity elements (paragraph 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 do not believe that the measurement methods should be restricted. A entity which has the ability to reliably measure the equity element of a compound financial instrument should continue to have this option. Therefore, in the case of a typical convertible bond, the value of short calls on the entity's own equity is easily measured. We therefore believe that measurement options should remain.

3. 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?

We believe that the provision of ED IAS 32.29C – 29G in which derivatives such as options, warrants or forwards on own shares should only be treated as equity instruments when the delivery occurs at a fixed price for a fixed number of shares is too restrictive. We do not agree with the reasoning that a contractually agreed net share settlement prohibits the classification as an equity instrument. We therefore recommend maintaining the current IAS 32.16 which does not include this restriction. This will permit entities greater flexibility in raising capital.

4. 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?

We believe an integration of ED IAS 32 and ED IAS 39 into one comprehensive Standard makes sense as the guidelines are similar in their content.

We would like to point out that the different application areas of the two Standards are very confusing and should be harmonised.

5. Disclosure (ED IAS 32.42 – 32.94)

The proposal in ED IAS 32.56 to disclose both the fair value and the cash flow interest rate risk should be re-considered. It could lead to an overstatement of the risks.

ED IAS 32.64(a) requires the presentation of more detailed maturity dates. We disagree with this proposal as the increased cost of collecting this information is much higher than any benefit provided to the users of the financial statements.

We disagree with the proposals of ED IAS 32.77A, ED IAS 32.77B(d), ED IAS 32.77B(e) as collection of the information, if at all possible, would be costly.

We disagree with the requirement in ED IAS 32.93A (h) to disclose, for non-derivative financial liabilities held for trading, the difference between the carrying value and the amount the entity is contractually required to pay at maturity. Held for trading financial instruments should always be valued at their market value.

ED IAS 39: Financial Instruments: Recognition and Measurement

1. Scope (ED IAS 39.1 – 39.7)

Question 1

Loan commitments (paragraph 1(i))
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 agree in principle with the proposal. However, the definition of "past practice" and „shortly after origination" set out in ED IAS 39.1(i) must be improved. We assume that:

1. the „practice of selling the assets shortly after origination" does not apply to the syndication of credits; and
2. "shortly after origination" means only a few days.

We disagree with the application of ED IAS 39.1(i) to all of an entity's loan commitments. We propose limiting the application to "all of its loan commitments in the same portfolio".

2. Derecognition

Question 2

Continuing involvement approach (paragraphs 35-57)
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 welcome the fact that the IASB has tackled the accounting for residual risks remaining with the seller. In practice there are many situations where the economic aims vary considerably from the legal form e.g. the sale of a receivable where the buyer immediately transfers back to the seller the complete credit risk. In such cases it is clear that derecognition is not appropriate. Such clear cut cases however rarely occur in practice. Often, the seller retains only partial risks. We believe that it is extremely difficult in these cases to set out criteria clearly defining when derecognition is appropriate.

The proposed „continuing involvement" approach does not, in our opinion, solve the problem because the rules do not always reflect economic considerations. In many cases they would not permit derecognition even though the seller has only retained a small residual risk. In such cases, the accounting treatment is too far detached from the legal ownership.

The proposed approach is based on several fictions which severely distort the economic aims and complicate a proper understanding of the net assets, financial position and operating results of the entity. We set out below the key deficiencies of the collateralised borrowings approach:

– A complete sale of receivables is accounted for, in part, as debt financing.
– A provision arising from a guarantee is shown as a provision against a fictional receivable.
– Payments made under a guarantee commitment are shown as repayment of a liability.
– The continuing involvement approach could lead to the same receivable being reported twice. This is confusing and also leads to material distortions in statistics based on balance sheets of financial institutions.

We cannot expect the typical user of financial statements to appreciate or understand the increasing level of fictions.

The concept of servicing assets and liabilities proposed by ED IAS 39.43 is not specific enough. The requirements are not clearly defined – what is an adequate servicing fee for example?

We propose the immediate derecognition of the asset even where the risk is only partially transferred by the sale. At the same time however, in the cases of partial risk transfer, a liability should be recognised. This approach, already contained in IAS 39.51 et seq., leads to the same results as the more complicated and obscure approach presented in the exposure draft.

The continuing involvement approach also causes further problems for example, how should the maturity dates of the residual amount be determined? How should the split by geographical market and segment be accomplished? The securitised assets are often receivables pooled from various sources and vary in quality. Finally we find the examples offer very little guidance and must therefore be clarified and expanded.

Question 3

Pass-through arrangements (paragraph 41)
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 agree in principle with the proposal.

3. Measurement

Question 4

Fair value designation (paragraph 10)
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?

We disagree with the proposal as it effectively provides an entity with a choice of accounting treatment. This choice will inevitably reduce the comparability of financial statements and goes against the aim of the IASB to reduce the choices contained in the Standards.
Furthermore we see this as a further step in the direction of full fair value accounting. Full fair value accounting however does not always enable the users of financial statements to evaluate "the ability of an enterprise to generate cash and cash equivalents and of [their] timing" (IASB Framework, para. 15).

The following example highlights this conflict.
If an entity acquires a fixed interest rate gilt with the intention to hold to maturity, any movements in the market interest rate would lead to changes in the fair value of the asset. The change in fair value however has no impact on the cash-inflows for the entity as it does not intend to sell its investment. Thus in some cases, fair value accounting does not provide relevant information. Indeed, in the above example the financial statements would provide the users with confusing information.

We thus request that the IASB urgently review the use of fair values. They may not only mislead users of financial statements, but they also reduce comparability of financial statements where market values are not readily available.

4. 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 in principle with the proposal.

5. Impairment

Question 6

Collective evaluation of impairment (paragraphs 112 and 113A-D)
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 agree in principle with the proposal.

Question 7

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

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

The proposal in ED 39.119 to disallow the reversal of impairment losses (recognised in the profit and loss account) through the profit and loss account as long as the instrument is recognised is not convincing. It is inconsistent not only with the other requirements of IAS 39 e.g. para. 114 but also with other Standards e.g. ED IAS 37, IAS 38.76. We therefore propose the retention of the current approach.

6. Hedge Accounting

Question 8

Hedges of firm commitments (paragraphs 137 and 140)
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? (paragraphs 137, 140)

We agree in principle with the proposal.

Question 9

Basis adjustments (paragraph 160)
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? (paragraph 160)

We agree with the proposal and welcome the removal of an unnecessary complication for current assets and liabilities. The basis adjustment is very difficult to apply in practice and provides the user of financial statements with little additional information. Finally, where sales of inventory and payments are closely matched, the basis adjustment has an immaterial impact on the reported result anyway.

For non-current assets and long term liabilities however we propose retaining the basis adjustment as an option. This ensures e.g. in the case of non-current assets, that the true acquisition cost is spread over the useful life of the asset rather than a fictitious acquisition cost fixed at the exchange rate on the date the non-current asset is booked into the accounting system.

Treatment of internal contracts

Under ED IAS 39.126B and the current standard, internal contracts do not qualify for hedge accounting. As indicated above, we strongly criticise the retention of this rule. Modern risk management uses internal positions to optimise efficiency (concentration of know-how, better pricing and reduced transaction costs) and reduce counter-party risk. The rule that internal hedging instruments can only be recognised for hedge accounting if the contract is back to back with an external party, completely mitigates this advantage. We thus strongly argue that the treatment of internal contracts should generally be exactly the same as external contracts.

Provided the internal contract is properly documented, and the conditions for effectiveness set out in IAS 39.142 are fulfilled, hedge accounting should be permitted.

We also point out that FRED 23, issued by the British Accounting Standards Board, does not differentiate between internal and external contracts. Indeed, internal contracts are treated exactly the same as external contracts.

Short cut-Method

We are critical of the decision not to make any changes to IAS 39.147 as this means that the short cut method is still not permitted.

It is preferable, in our opinion, if only for the purposes of easing the workload under IAS 39, to allow the use of the short-cut method, where the hedge effectiveness can be readily identified from the principal terms of each instrument. The guidance on this proposal should be based on SFAS 133.68 which explicitly permits the short-cut method. The British Accounting Standards Board also supports the short-cut method – FRED 23 paras. 10 and 14.

ED IAS 39.157

The addition clarifies the theoretically correct method of amortising premiums and discounts. For reasons of practicality however, the current option of straight line amortisation should be retained.

7. Transition

Question 10

Prior derecognition transactions (paragraph 171B)
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 (i.e. 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?

We do not agree with the transitional proposals. We propose the deletion of ED IAS 39.171B. The retrospective recognition of assets which have been derecognised would lead to additional costs for many entities which bear no relation to the benefits. We agree with the alternative proposal to grandfather prior derecognition transactions.

We generally reject any prior year adjustment. A retrospective change in the accounting or valuation method should not lead to an adjustment to prior years – consistent with the transitional rules of the original IAS 39.

We welcome the proposal in ED IAS 39.171A. The determination of the categories „trading“ or „available for sale“ must be made when using the “new” IAS 39 for the first time, regardless of any designation adopted under IAS 39 (revised 2000). We would also recommend permitting the grandfathering for a later transition to a fair value valuation e.g. where entire portfolios are reclassified. In many cases entities will need to create the infrastructure to support the reclassification. The proposed rule would require a double accounting (old and new transactions) which could hinder a reclassification.

We do not understand the meaning of ED IAS 39.171C and request clarification.

Yours sincerely

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