CA House • 87-89 Pembroke Road • Dublin 4

TEL: +353-1 637 7200
FAX: +353-1 668 0842
e-mail: ca@icai.ie

THE INSTITUTE OF
Chartered Accountants
IN IRELAND

CL 28

16th July 2004

Sandra Thompson,
Senior Project Manager,
International Accounting Standards Board,
30, Cannon Street,
London EC4M 6XH
United Kingdom

Dear Ms Thompson,

ED on Fair Value Option: proposed change to IAS 39

The Accounting Committee (AC) of the Institute of Chartered Accountants in Ireland (ICAI) has considered the proposed change to IAS 39 contained in the ED on the Fair Value Option.

As explained in the response to Question 1 below, AC does not consider that the proposed restriction of the fair value option is appropriate in principle. However, AC understands that the proposals are the IASB's response to concerns of regulators and would support the proposals if not to do so would delay full EU endorsement of IAS 39.

Question 1

Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

Firstly, AC believes that the option to carry any financial assets or liabilities at fair value is very important for many entities. It reduces the inconsistencies inherent in the mixed model approach in IAS 39, and avoids the need for complex hedging documentation for situations where entities have natural or economic hedges. AC does not support the proposed amendment to limit the application of the fair value option. AC believes that the requirement to designate a financial asset or liability as carried at fair value on inception and the prohibition on subsequent reclassification are stringent enough restrictions on its use. AC does not believe further restrictions are warranted.

Secondly, restricting the use of the fair value option to situations where the fair values are 'verifiable' is introducing a test not found else where in IFRS. It sets a 'higher bar' than that required by other standards. For example:

(i) IAS 39 requires traded assets and available for sale securities to be measured at fair value, without an additional requirement for these values to be verifiable.

(ii) IAS 40 (Investment properties), in its fair value via income statement option, notes that there is a rebuttable presumption that an enterprise will be able to determine the fair value of an investment property reliably on a continuing basis. (*IAS 41.53*) Where a direct market price is not available it is permissible for the fair value to be determined using discounted cash flow projections 'using discount rates that reflect the current market assessments of the uncertainty in the amount and timing of the cash flows.' (*IAS 40.40(c)*). It is only where comparable market transactions are infrequent and alternative estimates of fair value using discounted cash flow projections are not available that the particular property in question would use the cost model (assuming the enterprise's overall policy was to fair value investment properties).

(iii) IAS 38 (Intangibles) requires the acquirer in a business combination to recognise as separate intangibles the acquiree's intangibles at fair value where, at the acquisition date these can be 'measured reliably'. The Basis of Conclusions of IAS 38 notes that when, for the estimates used to measure an intangible's fair value, there is a range of possible outcomes from different probabilities, 'that uncertainty enters into the measurement of the asset's fair value, rather than demonstrates an ability to measure fair value reliably.' (*IAS 38, BC 24(a))* Such fair values are then amortised to the income statement.

Therefore the imposition of the verifiability test for certain financial instruments appears to be inconsistent with what is deemed appropriate elsewhere in IFRS.

AC believes that the ability to use the fair value option for any financial asset or liability provides entities with a surrogate to hedge accounting (e.g. for mortgages) and, thereby, avoids the potential difficulties and onerous requirements of hedge accounting. The proposals limit this ability and, therefore, may potentially produce more volatility in the profit and loss account.

Question 2

Are you aware of any financial instruments to which entities are applying, or are intending to apply, the fair value option that would not be eligible for the option if it were revised as set out in this Exposure Draft? If so:

(a) please give details of the instrument(s) and why it (they) would not be eligible.
(b) is the fair value of the instrument(s) verifiable (see paragraph 48B) and if not, why not?
(c) how would applying the fair value option to the instrument(s) simplify the practical application of IAS 39?

AC has discussed possible examples, including unlisted equity investments of venture capitalists and similar entities, and believes that there are methodologies available to meet the 'verifiability' test that can be used in applying the fair value option. Consequently, the AC is not aware of any financial instruments to which entities are applying, or are intending to apply, the fair value option that would not be eligible for the option if it were revised as set out in this Exposure Draft.

Question 3

Do the proposals contained in this Exposure Draft appropriately limit the use of the fair value option so as to address adequately the concerns set out in paragraph BC9? If not, how would you further limit the use of the option and why?

AC considers that the proposals address the concerns raised in paragraph BC9. However, AC does not believe that the concerns, that entities will use this option in a way that will inappropriately increase rather than decrease profit and loss volatility, are valid. AC believes that most entities are endeavouring to achieve hedge accounting in order to reduce volatility. Entities are likely to use this option to achieve offset for natural hedges and, thereby, reduce volatility.

Question 4

Paragraph 9(b)(i) proposes that the fair value option could be used for a financial asset or financial liability that contains one or more embedded derivatives, whether or not paragraph 11 of IAS 39 requires the embedded derivative to be separated. The Board proposed this category for the reasons set out in paragraphs BC6(a) and BC16-BC18 of the Basis for Conclusions on this Exposure Draft. However, the Board recognises that a substantial number of financial assets and financial liabilities contain embedded derivatives and, accordingly, a substantial number of financial assets and financial liabilities would qualify for the fair value option under this proposal.

Is the proposal in paragraph 9(b)(i) appropriate? If not, should this category be limited to a financial asset or financial liability containing one or more embedded derivatives that paragraph 11 of IAS 39 requires to be separated?

AC believes that this proposal is appropriate.

Question 5

Paragraph 103A proposes that an entity that adopts early the December 2003 version of IAS 39 may change the financial assets and financial liabilities designated as at fair value through profit or loss from the beginning of the first period for which it adopts the amendments in this Exposure Draft. It also proposes that in the case of a financial asset or financial liability that was previously designated as at fair value through profit or loss but is no longer so designated:

(a) if the financial asset or financial liability is subsequently measured at cost or amortised cost, its fair value at the beginning of the period for which it ceases to be designated as at fair value through profit or loss is deemed to be its costs or amortised cost.

(b) if the financial asset is subsequently classified as available for sale, any amounts previously recognised in profit and loss shall not be reclassified into the separate component of equity in which gains and losses on available-for-sale assets are recognised.

However, in the case of a financial asset or financial liability that was not previously designated as at fair value through profit or loss, the entity shall restate the financial asset or financial liability using the new designation in the comparative financial statements.

Finally, this paragraph proposes that the entity shall disclose:

(a) **for financial assets and financial liabilities newly designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the previous financial statements.**

(b) **for financial assets and financial liabilities no longer designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the current financial statements.**

Are these proposed transitional requirements appropriate? If not, what changes do you propose and why? Specifically, should all changes to the measurement basis of a financial asset or financial liability that result from adopting the amendments proposed in this Exposure Draft be applied retrospectively by restating the comparative financial statements?

AC believes this proposal is acceptable.

Question 6

Do you have any other comments on the proposals?

AC has no other comments.

AC would be happy to discuss or expand on any of the above issues with you.

Yours sincerely,

Simon Magennis
Secretary
Accounting Committee
Institute of Chartered Accountants in Ireland