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Ms Sandra Thompson
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29 June 2004

Dear Sandra

IASB EXPOSURE DRAFT - PROPOSALS ON AMENDMENTS TO INTERNATIONAL ACCOUNTING STANDARD (IAS) 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT – THE FAIR VALUE OPTION

The Institute's Accounting Standards Committee has considered the above Exposure Draft and I am pleased to set out its comments below.

Response to Detailed Questions

Our responses to the specific questions in the Exposure Draft are set out below:

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

We do not agree with the proposals. In the mixed accounting model under IAS 39, it would be possible to end up with asymmetric accounting. Also we do not believe that the proposals will cure the problem of volatility as set out in paragraph BC9(b). In considering the rationale for the proposed amendments set out in paragraph BC9, we reject points (a) and (b). We see some merit in point (c) of this paragraph and believe that it is inappropriate to recognise gains in fair valuing an entity's own deteriorating credit risk.

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(ii) *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?*

We suggest that one example of an instrument would be where loans are hedged with credit derivatives. This amendment, through the operation of the "substantially offset" rule, might prevent entities from fair valuing loans but they are required to fair value the credit derivatives. As a result, entities may be forced to adopt asymmetric accounting whereas under IAS 39 as currently issued it is possible for companies to fair value both sides of this transaction. The proposed remedy will therefore continue the problem and in some circumstances may indeed make the situation worse where it forces asymmetry. We believe that it is also important how the "substantial offset" rule is interpreted. We note that paragraph BC9(b) is concerned with the issue of volatility and suggest that this may be increased by this amendment.

(iii) *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?*

Please see our answers to questions (i) and (ii) above. We agree with the alternative view set out in paragraph AV4 of the Exposure Draft. As we do not agree with the proposals this will fall away and we believe no further limits are required.

(iv) *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 derivatives to be separated. The Board proposes 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?

We believe that if these proposals were to be adopted, we would support the original criteria rather than further restricting them.

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(v) *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 cost or amortised cost.*

(b) *if the financial asset is subsequently classified as available for sale, any amounts previously recognised in profit or 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?

We agree with the proposed transitional requirements.

(vi) *Do you have any other comments on the proposals?*

We agree with the alternative views on the proposed amendments set out in the Exposure Draft.

If you wish to discuss our comments further, please do not hesitate to contact me.

Yours sincerely

RICHARD ANDERSON
Assistant Director, Accounting and Auditing
Secretary to the Accounting Standards Committee

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