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EAA Financial Reporting Standards Committee

Address for correspondence:
Prof. Dr. Günther Gebhardt
Johann Wolfgang Goethe-University
Mertonstr. 17-25

60328 Frankfurt am Main
Germany

Sir David Tweedie
Chairman IASB

30 Cannon Street
London EC4M 6XH
UK

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Re: ED Amendments to IAS 39 Financial Instruments: Recognition and Measurement – The Fair Value Option

Dear Sir David,

On behalf of the EAA Financial Reporting Standards Committee I am writing this comment on the above quoted exposure draft. As this is the first comment letter of the EAA Financial Reporting Standards Committee I attach its mission statement and a list of members who have been appointed by the EAA Steering Committee in cooperation with the national coordinators.

Following is a list of topics summarizing briefly our comments:

- As explained in more detail in our Background of Comment, we see no convincing argument for limiting the fair value option. Limiting the application of the fair value option will unnecessarily prohibit that entities present the effects of their risk taking and of the efficiency of their hedges immediately in their financial statements.
- We do not share the concern of prudential supervisors that entities will want to apply the fair value option to only one side of a matched position. We suggest additional disclosures on the reasons for using the fair value option as a much better way to cope with the concern.
- We do not support the double standard for fair values that would be created by introducing the "verifiable" notion.
- We suggest deleting the potentially misleading reference to the role of prudential supervisors.

If you would like any clarification of our comments, please do not hesitate to contact me.

Yours sincerely

Prof. Dr. Günther Gebhardt
Chairman EAA FRSC
Email: gebhardt@wiwi.uni-frankfurt.de
Phone: +49-69-79828498 / FAX: +49-69-79823618

Background of Comment

Measurement of financial assets and financial liabilities and the related income recognition according to IAS 39 (revised 2003) depends on the classification as

(1) financial assets or financial liabilities at fair value through profit or loss;
(2) held-to-maturity financial assets;
(3) loans and receivables;
(4) available-for-sale financial assets.

For the purpose of the following discussion it is useful to add to the above categories listed in IAS 39.9 two more categories:

(5) financial liabilities not designated by the entity as at fair value through profit and loss;
(6) derivatives.

Changes in fair value due to changes in market risk factors (here: interest rate risk)[1] are reflected in the measurement of (1) financial assets and financial liabilities at fair value and of (6) derivatives; those changes in fair value are included in net income immediately. Changes in fair value of (4) available for sale financial assets are reflected in their measurement but not immediately in net income as they are temporarily included in a special equity component "other comprehensive income". Changes in fair value of all other categories (2) held-to-maturity financial assets, (3) loans and receivables and (5) financial liabilities not designated by the entity as at fair value through profit and loss are neither reflected in their measurement – at amortised cost – nor in net income.

This "mixed model" causes serious problems for companies that hedge financial instruments in these categories using derivatives. Without special hedge accounting an accounting mismatch in net income and equity arises *even for perfect economic hedges* of (2) held-to-maturity financial assets, of (3) loans and receivables and of (5) financial liabilities not designated by the entity as at fair value through profit and loss. For (4) available-for-sale financial assets an accounting mismatch arises between net income and other comprehensive income.

No accounting mismatches arise from perfect hedges of (1) financial assets or financial liabilities at fair value through profit or loss and from perfect "natural hedges" of (2) held-to-maturity financial assets or (3) loans and receivables refinanced by (5) financial liabilities not designated by the entity as at fair value through profit and loss. However, perfect economic hedges are rare – if they exist at all. Imperfections of economic hedges show up in accounting net income only if both the hedged item and the (derivative) hedging instrument are measured at fair value through profit or loss ("compensating (fair) valuation"). Imperfections of "natural hedges" where the financial assets and the financial liabilities are carried at amortized cost remain hidden in the books ("compensating nonvaluation").

The original IAS 39 (1998) offered two options to overcome the mismatch problems identified above, i.e. the fair value hedge accounting *option* and the cash flow hedge accounting *option*.

[1] The following discussion excludes impairment issues.

In order to take advantage of these options in IAS 39.86-102, companies have to fulfill burdensome requirements (documentation, effectiveness tests). Companies applying modern macro risk management techniques have serious problems in meeting these requirements which assume that a link between the individual hedged items and the hedging instruments exists and can be demonstrated. This is impossible for the dynamic hedging of huge portfolios of numerous financial assets and liabilities that change permanently due to e.g. transactions with customers. The hedging of such portfolios aims at securing a profit following risk management strategies that imply taking risks up to specified limits under tight management controls using advanced risk measurement techniques (e.g., value at risk).

Macro hedging concentrates on net positions that are hedged in part preferably using derivative contracts. Without special hedge accounting the mixed model of IAS 39 results in artificial volatility of accounting net income exaggerating the existing “real” economic income volatility. The fair value and cash flow hedge accounting options of the original IAS 39 help to reduce artificial excess volatility of accounting net income but for many companies neither to a sufficient degree nor to acceptable costs. A company that intends to give a fair presentation of its economic situation may not be able to do so under the original IAS 39 rules because of the burdensome requirements.[2]

The IAS 39 Improvement of December 2003 introduced the fair value option: By designating any financial asset or financial liability as “at fair value through profit or loss” companies can avoid the accounting net income mismatch problems that otherwise arise from the mixed model when hedging a portfolio of loans and receivables or held-to-maturity assets using derivatives. Artificial volatility of accounting net income can be limited if all assets and liabilities of a managed portfolio are “at fair value through profit or loss”. When a company following a risk management strategy deliberately takes risks by not fully hedging net positions of the portfolio, this will become transparent in the financial statements. For an imperfectly hedged “natural” portfolio consisting of loans and receivables financed by financial liabilities, the fair value option offers a way to present inefficiencies in the hedging relationships that otherwise would not show up in the financial statements immediately but only over the remaining life of the financial instruments in the portfolio. To summarize, a company that intends to present its economic situation timely in the financial statements can do so by exercising the fair value option.

Thus, any limitation on the fair value option will hinder companies to adequately reflect their economic situation in their financial statements. In particular, the proposed restriction in ED IAS 39.9 (b) (iii) to limit the use of the fair value option to the extent that changes in the fair value of financial instruments are “substantially offset”[3] by changes in the fair value of other financial instruments appears inadequate. This rule would imply that an IFRS deliberately prohibits more transparency of risk taking in financial statements: For example, a bank that runs an open interest rate position would not be allowed to present the effects of its risk taking immediately in accounting net income.

In the same line of argument, we strongly disagree with the proposed prohibition to designate loans and receivables in ED IAS 39.9 (b) (iv) at fair value through profit or loss. This would imply that the fair value option would not be available for loan portfolios of financial institutions refinanced by liabilities.

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2 For a detailled analysis see Gebhardt, G., Reichardt, R and C. Wittenbrink, Accounting for Financial Instruments in the Banking Industry: Conclusions from a Simulation Model, European Accounting Review, 13, 2004, pp. 335-365.

3 We will not discuss the „substantially offset“ – criterion as this is an implementation issue for an in our opinion seriously flawed concept.

In risk management practice, portfolios of financial assets and financial liabilities are often defined in a way suited to manage specific risks (e.g., interest rate risk, currency risk, credit risk, equity price risk, commodity price risk). Derivative hedging instruments are designed to attain a desired profile of the managed risk. For example, a company expecting increases in interest rates will try to create a short position in fixed rate net assets in a specific currency by entering into additional fixed rate payer swaps. Other risks (e.g., credit risk) of the financial instruments included in the portfolio may not be subject to hedging decisions at the same time. As the fair value varies with changes of all risk factors, applying the fair value option results in net income effects because of changes in the unhedged risks and because of inefficiencies with regard to the hedged risks. The first effect is not an increase in volatility because of the use of the fair value option; rather the use of the fair value option makes transparent that there exists real volatility in economic income that has not been presented in accounting net income before. Any restriction on the fair value option would imply that volatility from unhedged risks and volatility from imperfect natural hedges of hedged risks will continue to be hidden in the books. Arguing for limiting the fair value option is in effect arguing for intransparency.

Because of the greater transparency of the net income effects with respect to unhedged risks and imperfect hedges, some companies will be reluctant to use the fair value option as they face a trade-off between the reductions of artificial accounting income volatility caused by the restrictive IAS 39 rules and the increase of disclosed real economic income volatility. Generally, companies do not have incentives to increase volatility of accounting income as they will then most probably have to face higher required rates of return and lower security prices. Therefore we do not share the concern in BC9 (b) of prudential supervisors that entities may want to apply the fair value option to only one part of a matched position. A better way to address this concern would be to require additional disclosures on the reasons for exercising the fair value option.

Question 1
Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

For the reasons outlined in our Background of Comment, we do not agree with any of the proposals to limit the use of the fair value option. We propose to delete the proposed new wording in ED IAS 39.9 (b) (i)-(v).

The restrictions proposed would make IAS 39 an even more rules based standard.

We do not agree with the additional proposal that there should be a stricter test of the quality of the fair value of financial instruments designated under the fair value option by introducing the new verifiable notion. We note that the term is not defined in the IASB Framework or used in any other IAS/IFRS. We do not see a convincing case be made for requiring a higher quality of "verifiable" fair values for financial instruments that are *permitted* to be at fair value through profit or loss compared to only" "reliably measurable" fair values of financial instruments *required* to be at fair value through profit or loss. A distinction between fair values that are "verifiable" or only "reliable measurable leads to additional issues not addressed in the ED: For example, as fair value hedge accounting is optional, the question arises whether the fair value changes of the hedged items attributed to the risk being hedged and included in the carrying amount of the hedged item ("basis adjustment") are required to be "verifiable" or only "reliably measurable".

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?

See our Background for Comment.

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?

As outlined in our response to Question 1, we do not agree with introducing the verifiability notion. As only fair values of financial instruments that are reliably measurable may be used under IAS 39, we do not see room for profit or loss to be inappropriately affected by subjective fair value determination.

As outlined in our Background of Comment, we do not share the concern that entities will deliberately increase (accounting) volatility in profit or loss by, for example, applying the option to only one part of a matched position. If the matched position is hedged by derivatives any designation at fair value through profit or loss will decrease artificial accounting volatility. When volatility increases in such a situation, this is due to economic volatility resulting from unhedged risks or inefficient hedges. This real volatility in profit or loss is preferable to having the volatility concealed in the financial statements by measuring the financial instruments at amortised cost. If the matched position is a “natural hedge” of financial assets and liabilities carried at amortised cost designating only assets or liabilities under the fair value option may increase accounting volatility in profit or loss. Additional disclosures of the reasons for using the fair value option and the relation to the overall risk management strategies are a better way to cope with the concern.

The proposed changes of the standard do not prohibit liabilities to be designated at fair value through profit or loss if they contain one or more embedded derivatives and thus will result in an entity recognizing gains or losses from changes in its own credit risk. We do not see an issue here as fair value measurement of liabilities implies that changes in own credit risk will result in fair value changes to be included in profit or loss immediately. The net income effects are already to be disclosed under IAS 32.94 (f) and should be commented on in the management discussion and analysis.

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 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?

See our response to question 1 and our Background of Comment. We cannot support any limitation of the use of the fair value option.

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 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 did not discuss and do not comment on the transitional requirements that appear to be adequate.

Question 6
Do you have any other comments on the proposals?

The reference to prudential supervisors in the proposed wording of ED IAS 39.9 is not necessary and might be misunderstood as granting authority in the area of IFRS standard setting to those national bodies. ED IAS 39.BC 11 (b) clarifies the intention of the IASB and can be understood as a corrective means to the superfluous statement in the standard section. We fully agree with the alternative view in AV7.