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

Our ref RJ - comment letter fair value option

Amsterdam, 28 June 2004

Dear Ms Thompson:

Comments on Exposure draft of proposed amendments to IAS 39 Financial Instruments: Recognition and Measurement: The Fair Value Option

We appreciate the opportunity to respond to your invitation to comment on the *"Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement, The Fair Value Option" (*Hereafter referred to as ED*)*. Our response consists of general comments and answers to the questions raised in the ED.

The Council for Annual Reporting welcomed the fair value option in the Exposure Draft for the proposed amendments to IAS 39, issued in 2002. We refer to our comment letter on the proposed amendments to IAS 39 dated 11 October 2002. We understand the IASB's intention to accommodate concerns raised by constituents, in this case particular prudential supervisors and the European Central Bank. However in our view the proposals in this ED do not meet the objective the IASB intends to reach with this ED to limit the use of the fair value option while preserving the key benefits of the option. The proposals in the ED are cumbersome and may further complicate the standard unnecessary and are therefore in our view not an improvement of the standard.

As the IASB sets out in the Basis for Conclusions, the proposal to include the fair value option in IAS 39 has been issued for comment in June 2002 as part of the amendments proposed to IAS 39. Except for supervisors and the European Central Bank, a substantial majority has agreed with the proposals and the Board has considered the comments when making a decision on the amendments. In our view it is inappropriate to come up with an amendment so shortly after the comments on the fair value option were first considered and a revised standard IAS 39 was issued, in particular since no new views have been expressed. Moreover the timing of the further exposure draft is also significantly affecting the stable platform that is so important for the over 7000 entities in Europe and elsewhere in the world preparing for implementing IFRS in 2005. Our key concerns from a technical point of view are the following:

- The proposals are rules-based, contrary to the objectives of the IASB. The rules proposed are very complex and add to the complexity of the standard and of its implementation. Whether or not the proposed rules will have a substantial effect in practice is currently not clear. However the proposals will very likely limit the use of the fair value option in future when further developments in financial markets lead to changes in situations where the use of the fair value option could be beneficial.
- The criteria proposed when to allow the use of the fair value option, such as 'contractually linked' and 'substantially offset' are not clear and will require further interpretation. In particular the 'substantially offset' criterium could be interpreted as being similarly stringent and comparable to hedge accounting criteria. As a result, the use of the fair value option would not be beneficial in practice compared to applying the hedge accounting criteria of IAS 39.
- We do not agree with the proposal to introduce verifiability as a separate and new criterion for the use of the fair value option. In our view there should only be one definition of reliability in IAS 39, based on the definition included in the Framework. If the current definition is considered inadequate, this definition should be strengthened rather than creating a two-tier approach as is currently proposed. It is inconsistent to apply different requirements where fair value measurement is permitted rather than required. The use of a new notion in the context of the fair value option lacks conceptual arguments and basis and risks creating an expectation gap. We are furthermore not convinced that the proposed distinction is clear and expect the terminology used to require further interpretation. The main reason why there seems to be a need for introducing a new notion, is that reliability has been restricted in IAS 32 and 39 – for anti abuse reasons – to the fair value measurement of unlisted equity securities or derivatives based upon unquoted equity securities. We propose to develop one test of reliability to apply to all financial instruments measured at fair value, whether permitted or required.

In our view, it is not relevant to refer to the powers of prudential supervisors or other regulators in an accounting standard. The objectives of supervisors generally are somewhat different from the objectives of IFRS. We feel that the reference might give the impression that these supervisors have authority to interpret IFRS and even have power to overrule or amend standards. The result may be a violation of the level playing field that is aimed at in Europe through the adoption of IFRS in general and IAS 39 in particular, as supervisors in different jurisdictions may interpret IFRS inconsistently. Supervisors' mandates in respect of reporting for regulatory purposes should not be extended in an way to interpretation of IFRS for general purpose financial reporting.

Therefore, taking into account our comments raised in this letter, we recommend the IASB not to change the standard in respect of the fair value option. If the IASB continue to feel the need for an adjustment in order to meet the concerns raised by prudential supervisors and other regulators in order to make IAS 39 acceptable to those regulatory organisations, we propose an alternative approach consisting of (also refer to our response to question 1):

1. Developing one test of reliability for all financial instruments to be applied to all (permitted and required) fair value measurements . Given that the IASB seems uncomfortable with the current test included in IAS 39 – since the IASB introduced a new test 'verifiability' in this ED – the current reliability test as discussed in AG 80 should be further developed; and
2. Requiring entities to disclose as a policy note when an entity uses to option to measure instruments at fair value.

Answers to questions raised in the exposure draft

Question 1. Do you agree with the proposals

No, we do not agree with the proposals:

- The proposals lead to a rules-based approach to the fair value option.
- The proposals add to the complexity of the standard and are difficult to understand and implement in practice.
- The criteria proposed in paragraph 9b will require further interpretation. For example 'contractually linked' and 'substantially offset' will be interpreted in similar ways as the hedge accounting criteria in IAS 39 and there might as a result be little benefit in practice in the application of these criteria rather than the hedge accounting criteria.
- The proposals may lead to an increase in volatility in particular situations, while a decrease is intended with the fair value option. The reason is that the ED proposes that only in very limited circumstances loans and receivables can be measured at fair value. In situations where the strict criteria proposed under (ii) and (iii) cannot be met, however loans and receivables are used in the asset and liability management of, for example, an insurance company or a fund for (partially) matching certain insurance liabilities, volatility will increase as a result of the restrictions.

- We expect that situations will later arise that were not now foreseen and where fair value through income would be helpful.
- We do not agree with the proposal to introduce verifiability as a separate and new criterium. There is insufficient conceptual basis for the introduction and in our view the use of verifiability is not appropriate in an accounting standard (also see our remarks under General.
- We note that the examples included in paragraph 48B are redundant as they are a repetition of existing application guidance in IAS 39, AG 74 and AG 76.

Notwithstanding our preference for not adjusting current IAS 39, there is in our view a more advisable route to achieve the objectives intended with the proposals for limiting the use of the fair value option, if the IASB continues to feel that an amendment of IAS 39 is necessary to meet the concerns raised by prudential supervisors and the European Central Bank:

(1) We propose that the *one test of reliability* is developed for all financial instruments to be applied to all (permitted and required) fair value measurements. Given that the IASB seems uncomfortable with the current test included in IAS 39 – since the IASB introduced a new test 'verifiability' in this ED – the current reliability test as discussed in AG 80 should be further developed. This would require an amendment of the restriction of the reliability criterion applied in IAS 32 and IAS 39 and defined in AG 80. The test of reliable measurement should in our view not only be applied to the fair values of unlisted equity securities and derivatives based on unlisted equity securities, but to all financial instruments' fair values. In practice in Europe, other situations have arisen where the fair values of instruments (for example some commodity derivatives or some interest bearing instruments with very long durations) could not be determined with sufficiently reliability when applying the criteria of IAS 39 paragraph AG 80. We see no reason to apply a different test to the fair values of instruments where the measurement at fair value is permitted versus where such measurement is required.

(2) We furthermore propose to require that an entity *disclose in the policy notes* when (for which type of financial instruments or in which situations or for what purpose) it measures financial instruments at fair value by designation. In our view entities need to demonstrate the business rationale for applying the fair value option and disclose the designation policy as part of the accounting policy note. This may include hedging relationships at an aggregated level or in cases of insurance companies, circumstances where asset values match certain insurance obligations. In our view a consistent application of the fair value option as well as discipline can be achieved if the situations in which the fair value option is used are explained in the notes to the financial statements. It would enforce an accounting approach of IAS 39 based on the (risk management) policies and operations of the enterprise, without taking a rules-based approach to the fair value option.

Question 2. Are you aware of any financial instruments to which entities apply or intend 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?

Generally, we feel that there may be further situations that are now not identified and that should be eligible for the fair value option. However, it is at this stage impossible to provide a comprehensive list of instruments that should be eligible, since new developments may lead to new transactions that should be included. The following are examples of situations the investment fund and insurance industry where we expect that such situations could occur:

- The assets (and liabilities) of an investment fund where assets only partially offset the liabilities or where loans are entered into an investment.
- The assets, such as a portfolio of mortgage loans, of insurers to back certain liabilities of insurers, where the criteria of this proposal are not fully met or cannot be met as a result of further development of products. For example it has not been determined how insurance liabilities could be measured at fair value. The option included in paragraph 24 of IFRS 4 relates to measurement at a current value, using current interest rates. It is therefore not clear whether 9b (iii) is available to the insurance industry.
- The measurement of mortgage loans at amortised cost, while insurance liabilities are measured at fair value would lead to a measurement mismatch.
- A last example is where loans and receivables are used to back unit-linked insurance contracts, however where a formal contractual link is lacking and only an economic link exists.

Under paragraph 9 b(ii) liabilities are eligible for measurement at fair value if they are contractually linked to the performance of assets. Although we do not have a current example of a mirror situation, we are unclear about the limitation to financial liabilities to be optionally measured at fair value.

Question 3. Do the proposals contained in this Exposure Draft appropriately limit the use of the fair value option?

No, we prefer either not to change the standard again or to change the standard in a more principles based way as suggested in our response to question 1.

In respect of the conditions included in the proposed paragraph 9b, we note the following. The main criteria seem to be (ii) and (iii), where some form of linkage with the operations and the risk management of an entity is suggested. If any limitations were provided, we would prefer these criteria to more explicitly refer to operations and risk management policies and systems.

We also think that the other criteria would then be no more than sub-criteria of these more general criteria.

Condition 9b (v) refers to the option to measure venture capital activities that are under the scope of IAS 28 at fair value. Currently there are no further limitations to the application of fair value to these activities. Through this proposal the fair value option can only be applied if the fair value if verifiable. We agree that the option to fair value should not be applied if the fair value cannot be determined sufficiently reliable, but do not agree with the verifiability criterion as also noted above.

Question 4. Is the proposal in paragraph 9(b)(i) appropriate (the paragraph proposes that the fair value option could be used for a financial asset or a financial liability that contains one or more embedded derivative, whether or not IAS 39 requires the embedded derivative to be separated)

Yes, given the fact that we do not feel that the fair value option should be limited. However we note that many financial instruments will have some embedded derivatives or may be engineered to include embedded derivatives. For that reason we doubt whether the criterion as currently phrased provides more than intended possibilities for applying the fair value option. On the other hand if the option were limited to financial instruments with separable embedded derivatives, in practice little benefit would be gained from the application of the criterion, since entities would first have to determine whether there is a separable embedded derivative. The result would be that it is hardly beneficial to apply the fair value option, since the evaluation of whether or not a separable embedded derivative is included in the instrument nevertheless has to be performed. We reiterate that we continue to favour not to limit the fair value option at all.

Question 5. Are the proposed transition requirements appropriate?

The proposed transition requirements are adequately flexible and pragmatic, given the fact that the current IAS 39 allows the unconditional application of a fair value option.

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

No.

In our view, the fair value option should not be limited as proposed in this ED. If any changes are considered necessary, we propose that (1) the definition of reliable is reconsidered in respect of its scope and (2) a disclosure in the accounting policies is required to set out when the fair value option is applied.

If you have any queries regarding our comments and responses, please do not hesitate to contact us.

Yours sincerely,

Prof. dr. Martin Hogendoorn
Chair Council for Annual Reporting