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ED of Proposed Amendments to IAS 39
The Fair Value Option

Dear Sandra

I attach my submission on the fair value option.

Yours faithfully

Michael Bradbury
11 June 2004

ED of Proposed Amendments to IAS 39
The Fair Value Option

Invitation to Comment

Question 1

I do not agree with the proposals contained in this ED. I would not make any changes to IAS 39 to remove the fair value option.

In general I do not support the proposed amendments in this exposure draft. I regard IAS 39 as a (mixed model) interim standard because a full fair value model (as proposed by the joint working group for financial instruments) is not generally accepted at this point in time and requires further research, debate and due process.

Nevertheless, I regard the full fair value model for financial instruments as conceptually desirable. Therefore, I do not agree with placing a barrier for any entity that wants to achieve full fair value accounting.

Question 2

I believe the option to fair value is, in principle, the preferred treatment. I, therefore, think this question is irrelevant. Furthermore, I disagree with the introduction of verifiability (see response to question 3). Any change to IAS 39 from asking "…whether an entity is disadvantaged by the ED?" is likely to increase the patch-work nature of this standard.

Question 3

I consider the concerns raised in BC 9 to be ill-founded. I first deal with a general concern and then with each of the particular concerns dealt with in BC 9

<u>General Concern</u>
I am concerned that the amendments in the ED are being raised by banking supervisors, whereas the majority (of users and preparers) agreed with the fair value option. While prudential supervisors might be expected to have an important input into due process, they are primarily concerned with stability of the banking and financial system and the protection of depositors. Concerns over verifiability, volatility and creditworthiness are of primary concern to prudential supervisors. While these issues are important, the IASB ought to be concerned with accounting recognition and measurement rules for general purpose financial statements, not specific purpose reports for prudential supervisors.

On the other hand, the IASB has a clear mandate from the majority of submissions (from preparers and users of general purpose financial statements) to have a fair value option for financial instruments.

<u>Verifiable</u>
I disagree with the inclusion of the criterion of “verifiability”. First, I note that the IASC *Framework* does not employ the term “verifiable”. It merely states that information “…has the quality of reliability when it is free from material error and bias…” (*Framework para. 31).*

Second, the use of the term verifiability over-emphasizes only one aspect of the criterion of “reliability”. While the IASC *Framework* does not use the term “verifiable”, other conceptual frameworks (e.g., New Zealand *Statement of Concepts*) use the concept as a component of reliability.[1] Information is verifiable if a “knowledgeable and independent observer” concurs with the presentation “with a reasonable degree of precision” *SC 4.10*). The over-emphasis of the verifiable component of reliability ignores attributes of neutrality and representational faithfulness. It is not clear to me that the alternatives to fair value (except perhaps on a cost benefit basis) will be unbiased or will faithfully represent what they purport to represent.

Third, the use of “verifiability” will result in inconsistent measurement basis within classes of financial assets and financial liabilities that are measured at fair value. For example, even where there is no active market financial assets held-for-trading or designated as available-for-sale fair value will be measured on the basis of reliability not verifiability.

Fourth, I am not convinced that IAS 39.95 and 39.96 are deficient with regard to verifiability. These paragraphs relate to “…the variability in the range of reasonable fair value estimates in not significant for that instrument…”. In my view this (almost) means verifiability.[2]

<u>Volatility</u>
First, an increase in income volatility is not always unsatisfactory (or incorrect) if it faithfully represents the underlying economic conditions that have prevailed. Second there exists the possibility that not allowing an entity the option of fair value will result in a mixed method system that increases volatility. Whether removing the option or allowing the option results in an increase in income volatility is an empirical issue? No evidence has been presented that that removing the option results in more income volatility (or that it is harmful).

While there is no direct evidence, a natural assumption would be that the party best able to assess the potential impact of income volatility for an entity would be the majority of users that agree with the option, rather than parties external to the entity.

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[1] Other components of reliability are representational faithfulness and neutrality.
[2] Verifiability also has a component of independent assessment. However, this is more of an audit issue.

…2

Own creditworthiness

In my opinion the fair value of a liability ought to recognise a change in own creditworthiness to reflect the fact there has been a wealth transfer between debt holders and equity holders. Arguments against reflecting credit worthiness ignore the impact on the asset-side that causes credit worthiness. The arguments for inclusion of own credit risk in fair valuing debt developed by the Joint Working Group and by several publications issued by the FASB are compelling.

Question 4

I agree with this proposal.

Question 5

I agree with this proposal.