Accounting Standards Board AcSB CNC Conseil des normes comptables

Memo

CL 38

To: International Accounting Standards Board

From: Accounting Standards Board – Canada, Staff

Date: July 19, 2004

Re: **The Fair Value Option**

The following comprises the response of Accounting Standards Board – Canada staff (AcSB staff) to the IASB's Exposure Draft on The Fair Value Option, dated April, 2004.

We **do not support** the proposed amendments to IAS 39 set out in the IASB Exposure Draft. The AcSB has recently considered the IASB's proposals in conjunction with its own project to develop standards for recognition and measurement of financial instruments. While the AcSB believes that the fair value option should only be available when fair value is reliably determinable, it does not believe that other restrictions should be placed on the use of the fair value option[1]. The basis for the AcSB's conclusions, as set out in the Background Information and Basis for Conclusions document accompanying the AcSB's July 2004 Re-exposure Draft, Financial Instruments – Recognition and Measurement, is included in the Appendix to this comment letter.

[1] In the AcSB's case, an additional restriction is necessary for certain related party transactions, because of the interaction with measurement requirements for related party transactions in Canadian GAAP. Equivalent measurement requirements for related party transactions are not contained in IFRS.

We would be pleased to elaborate on these points in more detail if you require. If so, please contact Peter Martin, Director Accounting Standards at +1 416 204-3276 (e-mail peter.martin@cica.ca), or Ian Hague, Principal Accounting Standards at +1 416 204-3270 (e-mail ian.hague@cica.ca).

Appendix

Extract from Background Information and Basis for Conclusions to the AcSB's July 2004 Re-Exposure Draft, Financial Instruments – Recognition and Measurement

36. The AcSB has followed the IASB discussion that led to the April 2004 Exposure Draft, "The Fair Value Option," which proposes to restrict the circumstances in which an entity is permitted to designate a financial asset or financial liability on initial recognition as held for trading. The IASB proposal is largely the result of concerns expressed by financial institutions regulators that entities may be able to use this option to measure at fair value certain financial instruments for which fair value is not sufficiently reliable, as well as concerns that an entity might be able to selectively measure a financial instrument at fair value to generate income.

37. The AcSB continues to believe that the fair value option is useful to simplify the accounting in certain situations. In particular, it has the following benefits:

    (a) It eliminates the need for hedge accounting for hedges of fair value exposures when there are natural offsets, and thereby eliminates the related burden of designating, tracking and analyzing hedge effectiveness. Rather than being designated as a hedged item, the item could be designated as held for trading to achieve recognition of offsetting fair value gains and losses in the same periods. It also permits an entity to achieve a result similar to hedge accounting when using non-derivative instruments to manage risks other than foreign exchange risk.

    (b) It eliminates the burden of separating embedded derivatives. Often it may be easier for an entity to determine the fair value of the combined instrument as a whole rather than to identify the terms of the embedded derivative and separately measure the embedded derivative at fair value, for example, when the combined instrument is traded in an active market.

    (c) It eliminates problems arising from a mixed measurement model where financial assets are measured at fair value and related financial liabilities are measured at amortized cost. In particular, it eliminates volatility in profit or loss and equity that results when matched positions of financial assets and financial liabilities are not measured consistently. Because financial liabilities could now be designated on initial recognition as held for trading, an entity could consistently recognize fair value changes on matched financial asset and financial liability positions.

    (d) It de-emphasizes interpretive issues around what constitutes trading.

    In addition, since fair value is considered the most relevant measure for financial instruments, the AcSB does not believe that entities should be precluded from using such a measure, except when fair value cannot be reliably determined. Most respondents to the March 2003 Exposure Draft agreed with the introduction of this option, and the AcSB understands that certain entities, including life insurance enterprises and not-for-profit organizations, are likely to wish to make extensive use of the option in order to simplify their accounting.

38. While acknowledging the concern that some might apply the fair value measurement option inappropriately, the AcSB was not convinced of the need for limiting criteria. Any attempt to limit the circumstances in which the option may be available, without the benefit of practical experience, might inappropriately restrict the use of the option, frustrating the purpose it is intended to serve. The AcSB does, however, propose to specify that the fair value measurement option in Section 3855 may only be used when fair value is reliably measurable, and therefore proposes to incorporate guidance in the Application Supplement to describe what constitutes a reliable fair value. This guidance is based on that used in IAS 39 for available-for-sale financial instruments that can be measured at cost because fair value is not reliably determinable. However, it does not believe that a further restriction to those values that are "verifiable", as proposed by the IASB, is either necessary or appropriate in Canada. In particular, the AcSB notes that verifiability is an essential component of reliability within Handbook Section 1000, FINANCIAL STATEMENT CONCEPTS, but that it is inseparable from representational faithfulness.

39. The AcSB also notes that proposed amendments to Section 3860 would introduce disclosures of:

    (a) the carrying amount of financial instruments designated as held for trading;

    (b) the change in fair value of such instruments recognized in net income for the period; and

    (c) information about the extent to which changes in fair value of financial liabilities designated as held for trading result from other than changes in the benchmark interest rate.

    The AcSB believes that these disclosures provide sufficient information for users of financial statements to assess the extent to which elective use of the fair value has affected net income.