CL 33

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

16 July 2004

Dear Sirs,

Exposure Draft of proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement, The Fair Value Option

FAR, the institute for the accountancy profession in Sweden, is responding to your invitation to comment on the Exposure Draft of a Proposed Amendment to IAS 39 *Financial Instruments: Recognition and Measurement, The Fair Value Option*.

We welcomed the fair value option in our comment letter dated 24 October 2002 as it simplified the application of IAS 39 and facilitated the use of "natural hedges". We note that concerns raised by prudential supervisors and other regulators, have led to the issue of this exposure draft proposing a restriction of the use of the fair value option. We do not see why these – unproven – concerns should result in a limitation of the fair value option. For the reasons set out below, we believe that the proposed changes should be rejected.

General comments

The proposals are rules based, contrary to the objectives of IFRS, and also very complex. In our view, the proposals do not meet its objectives to limit the use of the fair value option while preserving the key benefits of the option. We do not agree with the concerns that the fair value option would be inappropriately used or abused. We do not agree with the proposal to introduce verifiability as a criterion for the use of the fair value option but prefer consistent application of the general reliability criterion for all assets and liabilities. In our experience, entities tend to avoid volatility and would not voluntarily raise it. Therefore, we do not see the rationale for the concerns for increased volatility through the use of the fair value option. Instead, the proposals may raise volatility by limiting the use of the fair value option for natural hedges through the introduction of rather strict offsetting and verifiability criteria. To avoid volatility, hedge accounting should consequently not be an option but should be mandatory, which, however, is not a realistic option. The proposals do not meet the objective to avoid the recognition of gains and losses in profit or loss arising from changes in an entity's own creditworthiness. In our opinion, the requirement to disclose the impact of other than interest changes on the fair value of financial liabilities is adequate. Our conclusion is that the fair value option, as it currently stands, is the appropriate solution and we believe that the proposals in the exposure draft should be rejected.

The proposals limit the December 2003 improvement of IAS 28 Investments in Associates as regards the option to measure investments in associates at fair value in accordance with IAS 39, with changes in fair value recognised in profit or loss in the period of the change. Such a limitation seems in conflict with the underlying reason for the IAS 28 option that the Board considers fair value information often to be readily available because fair value measurement is a well-established practice in the industries of venture capital, mutual funds and unit trusts (see BC 7 of IAS 28).

The reference to prudential supervisors and other regulators may incorrectly be understood to mean that regulators have power to amend or overrule IFRS for the purposes of financial reporting. Such regulators have the appropriate means to require the information to address their concerns and there is no need to include their specific requirements in general purpose financial statements.

We are also concerned about the detrimental delay and uncertainty about applicable standards for European listed companies due to the EU endorsement procedure.

We have the following comments on the questions raised in the exposure draft:

Question 1

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

Verifiability and classification

In our opinion the proposed definition of what is verifiable, namely "*if and only if the variability in the range of reasonable fair value estimates made in accordance with paragraphs 48, 48A and 49 and Appendix A paragraphs AG69-AG82 is low*" is too restrictive. We believe that it is not in accordance with other aspects of the IAS/IFRS standards to demand accounting measurements to be within a low range of reasonable fair value estimates. The verifiable notion does not exist in other areas of measuring fair values in IFRS. We believe that fair value measurement criteria should be applied consistently for all assets and liabilities, regardless if they are financial or non-financial.

We disagree with the proposed double standards on the application of fair value. Identical items may be measured differently depending on whether the item is *required* to be accounted for at fair value through profit or loss or whether or not it is *permitted* to be accounted for at fair value through profit or loss. The verifiable notion does not exist in other areas of measuring fair values in IFRS. Instead, it is generally accepted that when something is reliable it should also be verifiable.

Information is only reliable if it "can be *depended on* by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent" (Framework paragraph 31). The notion of verifiability implies that either some measurements of fair value are not to be depended upon at all or that more dependence may be given on other measures of fair value. The proposal, if accepted, does not contain sufficient guidance on how to distinguish between reliable fair values and verifiable fair values, leaving the preparers to determine the distinction. This may cause considerable confusion about the practical application of fair value measurement to financial instruments in general. Specifically, the distinction between "reliable" and "verifiable" creates a new dimension when classifying assets. Also, we do not understand why volatility in equity would be acceptable but not volatility in the income statement. We do not see the rationale for accepting less verifiable fair value measurements for held for trading and available-for-sale instruments. Noteworthy is that the verifiability requirement applies on initial recognition only. When subsequently measuring a financial assets or liability it must be measured at fair value as long as it is possible to establish a reliable fair value.

If it is not possible to separate an embedded derivative, either at acquisition or at subsequent financial reporting date, the combined instrument shall in its entirety be treated as held for trading. Hence, there is a fair value requirement. This requirement could potentially give rise to peculiar accounting effects. An entity is precluded to use fair value option for a hybrid instrument for which it is not possible to determine a *verifiable* measure of fair value. Therefore the entity will be required to separate the embedded derivative. If it is impossible to determine the fair value of the embedded derivative *reliably*, the combined contract must be treated as if it where held for trading. Therefore, the combined instrument must be measured at fair value if that value can be determined *reliably*. Supposing that the derivative shall be separated when a *reliable* fair value is possible to establish (for the embedded derivative), what accounting should be applied for the host instrument?

For embedded derivatives that must be separated, the combined instrument has to be classified as held for trading and measured at fair value applying the "lower" reliability criterion, if the derivative component cannot be measured reliably separately. This would also be the case for an investment that would otherwise be classified as available-for-sale. This way, changes in fair value of the combined instruments would be measured in profit or loss without complying with the verifiability criterion. Thus, we fear the imposed restriction on fair value option may create incentives to construct financial instruments with non-separable embedded derivatives to circumvent the verifiability criterion in the proposed amendment.

We do not see the rationale for the proposed full exclusion of financial assets otherwise classified as loans and receivables from being designated as fair value through profit or loss.

We would propose that the Board keeps the criteria for classification as fair value through profit or loss according to IAS 39 (revised December 2003) but imposes more comprehensive guidelines on how to deal with situations where fair values cannot be measured reliably (including interest bearing investments) that should be applied equally for all fair value based categories of financial instruments.

Volatility and hedges

In particular the limitation of the use of the fair value option may barrier "natural hedges" from being appropriately portrayed in the financial statement thereby increasing artificial volatility in profit or loss rather than reducing it. Volatility could be depicted as "artificial" when an economic match results in accounting mismatch. To avoid volatility, hedge accounting should consequently not be an option but should be mandatory, which however is not a realistic option. In our experience, entities tend to avoid volatility and would not voluntarily raise it.

The linking and offsetting criteria in paragraph 9 b) (ii) and (iii) may fail to reduce volatility if one side of the positions is derecognised.

Changes in own creditworthiness

The proposals do not meet the objective to avoid the recognition of gains and losses in profit or loss arising from changes in an entity's own creditworthiness. In our opinion, the requirement to disclose the impact of other than interest changes on the fair value of financial liabilities is adequate.

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?

We are concerned about the non-controlling investments made by venture capital organisations that focus on fair value reporting. According to IAS 28/IAS 31 (revised 2003) investments in associates and joint ventures held by venture capital organisations should be measured at fair value provided that the fair value option is used. The proposed verifiability requirement would probably restrict the application fair value measurement of associates and joint ventures to quoted equity instruments. We find it hard to believe that this is the reason for imposing the revised rules on venture capital organisations. Most of the investments are made in newly started businesses, often with a large proportion of R&D activities. Also, other non-controlling investments would similarly have to be classified as available-for-sale with unrealised changes in fair value recognised in equity. This would not end up with a consistent presentation of the performance of the venture capital organisation. If the fair value option were to be limited, the Board should consider reintroducing the option in the available-for-sale category to record changes in fair value in profit or loss.

It has not been determined how insurance liabilities could be measured at fair value and whether the fair value option is available for insurance liabilities as they are scoped out from IAS 32. IAS 39 paragraph 9 (b) (iii) would probably not be available for the insurance industry.

We are concerned about the proposed paragraph 9 (b) (v) relating to items that this or other standards allows or requires to be designated as at fair value through profit or loss. In the case of *permitted* application of the category, the verifiability criterion may be detrimental. One example is the venture capital organisations as mentioned above. The proposed paragraph 9 (b) (v) makes reference to items that IAS 39 or other standards *requires* to be designated as at fair value through profit or loss. When it is a requirement to designate as fair value through profit or loss it should be sufficient that a *reliable* fair value can be established.

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?

We do not believe that the proposed limitations would limit the volatility in profit or loss, but rather increase it, especially in hedging situations where hedge accounting is not applied. We find no reason for limiting the use of the fair value option, but would welcome more general guidance on criteria for reliable measurement for different instruments including interest-bearing investments.

Question 4

…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 do not support the proposed purpose of limiting the use of the fair value option. If the proposals would come into effect, the proposed paragraph 9 (b) (i) would serve as an important way to enter the fair value through profit or loss category. The tendency to embed derivatives with formal but of no commercial substance would probably be common and may raise the transaction costs of the instruments.

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 do not support the proposed limitations of the fair value option, but if they would come into effect we do support the proposed transition rules.

Question 6

Do you have any other comments on the proposals?

We do not find it appropriate for principle based accounting standard setting to state in a principle that "*For entities subject to prudential supervision such as banks and insurance companies, the powers of the relevant prudential supervisor may include oversight of the application of these requirements and of relevant risk management systems and policies.*"

This fact is a consequence of national legalisation that already is well known to the parties concerned. We do not find it appropriate for IASB to include this reminder as a principle. It should rather be moved to the basis for conclusions in case it is decided to maintain the proposed changes**.**

Yours sincerely,

Jan Buisman
Chairman Accounting Practices Committee

Dan Brännström
Secretary General