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Sir David Tweedie
Chairman
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30 Cannon Street
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20 July 2004

Dear Sir David

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

We are responding to your invitation to comment on the above exposure draft on behalf of the worldwide organisation and Global IFRS Board of PricewaterhouseCoopers.

We do not support the proposed amendment to limit the application of the fair value option set out in this exposure draft. The requirement to designate a financial asset or liability at inception and the prohibition on subsequent reclassification already impose stringent conditions on the selection of the option. We do not see a need for any additional restrictions on its use. We are not aware of any particular abuses being proposed by preparers that would warrant this late amendment to the standard.

The use of fair value reporting, particularly with respect to financial instruments, is the best representation of economic/commercial substance and is one of the primary principles that global standard setters are striving to implement. Limiting the use of the fair value model by imposing new complex rules is contrary to this principle and is a step backward for International Financial Reporting Standards.

The right to carry any financial asset or liability at fair value that was introduced by the recent revisions to IAS 39 is important for many entities, particularly in the financial services sector. An entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognized in profit or loss. This ability helps resolve some of the inconsistencies inherent in the mixed measurement model in IAS 39. In particular, it enables companies to avoid the need for complex hedging documentation where there is a natural hedge, as well as permitting consistent accounting where non-derivative assets and liabilities have offsetting risks.

It is common knowledge that the use of fair value is not without its challenges. That does not, however, warrant the introduction of an additional test of "verifiability". The application guidance, hierarchy and disclosure requirements already in IAS 32 and IAS 39 help address those challenges.

The proposals in the exposure draft add further levels of complexity to a standard which is already difficult to apply. We do not consider the arguments in the Basis of Conclusions to be sufficiently strong to justify this. The proposals will not satisfy the concerns expressed in BC9, since a creative application of the criteria in paragraph 9(b) will still allow some flexibility. However, the introduction of these criteria will impose additional requirements, including systems and other operational changes, which may impede the use of the fair value option in circumstances where it is relevant to a fair presentation of financial position.

Question 1
Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?
We do not agree with the proposals in this Exposure Draft. We are not aware of any proposed abuses of the fair value option that would support new arguments that were not discussed when this topic was first exposed in 2002. The Exposure Draft proposes a series of rules and introduces new terminology and a stricter test of "verifiability" for fair value that is not required for available for sale securities, derivatives or fair value disclosures. As such, IAS 39 should remain unchanged. However, should the Board continue with these proposals, our responses to the questions below indicate areas where we believe changes should be made.

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 the Exposure Draft? If so:
(a) please give details of the instruments and why they would not be eligible.
(b) is the fair value of the instrument verifiable (see paragraph 48B) and if not, why not?
(c) how would applying the fair value option to the instrument simplify the practical application of IAS 39?
(a) We understand that a number of banks and insurance companies are planning to apply the fair value option in circumstances where this would no longer be permitted if the Exposure Draft is adopted.

> (i) The requirement for verifiability makes it difficult to apply to prepayable and structured loans, issued notes, and other financial instruments not quoted in an active market (such as private equities, private placement debt and guaranteed insurance contracts) as well as other structured products that contain embedded derivatives (e.g. credit linked notes).
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> (ii) The requirement for verifiability will also be difficult for venture capital organizations and other entities which choose to apply the scope exemption in IAS 28 and 31 as they are required to designate their investments in associates and joint ventures at fair value through profit or loss. In the absence of current market

transactions in such investments, these entities would be required to account for them using the equity method. This conflicts with the IASB's rationale for introducing the scope exemption in the standards.

(iii) The requirement for a contractual link between movements in the fair value of financial assets and financial liabilities will create artificial volatility for insurance companies. Many insurance companies have an accounting policy for insurance liabilities which measures them using current market rates even though there is no contractual link with the assets that fund these liabilities. To avoid volatility in the income statement arising from current interest rate changes, an insurance company will need to designate its assets as at fair value through profit or loss. However, the amendment to the fair value option will limit the designation of certain assets at fair value since there is no contractual link to the insurance liabilities and their fair value is not necessarily verifiable. This cannot be fixed by changing the insurance liability accounting policy as a move away from reflecting current interest rate changes would be a departure from the IAS 8 criteria of relevance and reliability required in IFRS 4.

(b) We do not believe that prepayable loans, such as mortgages, would meet the verifiability requirement as proposed in paragraph 48B. This is primarily because there are limited market transactions in mortgages outside the US and valuation techniques would therefore incorporate primarily entity specific information. Venture capital investments and insurance products will also be difficult to fair value given the lack of observable market data to support a verifiable valuation. This is inconsistent with the requirement to carry complex derivatives at fair value through profit and loss as trading instruments under IAS 39 even though some of the inputs to recognised valuation techniques are not observable.

(c) If the fair value option were applicable to financial instruments such as prepayable loans, it would simplify the onerous hedge accounting requirements with regards to designation and effectiveness testing and ensure a consistent treatment of liabilities used to fund trading assets. Whilst it is possible to hedge some of the fair value risk inherent in mortgages, for example, it is not always possible to meet the stringent hedge effectiveness tests in IAS 39. Permitting insurers to fair value all assets backing insurance liabilities, even when there is no contractual link, will also simplify the process of rectifying the accounting mismatch. Applying the fair value option in these circumstances decreases rather than increases volatility in the income statement.

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?

The proposals contained in this Exposure Draft limit the use of the fair value option in such a way as to address the concerns set out in paragraph BC9. However we do not believe that these concerns are all genuine.

We recognise that the valuation of many financial assets and liabilities is subjective, but that does not imply that entities might determine their fair value in a way that inappropriately affects profit or loss. Entities will apply as much subjectivity in determining the fair value of complex derivatives that are required to be fair valued through profit and loss under IAS 39. This is mitigated by the requirements in IAS 32 to disclose the methods and significant assumptions applied in determining those fair values, where fair values are determined by valuation techniques that are based on assumptions not supported by observable market prices and the sensitivities surrounding those assumptions.

There is no evidence to suggest that entities will apply the option to increase rather than decrease volatility in profit or loss. Entities do not want volatility in their income statements any more than the regulators. This is evidenced by the time and effort entities are currently expending to achieve hedge accounting, despite the restrictions. Therefore in our opinion the use of the option is unlikely to result in abuse.

The proposals respond in part to the concerns we expressed to the IASB in our 18 October 2002 letter on the problems caused through recognising own credit risk when measuring liabilities at fair value. However, the IASB debated this issue when it was revising IAS 39 last year and we welcomed its decision to require disclosure of the change in fair value of liabilities due to credit risk as an alternative. We do not anticipate that this option will be used frequently since designation is required at initial recognition. Consequently, few entities will choose to fair value their own liabilities in view of the resulting volatility if their credit rating changes. We do not believe it is necessary to debate this issue again and would prefer to see the prompt finalisation of IAS 39 as part of the IASB's stable platform.

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 derivatives to be separated. The Board proposes this category for the reasons set out in paragraphs BC6(a) and BC16-BC18 of the Basis of 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?
The proposal in paragraph 9(b)(i) is appropriate. We support the use of the fair value option to measure the entire instrument at fair value rather than separately measuring the embedded derivative because the process of determining which embedded derivatives should be separated and valuing those that are separable can be complex, highly subjective and time consuming.

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 transitional requirements. Since the amendments to IAS 39 are to be applied retrospectively by restating the comparative financial statements, these proposals should be adopted on a consistent basis. The proposals introduce unnecessarily complex transitional provisions when there will be a limited number of preparers that have already adopted IAS 39 (revised December 2003) and may have applied the fair value option to financial assets and liabilities that would not meet the requirements in these proposals.

Question 6

Do you have any other comments on the proposals?

(i) Many insurance contracts and discretionary participating contracts are contractually linked to the fair value of assets, or the changes in their measurement may be substantially offset by the exposure to fair value changes of other financial assets. It is not clear from these proposals whether the assets backing such contracts can be carried at fair value through profit or loss, even though the linked or offsetting liabilities are excluded from the scope of IAS 39 and are therefore not treated as financial liabilities for this purpose. In any case, such contracts are not yet capable of being carried at fair value, as the IASB has already accepted in the context of IFRS 4. In the current draft, the ability to measure an instrument at fair value is a prerequisite for financial liabilities that meet the conditions of subparagraphs 9(a) and (b). Since the assets backing such liabilities may include loans or receivables which are not otherwise capable of being carried at fair value through the profit or loss account, issuers of insurance and discretionary participation contracts are subject to more restrictive provisions in this respect than other entities.

Insurers in many countries (eg Australia and New Zealand) are already required to carry all financial assets backing insurance liabilities at fair value through the profit and loss account to match the required treatment under local GAAP for insurance liabilities. The availability of a flexible fair value option is necessary to permit this treatment to continue.

(ii) The proposed requirements for category 9(b)(iii) appear to be very restrictive in that they require the identification on initial recognition of an existing exposure that substantially offsets the changes in fair value of another financial instrument. This requirement is similar to the documentation required for hedge accounting, and may indeed be even more restrictive, depending on the interpretation of "substantially". This is counterintuitive given that the intention of the fair value option was to simplify the practical application of IAS 39.

(iii) The criterion set out in 9(b)(iii) also appears to be open to abuse. Since reclassifications are prohibited after initial recognition, the subsequent derecognition of one of the offsetting financial instruments will not change the requirement to carry the remaining one at fair value through profit and loss even if it would not have met the initial requirements for this classification as a standalone instrument (eg a loan or receivable). Consequently, entities could ensure the existence of an offsetting relationship at inception even if they subsequently planned to close out the position in the short term.

(iv) The requirement in paragraph 9(b) to measure the asset or liability and its related offsetting exposure at fair value through profit or loss appears to override the principle in IAS 39 that designation at fair value through profit or loss is only permitted at inception of the instrument. For example, if an entity holds shares as available for sale and subsequently issues a bond exchangeable into those shares, it can apply criterion (iii) of the fair value option to the bond as the exposure to changes in fair value of the exchangeable bond substantially offsets the exposure to changes in their AFS shares. In such circumstances, paragraph 9(b) requires the entity to change the classification of the shares to fair value through profit or loss at this date. It is not, however, clear what impact the subsequent repayment of the bond without derecognition of the shares would have on the classification of the asset.

(v) The IASB should not make reference to the oversight of prudential supervisors in its standards. Nor should they revise standards to meet the requirement of the regulators unless they believe the standards are thereby genuinely improved. Although the basis of conclusions attempts to clarify this statement, some may incorrectly interpret the reference as suggesting that regulators have the power to vary the requirements of IAS 39.

Regulators have their own powers to impose restrictions on regulated entities. If the regulators wish to restrict the selection of options under an accounting standard, that is a matter for them to address with their respective regulated entities. However, it should be clear that divergence from the standard results in non-compliance.

(vi) We do not support the introduction of another level of fair value hierarchy using the concept of verifiability. IAS 39 already provides sufficient guidance for determining fair value. The use of different terminology indicates that this is intended to be a tougher test than is already applied for complex derivatives which have to be carried at fair value through the profit or loss account. However in practice the definition appears to reflect the guidance in AG74-82. It is therefore unclear how this differs from the requirements that apply to financial assets and liabilities that are held for trading. IAS 39 states that the variability in the range of fair value estimates should not be significant, whereas the proposals require the range of estimates to be low. The words then used in paragraph 48B (a-c) mirror those already used in the application guidance in IAS 39.

(vii) The proposals also introduce an anomaly in the treatment of financial instruments containing embedded derivatives. Under paragraph 12 of IAS 39 an entity that is not able to determine reliably the fair value of the embedded derivative is required to treat the entire combined contract as a financial asset or liability that is held for trading and thus fair value it through profit or loss without any requirement to show that the fair value is verifiable. However if an entity chooses not to separate the embedded derivative and to opt for fair value through profit or loss, it is required to pass the tougher test of verifiability.

If you have any questions in relation to this letter please do not hesitate to contact Jochen Pape, Chair of the PwC Global IFRS Board (+49 211 981 2905), or Ian D Wright (+44 207 804 3300).

Yours faithfully

PricewaterhouseCoopers