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Ms Lay Wee Ng
Director – Accounting & Professional Standards
Institute of Chartered Accountants of New Zealand
PO Box 11-342
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Advance copy by email

Dear Lay Wee

COMMENTS ON IASB EXPOSURE DRAFT: *PROPOSED AMENDMENTS TO IAS 39: FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT – THE FAIR VALUE OPTION*

Thank you for your invitation to comment on IASB ED: *Proposed Amendments to* IAS 39 *Financial Instruments: Recognition and Measurement – The Fair Value Option* (ED *The Fair Value Option*).

The Commission has considered the Exposure Draft and our main comments are given below. We have included our detailed responses to the Questions contained in the Discussion Paper in the **attached** Schedules. We note that in making these comments our perspective focuses on the financial reporting undertaken by *issuers*.

We support the inclusion of the fair value option in IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) as a means to simplify the Standard's application, and to ensure that economically matched positions are appropriately reflected in an entity's financial statements. We do not, however, support the IASB's current proposals to amend the fair value option as contained in the Exposure Draft.

Whilst we are cognisant that there are some application difficulties in relation to use of fair value measurement concepts, our overall view is that the IASB should work to resolve these issues in future by taking a holistic approach, rather than adjusting the standards for application of fair value measurement in particular sets of financial reporting circumstances arising in the context of applying IAS 39. We believe that the proposed amendments to IAS 39 set out in the Exposure Draft demonstrate the latter approach.

We believe the proposed amendments introduce an additional level of complexity to an already complex standard and may not achieve the outcomes that the introduction of the fair value option was intended to achieve.

Furthermore, we have concerns about the IASB's proposal to introduce a new recognition criterion – *verifiability* – for application to those financial instruments to which the fair value option is applied. We are of the view that the conceptual principle of reliable measurement, which encompasses the attributes of representational faithfulness, neutrality and verifiability, should be applied consistently across all financial assets or financial liabilities measured at fair value. We also believe that certain aspects of the proposed amendments require further clarification. For example, further guidance is required on how to apply the principle of substantial offset, and clarification is required of the term contractual link.

Our detailed comments in relation to the IASB's Questions and the FRSB's Specific Questions are outlined in the Schedules **attached**. You will note that we have also sent a copy of this letter directly to the IASB.

We trust that the comments we have submitted are of assistance to the FRSB, and to the IASB. If you require clarification of any of the views expressed in this submission please do contact us.

Yours sincerely

Jane Diplock AO

Chairman

Copy to: Sandra Thompson
Senior Project Manager, IASB

SCHEDULE 1

New Zealand Securities Commission Responses to Questions contained in the Request for Comment on Discussion Paper and IASB Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement - The Fair Value Option

IASB Question 1

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

We support the inclusion of the fair value option in IAS 39. Our support is based on the premise that the fair value option simplifies the practical application of IAS 39 and addresses those situations in which, without the fair value option, IAS-39's mixed measurement model could result in increased volatility in the financial statements of an entity holding positions that may be economically matched.

We are concerned that the proposals to amend the fair value option introduce a new recognition criterion ("verifiability") for application to some financial instruments to which the fair value option is applied, that those the entity designates, irrevocably on initial measurement, to be measured at fair value. We note that this is different to the recognition criterion ("reliable measurement") that would apply for other financial instruments covered by IAS 39 (such as financial assets and liabilities held for trading (including derivatives) and available for sale financial assets). We believe that this deviation from the conceptual framework for measurement of selected financial instruments is problematic.

The IASB's proposed amendments for paragraph 9 of IAS 39 (December 2003) raise the prospect, as an unintended consequence, that the verifiability concept may be de-emphasized when an entity classifies a financial asset or financial liability as held for trading, or when an entity classifies a financial asset as available for sale and the gain is recognised in equity. In our view the principle of reliable measurement should be required to be applied consistently to any category of financial asset or financial liability measured at fair value.

We agree that the IASB should seek, in its development of Standards addressing the issue of what is considered to be reliable measurement, to align wherever reasonably possible with the requirements of regulators, including prudential supervisors. However, in our view, the IASB's objective of finalising a stable platform of International Standards ready for adoption in various jurisdictions by 1 January 2005 is an overriding priority. Consequently there is a need to finalise IAS 39, and measurement considerations such as the ones raised in this set of proposed amendments (which are one example of many such issues) are perhaps more appropriately left to be addressed in a holistic context as part of the IASB's continuing project to refine the financial reporting for financial instruments.

IASB 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?*

The Commission has no comments to make in relation to this question. However, we will be interested to see responses given by other financial services industry participants, such as insurers, and other market participants who fair value financial instruments.

IASB Question 3

Do the proposals contained in the 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 believe that the proposals introduced to address the concerns in BC9 are problematic, and will introduce further complexity to IAS 39. In particular, we have concerns about the following:

(a) The exposure draft does not propose guidance on how to implement the principle of substantial offset. While some economic variables will be common to a matched financial asset and liability, others will not. For example, a change in creditworthiness of the issuer will affect the fair value of its financial liability but will not affect the fair value of its financial asset. The concern that arises is that for some matched financial assets and financial liabilities an entity will not be able to apply the fair value option because there is no substantial offset.

(b) The term "contractual link" requires clarification because it is not clear whether the contractual link must be a link to a specific asset or specific pool of assets or whether this could be to a pool of assets when some or all of the assets comprising that pool may vary. For example, if the link must be to a specific asset or a specific pool of assets, then when a financial liability is linked to a pool of assets that may be sold or replaced with other assets as occurs with managed investments, an entity could not apply the fair value option to the financial liability.

IASB 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 derivative to be separated. The Board proposes this category for the reasons set out in paragraphs BC6(a) and BC16-18 of the basis for 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?

We support the proposal in paragraph 9(b)(i) as it has the effect of simplifying the practical application of IAS 39 and has the objective of ensuring that positions that are economically matched do not result in volatility in an entity's financial statements.

IASB Question 5

IASB Question 5 addresses transitional provisions proposed for entities that have already adopted IAS 39 (December 2003). We note that the FRSB has pointed out that this question is not relevant to New Zealand constituents as the NZ equivalent of IAS 39 may only be adopted in 2005. Therefore, it is highly unlikely that any NZ entity would have adopted IAS 39 (2003).

IASB Question 6

Do you have any other comments on the proposals?

Credit Risk

We understand the concerns expressed by prudential supervisors of banks, insurers and securities companies that it is undesirable for entities to recognise gains or losses in the profit and loss account for changes in an entity's own creditworthiness. However, we support the IASB's current stance as outlined in BC87-92 of IAS 39 (December 2003) which confirms that credit risk should be taken into consideration when fair valuing financial liabilities and that disclosure is the best method of providing information which is both useful to users and helps to alleviate the concerns expressed by certain constituents.

As we have expressed in our response to IASB Question 1 above, this issue is one of many application issues associated with use of fair value measurement principles, and it should be considered as part of the IASB's wider project to refine financial reporting for financial instruments. At the present time we believe that it is a priority that the IASB's stable platform of international standards be finalised, including IAS 39 (as approved in December 2003).

Application Date

Notwithstanding our disagreement with the proposed amendments to IAS 39 as outlined above, should the IASB decide that it will adopt the proposed changes to the fair value option as set out in this Exposure Draft, then the Commission supports the proposed 1 January 2005 application date for those amendments. We would be concerned if the situation arose where entities were required to comply with IAS 39 (December 2003) for financial years beginning on or after 1 January 2005 but would then have to make further changes to their accounting treatments in a subsequent period when the amended version of IAS 39 becomes applicable.

We do not envisage that the application date of 1 January 2005 will be a problem for the majority of New Zealand entities reporting under New Zealand equivalents to IFRS, given that in New Zealand the proposed amendments would not be effective until 1 January 2007 with the ability for any entity that chooses to, to adopt early from 2005.

SCHEDULE 2

New Zealand Securities Commission Responses to the Specific Questions of the Financial Reporting Standards Board, contained in the Request for Comment on Discussion Paper and IASB Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement - The Fair Value Option

FRSB Question 1

Should ED: The Fair Value Option contain any additional material to allow public-benefit entities to comply with the proposed requirements?

In submitting comments to the FRSB, the Commission's perspective focuses on the financial reporting undertaken by *issuers*. The Commission has no comments to make in respect of the application of ED: *The Fair Value Option* to public benefit entities.

FRSB Question 2

Are there any regulatory issues or other issues arising in the New Zealand environment that may affect the implementation of the proposals, particularly any issues relating to:

(a) public-benefit entities

(b) public sector profit-oriented entities; and

(c) the Privacy Act 1993

Refer to our comments for FRSB Question 1 above. We are not aware of any issues under the Privacy Act 1993 that the proposals to amend the fair value option might raise.

FRSB Question 3

Is the adoption of the proposed amendments to NZ IAS 39, in the IASB's ED: The Fair Value Option, in the best interests of users of general purpose financial reports in New Zealand?

We do not believe this is the case. We have a number of concerns in relation to the IASB's proposed amendments to the fair value option contained in IAS 39, as set out in our responses to the IASB's Questions 1-6 above.