EFRAG
European Financial Reporting Advisory Group

October XX, 2002

Sir David Tweedie
Chairman International Accounting
Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear David

Re: Proposed amendments to IAS 32 and 39 Financial Instruments

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft of proposed amendments to IAS 32 Financial Instruments: Disclosure and Presentation and IAS 39 Financial Instruments: Recognition and Measurement. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS on the issues.

In general, we believe that IAS 39 is a complex and controversial rule-based standard requiring further changes, in addition to the currently proposed amendments. We are concerned, in particular, with the provisions regarding hedge accounting. The effect of the current provisions goes beyond accounting to unduly influence the Risk Management activities of the treasury departments of conglomerates, insurance companies and banks, resulting in artificial transactions in those departments. Appendix 1 sets out our objections to the current hedge accounting requirements as well as our alternative proposals on how hedge accounting could be substantially simplified, while preserving reasonable constraints on its use.

In summary, the most serious criticism of the current hedge accounting provisions is that, taken together, they lead to the reporting of very different numbers for what are basically identical economic situations. For fair value hedges, changes in the fair value of both the hedging instrument and the hedged item are recognised, whereas for cash flow hedges the hedged item is unchanged but the gain or loss on the hedging instrument is taken to equity and released only as the hedge ceases to be effective. We propose reducing the overall complexity by focusing the hedge accounting provisions on the following three principles that should be adhered to in all hedging relationships: hedges should from the outset be seen to be: (i) clearly defined, (ii) measurable and (iii) effective.

Further, we support an approach under which the accounting rules of the hedging instrument should follow the accounting rules of the hedged item during the life (and ongoing effectiveness) of the hedge. This is the opposite of the current provision for a fair value hedge in IAS 39, where the accounting treatment of the hedged item has to follow the accounting rule for the hedging instrument. We recognise that our proposal may be taken to mean that derivatives used to hedge instruments carried at amortised cost would no longer be carried at fair value. That is not our intention. We suggest that changes in the fair values should be taken to equity rather than to income.
We believe that our proposed approach is not only more logical but also more practical because it is difficult to make constant adjustments to the basis amounts of a portfolio of hedged items.

We also believe that there is no good reason to limit hedging instruments (for other than currency hedges) to derivatives – or to prevent risk managers from hedging the interest rate risk on assets held-to-maturity.

Finally, SFAS 133 paragraph 68 explicitly states that an interest swap that exactly matches the terms (maturity, size, currency, underlying) of a hedged interest-bearing instrument is assumed to represent a perfect hedge, which means that no further effectiveness testing is needed (so called “short-cut method”). Since paragraph 147 of IAS 39 currently says that such a hedge is likely to result in effectiveness without stating that perfect hedge effectiveness can be assumed, we recommend that paragraph 147 be conformed to the wording of SFAS 133.

Appendix 2 comprises our answers to the questions raised in the draft standard and other comments which we believe require consideration.

If you like further clarification of the points raised in this letter Paul Rutteman or myself would be happy to discuss these further with you.

Yours sincerely

Johan van Helleman
EFRAG, Chairman

EFRAG's objections to and alternative proposals for the current hedge accounting requirements

As shown by the history of its development, IAS 39 represents a standard of high complexity and extensive implementation difficulties. Whilst the IASB has addressed some of the difficulties with its current amendment project, it has not looked at one issue that has drawn the most serious criticism: hedge accounting. Evidence suggests that this area of the standard causes difficulties that go deeper than just creating a certain amount of awkwardness.

The more general complaint is that hedge accounting is an area where the standard is much too complicated and detailed. It has, therefore, been suggested that it be simplified by reducing the hedge accounting provisions to requirements that are based on, and justified by, clearer principles. The key principle should be that hedge accounting requires the hedging relationship to be "clearly defined, measurable, and actually effective" (Introduction to IAS 39, par. 22). These three criteria alone are needed because they represent the benchmark against which to measure the need for and the content of more detailed rules. Furthermore, we believe that the accounting for the hedging relationship should be such that the accounting rules for the hedging instrument follow the accounting rules for the hedged item in achieving the desired offsetting of gains and losses on the hedged item and the hedging instrument in the same performance statement and the same reporting period(s).

We support the requirement for clear and tight rules for designation, documentation and measurement of effectiveness for hedges as a prerequisite for the simplification of hedge accounting.

The most serious criticism of the current provisions is that the quite different methods chosen by the IASB for aligning value changes of the hedged item and its hedging instrument in the income statement lead to the reporting of very different numbers when the underlying basic economic situation is exactly the same. For fair value hedges, changes in the fair value of both the hedging instrument and the hedged item are recognised, whereas for cash flow hedges the hedged item is unchanged but the gain or loss on the hedging instrument is taken to equity and released only as the hedge ceases to be effective. The result is that even when the same risk is being hedged (interest rate risk) and the same hedged items are involved, using the same hedging instrument, very different accounting consequences arise depending on which side of the balance sheet the risk manager chooses to hedge, because in the one case the hedge would be a cash flow hedge while in the other it would be a fair value hedge. The use of fair value hedges in large portfolios becomes impractical. Where cash flow hedges may work in the area of interest rate risk management, fair value hedges require basis adjustment of the hedged item, which can in practice only work for small portfolios and single transactions. However, the bulk of the business of ALM risk management involves such large portfolios that the systems cannot provide the link between the calculated (generated) cash flows and the single hedged items in the balance sheet.

We believe it may be helpful to put forward some possible solutions that the IASB may wish to consider. The easiest solution would be to amend the form hedge accounting should take. Hedge accounting ought to align the accounting treatment of the hedging instrument and the hedged item during the existence of the hedge, if they otherwise differ, so that gains and losses on the hedging instrument are recognised in the same performance statement and the same reporting period(s) as offsetting gains and losses on the hedged item. We believe that the accounting rules for the hedging instrument should follow the accounting rules for the hedged item during the life (and ongoing effectiveness) of the hedge. This is the opposite of the provision for a fair value hedge in IAS 39, where the accounting treatment for the hedged item has to follow that of the hedging instrument. The current IAS 39 approach leads in a vast number of cases to partially fair valuing items that are normally carried at amortised cost.

We recognise that our proposal may be taken to mean that derivatives used to hedge instruments carried at amortised cost would no longer be carried at fair value. That is not our intention. Derivative instruments will still be valued at fair value but where hedged items are carried at amortised cost, the changes in the fair values of the derivative instruments will be taken to equity and transferred to the Profit & Loss account when and to the extent that gains or losses on the hedged item are recognised in the Profit & Loss account. Although we argue in the answer to question 9 (see appendix 2) to retain the basis adjustment approach, we believe that our proposed approach would work whether the basis adjustment approach is retained or not. Our proposed solution eliminates the distinction between accounting for fair value hedges versus the accounting for cash flow hedges and consequently would make hedge accounting more comparable, especially when accompanied by appropriate disclosures. It would significantly reduce the number of adjustments to the carrying amounts of the hedged items while reporting clearly the amount of gains or losses deferred during the life of hedges.

We see no good reasons why:

- hedging instruments for other than currencies are restricted to derivatives
- the interest rate risk in the held-to-maturity category may not be hedged

and therefore propose to abandon these restrictions.

The effect of our proposed amendment would be the following:

- A hedge of a non-derivative instrument carried at amortised cost by a derivative would leave the accounting treatment of the non-derivative untouched, while the changes in fair value of the derivative would be shown in equity until transfer to the Profit & Loss account. Transfer to the

Profit & Loss account would occur when and to the extent that gains or losses on the hedged item are recognised in the Profit & Loss account.

- A hedge of a non-derivative instrument at amortised cost by a financial instrument in the available-for-sale category would show the same results.
- A hedge of a non-derivative instrument at amortised cost by a financial instrument in the held-to-maturity category would not change the accounting treatment of either.

SFAS 133 paragraph 68 explicitly states that an interest swap that exactly matches the terms (maturity, size, currency, underlying) of a hedged interest-bearing instrument is assumed to represent a perfect hedge which means that no further effectiveness testing is needed (so called “short-cut method”). Since paragraph 147 of IAS 39 currently says that such as hedge is likely to result in effectiveness without stating that perfect hedge effectiveness can be assumed, we propose conforming paragraph 147 to the wording of SFAS 133.

Improvements to IAS 32

Q1. *Probabilities of different manners of settlement (paragraphs 19, 22, and 22A). Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).*

A. We do not support the proposed change to paragraph 19 in the form suggested because we consider it confusing. The important message is that the classification of an instrument is made on the basis of an assessment of its substance when it is first recognised as set out in the original paragraph 19. The additional wording "and without regard to probabilities of the manners of settlement" (second issue) reduces the focus on the issue of substance in paragraph 19. Paragraph 20 (virtually unchanged) deals with the second issue separately and effectively so there is no need to complicate paragraph 19 by introducing this issue prematurely.

Paragraph 22 makes it clear that a preferred share that does not establish a contractual obligation explicitly may nevertheless do so indirectly through its terms and conditions. The original example suggested that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. Whilst we accept that economic compulsion will not always create a liability (e.g. the need to maintain facilities in good repair), the example illustrated the importance of determining the substance.

The new example in paragraph 22A is helpful also but, in our view, should make clear that the classification would be different if the settlement depended on the outcome of uncertain future events that were so unlikely to happen that the substance is that the condition is artificial and unrealistic (e.g. if payment would only be made if the FTSE Index were to increase by 200% in one month).

Q2. *Separation of liability and equity elements (paragraphs 28 and 29). Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?*

A. Whilst we accept the principle of separation of equity and liability elements in a compound instrument we note that this goes beyond US requirements on which IAS 39 was based. Instinctively we would have preferred a simpler solution (as in the US) and feel that this would have the benefit of convergence. However we recognise that compound instruments are complex and that splitting them into elements is therefore acceptable. We agree that any asset and liability elements should be separated and measured first and then the residual assigned to the equity element. We also agree that the other option for measuring the elements be eliminated.

The amended paragraph 17 states that "a financial instrument classified as an equity instrument by a subsidiary is eliminated on consolidation when held by the parent, or presented by the parent in the equity section of the consolidated balance sheet as a minority interest separate from the equity of the parent." This statement can be taken to suggest that an equity instrument of a subsidiary can be "automatically" considered as an equity instrument at the consolidated level. That could lead to inappropriate equity classification at the consolidated level of certain financial instruments guaranteed by another group company and classified as equity at the subsidiary level. We are aware of various schemes which use such structures to classify what is in substance debt as equity and believe it would be helpful to clarify that, on consolidation, the subsidiary's "equity" would be classified as debt in those circumstances.

Q3. *Classification of derivatives that relate to an entity's own shares (paragraphs 29C – 29G). Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?*

A. We agree with the guidance proposed in paragraphs 29C-29G on the classification of derivatives that relate to an entity's own shares.

Q4. *Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard. Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)*

A. EFRAG has no particularly strong feelings on the integration of IAS 32 and 39 but we do see the benefit of setting out in one comprehensive standard the recognition, measurement, presentation and disclosure requirements for Financial Instruments. Such a standard will inevitably be voluminous.

Other comments

1. We note the different definitions for insurance contracts in IAS 32 and the Draft Statement of Position for insurance contracts:

IAS 32 paragraph 3: "For the purposes of this Standard, an insurance contract is a contract that exposes the insurer to identified risks or loss from events or circumstances occurring or discovered within a specified period, including death (in case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others and business interruption. However, the provisions of this Standard apply when a financial instrument takes the form of an insurance contract but principally involves the transfer of financial risk (see paragraph 43), for example, some types of financial reinsurance and guaranteed investment contracts issued by insurance and other entities.
Entities that have obligations under insurance contracts are encouraged to consider the appropriateness of applying the provisions of this Standard in presenting and disclosing information about such obligations."

DSOP 1.19: "An insurance contract is a contract under which one party (the insurer) accepts an insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary (other than an event that is only a change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable)."

The definition of an insurance contract is a legal matter that falls within the mandate of national legislators and regulators. Legislators and regulators determine what contracts can be marketed and whether those contracts are called insurance. The mandate of accounting standard setters is to ensure that similar transactions receive similar accounting treatment, without regard to regulatory designation. Accounting standard setters determine the relevant standard to account for the various forms that insurance contracts take and do not need to define what an insurance contract is since its legal contractual form suffices to do so. We think it is gratuitous to promote the distinction between real risk and financial risk to determine whether a contract is an insurance or not, depending on some respective weighting of these risks.

We have to separate clearly the definition of an insurance contract from the determination of the accounting standard applicable to the different kinds of insurance contracts. To address this question of high legal and fiscal importance in several European countries, we suggest replacing the words “for a contract to qualify as an insurance contract” with “for a contract to be subject to the accounting regulations” or substituting “a contract creates insurance risk” with “a contract falls under the insurance standard”. This proposal leaves the accounting analysis of what the insurance standard could be completely unchanged. In order to be consistent we suggest that our proposed changes in wording be taken into account when defining insurance contract in IAS 32, IAS 39 and the future insurance IFRS.

2. The TEG intends to make submissions regarding savings and investment contracts with profit participation features. TEG would welcome comments as to what should be included in these submissions.

Improvements to IAS 39

Q1. *Scope: loan commitments (paragraph 1(i)). Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?*

A. We concur with this simplification of the accounting requirements for both holders and issuers of loan commitments for the reasons explained in paragraphs C10-C15 of the Basis for Conclusions.

Q2. *Derecognition: continuing involvement approach (paragraphs 35-57). Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?*

A. Whilst the continuing involvement approach has a number of attractive features we consider the measurement aspects as described in the exposure draft to be fundamentally flawed. The proposed measurement principles can result in the recognition of assets and liabilities that do not meet the definitions of those elements in the Framework. This is perhaps best explained with the example of a transaction with a credit guarantee for default of 10% of the principal amount of transferred receivables, while the expectation is that default losses will not exceed 5%. Under the proposed continuing involvement approach this example will be considered as if the transferor has transferred 90% of the receivables unconditionally (90% to be derecognised) while retaining a continuing involvement of 10% through the guarantee for which the consideration is accounted for as a collateralised borrowing. We believe that when compensation based on the performance of the transferred asset can be reliably estimated (e.g. based on historical loss data in the case of a guarantee) the (portion of the) asset should be derecognised in full while recognising a provision for the guarantee (current paragraph 53 approach). This approach reflects the new assets and liabilities that were generated following the transaction and is consistent with the IAS 18 recognition conditions. It also avoids the unnecessary recognition of a fictitious asset and liability. The asset and liability are considered fictitious because they will almost certainly be settled for a significantly different amount than the amount initially recognised. We note that two of the IASB members have a similar dissenting view (see Appendix D Alternative views).

Because of the flawed basis of measurement we cannot support the currently proposed continuing involvement approach but nevertheless we believe that this approach warrants further study to overcome its present flaws.

Q3. *Derecognition: pass-through arrangements (paragraph 41). Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?*

A. We agree that the conditions set out in paragraph 41 qualify an asset for derecognition. In paragraph 41 we propose deleting the words "(a 'pass-through arrangement')" since in effect they define a term which is not used again.

Q4. *Measurement: fair value designation (paragraph 10). Do you agree that 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 recognised in profit or loss?*

A. We regard the proposed amendment to allow entities to irrevocably designate any financial instrument at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss as a very important change which we welcome in so far as it simplifies the application of IAS 39 and facilitates the use of natural hedges. However, we do not agree that such a fair value designation should be irrevocable: items carried at fair value should be allowed to be subsequently redesignated as an instrument that is measured at cost (the fair value at the moment of the change in the designation would be the deemed cost) since the same effect can currently be obtained by the sale of the instrument at fair value in the market and the purchase of another instrument with similar terms which is intended to be held to maturity. We believe that entities should not be forced into market transactions that generate transaction costs while an internal transfer at market value would have exactly the same effect without incurring any transaction costs. The Board argued not to allow reclassification into or out of the trading category while they are held "to impose discipline on the approach". We believe that this argument is incompatible with a high quality standard. We accept however that it should not be possible to make further reclassifications once an instrument has been redesignated from a fair value instrument to an amortised cost based instrument.

Q5. *Fair value measurement considerations (paragraphs 95-100D). Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95–100D of the Exposure Draft? Additional guidance is included in paragraphs A32–A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?*

A. We welcome the expanded guidance.

Q6. *Collective evaluation of impairment (paragraphs 112 and 113A–113D). Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A-113D?*

A. Yes, we agree with the proposed amendment to include loans or other financial assets measured at amortised cost, that are individually assessed for impairment and found not to be impaired, in a group of similar financial assets that are assessed for impairment on a portfolio basis. We also agree that, in the light of the law of large numbers, impairment may be probable in a group of assets, but not yet probable in assessing any individual asset in that group.

Q7. *Impairment of investments in available-for-sale financial assets (paragraphs 117–119). Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?*

A. We do not support the proposed amendment since we fail to see any substantial difference between this and the situations as explained in IAS 2 paragraph 31 (reversal of any write-down of inventories), IAS 8 new paragraph 27 (recognition of the effect of a change in accounting estimate in profit or loss), IAS 16 paragraph 37 (Property, plant and equipment: the reversal of a revaluation decrease of the same asset previously recognised as an expense shall be recognised as income) and IAS 38 paragraph 76 (Intangible assets : a revaluation increase should be recognised as income to the extent it reverses a revaluation decrease of the same asset which was previously recognised as an expense) all of which require a consistent treatment of reversals through income when the initial revaluation decrease was previously recognised as an expense.

Q8. *Hedges of firm commitments (paragraphs 137 and 140). Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?*

A. We do not agree with the proposed amendment and believe that in all cases the accounting for a hedging instrument should follow the accounting for the hedged item and not vice versa. In appendix 1 we have indicated our major objections to the current hedge accounting rules and set out our proposals as to how hedge accounting could be substantially simplified.

Q9. *'Basis adjustments' (paragraph 160). Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?*

A. We do not support the proposal to revise the rule in IAS 39 that the gain or loss on a hedge should be removed from equity at the time the hedged transaction gives rise to an asset or liability and should be included in the measurement of the asset or liability. The former treatment was significantly simpler both to record and present. The proposed treatment, to recycle the gain or loss out of equity, period by period, in line with depreciation on the asset or other recognition in profit or loss of the consumption of the asset or reduction of the liability is cumbersome and would make the effects of the hedge much harder to understand. We also find it difficult to see how different carrying amounts for two different transactions – one hedged and one not hedged – impair comparability, as stated in paragraph C103. The economic difference justifies the different treatment. It also provides better information for the investor to see the success (or failure) of a hedge directly connected to the hedged item. The IASB has taken its position using the principle that a gain or loss does not form part of an asset or liability. The problem is that hedge accounting, by definition, suspends the normal rules of recognition and/or measurement. If, to promote convergence, a choice needs to be made between abandoning the basis adjustment approach or retaining it, we believe that the basis adjustment approach needs to be retained: the US GAAP alternative is considered too complex and the proposed amendment would not result in a better standard.

Q10. *Prior derecognition transactions (paragraph 171B). Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (ie that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?*

A. We support the proposal in paragraph 171B but recognise that in some cases this approach might be impractical. Therefore an undue cost or effort exemption (with a high threshold) is required.