

Organismo Italiano di Contabilità (OIC)
Italian Accounting Standard Setter

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Re: Proposed amendments to IAS 32 and 39 Financial Instruments-Comments of OIC

Dear Mr. Tweedie,

The Organismo Italiano di Contabilità, recently established in Italy in order to play the role of Italian standard setter, has carefully examined the International Accounting Standards Board's Exposure Drafts related to IAS 32 and IAS 39. At the same time, OIC has considered the comments set out by EFRAG and has referred, if appropriate, its comments to the EFRAG'S proposals.

The IASB's paper, both in the original version and in the revised version, which is presently at the exposure draft stage, introduces significant innovations for all entities operating in Italy, where preparers have applied national accounting standards until this moment. The more significant innovations relate to the extension of fair value accounting to financial instruments, into an accounting framework such as that existing in Italy, which calls for the historical cost and the prudence standards as guidelines in the recognition and measurement of transactions, including hedges, and in the determination of loss expectations on loan exposures not included among doubtful or non-performing loans.

This new Standard involves complex application techniques that, both for banks and financial entities and for manufacturing or commercial entities, will have significant impact not only in accounting terms but also, and above all, from an operational, organisational, and data processing standpoint.

In Annex 1, we have set forth the answers to the questions proposed by IASB - with reference to IAS 39 – including some considerations to support the responses provided.

In Annex 2, are the responses to the IASB's questions concerning IAS 32.

In Annex 3, we have pointed out some critical aspects of IAS 39 which were not considered in this "exposure draft" and which mostly correspond to the perplexities expressed in your proposed draft. In relation to these issues we explicitly invite IASB to start a constructive debate in the very near future.

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We hope that this first contact between the Organismo Italiano di Contabilità and IASB can represent the beginning of a collaboration in this new accounting standard harmonisation process, and are at your disposal for any further clarification concerning this document.

Yours sincerely,

Prof. Angelo Provasoli
Chairman Executive Board
Organismo Italiano di Contabilità

RESPONSES TO QUESTIONS ON ED 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?

We agree with the EFRAG's answer.

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?

The question related to how and when a financial asset can be removed from the balance sheet following the transfer of an asset and the related risks is certainly a delicate matter, because a sale contract in many cases involves a series of related transactions such that the risks of the transferred asset can be considered to be still upon the transferor.

However, the "continuing involvement" principle involves significant application problems and does not seem to be consistent with the definition of asset set out in the "framework", which is based on the control principle.

Therefore, we share the EFRAG's proposal to re-consider the proposed approach related to the "derecognition" included in the "exposure draft".

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?

The requirement set out by paragraph 41 is certainly acceptable as it allows the derecognition of those assets which, while forming part of the assets of a special purpose entity, actually go to pay investors.

However, it would be useful to specify that, when at the same time the management of cash and its equivalent arising from the asset and all the payment orders are effected by independent third parties, and the transferor, by express contractual provision, does not participate in any gains or losses arising from the management of these assets, the "derecognition" refers to the asset as a whole and that it entails its exclusion from the consolidated accounts.

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?

OIC agrees with the EFRAG's answer.

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?

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OIC considers that an additional guidance concerning the concept of “*active market*” should be provided as this affects the method of “*fair value*” measurements. Furthermore, the requirements regarding the measurement of own liabilities should be clearly defined: to carry out these items at “*fair value*” would result in the recognition of gains in the income statement in the presence of a worsening of the issuer’s credit risk.

As to the “*fair value*” measurements, we do not agree with the elimination of the last part of paragraph 98 because, in those cases in which the fair value is influenced by a selling decision, this different value seems to be appropriate also for accounting purposes (if there is an available evidence).

Finally, we do not agree with the elimination of the last part of paragraph 100, which “disown” the market values when the market is not liquid and, for this reason, not indicative.

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?

We agree with the proposal of a collective measurement of those financial assets which, even though previously assessed individually for impairment, were found not to be impaired. However, we believe it is more reasonable to base estimates on statistical data from past experience rather than the discounted value of cash flows. The use of “*expected cash flows*” is one possible method.

Moreover, given the operational complexity of this procedure, it would appear to be more suitable for individually assessed items rather than groups of assets.

As far as this issue is concerned, we would welcome an alignment between the IASB’s provisions and those expected from the Basel Committee concerning the reform of the Capital Adequacy Accord’s provisions in this area. In this connection, where “*credit risk management*” models have supervisory relevance, if these models comply with the requirements set out by the supervisory authorities and if they are certified by internal control bodies, it is important that these models be usable as points of reference for accounting measurements.

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?

The change introduced by IASB precludes the recognition in the income statement of those value adjustments resulting from the measurements of the assets classified as available for sale and written down in previous periods because reasons for the writedown are not existing any more. We do not share this change considering that it conflicts with the principle of valuation consistency and with the provisions of the other main accounting standards issued by IASB (IAS 2, IAS 8, IAS 16, IAS 38).

We do not understand the reasons for a change, which discriminates the accounting treatment of value adjustments between debt or equity instruments and credits originated by the entity.

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For the same reason, we ask for the modification of paragraph 116 so that value adjustments on unlisted shares are taken to the income statement when the reason for their previous devaluation no longer exists.

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?

We agree with the EFRAG's answer.

The best solution is to take the hedged item (in this case the commitment) as the guide for the accounting treatment of the hedging instrument. In this situation the commitment would be valued at fair value only if it was classified in the trading segment or as available for sale. Alternatively, we propose giving the entity the option of designating such hedges as either fair value hedges or cash flow hedges.

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?

We agree with the EFRAG's answer. The hedge of a future transaction, such as hedging of exchange rate risk on future purchases of assets, has the main purpose of "locking in" the price against exchange rate changes and it thus seems more reasonable, in presenting the balance sheet, to adjust the initial asset accounting value by the amount of the gain or loss on the hedge (which was temporarily taken to equity), because this is the actual cost to the entity for the acquisition of the asset.

The different accounting treatment for the purchase of an asset on which risks are hedged, compared with unhedged purchases, is justified by the economic substance of the hedge.

Finally, note that the proposed accounting standard is very cumbersome from an administrative viewpoint.

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 (i.e. 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?

OIC does not agree with the approach of paragraph 171B, under which previously derecognised assets, that do not qualify under the new derecognition requirements, must be recognized. We believe that this provision should apply only to transactions completed after that this Standard becomes effective, while transactions completed in previous periods shall continue to be treated according to the standards existing in the related period.

Instead, we welcome the suggested alternative proposal included in the IASB's question to require a disclosure concerning transactions completed in previous periods which arose derecognitions no

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longer allowed. It should also be specified that this disclosure is limited only to the periods for which a comparative information is required.

ANSWERS TO QUESTIONS ON ED IAS 32

Generally speaking, many of the issues involving disclosure have been dealt with in other documents already released or in course of publication by international organizations.

For this reason, in order to assure adequate and real transparency to the financial statements users and not to make the preparers' job too onerous, we would ask that the definitive IAS 32 version adopts terminology and concepts similar to and consistent with those set forth in recent years by the Basel Committee for banking supervision (for example, as regards the risk classifications in paragraph. 43, the time breakdown for information on interest rate risk in paragraph 64, and the effects of interest rate shocks in paragraph 65).

As for the qualitative and quantitative information required by ED IAS 32, there should be a clearer specification, possibly using clarifying and application information, regarding the way in which banks have to comply with the requirements. In this regard, reference is made to the detailed information contained in paragraph. 47A and paragraph. 49 and to the possible alternative option between timely information and targeted information drawn from advanced risk management and control systems (e.g. VAR, shift analysis).

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).

We agree with the EFRAG's criticisms on the corrections made to paragraphs 19, 22 and 22A.

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?

The change to IAS 32 eliminates the option in paragraph 28 on the valuation of compound financial instruments, allowing only a single valuation standard.

EFRAG accepts this change, adding a comment on paragraph 17, although this is not formally asked for in Question 2.

In substance, OIC agrees with the EFRAG's comment, criticising the volatility that this approach would create to the equity measurement in the light of current supervisory regulations. This concern does not compromise the acceptance of the proposed change but underscores the need for regulators to examine the effects of the new valuation method promptly.

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As to the comment on paragraph 17, we agree with EFRAG, stressing the need, given the specificity of the issue, to supplement the comment with a request to include explanatory examples in paragraph 17.

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?

We agree with the introduction of the guidance (paragraphs. 29C - 29G) on the classification of derivatives on 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.)

OIC agrees with the adoption of a single comprehensive Standard, provided that the degree of understandability is safeguarded and that the timing for the integration of the two existing standards is consistent with the need for the regulatory framework to be defined well in advanced of the deadline of 1 January 2005.

Specifically, we believe that for each category of financial instruments, there must be a consistent, comprehensive presentation of guidance on the issues of recognition/derecognition, measurement and disclosure.

The need to define a complete coordination with regard to the disclosures on financial transactions by the financial institutions has to include, among other things, IAS 30 .

OBSERVATIONS ON ED IAS 39

In our opinion, the requirements set out by IAS 39 give rise to some issues that require a detailed re-consideration on the effects and impact that they could have – and that they would surely have if there is no change in this current approach – on the operating management of financial risks. Particularly, we refer to the rigid and restrictive accounting rules concerning hedging accounting, which do not take into account the way in which the entities manage risks and which could lead to a lesser recourse to financial risk hedging by the same entities or to an untrue presentation in the financial statements of transactions..

Hedge accounting

Hedge accounting undoubtedly represents one of the most complex and controversial issue included in IAS 39.

We share the need to review completely this matter starting from its general accounting basis and, consequently, we agree with the request to reverse this general accounting basis for the hedge accounting that, at the moment, would imply a “fair value” valuation of assets and liabilities which, if not hedged, would be measured at the historical cost.

The adoption of this alternative approach would rightly imply, among other things, the elimination of the distinction between “*cash flow hedge*” and “*fair value hedge*” and would lead, for this reason, to a simplification of the accounting standard adoption and to a better accounting approach uniformity, reducing the options allowed from the existing IAS 39.

We agree with the EFRAG’s position also with reference to the not justified limitation (obviously from an accounting presentation point of view) of the possibility to hedge assets held to maturity in consideration of the fact that this limitation can lead to a justified disparity of accounting treatment (with consequent misstatement of the economic performance).

Finally, with reference to the so-called “perfect hedge”, we concur with the proposal to be more specific. In addition to the issues examined in your document relating to the “*hedge accounting*”, we believe it is appropriate to make critical observations also with reference to the issues connected to the so called “macrohedges” and to the “*internal deals*”.

In relation to the first aspect, this Standard indicates its intention of breaking down hedges of groups of assets or liabilities (the so called macrohedges) into single items.

Banks - but also other operators - make very extensive use of macrohedges in their risk management. When groups of assets or liabilities are hedged as a whole or in their net position, it is quite impossible to match the hedging transactions with the single hedged items. Due to this, the requirements included in the current approach of IAS 39 make extremely difficult to consider, under the accounting view, these transactions as hedging accounting transactions.

With reference to the “*internal deals*”, the limitation set out in IAS 39 would require the financial institution and the larger entities to modify their internal organisation in hedging their asset and liability items, with severe economic consequences.

The requirement to eliminate internal deals would force operators to make contracts for every single hedging need and this would represent a very severe constraint in risk management.

Further issues

IAS 39 gives rise to many other issues, in addition to those already mentioned for the hedge accounting area. We believe appropriate to point out, at least, other two aspects that, without any modification, could result in a significant and not justified impact on the entity performance and a third issue related to the insurance contracts on which a specific accounting standard will be enacted.

Purchase of own debt instruments

IAS 39 states that the repurchase of own debt instruments, like own shares, extinguishes the corresponding fund-raising or equity components. The standard does not consider the purposes for which such repurchase is undertaken and consequently has unreasonable effects on their accounting representation, treating all such transactions as if their purpose were to extinguish the debt or reduce the company's equity capital. In the case of repurchase of own bonds or certificates of deposit, the standard requires the immediate allocation in the income statement of the difference between the purchase price and the balance-sheet value of the bonds issued.

However, in their current operations banks frequently operate in the secondary market for their own securities with both purchases and sales. Therefore, consistent with their business purposes, the repurchased own securities are normally classified under the trading portfolio and consequently aligned with market value. The standard does not specify the accounting treatment when such repurchased shares or debt instruments are resold.

In the light of the foregoing, we believe that the standard needs to be amended by including different provisions depending on the purpose for which the own shares or debt instruments are repurchased and eliminating the present assumption that, in substance, such securities must be considered as to be held to maturity.

Impossibility of classifying strategic investments as “held to maturity” (paragraph 10, paragraph 80)

In substance, paragraph 10 of IAS 39 requires classifying as “for sale” all equity investments which are not in subsidiaries, related entities or joint ventures, even if such investments are strategic.

In this circumstance fair value measurement with a corresponding charge in the equity is necessary.

Fair value valuation (i.e., the market price, for listed shares) is not always appropriate for this kind of investment, especially where the market may be illiquid for large orders, or when they are traded at a premium.

Further, problems may arise in relation to the concentration and separation limits set by individual regulators. Thus, in view of the distortions of financial statements presentation generated by the application of the standard, cost measurement or equity method could be allowed for equity instruments which have the characteristics of strategic investment

We further believe that IAS 39 should better define the concept of “strategic investment,” not simply referring to IAS 28 and IAS 31 but broadening the definition to all so-called durable investments, which, in the current balance sheet, are comprised in the item “equity interests”.

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Adoption of IAS 39 to insurance contracts (par. 1)

IAS 39, paragraph 1 and 3 (as well as IAS 32, paragraph 1 states that the Standard is not applicable to insurance contracts, except for those contracts that, even if qualifying as insurance contracts because this last element is one of the contractual items, provide the transfer of interest rate, of exchange or of price risk (that is usually financial risks) as the main characteristic. Moreover, this Standard shall be applied to derivatives embedded in insurance contracts.

With reference to the first aspect, given that as far as insurance contracts are concerned:

- it is not always easy to distinguish the prevalence of the financial item over the insurance item in the insurance contracts;
- a specific accounting standard on this issue is expected to be promulgated,

We believe that it is appropriate to exempt these contracts without any exclusion from the adoption of IAS 39.

With reference to insurance contracts that embed one or more derivative contracts, the separation of these last ones from the main obligation is in the most of cases impracticable. The normal consequence, under the current IAS 39, would be to consider the whole contract as a financial instrument with the need to measure the relating “fair value” (see paragraph 26), contrary to the general exclusion principle concerning the insurance contracts.

On the base of what said above, it is believed to be appropriate to exempt the embedded derivative contracts included in the insurance contracts from the scope of IAS 39. The same proposed corrections would obviously result in the IAS 32, paragraph 1c.