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12 July 2004

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

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

Dear Sir David:

The Global Financial Reporting Advocacy Committee (GFRAC) of the CFA Institute[1] is pleased to respond to the International Accounting Standards Board (IASB) Exposure Draft (ED) of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement ─ The Fair Value Option. GFRAC is a standing committee of the CFA Institute charged with representing the views of investors to, and maintaining a liaison with, bodies that set financial reporting and disclosure standards in a global context, particularly the IASB. The committee is also charged with responding to requests for comment from national standard setters and regulators on international financial reporting issues. GFRAC includes CFA Institute members from Asia, Europe, and North America with varying professional backgrounds and expertise in the investment industry.

General Comments

At the outset of this letter, we would like to state that this ED presents us with a dilemma. On the one hand, we would like to support the IASB in helping to resolve its stalemate with the European Commission and European constituents over adoption of IAS 39. On the other hand, although we would like to see improvements to IAS 39, we believe that the amendments proposed in this ED takes us farther from our goal of a full fair value model ─ and from improved financial reporting to investors ─ rather than closer.

Our dilemma is exacerbated because we are being asked to express a preference between what we see as two "bad" alternatives: giving issuers the "option" of selecting fair value measurements (current IAS 39) or

[1]With headquarters in Charlottesville, VA and regional offices in Hong Kong and London, the CFA Institute [formerly, the Association for Investment Management and Research® (AIMR®)] is a non-profit professional association of more than 68,000 financial analysts, investment managers, and other investment professionals in 117 countries of which 57,000 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 129 affiliated societies in 50 countries.

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curtailing that option (proposed amendments). We neither like giving issuers options nor do we want to curtail the use of fair values in measuring financial instruments. Our conundrum can best be explained as follows:

(1) We believe that issuers should be required to measure all financial instruments at fair value since it is the most relevant measurement.
(2) We adamantly disagree with the notion that issuers will not be able to determine a reliable fair value measurement.
(3) We do not believe issuers should have "options" in the recognition and measurement principles used in financial reporting and disclosure.
(4) We recognize that political pressures are such that the IASB could not mandate the use of fair value measurements at this time.

As a basic premise, we believe that a preferred principle can always be found when addressing recognition and measurement in financial statements and that issuers should always be required to use that principle in preparing financial statements. When issuers are presented with options or choices among recognition and measurement principles, investors are always disadvantaged. Either there will be a race to the bottom as issuers use the least preferred option (from the investor viewpoint) or investors will need to expend their limited resources understanding the various options and restating financial statements where possible. Inconsistency invariable leads to lack of comparability both across issuers and, over time, for a single issuer.

We believe that concerns about measurement reliability are unfounded. Issuers are being asked to fair value financial instruments that they are using to manage existing exposures. Prudent managers should be managing the economic value of their transactions, contracts, and arrangements at both their inception and for their duration. We assume that, if at any point in time management could not reliably determine fair value, such a significant uncertainty would cause them to be concerned or even alarmed. Evidence suggests that managements monitor their transactions and engage in on-going rebalancing of exposures and duration gaps. In addition, financial statements are replete with estimates of dubious reliability. We ask that you consider the examples of accounts receivable and depreciable lives. The former requires constant management (and investor) attention to changes in estimates of collectibility. Estimates of the latter are tenuous at best and concerns about the reliability of these numbers call for vigilance with respect to the implications for both the income statement and balance sheet.

Therefore, we were willing to support the current IAS 39 with the fair value option because we believed that having some issuers choose fair value measurements was more important than eliminating options. The proposed amendments in this ED, therefore, are impossible for us to accept.

Question 1: Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

No, we do not agree with a proposal to limit the use of the fair value option. We consider the fair value option to be the preferred measurement principle. In fact, rather than limiting its use, we would propose requiring all companies to recognize and measure all financial instruments at fair value.

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?

We are not aware of any financial instruments that would fall into this category, but we would be unhappy should companies who had intended to apply the fair value option to their financial instruments were no longer permitted to do so. We believe that the fair value of such instruments would be both relevant and reliable, which are the important characteristics to consider within the current framework.

Question 3: Do the proposals 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 consider the concerns set out in paragraph BC9 to be legitimate concerns and we will address each separately. We believe the concerns expressed are merely camouflage for an attempt to minimize the use of fair values and buttress the opposition to IAS 39.

Verifiability

We do not understand what the IASB intends by requiring "verifiability" or what would constitute "low" variability in the range of fair value estimates. We have found that attributes like "low" or "high" are in the eye of the beholder. What would constitute sufficiently low for issuers may be very different from low for investors. If constituents are concerned about communicating the variability of fair value estimates to readers of the financial statements, we suggest that a disclosure which is highly transparent with respect to underlying assumptions and includes a robust sensitivity analysis would do the job better than limiting issuers' ability to provide investors with relevant information.

All balance sheet numbers are to some extent "subjective": every number has some degree of estimation or measurement uncertainty. The only question should be whether or not the extent of the measurement uncertainty is adequately communicated to readers of the financial statements. Issuers rarely are concerned with the degree of measurement uncertainty of property or equipment even though the original cost has been allocated among component assets, useful lives and salvage values were estimated, and a depreciation method was arbitrarily selected and applied. We believe that any arguments for a verifiability requirement are just as "valid" and, hence, just as silly for inventory or fixed assets as we do for financial assets and liabilities.

Finally, we disagree with the introduction of a new concept, "verifiability", because we believe it to be a very bad signal to the markets. It suggests that the IASB is moving away from the traditional characteristics of reliability to a more onerous standard requiring verifiability. Investors are increasingly opting for more relevance in recognition and measurement even when there is a tradeoff with reliability. In addition, we would hate to see the IASB introduce new concepts into the framework without adequate discussion and deliberation about how this concept would work across a broad spectrum of accounting issues. We have seen all too often that concepts and choices that were intended solely for application to a particular accounting issue are extended with very little additional thought to other issues. We do not consider this practice to afford constituents appropriate due process.

Volatility

Volatility is a fact that, as users of financial statements, we would prefer revealed rather than hidden. Assumptions about the permanence and volatility of earnings and cash flow streams are at the heart of all valuation models. Therefore, we are not concerned about whether use of the fair value option would increase or decrease *reported* earnings volatility. Rather we are interested in observing its effect. We would not be thrilled if an issuer chose to apply the fair value option to only one side of a "matched" position ─ and we would definitely want that fact disclosed. But truthfully, we find it difficult to believe that issuers would make such a choice if the match is effective. In our discussions with issuers on a wide variety of topics, we have found that issuers are consistent in preferring choices that minimize volatility. Therefore, we think it more likely that issuers will fair value both sides of a "matched" position and, hence, will communicate better how good or poor the match is. Rather than limit the use of the fair value option, we would prefer that, in the rare circumstances that issuers would fair value only one side of a matched position, they be required to fair value both sides. We reiterate: the IASB is only in the position of proposing this amendment because IAS 39 does not require fair value measurement for all financial assets and liabilities.

Gains and Losses from Changes in Creditworthiness

We are also not concerned about recognition of gains or losses in earnings from changes in an issuer's creditworthiness. Such affects are only counterintuitive when financial statements are (incorrectly) viewed as reflecting some sort of amorphous view of an entire entity. If financial statements are viewed as presenting the position of existing shareholders, a decrease in creditworthiness is effectively a wealth transfer from bondholders to stockholders (or vice versa for an increase), which is exactly what the income statement should communicate.

Earnings Management Concerns

Finally, we believe that concerns about earnings management or manipulation by judicious (or injudicious) use of the fair value option are not credible. We are extremely doubtful that constituents should be concerned that issuers will select the fair value option to manipulate the income statement. The selection of the fair value option is irrevocable. If there are issuers whose forecasting skills of future fair value changes due to interest rates, currencies, etc., are so good that they can permanently forecast the effect of those changes on their income statement, we believe these issuers will soon abandon their current business model in favor of speculating on interest rate or currency movements.

Quite the contrary, we believe that issuers will be quite circumspect about selecting this option and there is no reason to curtail their ability to do so *ex ante.* Issuers are in no position to forecast future changes in the fair value of their financial assets and liabilities at the time they purchase the instrument. Since the fair value option is irrevocable at inception, the only way management could use an instrument to mange earnings over the holding period of the instrument is to be able to do that effectively and consistently. We are unaware of any management that has this type of crystal ball and would be eager to identify the profit-making opportunity associated with any management team that does.

View of Dissenting Board Members

We believe that Board should give more weight to the objections by the three dissenting Board members. We agree with their view. In its deliberations on IAS 39, the Board already considered and rejected the view of prudential supervisors. As the dissenting Board members contend, there is no new or compelling evidence that would invalidate the original decision.

Question 4: Is the proposal to permit use of the fair value option for financial assets and liabilities appropriate or should it be limited to only those assets and liabilities with embedded derivatives that can be separated?

At the risk of being repetitive, all financial assets and liabilities should be measured at fair value: with or without embedded derivatives, separable or not.

Question 5: Are the transition provisions appropriate? Should any changes to the measurement bases of financial assets and liabilities that result from adoption of these amendments be applied retrospectively by restating the comparative financial statements?

If these amendments go into effect, we would prefer that they be applied retrospectively by restating the comparative financial statements.

Concluding Remarks

The GFRAC supports recognizing and measuring financial assets and financial liabilities at fair value with changes in fair value recognized in profit and loss rather than at historical cost or some other measurement option. We do not support giving issuers recognition or measurement options in IFRS. In addition, we often find ourselves in the unfortunate positions of having to choose between "the lesser of two evils" in responding to financial accounting proposals. Specifically, in our 16 December 2003 letter on previous amendments to IAS 39, we supported giving issuers the option of recognizing and measuring their financial instruments at fair value because the goal of moving more items to a fair value measurement seemed, on balance, to be better than arguing for no options. We maintain this position and, therefore, do not support limiting issuers' ability to select the fair value option in IAS 39.

The GFRAC appreciates the opportunity to comment on this Exposure Draft. If you or the IASB staff have any questions or require further elaboration of our views, please do not hesitate to contact Patricia Doran Walters, CFA, at 1.434.951.5315 or patricia.walters@cfainstitute.org.

Sincerely,

/s/Patricia A. McConnell

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Chair
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