Setting the global standard for investment professionals

15 March 2005

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

sthompson@iasb.org.uk

Re: ***Amendments to IAS 39: The Fair Value Option***

Dear Sir David:

The Corporate Disclosure Policy Council (CDPC) of the CFA Centre for Financial Market Integrity (CFA Centre) of CFA Institute[1] appreciates the opportunity to comment on the International Accounting Standards Board's ("IASB") proposal, *Amendments to IAS 39: The Fair Value Option.* The CFA Centre develops, promulgates, and maintains the highest ethical standards for the investment community including the CFA Institute *Code of Ethics* and *Standards of Professional Conduct.* The CFA Centre represents the views of investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education, and licensing requirements for investment professionals, and the efficiency of global financial markets. The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide.

General Comments

Financial statements should be useful to those who use them, including investors and other financial decision-makers. Indeed, their decisions can depend critically on the information found in the statements. As we have observed on a number of occasions, all financial decisions should

[1] With headquarters in Charlottesville, VA and regional offices in Hong Kong and London, CFA Institute (formerly, the Association for Investment Management and Research®) is a non-profit professional association of 73,000 financial analysts, portfolio managers, and other investment professionals in 119 countries of which 57,900 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 131 Member Societies and Chapters in 52 countries and territories.

Charlottesville Hong Kong London
560 Ray C. Hunt Drive
PO Box 3668
Charlottesville, VA
22903-0668 USA
434 951 5499 tel
434 951 5262 fax
info@cfainstitute.org
www.cfainstitute.org

be based upon fair values. Hence, fair value is the *only relevant measurement attribute* for items included in financial statements. All other bases, including historical cost, sacrifice usefulness and relevance to some other objective, such as convenience, or practicality, or a desire to obscure the underlying economics of a business.

We believe that this proposal turns such logic upside down. From Paragraph 9(b) of the current draft of the proposal:

> *Upon initial* recognition [a financial asset or liability] *is designated by the entity as at fair value through profit or loss. An entity shall use this designation* ***only when permitted by paragraph 11A, or when doing so results in more relevant information because either***
>
> *(i)* *it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as "an accounting mismatch") that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases; or*
>
> *(ii)* *a group of financial assets and/or financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and this is the basis on which information about the assets and/or liabilities is provided internally to the entity's key management personnel (as defined in IAS 24* Related Party Disclosures (as revised in 2003))*, for example the entity's board of directors and chief executive officer.* [Emphasis added]

We do not believe that the constraints on the fair value option that exist in IAS 39 will serve user needs. These provisions **constrain** the use of fair value recognition to **only** those instances (other than for trading instruments) in which management might find the method to be either (i) more practical, as a result of an "inconsistency", or (ii) when management decides for whatever reason to use fair value for its own internal purposes. In short, in both cases fair value measurement and recognition would still depend upon the whims of management rather than the decision needs of investors and other users. We believe that issuers should be required to measure all financial assets and liabilities at fair value.

In our letter to the IASB dated 16 July 2004 regarding a prior draft for the fair value option, which is appended to this letter, we stated the following:

> *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.*

We invite the Board to review our comments in that letter because they explain more fully our views on these matters.

From Paragraph AGX2

> *Designation of a financial asset or financial liability as at fair value through profit or loss is an accounting policy choice. When an entity has such a choice, paragraph 14(b) of IAS 8* Accounting Policies, Changes in Accounting Estimates and Errors *requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. Paragraph 9 sets out the two instances when the requirement for more relevant information will be met in the case of designation at fair value through profit and loss.* ***Accordingly, to choose this policy in accordance with paragraph 9, the entity needs to demonstrate that it falls within one (or both) of these two instances.*** [Emphasis added]

Perhaps, most disturbing of all is the shift in logic that places a burden of proof on managers to justify the use of fair value reporting for some instruments, rather than requiring the use of fair values for all. That is, management would not have to justify another lesser quality accounting choice, such as historical cost, but would be required to show that an item meets one or both of the two designated criteria, neither of which recognizes the superiority of fair value measurement for financial reporting and decision-making. Moreover, neither of the criteria recognizes that financial statements are prepared for users, rather than for managers.

We strongly support the Board's proposal to require the extensive disclosures proposed in the current draft. These disclosures are essential if users of statements are to understand companies' fair value recognition and measurement policies and the implications of those policies. In addition, we believe that the following disclosures would greatly assist users in understanding the effects of the elective use of fair value on an instrument-specific basis:

1. Disclosures about management's election and selection policies and procedures, including:

   a. The type of financial assets and liabilities for which the fair value option is elected; *(Current IASB proposed disclosure)*

b. Whether all financial assets and liabilities of the same type received the same elective fair value treatment; *(Incremental but arguably covered by ED 7 paragraph 23(a))* and

c. The reason(s) for electing fair value for the specific financial instruments identified. *(IASB proposed new disclosure)*

2. Disclosures about the effects of the election and selection process on the financial statements, including:

a. The value of instruments for which fair value was elected; *(ED 7 paragraph 10(a), IAS 32 paragraph 94 (e)(ii)*
b. Additions to that population during the period; ***(Proposed by the CDPC)***
c. Settlements of those instruments during the period; ***(Proposed by the CDPC)***
d. The amount of the fair value changes recorded in profit and loss during the period; *(Proposed by ED 7 paragraph 21 (a)(i))* and
e. Where in the income statement (which line item or items) the fair value changes are recorded. ***(Proposed by the CDPC)***

3. The method(s) used to measure fair value by type of transaction for which the fair value option is elected*. (ED 7 paragraph 31(a), IAS 32 (paragraphs 92 (a) and 93).*

Investors and other users of financial statements require this degree of detailed disclosure because individual company valuation is developed, and price multiples are assigned, based upon the values of asset and liability classes in the balance sheet, changes in those values flowing to net income, and the measurement bases of the items. For example, a change of a given amount (in currency units) of cash flows, accruals, or fair values would receive different price multiples. Financial instruments, and gains and losses resulting from changes in the carrying value of financial instruments, including derivatives, recorded at fair value will receive significantly different weights and values than for those instruments and other transactions that are no so measured.

Detailed disclosures would also serve to reduce the risk that managements will misuse the fair value option to mislead investors and regulators. When managements are required to both describe the accounting methods used and disclose the financial statement effects of those policies, the resulting transparency makes it possible for investors and regulators to question management about the underlying transactions and to expose any misuse of the fair value option.

Conclusions

In conclusion, we believe that this proposal, *Amendments to IAS 39: The Fair Value Option,* is severely flawed, focusing as it does on the concerns of regulators rather than on the usefulness of the information to investors and other users of financial statements who base their decisions on fair value measures.

Although no disclosure can repair the infirmities of deeply-flawed financial reporting, we have recommended disclosures that, if adopted by the Board, will allow users who have sufficient knowledge and experience, and can invest the necessary resources, to at least partially compensate.

Respectfully,

/s/ Patricia A. McConnell, CPA_____
Chair, Corporate Disclosure Policy Council
CFA Centre for Financial Market Integrity
CFA Institute

/s/ Rebecca T. McEnally, Ph.D, CFA____
Director, Capital Markets Policy Group
CFA Centre for Financial Market Integrity
CFA Institute

Cc: Jeffrey Diermeier, CFA, Chief Executive Officer, CFA Institute
Raymond DeAngelo, Executive Vice President, Member & Society Division, CFA Institute
Kurt Schacht, J.D., CFA, Executive Director, CFA Centre for Financial Market Integrity
Corporate Disclosure Policy Council
Robert Luck, CFA, Director, Society & Administration, CFA Centre for Financial Market Integrity
Wayne Upton, Research Director, International Accounting Standards Board

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[2] 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 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:

[2] 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.

(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

Patricia A. McConnell, CPA
Chair
Global Financial Reporting Advocacy Committee

/s/Patricia Doran Walters

Patricia Doran Walters, Ph.D., CFA
Director of Research & Senior Policy Analyst
CFA Institute

Cc: Raymond DeAngelo, Executive Vice President, CFA Institute
Kurt N. Schacht, CFA, Executive Director, CFA Centre for Financial Market Integrity, CFA Institute
Rebecca Todd McEnally, CFA, Vice President, Advocacy
Global Financial Reporting Advocacy Committee