Deloitte & Touche
Statsautoriseret Revisionsaktieselskab
H. C. Andersens Boulevard 2
DK-1780 Copenhagen V
Denmark

Telephone: +45 33 76 33 33
Facsimile: +45 33 76 39 93
www.deloitte.dk

Deloitte Touche Tohmatsu

8th October 2001

Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir David,

Draft Standard - Joint Working Group of Standard Setters Recommendations on Accounting for Financial Instruments and Similar Items

Deloitte Touche Tohmatsu is pleased to comment on the Draft Standard from the Joint Working Group of Standard Setters ("JWG"), *Recommendations on Accounting for Financial Instruments and Similar Items*, dated December 22, 2000 (the "Draft Standard").

Our recommendations to the IASB are founded on our general agreement with the conceptual premise that fair value is the most relevant measurement model for all financial instruments. Therefore, we support the fundamental goal of the JWG of developing a comprehensive standard for accounting for financial instruments that is based on fair value measurement principles. However, considering the implementation issues discussed herein relating to performance reporting and fair value measurement, we have diverse views throughout our global organization about how best to implement a fair value model, including the derecognition provisions. While our recommendations herein do not reconcile our diverse views given our various geographies and different industry experiences, we believe that they provide a basis for furthering the use of fair value for financial instruments.

We support the increased use of fair values for financial instruments in financial statements as part of the evolutionary process that may ultimately result in a full fair value accounting model for financial instruments. However, we will not support the recognition in the income statement of changes in the fair values of financial instruments that are not being held for trading until issues relating to performance reporting and fair value measurement are resolved.

We have concerns about the usefulness and understandability of fair value amounts being recognized in the traditional income statement. We believe the project on performance reporting should specifically consider how to improve the usefulness of fair value amounts recognized in the income statement. We recommend that consideration be given to financial statement alternatives that will improve the usefulness of earnings as a measure of performance and predictor of value under a fair value model. We also believe there are considerable difficulties involved in estimating fair values with sufficient reliability. The difficulties relating to performance reporting and measurement that we believe will be introduced by a change to a fair value accounting model for all financial instruments require solutions before we would support such a model and before the full benefits of that model can be realized.

We believe that a movement to fair value accounting should be an evolutionary process that is accomplished in stages. International Accounting Standard ("IAS") 32 started the movement by requiring disclosures of fair values of financial instruments. IAS 39 continued that movement by requiring that all derivatives and most financial instruments be reported at fair value. We believe the next step in the evolution could be a partial increase in the use of fair value accounting. The objective of this next movement should be to increase the familiarity and understandability of fair value use and provide additional time to further identify and resolve issues related to performance reporting and fair value measurement. We also encourage the IASB to consider field tests as part of the next steps, as many of the suggested changes in the Draft Standard will change practice significantly.

We recommend that the next step in the process of moving to fair value accounting for financial instruments be accomplished by amending IAS 39 to eliminate the use of amortized cost for originated loans, held-to-maturity financial assets and financial liabilities. Enterprises would have a choice of recognizing changes in fair value in equity or in the income statement, except that there should be no choice for financial instruments held for trading. Enterprises would continue to be permitted to use hedge accounting. This approach has the effect of recognizing all financial instruments at fair value, but it does not place undue significance on the amounts since they are not required to be reported in the income statement. It also provides additional time to resolve performance reporting and fair value measurement issues. We also recommend that a review be conducted of various other provisions of IAS 39. If necessary, we recommend that it be further amended to simplify its application and further the goal of fair value reporting. For example, instead of requiring that embedded derivatives be bifurcated (or unbundled) from the host financial instrument, the entire instrument could be required to be carried at fair value.

We believe that acceptance of fair value accounting in the Draft Standard will be hindered because the document, as drafted, is unnecessarily complex. It will require considerable interpretation. We believe that the complexity is due to (i) combining guidance on fair value measurement of financial instruments with derecognition principles and (ii) incorporating a considerable amount of rule-based guidance that exists currently in US GAAP into the Draft Standard.

We recommend that document be split into two projects: one addressing fair value measurement and recognition and the other addressing derecognition of financial instruments. We believe that a considerable amount of complexity can be eliminated by evaluating and relating scope and other exceptions back to the concept that fair value is the most relevant measurement attribute for financial instruments. Guidance on presentation in the financial statements can be addressed in the next step in the movement to full fair value accounting.

We also believe that there is no "right" answer in the debate over risks and rewards and control as the model for derecognition. There are legitimate arguments for concluding that a transfer should be either accounted for as a sale or as a financing when the transferor has some form of continuing involvement in the transferred financial asset. It is difficult to determine which event has occurred. As a result, considerable and unnecessarily detailed rules have been developed to make this distinction for accounting purposes. In many situations, control cannot be assessed easily because neither the transferor nor transferee controls the financial asset that is the subject of the transfer. A distinction based on isolation facilitates structuring and emphasizes form. However, we also understand that a distinction based on risks and rewards is often difficult to assess. Since there is no perfect model, we favor an approach that avoids complex rules and dependence on legal form. We believe a linked-approach is a simpler model. It recognizes the relationship between cash inflows dedicated to a third party investor and it does not force subjective measurements of portions of financial assets that have been carved up disproportionately. Further, we do not believe that derecognition can be addressed without addressing issues around consolidation of enterprises that are commonly established in transactions involving transfers of financial assets.

Our major concerns and suggestions related to fair value measurements and performance reporting are described more fully in Appendix I.

Our proposal concerning the linked approach for accounting for transfers of financial assets are included in Appendix II.

Our responses to the questions posed in the Draft Standard are included in Appendix III.

If you have any questions concerning our comments, please contact Stig Enevoldsen in Copenhagen, Denmark at 45 33 76 36 91.

Yours faithfully

DELOITTE TOUCHE TOHMATSU

Stig Enevoldsen

Partner

Encl.

Deloitte
Touche
Tohmatsu

APPENDIX I

DELOITTE TOUCHE TOHMATSU COMMENTS
on
DRAFT STANDARD
JOINT WORKING GROUP OF STANDARDS SETTERS
RECOMMENDATIONS ON ACCOUNTING FOR FINANCIAL INSTRUMENTS AND SIMILAR INSTRUMENTS

Our concerns and suggestions in Appendix I focus on issues related to fair value measurements and performance reporting. These concerns and suggestions address:

(i) Distinguishing wealth and financial performance to enhance the understandability of the income statement,

(ii) Determining fair values based on their proximity to closely and objectively related market factors,

(iii) Developing valuation standards to enhance comparability and

(iv) Establishing consistent recognition criteria for revenues and gains in the income statement.

Distinguishing Wealth and Financial Performance to Enhance the Understandability of the Income Statement

Wealth is a balance sheet notion - it is a point in time measurement. Performance is an income statement notion - it is a measurement for a period of time. Fair values clearly measure wealth, but they do not necessarily measure financial performance, unless all assets and liabilities, not just financial instruments, are carried at fair value.

Financing decisions frequently support operations and, although important, they are ancillary to the revenue generating activities of an enterprise. For example, an enterprise, after significant study, decides to build a plant to take advantage of revenue growth opportunities. As a consequence of that decision, there is a requirement to finance the construction at a time when prevailing market interest rates are considered to be unusually high. The interest charges and repayment of the debt, however, are expected to be absorbed fully by the cash flows from the increased revenue growth. The interest charges are only a secondary consideration in deciding to undertake the project to expand operations. Under a fair value model, the impact of any change in interest rates is recognized in the income statement immediately, while the cash flows from the increased growth are recognized as they are earned in the future. Fair value is clearly more relevant than the proceeds of the debt. However, in this example, the recognition of the change in the fair value of the debt due to changes in interest rates in the income statement de-emphasizes the benefits expected from the project: the increased future net cash flows that seem to be a better indicator of performance.

We believe that there is a trade-off between the benefits to be derived from the use of fair values as indicators of both wealth and performance. A focus only on the wealth indicator will make it more difficult to understand and interpret the results of operations. We recommend that, before requiring the recognition of changes in fair values in the income statement, the JWG consider financial statement presentation alternatives that will improve the usefulness of earnings as a measure of performance and predictor of value under a fair value model. We believe that changes in fair values of financial instruments that provide liquidity or finance the

primary operations of an enterprise should be clearly segregated from earnings so as not to diminish the predictive value of that aspect of operations.

Determining Fair Values Based on Their Proximity to Closely and Objectively Related Market Factors

Fair value, as defined in paragraph 70 of the Draft Standard, is "an estimate of the price an enterprise would have received if it had sold the asset or paid if it had been relieved of the liability on the measurement date in an arm's-length exchange motivated by normal business considerations." Fair value is considered more relevant than cost for financial instruments because financial instruments generally have a close proximity to cash. In other words, financial instruments are often readily convertible to cash and fair value is intended to represent the cash that could be realized, or would be paid, to settle the financial instrument.

Fair value is relevant because it is considered to be a proxy for market value. However, we question whether the number assigned to an instrument to represent its fair value is a reasonably close substitute for market value if (i) the estimate of fair value is subject to a wide range of possible outcomes and (ii) no single outcome can be determined to be a better estimate than the others. In those circumstances, the usefulness of the assigned number is difficult to assess.

The use of the term "fair value" is misleading when the amount represented to be the fair value is not founded on closely and objectively related market evidence. We believe the term is too broad. There is no guidance that limits the use of the term "fair value" to those situations in which an estimate of value can be made within a limited range using market evidence. Certain financial instruments are not traded and there is considerable uncertainty about the ultimate amount that might be paid or realized for them in a transaction between a willing buyer and seller in the marketplace. Accordingly, it may not be possible to associate probabilities with future cash flows. In those situations, the use of the term "fair value" seems to be a misnomer. It does not convey to users of financial statements that there is little or no market evidence to support the valuation. Further, it does not convey that a wide range of possible estimates exists and any one of them could have been selected and labeled "fair value". The term fair value does not seem to describe adequately the number selected when there exists such a wide range of alternative values. Users of financial statements may not know that amounts selected to represent fair value could just as well have been much higher or lower. Without that knowledge, users may ascribe an unwarranted precision to the fair value amount and make invalid comparisons to other enterprises.

As discussed, we believe that the term fair value can be misleading if the amount can be selected from a wide range of alternative values. It is not clear to us how reliability is being considered in the Draft Standard. We believe that reliability simply cannot be ignored on the basis that fair values are relevant. There should be some guidance for assessing reliability. It is not clear to us that the use of different recognition requirements could be made operational based on the extent to which the estimates can be made within a limited range. However, we believe that the precision of the estimates is important to understanding the financial statements. We encourage the JWG to consider requiring that fair value estimates be differentiated based on a test of how clearly and objectively the estimates are based on market evidence that limits alternative valuations.

A hierarchy could be used to disclose the proximity of the estimates to market value: (i) realizable fair values, (ii) market-based fair values and (iii) theoretical fair values. The term

realizable fair values can be used to describe holding gains that are readily convertible to known amounts of cash because the assets have interchangeable (fungible) units and quoted prices available in an active market. The term market-based fair values could be limited to situations in which all of the critical valuation factors relating to a financial instrument can be validated either (i) directly and objectively, based on transactions for similar instruments in the marketplace or (ii) indirectly, based on available market variables that are directly related to the instrument (such as credit spreads for credit-sensitive instruments). The third category, theoretical fair values, is needed to describe the valuations that are subjective because critical market-based valuation factors are not available.

We believe that most financial instruments will fall into the first two categories. Use of the third category could be based on judgment about the availability of appropriate market information. Alternatively, it could be specifically required for certain instruments, which would result in the middle category being a default category. For example, the use of the term theoretical values could be required for, and limited to, certain categories of financial instruments whose valuation within a narrowly defined range is known to be problematic. Examples of instruments that we believe are difficult to value within a sufficiently narrow range such that they provide useful and comparable information include, but are not limited to: (i) equity instruments that are not traded, (ii) options and option-based instruments whose underlying is not traded, (iii) subordinated residual interests and (iv) debt instruments that are in default. We provide further comments on these and other instruments in our response to Q20 in Appendix III.

Developing Valuation Standards to Enhance Comparability

We support the use of fair values when they are described in a manner that permits a reader to understand their proximity to market-based factors. We believe, in instances in which critical market evidence does not exist, that valuation standards should be used. Valuation standards would enhance the usefulness of the fair value amounts assigned to financial instruments and limit the range of alternative values that could be used. We understand that the introduction of valuation standards would be criticized as producing a result unrelated to an enterprise's best judgment of the market factors that should be used in making the estimate. However, in instances where market information is not available, we believe that the judgment as to the best evidence of market is not distinguishable from a biased selection of market evidence because of the availability of many alternative factors. The increased comparability that would result from the use of valuation standards in certain circumstances more than outweighs the criticism.

We observe that certain high-level valuation standards already have been introduced into the recommendations. The requirements to use exit values and to first consider exchanges in the marketplace before using valuation models are valuation standards that are helpful in limiting choice as to what constitutes fair value. These standards are only a start. We believe that more explicit guidance is needed for certain categories of instruments when direct market information does not exist or is not available.

Common stock that is not traded typically will be difficult to value within a narrow range. We disagree with the proposal in the Draft Standard that it will be "rare" that common stock not traded will not be able to be reliably measured. A fair value estimate normally would consider expected cash flows from earnings, but it is not clear what earnings periods would be used or what multiple would be applied to those earnings. Perhaps, for common stock that is not traded, a valuation standard could be employed that would require the valuation to be based on the earnings being reported in the most recent financial statements and on a specified

benchmark or limited to an average-market benchmark multiple. In instances where there are no earnings, the estimate might be based on a benchmark multiple of revenues or limited to the estimated values of the net assets.

Options that are not traded on underlyings that also are not traded are extremely difficult to value within a narrow range because there is no market reference. The valuation is even more difficult if the option were exchanged as part of another transaction. In that circumstance, it may not be possible to establish the option's initial value for use as a basis to estimate subsequent changes in value. To estimate the fair value of the option in these circumstances, a fair value must first be established for the underlying and a volatility factor for expected changes in the value of the underlying must then be determined. Any estimate of value generally will be extremely subjective. A valuation standard might be used to limit alternatives through use of a required benchmark volatility. Alternatively, since in these circumstances the arbitrage value of the option cannot be realized, a valuation standard might specify use of intrinsic value discounted to the exercise date.

Residual interests in financial instruments also are difficult to value when those residual interests are not traded and are subordinated to other interests in the pooled financial instruments. The subordination can be described as a credit option. The underlying financial instruments that generally can be prepaid include another option. In some instances, the value of the whole (that is, the financial instruments that underlie the residual and the value of the senior interests) can be determined from actual exchanges in the marketplace. Obtaining a reliable value for debt instruments that underlie a residual, even if they are not traded in the marketplace, generally is much less difficult than valuing the residual itself. For such residual interests whose values cannot be validated by actual market exchanges, a valuation standard could be employed that would limit the value assigned to the residual based on the value of the underlying, so that the sum of the parts could not exceed the value of the whole. (We provide additional comments on residual interests in connection with our support for the linked approach in Appendix II.)

Debt in default also is difficult to value, particularly when there is no collateral. Lenders would not make a loan if there were any expectation of default, unless they had some means of being compensated for the risk and ensuring repayment (for example, through beneficial equity conversion rights or over collateralization). After a loan is in default, lenders typically do not sell the loans because the loans would be discounted in the marketplace, resulting in a loss. A fair value estimate entails estimating the amount that ultimately will be received by making a subjective probability assessment of expected amounts or by discounting the best estimate of the amount ultimately expected to be received by a subjective risk-adjusted rate. The assessment also must consider the time period in which the borrower in default is expected to remit the expected amounts to be received; when a loan is in default, this factor often is highly uncertain and subjective. In addition, from an exit value perspective, the valuation would have to consider costs of collection because a buyer in the marketplace would clearly consider that cost in a purchase transaction. Absent transactions in the marketplace, it is not clear how the perspective of a market participant in assessing risk can be determined objectively or reliably. Without a market reference, any bias of the lender can easily be factored into the valuation. Given the uniqueness of each borrower, however, it is not clear that valuation standards would be meaningful for loans in default. Segregation in the financial statements may be one alternative to increase transparency and highlight the subjectivity. Another consideration may be to exempt such instruments from the fair value requirement on the basis that the contractual rights conveyed have effectively been retracted.

Establishing Consistent Recognition Criteria for Revenues and Gains in the Income Statement

We believe a decision to recognize changes in fair values in the income statement requires further study and evaluation. The basis for recognition in the income statement should be reconciled with general revenue recognition criteria. It is not clear to us why revenue recognition criteria should be more stringent than the criteria for the recognition of holding gains. For example, revenue recognition is not permitted in certain instances in which the seller has continuing involvement with the asset sold even if the exposure resulting from such involvement is subject to reasonable estimation. Revenue recognition also is generally not permitted unless an exchange has taken place with transfer of title, even if the parties are committed to the exchange. We find it difficult to understand why reasonable estimates are not considered in recognizing certain revenues in the income statement, but highly subjective estimates that may be no more than a best guess and include changing market conditions that cannot be controlled can be used as a basis for recognizing holding gains in the income statement. As another example, consider a contract to purchase an asset at a fixed price and a contract to sell it at a higher price. The difference in prices represents the gain that will be recognized when the exchange takes place and title transfers. However, it is not too difficult to combine the contracts into a single financial instrument that, under the recommended approach, would require the immediate recognition of the gain. We believe the foundations for the recognition of earnings should be consistent for revenues and gains.

APPENDIX II

DELOITTE TOUCHE TOHMATSU COMMENTS
on
DRAFT STANDARD
JOINT WORKING GROUP OF STANDARDS SETTERS
RECOMMENDATIONS ON ACCOUNTING FOR FINANCIAL INSTRUMENTS AND SIMILAR INSTRUMENTS

Our comments in Appendix II address our support for the linked approach. We favor a linked-approach because (i) it is a simpler model, (ii) it recognizes the relationship between cash inflows dedicated to a third party investor and (iii) it does not force subjective measurements of portions of financial assets that have been carved up disproportionately.

The Linked Approach

We believe that the rules for accounting for a transfer of financial assets are overly complex and, as a result of the complexity, they are being applied on the basis of form.

We believe that a realistic focus on the transferor in determining whether control has been transferred would have the effect of reducing the instances in which a transfer with considerable recourse would qualify as a sale. We also believe that a realistic consideration of control as it relates to the consolidation of special-purpose entities ("SPEs") would result in a greater number of SPEs being consolidated.

Another significant issue is valuation. We believe that there are difficulties in determining fair values of certain financial instruments reliably, including components of transferred financial assets that are retained and infrequently exchanged in the marketplace. As discussed more fully below, due to the inability to reliably measure the fair values of certain components, the use of a linked presentation or net presentation also should be considered whenever a transferor has substantial continuing involvement with the transferred financial assets.

We believe that the linked approach is a simpler alternative to the proposed accounting model in the Draft Standard. The linked approach permits proceeds that qualify for the linked presentation to be netted against the portion of the financial assets sold. This approach results in the derecognition of the financial assets in the balance sheet to the extent of proceeds and it avoids considerable difficulties. We believe a linked presentation is conceptually consistent with a definition of control that focuses on control over benefits of the transferred assets. In many instances, particularly when the transferor has provided some form of credit enhancement, the transferee acquires an interest in the cash flows of an asset and the transferor transfers its rights to those cash flows. However, the asset itself generally cannot be physically separated into the portion sold and the portion retained to enable each party to control its portion of the underlying asset. As a result, control over the underlying asset is shared and relegated to provisions in trust documents or other agreements that are acceptable to both the transferor and transferee. In instances in which control is specified by these agreements, it is particularly difficult to assess it without focusing on the control over benefits. The linked presentation recognizes the transfer of the rights to the cash flows of the underlying asset, but the retention of the benefits.

Obviously, criteria would need to be developed to qualify for the linked presentation and there would need to be discipline over its use. A number of factors that could be considered for eligibility include:

- The transfer of control is the basis for qualifying for the linked presentation. The focus of the control is on the cash flows that are being transferred and no longer under the control of the transferor.
- There is a transfer of financial assets. A transfer for this purpose includes selling the assets or portions thereof, or contributing them directly or indirectly through special purpose vehicles to a securitization SPE.
- The investor looks solely to the cash flows of the financial asset to repay its investment.
- If the SPE's beneficial interest holders have any recourse to the transferor or any of its consolidated affiliates, then the maximum amount of recourse (other than for normal representations and warranties) must be classified as debt in the balance sheet—that is, it is not eligible to be displayed as a contra to the assets.
- Similarly, netting to the full extent of the repurchase provisions is inappropriate if (i) the SPE or any beneficial interest holders can put the assets or their beneficial interests to the transferor, (ii) there is a forward requiring the repurchase of those assets or (iii) the transferor retains a call option on the transferred assets.
- If the transfer is to an SPE and the SPE is not able to sell or pledge the transferred assets, control is relinquished by the transferor if the transferor is unable to recover the transferred cash flows.
- If an SPE is required to be consolidated, the third party beneficial interests in the SPE may qualify for the linked presentation in the balance sheet of the transferor if the transferor is unable to recover the cash flows and the SPE is the primary obligor, not the transferor. The securitization SPE can issue debt securities collateralized by financial assets and/or participation securities representing undivided interests in the assets and/or equity securities representing residual interests in the assets.
- The transferor or an affiliate can service the assets and can enter into derivative transactions with the SPE.
- Revolving structures qualify. Random removal of accounts that are no longer needed to support the debt or participation interests, according to the governing documents, can be removed from the securitization SPE and reclassified on the balance sheet to an unlinked category of assets.
- The transferor can retain a cleanup call option when the level of the financial assets outstanding falls to 15% of the level at the date transferred. However, the amount subject to the call would not be afforded the linked presentation.
- The income earned from the investment in the securitization SPE should be shown net in the income statement with disclosure of the gross amounts of interest income, interest expense, servicing fees, bad debt losses, etc. in the notes to the financial statements.
- Assets have to be owned by the transferor prior to transfer and cannot be third party assets.

Disclosures under the Draft Standard should be required for the full amount of the asset and amounts due to transferees. However, only the net interest income would be shown in the income statement. It also will be necessary to establish criteria for derecognizing transferred assets and recording a sale. Such criteria could be based on qualifying for the linked

presentation but without any significant continuing involvement by the transferor in the form of puts, calls, repurchase agreements or recourse obligations.

We believe that the use of a linked presentation approach has appeal because it highlights significant information about transactions that have characteristics of both sales and secured borrowings. We believe there are considerable benefits for using a linked presentation. These benefits include:

- Avoids issues relating to call options and repurchase agreements, whether embedded, attached or freestanding, including:
    - Relinquishing control by transferee,
    - Temporary control of transferee,
    - Constraint of transferee,
    - Removal of account provisions and
    - Cleanup calls.
- Avoids the recognition in income of amounts related to the profit for providing credit enhancement and the inability of separating reliably the increase in the value that may result from increased liquidity.
- Is more consistent with the substance of securitization transactions because rights to cash flows are actually being transferred.
- Eliminates the subjectivity of determining how to recognize the deferred guarantee fee in income.
- Avoids complexities of basis allocation because there would be no gain or loss on the transaction to be recognized.
- Avoids the need to determine what adequate compensation is for establishing a servicing asset.
- Eliminates considerable complexity in estimating fair values because it would not be necessary to value each component that could be identified or certificated. Avoids complexity of estimating values of components when cash flows are divided up and risks including optionality are reallocated among components. It is true that there are derivatives that will be required to be carried at fair value that are just as difficult to value as the components of a financial asset. However, a very significant distinction is that the derivative itself, unless of course it was an embedded derivative, resulted from a separate transaction that established its initial value.
- Facilitates computations of fair value consistent with the JWG's long-term goal of requiring all financial instruments to be carried at fair value. We believe that it is much easier to mark the entire asset to market than it is to mark its components.
- Improves comparability in the income statement. Avoids considerable focus on form and ability to choose whether transactions that are economically the same are recognized in the income statement. Although the balance sheet classifications are affected based on qualification, gross amounts would be disclosed in the footnotes, including gross fair values.
- Avoids burdensome, complex, and not too meaningful monthly (daily) gain calculations for "transferettes" in credit card transactions.

Some form of the linked presentation is permitted in the United Kingdom. We also note that the IASB's rule for netting is more permissive than Financial Accounting Interpretation 39 in the United States because it permits netting between more than two parties. We believe that the United Kingdom has an efficient and elegant solution. We recommend the JWG consider

this alternative or any other alternative that might help reduce the complexity around transfers of financial assets without compromising financial reporting.

APPENDIX III

DELOITTE TOUCHE TOHMATSU COMMENTS
on
DRAFT STANDARD
JOINT WORKING GROUP OF STANDARDS SETTERS
RECOMMENDATIONS ON ACCOUNTING FOR FINANCIAL INSTRUMENTS AND SIMILAR INSTRUMENTS

Scope and Definitions

Q1. The Draft Standard would apply to all enterprises (see Draft Standard paragraph 1 and Basis for Conclusions paragraphs 2.1-2.12). Do you agree? If not, please specify which enterprises you believe should be excluded from the scope (and why), and the basis on which you would distinguish those enterprises that should apply the Draft Standard from those that need or should not.

We agree that the Draft Standard should apply to all enterprises. The definition of a financial instrument is not different between enterprises. Therefore, in order to attain the ultimate goal of a coherent framework for accounting for financial instruments, no enterprises should be excluded.

Q2. The definition of a financial instrument would differ somewhat from the present IASC definition (see Draft Standard paragraph 7 and Basis for Conclusions paragraphs 2.13 and 2.14). Do you agree with the definition in the Draft Standard? If not, what changes would you make, and why?

We generally agree with the definition of a financial instrument, except for the problems that it presents with the specific scope inclusions and exclusions that are provided in the Draft Standard. We are unclear why specific scope inclusions and exclusions are made when the Draft Standard is meant to address a comprehensive accounting model for all contracts that meet the definition of a financial instrument.

We are unclear why a definition of a "loan asset" is required.

We believe that it will be difficult to objectively calculate changes in the fair value of an "impaired loan asset" due to the difficulties in estimating credit changes.

Q3. The Draft Standard would apply to all financial instruments except for those referred to in paragraph 1 (see also Basis for Conclusions paragraphs 2.20-2.36).

(a) Do you agree with the proposed scope exclusions and the manner in which they are defined? If not, why not?

We are unclear about the basis for defining the scope exclusions. We agree with the premise in the Draft Standard that reporting all financial instruments at fair value is

the conceptually best measurement model. We believe that attempting to define or limit the applicability of the Draft Standard based on rules, rather than adherence to the concept that reporting all financial instruments at fair value is more relevant, will hinder achieving the ultimate goal of providing a comprehensive framework for accounting for all financial instruments. We are unclear what the basis for the exclusions is. Although certain instruments meet the definition of a financial instrument, does the JWG believe that fair value is not the most relevant measure for these instruments or that recognition of changes in fair value in the income statement is not meaningful? In order to achieve global acceptance for the Draft Standard, we encourage the JWG to define the scope of the Draft Standard based on broad accounting concepts rather than specific rule-based exceptions.

In particular, we are unclear about the specific exclusion afforded employee benefit plans and retirement benefit obligations. Paragraph 2.23 identifies that the basis for affording the exclusion is because of "unique estimation problems". We contend that unique estimation problems exist for the measurement of many financial instruments. Our comments in Appendix I and our response to Q20 provide examples of financial instruments that we believe pose unique estimation problems.

(b) Are there other items that should be excluded from the scope of the Draft Standard? If so, why, and how should those items be defined?

We believe that the scope of the Draft Standard should be more concept-based than rule-based. We have provided comprehensive comments on the scope of the Draft Standard in Q5.

Q4. The definition of an insurance contract used in the IASC Insurance Steering Committee's, Issues Paper: Insurance, November 1999, is used as the basis to exclude insurance contracts from the scope of the Draft Standard. However, financial guarantees and certain contracts that require payment based on the occurrence of uncertain future climatic, geological or other physical events would not be excluded (see Draft Standard paragraphs 1(d), 17-19 and Basis for Conclusions paragraphs 2.23-2.30)? Do you agree with this approach and definition? If not, what approach and definition would you propose?

We are unclear about the basis for the exclusion for insurance contracts. Similar to our comments in Q3 concerning other scope exclusions, we believe that the basis for exclusions should be founded in accounting concepts that can be broadly and consistently applied. In the Basis for Conclusions, it is acknowledged that, internationally, accounting for insurance contracts is diverse. We do not believe that this diversity is a valid basis for excluding these contracts. We are unclear why an exclusion would be made for an instrument that meets the Draft Standard's definition of a financial instrument. Further, it seems inconsistent to us to include contracts similar to insurance contracts (i.e., financial guarantees) because these contracts meet the definition of a financial instrument, but to exclude a certain type of insurance contract because of a definition in an IASC document.

Q5. The scope of the Draft Standard would include certain additional items, including certain contracts to buy or sell a non-financial item and servicing assets and servicing liabilities (see Draft Standard paragraphs 2 and 3, Application Supplement paragraphs 197-210, and Basis for Conclusions paragraphs 2.37-2.47).

(a) Do you agree that these additional items should be included in the scope? If not, why not?

We believe that the additional scope inclusions, along with the exclusions addressed previously, are too rule-based. We are unclear what the JWG's basis is for including these items. The inclusion of additional items should be based on concepts such as (i) whether or not accounting for the additional items at fair value is useful to users of financial statements and (ii) whether those items can be measured with sufficient reliability.

Paragraphs 2(a) and 205 provide an exception for items that will be used in the normal operations of an enterprise. There are many complex interpretive issues in the United States addressing what is "normal" for purposes of Statement of Financial Accounting Standards No. ("SFAS") 133 that have resulted in many rules being promulgated for specific instances, as opposed to concepts that can be applied widely by all enterprises. It is inconsistent to subject "normal" contracts to fair value accounting in the Draft Standard when other accounting standards (SFAS 133 and IAS 39) provide an exclusion from fair value accounting due to their unique characteristics. We question why the JWG believes that it is relevant to account for contracts that may result in the delivery of commodities at fair value if the only reason is that the contract may be net settled. We encourage the JWG to reconsider this provision and not focus on the terms of the contract. Enterprises often enter into the types of contracts contemplated by these paragraphs because the item to be purchased or sold subject to the contract is used in the enterprise's normal operations and is a source of the enterprise's normal operating profit. To require that these contracts be accounted for at fair value with changes in fair value reported in the income statement does not seem to provide useful information to users of the financial statements.

Further, the rule of a contract that is used in an enterprise's normal operations seems to give rise to a conflict between the provisions of paragraphs 204 and 205(f). In order to be normal under paragraph 204, the contract must deliver an asset that will be used or sold by the enterprise as part of its normal business requirements. Paragraph 205(f) asserts that a "trader" can satisfy this requirement. It can be argued that a trader does not use or sell physical assets in its normal operations even if it may hold the item for a short period in inventory while taking advantage of market movements. We believe that the Draft Standard should address the concept of a "trader". The Draft Standard should also define what types of activities constitute trading activities and what activities are non-trading. A very simplistic distinction is that trading activities are entered into with the goal of taking profit from short-term

movements in market prices. A characteristic of non-trading activities is that they are used to support the revenue-generating operating activities of an enterprise, such as consumption of the item in manufacturing operations or resale of the item as a wholesaler. Non-trading activities do not speculate on price. We believe that all contracts used in trading activities should be accounted for at fair value with changes in fair value recorded in the income statement. We are unclear why the Draft Standard focuses on the terms of a contract (its form) rather than the business reason that enterprises enter into such contracts. By focusing on the business reason for the contract, we believe that the Draft Standard would be more operational for a broad range of enterprises and would also reflect relevant information in the financial statements.

Paragraph 197 is also rule-based, similar to SFAS 133 in the United States. The criteria in paragraph 197 mirror the net settlement criteria in SFAS 133. Similar to the interpretive issues related to "normal" contracts, the net settlement issues in the United States have produced many subjective rules, as opposed to practical concepts.

(b) Are the additional items included defined in a manner that can be clearly applied? If not, how would you amend the requirements?

We are unclear about the basis for defining the additional scope inclusions. One premise in the Draft Standard is that fair value is the most useful measurement method for financial instruments. We are unclear why the JWG believes that subjecting non-financial contracts (described in paragraph 2(a)) that can be net settled via a financial instrument to fair value accounting provides useful information about an enterprise's operations. We believe that more useful information is determined by the nature of the enterprise's operations rather than focusing on the form of various contracts that an enterprise enters into. The additional scope inclusions appear to be arbitrary rules that have been developed to provide for fair value accounting for a broader range of contracts. The scope inclusions do not focus on whether certain types of contracts being accounted for at fair value would provide more useful information to users of financial statements.

(c) Are there other items that should be included in the scope of the Draft Standard and, if there are, how should they be defined?

We do not believe any specific inclusions should be made, but encourage the JWG to reconsider the manner in which the scope of the Draft Standard has been defined. The Draft Standard incorporates a significant number of accounting rules, particularly in the area of the scope, as opposed to accounting concepts.

As we understand it, the ultimate goal of the JWG is to publish a standard that will be accepted globally as the basis for accounting for financial instruments at fair value. In order to achieve such global acceptance, constituents must be able to understand and apply the proposed accounting standard. The Draft Standard,

therefore, should be operational and lend to relatively easy implementation. Accordingly, we believe that the Draft Standard should be based on broader accounting concepts and principles rather than accounting rules. As an example, in the United States, the rule-based accounting models in both SFAS 133 and SFAS 140 (the two United States' standards most closely related to the Draft Standard) have resulted in arduous implementation processes because of the rigid rules that those standards promulgate. One goal of the JWG in developing the Draft Standard as a global standard should be to limit complexity in interpretation and implementation. Without such limits, the rules promulgated by the Draft Standard will only lead to rules in implementation by each standard-setting body, which will foster divergence between standard-setting bodies rather than convergence.

Q6. The Draft Standard would require an enterprise, with certain exceptions, to separately account for sets of contractual rights and contractual obligations in a hybrid contract that, if they were separated, would fall within the scope of the Draft Standard (see Draft Standard paragraphs 4-6 and 25 and Basis for Conclusions paragraphs 2.48-2.52). Do you agree with this proposal? Is the definition of a hybrid contract clear and operational? If you disagree with either of these two questions, what alternative would you suggest?

Paragraph 4 states that the Draft Standard applies to "contractual" rights and obligations in a hybrid contract. We are unclear why contractual is specified because it seems that all features included in a hybrid contract are contractual. We agree with the provisions in paragraph 4 that if contractual rights and obligations fall into the scope of the Draft Standard then those rights and obligations should be separated and accounted for under the Draft Standard.

We do not understand how the provisions in paragraph 5 fall within the scope of the Draft Standard. If contractual rights and obligations in a hybrid contract (that is not a financial instrument) do not meet the scope of the Draft Standard but should be accounted for at fair value under another accounting standard, the Draft Standard would require the entire hybrid contract to be accounted for pursuant to the Draft Standard. We are unclear about the basis for including an instrument that does not meet the definition of a financial instrument in the scope of the Draft Standard.

The inclusion of contracts described in paragraph 5 seems to contemplate identifying and accounting for components of contracts. This scope inclusion seems inconsistent with the intent of the Draft Standard – to provide a comprehensive framework for reporting financial instruments.

Additionally, we are unclear what types of existing instruments are contemplated by paragraph 5.

Recognition and Derecognition

Q7. The basic recognition principle is that an enterprise should recognise a financial asset or financial liability on its balance sheet when, and only when, it has contractual rights or contractual obligations under a financial instrument that result in an asset or liability (see Draft Standard paragraphs 31-34, Application Supplement paragraphs 214-220, and Basis for Conclusions paragraphs 3.1-3.8). Do you agree? If not, why not? How would you amend the principle?

We agree with the basic recognition principle that an enterprise should have contractual rights or obligations to a financial asset or a financial liability.

Q8. The Draft Standard would require that a transfer that does not have substance not affect the assets and liabilities recognised. It proposes that a transfer has substance only if either the transferee conducts substantial business, other than being a transferee of financial assets, with parties other than the transferor, or the components transferred have been isolated from the transferor (see Draft Standard paragraphs 35 and 36, Application Supplement paragraphs 222 and 223, and Basis for Conclusions paragraphs 3.72-3.80). Do you agree? If not, how would you propose to limit the potential for non-substantive transactions that might occur without such a test?

We disagree, in part, with the Draft Standard's concept of "substantial business" in paragraph 36(a). The Basis for Conclusions in paragraphs 3.72 – 3.77 provides clarity on the considerations of the JWG. We believe that the issuance of beneficial interests by the transferee to parties other than the transferor is a substantial business of the transferee. Typically, a transferor will establish the enterprise that will be the transferee in an asset transfer transaction. Subsequent to the transfer, the transferor will have no further involvement with the beneficial interests issued by the transferee to other parties. We believe that the criterion in paragraph 36(a) is not well defined and will be too subjective to apply in practice. As an alternative to removing the criterion, we believe that consideration of the issuance of beneficial interests to parties other than the transferor, over which the transferor has no control, should be deemed a substantial business of the transferee.

Paragraph 223 recognizes that a transfer can involve either financial assets or components thereof. In certain paragraphs, the Draft Standard identifies only financial assets but, in others, seems to indicate that components of financial assets can be transferred. We suggest that the Draft Standard clarify whether or not a component of a financial asset can be transferred and also what a "component" is. We are unclear, for example, if a component may be (i) an identifiable contractual right, (ii) a specified proportion of cash flows or (iii) a portion of the entire financial asset. We believe that an enterprise could transfer any of these "components" of a financial asset, but suggest that the Draft Standard explicitly address what can be transferred. For additional comments, see our response to Q11.

Q9. The basic derecognition principle is that an enterprise should derecognise a financial asset or financial liability or a component thereof when, and only when, it no longer has the contractual rights or the contractual obligations that resulted in that asset, liability or component (see Draft Standard paragraphs 37-40, Application Supplement paragraphs 224- 231, and Basis for Conclusions paragraphs 3.1-3.8 and 3.15-3.30). Do you agree? If not, why not? How would you amend the principle?

We agree generally with the concept in paragraph 37. We believe, though, that it should be clarified that it is not only whether the enterprise currently has the contractual right, but that the ability to obtain or control that contractual right should also be considered.

Q10. The Draft Standard would require that, in certain circumstances, when cash flows are passed through one enterprise to another, the assumption of a contractual obligation to make payments that fully reflect the amount of the cash flows being received from another enterprise would qualify as a transfer of the contractual right to receive the cash flows (see Draft Standard paragraphs 41-48, Application Supplement paragraphs 309-314, and Basis for Conclusions paragraphs 3.32-3.37).

(a) Do you agree? If not, why not? How would you amend the requirement?

We agree with the criteria in paragraphs 43 and 44. We believe that consideration should be given to the concept of a "principal", as mentioned in paragraph 41. Alternatively, the Draft Standard should clearly distinguish between a principal and an agent for purposes of applying the concepts in paragraphs 43 and 44.

(b) Is the requirement and implementation material workable? If not, what changes do you believe are necessary to make them workable?

We believe that the requirement should be workable, provided that the documents governing the transaction that obligates the collector to the pay the cash flows to a second enterprise provide sufficient clarity on the rights and obligations of the parties to the contract.

Q11. The JWG has developed criteria to be used to determine whether a financial asset (or a component thereof) should be derecognised by the transferor when a transfer of substance involving a financial asset takes place. In particular, the Draft Standard would require the whole of the financial asset previously recognised by the transferor to be derecognised if either the transferor no longer has a continuing involvement in that asset or the transferee has the practical ability, which it can exercise unilaterally and without imposing additional restrictions, to transfer the whole of that asset to a third party (see Draft Standard paragraphs 51-62, Application Supplement paragraphs 236, 237 and 242-250, and Basis for Conclusions paragraphs 3.50 and 3.81-3.92).

(a) Do you agree? If not why not? How would you amend the requirement?

We are unclear about the requirement. We believe that the Draft Standard does not just provide for the transfer and derecognition of the "whole" of a financial asset, but also provides for the transfer of a component. If our understanding is correct, then we are unclear how the derecognition test could ever be satisfied when a component is transferred.

Further, to follow our response to Q8, paragraph 55 only refers to transferring the whole of "financial assets", yet other paragraphs seem to indicate the ability of an enterprise to transfer a component of a financial asset. We suggest that the Draft Standard better clarify the transfer and derecognition provisions.

(b) The JWG has developed some material to determine whether the transferee has the practical ability described above (see paragraphs 56-61 and 244-249). Is this material appropriate, clear and operational? If not, how would you amend it?

Paragraph 57 provides guidance on the transferee's ability to make an immediate resale. We believe that a better concept should be developed than the rule that is in paragraph 57. Based on the rule provided, we question what the accounting would be for a transaction that provides the transferee the one-time ability to sell.

Another consideration for "practical ability" is whether or not the transferee obtains a call option in the transfer. Paragraph 60(c) identifies situations when an enterprise does not have a call option. This paragraph indicates that an enterprise is permitted to have a call over "some by not all" of the asset(s), but not have the ability to select which "some". Is an enterprise permitted to have a call on 99% (which is "some"), but be constrained from selecting which 99%?

In providing guidance on whether or not an option contract will be exercised, paragraph 248(a) provides for consideration of whether there is a "genuine possibility" that the option will be in the money at expiration. We are unclear how "genuine possibility" should be evaluated for accounting purposes. If an option pricing model produces a value for an option contract, then we believe that there is a genuine possibility that the option will be exercised. We believe that a better test would focus on the probability of the option being exercised. This probability may focus, among other factors, on the degree to which the option contract is in or out of the money.

Q12. The Draft Standard also would require, in the case of a transfer that does not result in the transferee having the practical ability described in Q11, if the transferor is left with either (a) an obligation that could or will involve the repayment of consideration received or (b) a call option over a transferred component that the transferee does not have the practical ability to transfer to a third party, some or all of the transaction to be treated as a loan secured by the transferred component (see Draft Standard paragraphs 63-67, Application Supplement paragraphs 251-258, and Basis for Conclusions paragraphs 3.38-3.71 and 3.93- 3.102).

(a) Do you agree? If not, why not? How would you amend the requirement? In particular, if you believe that some transfers involving financial assets are loans secured by the transferred asset, how would you differentiate between those transfers and transfers that are, in effect, sales of the transferred asset? If you do not believe that some transfers involving financial assets are loans secured by the transferred asset, or do not believe that some transfers are sales of the transferred asset, please explain your reasoning.

We believe that legitimate arguments can be made to account for a transfer of financial assets as a loan or a sale when a transferor has retained some form of continuing involvement in the transferred financial assets. In order to avoid complex and detailed rules to determine the accounting for a transfer of financial assets, we believe that the linked approach (as discussed in Appendix II to this letter) is a simpler model. This approach is conceptually sound and avoids subjective measurements of portions of financial assets. We believe that a simpler model would facilitate the acceptance of a global standard.

(b) The Draft Standard would require the liability to be recognised in such circumstances to be measured initially at the maximum amount that might need to be repaid under the obligation or the amount of the consideration received in respect of the transferred component over which the transferor has the call option. To the extent that the obligation and call option overlap, only the larger of the two liabilities would be recognised (see Draft Standard paragraph 64 and Basis for Conclusions paragraphs 3.93-3.98). Do you agree with this approach to determining the amount of the liability? If not, how would you change the approach?

We disagree with the approach to determining the amount at which the liability is recognized. In particular, paragraphs 254(b) and 257(b) address the measurement of liabilities and permit an enterprise to measure a liability at the maximum amount. We do not believe that the maximum amount is representative of fair value. We assume that this liability will satisfy the definition of a financial instrument and, therefore, believe that the liability should be measured at fair value. We are unclear why an exception is being made to the general premise in the Draft Standard that financial instruments be measured at fair value.

(c) The Draft Standard would require, in the case of transfers that the Draft Standard would require the transferor to treat in part or entirely as loans secured on the transferred asset, the transferee not to adopt accounting that is the mirror-image of the transferor's (see Application Supplement paragraphs 238-241 and Basis for Conclusions paragraphs 3.64-3.68). Do you agree with this approach? If not, why not? How would you amend the Draft Standard?

We disagree that the accounting for the transferor and the transferee should not be mirror-images. We are unclear why the transaction discussed in paragraph 238 (where the transferor has either (or both) an obligation to repay consideration

received and/or a call option over the transferred asset or component) would not result in the transferee accounting for a loan to the transferor.

Q13. The Draft Standard would require the basic recognition and derecognition principles set out in paragraphs 31 and 37 to be applied to all transfers not falling within paragraphs 51-67 (see Draft Standard paragraph 68 and Basis for Conclusions paragraph 3.62). Do you agree with this proposal? If not, why not? How would you amend the Draft Standard?

We agree with the proposal.

Measurement

Q14. The Draft Standard would require an enterprise to measure all financial instruments at fair value when recognised initially and to re-measure them at fair value at each subsequent measurement date, with one exception (see Draft Standard paragraph 69, Application Supplement paragraphs 315-317, and Basis for Conclusions paragraphs 1.6-1.26). Do you agree? If not, what other approach would you suggest and why?

We agree that, conceptually, all financial instruments should be measured at fair value. We believe, though, that reliable measurements may be difficult to obtain for certain instruments.

Q15. The Draft Standard would require the fair value of a financial instrument to be an estimate of its market exit price determined by interactions between unrelated enterprises that have the objective of achieving the maximum benefit or minimum sacrifice from the transaction (see Draft Standard paragraphs 28, 70 and 71 and Basis for Conclusions paragraphs 4.1- 4.10). The JWG also proposes that any expected costs that would be incurred to exit a financial instrument at that market exit price should not be taken into account in arriving at fair value (see Draft Standard paragraphs 72 and 73 and Basis for Conclusions paragraph 4.11).

(a) Do you agree with the market exit price objective? If not, how would you amend it and why?

We agree that market exit price is the proper measure of fair value. Further, we believe that any valuation techniques should have observable market variables as the basis for assumptions used in the models.

(b) Do you agree with the proposed treatment of direct costs to sell or obtain relief from a financial instrument? If not, how would you amend it?

We believe that an estimate of the fair value of financial instruments based on market exit prices should be used. Therefore, we agree that direct costs should be excluded from the measurement of the fair value of a financial instrument as the

value determined by market transactions represents the fair value of that financial instrument.

Q16. The Draft Standard would require an enterprise to measure a part of a hybrid contract that is to be separately accounted for as if it were a free-standing financial instrument, except if the enterprise determines that it cannot reliably identify and measure the separate sets of financial instrument rights and obligations in the hybrid contract. In the latter case the enterprise would account for the entire contract in the same manner as a financial instrument falling within the scope of the Draft Standard (see Draft Standard paragraphs 74-76 and Basis for Conclusions paragraphs 4.12-4.16). Do you agree with this proposal? If not, what alternative would you suggest?

We are unclear about the basis for this proposal in the Draft Standard. One premise of the Draft Standard is that reporting financial instruments at fair value is the most useful measurement method. We are unclear why instruments that do not meet the definition of a financial instrument are included in the scope. Is the basis for the inclusion that the JWG believes that reporting these hybrid instruments at fair value is more useful than historical cost? Further, we are unclear what the basis is for the difference between this provision and the exception for certain private equity securities. The Draft Standard indicates that only in "rare" circumstances will an enterprise not be able to reliably value private equity securities, but the Draft Standard does not seem to impose the same "rare" standard for hybrid instruments.

This proposal in the Draft Standard is in accordance with our proposal in our introductory comments to record all hybrid instruments at fair value on the balance sheet.

Q17. The Draft Standard sets out principles for estimating the fair value of financial instruments within a hierarchy. First, observable market exit prices for identical instruments are to be used if available. If such prices are not available, market exit prices for similar financial instruments are to be used with appropriate adjustment for differences. Finally, if the fair value of a financial instrument cannot be based on observable market prices, it should be estimated using a valuation technique that is consistent with accepted economic pricing methodologies (see Draft Standard paragraphs 77-86 and 104-117, Application Supplement paragraphs 320-327 and 344-369, and Basis for Conclusions paragraphs 4.17 and 4.36- 4.47). Do you agree with this hierarchy? If not, how would you amend the proposals, and why?

We generally agree with the hierarchy for estimating the fair value of financial instruments. However, we believe that more explicit guidance on the availability of market evidence should be incorporated. We believe that an enterprise cannot ignore recent trades that have occurred in the marketplace.

We disagree with the notion in paragraph 110 that present value techniques are acceptable for valuing options without further explanation of how the present value

model produces the same result as an option pricing model. We believe that an option pricing model is the best model for valuing option contracts. If another model produces comparable results and is based on sound valuation theory, we believe that model would also be acceptable.

Q18. The Draft Standard addresses a number of circumstances requiring special consideration in using observed market prices to determine fair value (see Draft Standard paragraphs 87-103, Application Supplement paragraphs 328-343, and Basis for Conclusions paragraphs 4.18-4.35).

(a) Do you agree with the Draft Standard's conclusions in these circumstances? Are there additional circumstances that should be addressed (please specify)?

We agree with the Draft Standard's conclusions related to special considerations, except as provided in questions (b) and (c) following.

(b) Is the conclusion that value that is not directly attributable to a financial instrument should not enter into the determination of the fair value of a financial instrument (see Draft Standard paragraphs 92-94, Application Supplement paragraphs 331-339, and Basis for Conclusions paragraphs 4.18-4.32) appropriate and operational, in particular as it applies to demand deposit and credit card relationships? If not, why not?

It seems that the guidance in paragraphs 92-94 conflicts with the guidance in paragraph 20. Paragraph 20 states that ancillary fees and float should be included in the calculation of the value of a servicing right, yet paragraphs 92-94 indicate that values not directly attributable to contractual rights should not be included in an estimate of fair value. It seems that ancillary fees and float are factors that are not directly attributable to the financial instrument being valued (the servicing right). We believe that these two concepts should be reconciled.

In paragraph 94(c), we do not understand why a rule for prepayment options exists. The market cannot predict potential future actions that may cause a holder of an option to exercise. Although financial theory proposes the concept of a rational investor as part of its basis, prepayment decisions are not necessarily founded on market movements, but rather on factors that are particular to the option holder (i.e., move, divorce, other financial variables).

(c) Do you agree with the conclusion that, if an enterprise holds a large block of financial instruments and market exit prices are available only for individual instruments or small blocks, the available price should not be adjusted for the potential effect of selling the large block (see Draft Standard paragraphs 102 and 103 and Basis for Conclusions paragraphs 4.34 and 4.35)? If not, in what circumstances would you require adjustment, and how would you ensure consistency of the amount of adjustments that would be made?

We agree with the guidance regarding large blocks of financial instruments, unless more useful information regarding the large block of stock is available. Paragraphs 102 and 103 require the use of a market exit price for the financial instrument that an enterprise owns. If market exit prices are not available for large blocks or for similar items when an enterprise only owns a large block, then we believe that it may be appropriate to value the holding based on a valuation model that uses the price of the individual security as the basis for the model. As described in paragraphs 104-112, the valuation model may produce a more useful fair value of the large block.

Q19. The Draft Standard would require an enterprise that cannot estimate fair value using observable market exit prices of identical or similar financial instruments to estimate fair value by using a valuation technique. The Application Supplement includes material explaining how valuation techniques would be used in a number of situations (see Draft Standard paragraphs 104-117, Application Supplement paragraphs 344-369, and Basis for Conclusions paragraphs 4.36-4.47).

(a) Is this material clear and operational? If not, how would you modify it?

We agree generally with the material, but we believe that the guidance is not sufficient for purposes of establishing a comprehensive, consistent framework for accounting for financial instruments.

(b) Is this material sufficient, or do you believe that more detailed material is necessary? Please specify what additional material you believe to be necessary.

We believe that consideration about the formulation of comprehensive valuation standards to increase the comparability between enterprises should be considered. Although we do not disagree with the general information provided in paragraphs 104-117 and in the Application Supplement, we do not believe that it provides sufficient guidance for enterprises to estimate the fair value of financial instruments that are not traded. We believe that a separate project on valuation standards should be considered that would delineate comprehensive guidance for general types of financial instruments. Many preparers and users of financial statements do not fully understand or appreciate the complexity of fair value models. Therefore, if fair value is to be meaningful to enterprises and users of financial statements, a consistent framework should first be developed and accepted.

The guidance in paragraphs 346(c) and (d) seems incomplete. Many commodities are not actively traded and those that are traded sometimes have market data that only extends for a short time period (i.e., market data for some commodities is only available for a three-year time frame). Additionally, many foreign currencies are illiquid. Guidance should be developed that will describe acceptable techniques for estimating price curves in these situations.

We are unclear about whether the guidance in paragraph 346(e) for all equity securities is meant to be only for common or preferred stock investments or if instruments such as equity options are subject to the guidance in paragraph 346(e). If the equity security is an option, we believe that present value techniques are not acceptable without further guidance on how the present value techniques will produce a result similar to an option pricing model. Further, if the guidance in paragraph 346(e) is meant to apply to all equity investments, we are unclear why the Draft Standard provides an exception for equities not traded.

The guidance provided in paragraph 346(f) on "probabilities" of events seems too general. We agree that the occurrence of certain contingent events (i.e., weather, change in control, expected earnings, etc.) should be considered in the estimate of the fair value of contracts that contain contingent provisions. We are unclear, though, if it is being suggested that the probability of exercise based on "intangible" factors should also be considered in fair value estimates. For example, if an enterprise may face the threat of a lawsuit or suffer reduced investor confidence due to potential debt covenant violations from the failure or election to exercise a financial instrument, should the enterprise somehow factor those events into its estimate of fair value?

We disagree with the notion in paragraph 346(h) that historical market data should be used as the basis for measuring volatility. We believe that the proper measure of volatility is implied, not historical, volatility. When valuing items not traded, we believe that the implied volatility from similar items should be used in the valuation models.

We do not believe that the reference to SFAS 123 is appropriate in paragraph 356. This FASB statement is not a fair value-based accounting standard and does not provide sufficient guidance for estimating the fair values of financial instruments. SFAS 123 permits the use of a zero volatility factor in certain circumstances. An option pricing model that does not include a volatility factor does not produce a result that is the fair value of the option. However, we are unclear if the Draft Standard is suggesting that, in certain circumstances, this model is acceptable as it may produce the best estimate of fair value based on all available data.

(c) Are there other significant circumstances (please specify) on which guidance should be provided?

As noted in sub question (b) to this question, we believe that comprehensive guidance should be provided that would address various general types of financial instruments. For example, specific guidance should be provided on how enterprises should value an interest rate swap versus an interest rate cap. We believe that guidance on what acceptable models and assumptions are for various financial instruments will aid in promoting consistent financial reporting.

(d) Is the proposed material consistent with market pricing practices? If not, how should it be modified?

The material provided presents very general, theoretical concepts, with which we do not disagree. We believe, though, that the information is not comprehensive enough. We believe that different industries may utilize different assumptions or models to estimate the fair value of similar instruments. We encourage more extensive study in this area to determine how enterprises model the fair value of their financial instruments and how comparable the results are.

Q20. The JWG believes that fair values are, generally, reliably determinable, at reasonable cost, for all financial instruments except certain investments in private equity instruments (see Draft Standard paragraphs 122-125 and Basis for Conclusions paragraphs 1.14-1.21 and 4.64-4.67). Do you agree? If not, why not? If you believe that other items are not capable of reliable fair valuation, what are they, what factors cause their fair values not to be reliably determinable, and how should these items be measured?

We do not agree with the notion that all financial instruments can be valued reliably except for certain private equity investments. We believe that the following instruments, in addition to non-publicly traded equity securities, are difficult to measure reliably:

- *Forwards and options on non-publicly traded equity securities,*
- *Non-collateralized (or under-collateralized) debt instruments of issuers experiencing significant credit difficulties,*
- *Residual interests subject to substantial credit and prepayment risks,*
- *Financial instruments that have more than one underlying with the payoff on one being dependent on the other,*
- *Financial instruments dependent on contingent or conditional events, such as insurance, warranties and credit guarantees and*
- *Combinations of any of the above.*

Measurement uncertainties result from a number of factors, primarily the inability to obtain market information. However, models often produce theoretical results and such results can differ significantly depending on the model selected and the inputs used in the models. We are unclear how the Draft Standard contemplates a presumption of the precision of estimating the fair value of financial instruments. We believe that the concept of fair value is not as precise as the Draft Standard presumes it to be.

Although valuation may be difficult and subjective, we believe that a move to fair value for these types of instruments is appropriate. As we discussed in our introductory comments and in Appendix I, we do not believe that these instruments can be measured with sufficient reliability that warrants the inclusion of changes in fair value being recorded in the income statement. We believe that the changes in

the fair value of these instruments should be classified as a separate component of equity until appropriate valuation standards or further evaluation of the precision of estimates can be made.

Our response to Q24 expands on these comments.

Q21. The Draft Standard would require the reported value of an enterprise's financial liabilities to reflect the enterprise's own creditworthiness and changes in it (see Draft Standard paragraphs 118-121, Application Supplement paragraphs 370-372, and Basis for Conclusions paragraphs 4.50-4.62).

(a) Do you agree? If not, why not? How do you propose that the effect of changes in the enterprise's own credit worthiness could be excluded without giving rise to the difficulties noted in Basis for Conclusions paragraph 4.59?

We agree that changes in an enterprise's own creditworthiness should be included in an estimate of the fair value of its financial liabilities. We do not agree, though, that such changes should be included in the income statement. We believe that these changes should be recorded as a separate component of equity. Because of the subjectivity in valuing credit changes, we do not believe that such fair values can be determined with sufficient reliability to make the results of an enterprise's operations more useful.

(b) Is the material in paragraph 370 of the Application Supplement, explaining how an enterprise can establish whether there has been a change in its own creditworthiness affecting its financial liabilities when there is no observable market exit price, appropriate and operational? If not, why not? How could it be improved?

We agree with the proposed guidance in paragraph 370.

Q22. The Draft Standard would require an enterprise to establish appropriate policies and procedures for estimating fair value of financial instruments (see Draft Standard paragraphs 129 and 130, Application Supplement paragraphs 376-379, and Basis for Conclusions paragraphs 4.68 and 4.69). Do you agree with this proposal? If not, how would you change it in a manner that provides reasonable assurance of reliable and consistent fair value estimates?

We agree that policies and procedures should be required to identify how an enterprise is calculating the fair value of its financial instruments. We are unclear how an enterprise will determine if a "more accurate" model is available. We believe that the valuation for many instruments (some of which are identified in our response to Q20) is subjective and complex. Consequently, valuation models may generate significantly different estimates of fair value depending on the assumptions that an enterprise uses. Those varied assumptions may all be equally supportable.

Because the JWG believes that such policies and procedures must be established for fair value purposes, we believe that an exception from the scope of the Draft Standard for certain equity securities not traded is not appropriate. An enterprise should establish an appropriate valuation model and procedures for valuing such instruments. These procedures would allow the enterprise to calculate a best estimate of the fair value of the instrument and recognize a theoretical fair value, as we describe in Appendix I to this letter. Changes in this theoretical fair value should be recognized separately from other fair value estimates, as we describe in Appendix I. We believe that consideration should be given to expanding the exception list for the types of instruments that we describe in our comments to Q20 and to the model that we propose in Appendix I.

Balance Sheet Presentation

Q23. The Draft Standard would require that minimum categories of financial assets and financial liabilities be distinguished on the face of the balance sheet and in the notes to the financial statements (see Draft Standard paragraphs 131-135 and Basis for Conclusions paragraphs 5.1-5.5). Do you agree with the categories proposed? Are the categories clear and useful? If not, how would you amend them and why?

The categories of financial assets and liabilities proposed by the Draft Standard seem rather arbitrary and based, in part, on definitions outlined in the Draft Standard itself. We believe that different enterprises will have different reporting requirements and various financial instruments will be more relevant to some enterprises than to others. We do not agree that the Draft Standard should provide minimum categories of financial assets and liabilities. We believe that enterprises should be permitted to display their balance sheets in the way that is most relevant to the users of their financial statements.

Income Statement Presentation

Q24. The Draft Standard would require an enterprise to recognise all changes in the fair value of financial instruments, after adjustment for receipts and payments, in the income statement in the reporting periods in which they arise, with one exception (see Draft Standard paragraph 136, Application Supplement paragraphs 380 and 381, and Basis for Conclusions paragraphs 6.1-6.29) Do you agree? If not, how should such gains and losses be treated, and why?

We do not agree with the proposal in the Draft Standard.

We believe that the term fair value often connotes an unwarranted degree of precision of the estimate and proximity to market values. Measurement methodologies are not uniform and can be extremely complex. As a result, amounts that are represented to be fair value can vary over a wide range, making such amounts difficult to interpret and compare. Although the recognition of changes in

fair values in the income statement would improve the quality and usefulness of financial statements in many respects, we believe that it will also introduce a number of difficulties that will significantly detract from the benefits. It is not clear whether, or how, the recognition of changes in fair values in the income statement will make performance more understandable. While we agree that fair values are relevant and that changes in fair values should be recognized, we are not convinced that all changes should be recognized in the income statement. We have concerns around the estimates of fair value being reliably measurable.

We believe that the term fair value can be misleading if the amount that is represented to be fair value is selected from a wide range of alternative values. It is not clear to us how reliability is being taken into consideration in the Draft Standard. We believe it simply cannot be ignored on the basis that fair values are relevant. There should be some guidance for assessing reliability. It is not clear to us that the use of different recognition requirements could be made operational based on the extent to which the estimates can be made within a limited range. However, we believe that the precision of the estimates is important to understanding the financial statements. We encourage consideration of a requirement that fair value estimates be differentiated based on a test of how clearly and objectively the estimates are based on market evidence that limits alternative valuations.

A hierarchy could be used to disclose the proximity of the estimates to market value: (i) realizable fair values, (ii) market-based fair values and (iii) theoretical fair values. The term realizable fair values can be used to describe holding gains that are readily convertible to known amounts of cash because the assets have interchangeable (fungible) units and quoted prices available in an active market. The term market-based fair values could be limited to situations in which all of the critical valuation factors relating to a financial instrument can be validated either (i) directly and objectively, based on transactions for similar instruments in the marketplace or (ii) indirectly, based on available market variables that are directly related to the instrument (such as credit spreads for credit-sensitive instruments). The third category, theoretical fair values, is needed to describe the valuations that are subjective because critical market-based valuation factors are not available.

We believe that most financial instruments will fall into the first two categories. Use of the third category could be based on judgment about the availability of appropriate market information. Alternatively, it could be specifically required for certain instruments, which would result in the middle category being a default category. For example, the use of the term theoretical values could be required for, and limited to, certain categories of financial instruments whose valuation within a narrowly defined range is known to be problematic. Examples of instruments that we believe are difficult to value within a sufficiently narrow range such that they provide useful and comparable information include, but are not limited to: (i) equity instruments that are not traded, (ii) options and option-based instruments whose underlying is not traded, (iii) subordinated residual interests and (iv) debt instruments that are in default.

Q25. The Draft Standard would require an enterprise to separately disclose the income statement effects of certain changes in fair value (see Draft Standard paragraphs 137-152, Application Supplement paragraphs 382-390, and Basis for Conclusions paragraphs 6.30- 6.84).

(a) Do you agree with the proposed disaggregation? If not, why not? What other basis of disaggregation would you propose to provide information about the components of changes in fair value of financial instruments?

We are not yet prepared to support the recognition of changes in the fair values of financial instruments in the income statement. Therefore, we cannot support the disaggregation proposed by the Draft Standard until significant issues related to the reliability of fair value estimates and the usefulness to users of financial statements are resolved.

(b) Do you believe that any other gains and losses arising on fair value measurement of financial assets and financial liabilities should be separately presented in the income statement or notes thereto? If so, which gains and losses, and why do you believe that they should be shown separately? On what basis should such gains and losses be distinguished?

We recommend that the Draft Standard consider alternatives that will improve the usefulness of earnings as a measure of performance and a predictor of value. We believe that changes in fair values of financial instruments that provide liquidity or finance the primary operations of an enterprise should be clearly segregated from earnings so as not to diminish the predictive value of that aspect of operations.

We believe that some aspects of the traditional income statement may have to be changed. We are not yet convinced that all changes in the fair values of financial instruments should be recorded in the income statement, at least until the major issues are resolved.

Q26. The Draft Standard would require that interest revenue and interest expense be determined on the fair value basis, using the current yield to maturity basis, except that an enterprise may use the current market expectations basis if the chief operating decision maker relies primarily on that basis for assessing the performance of its significant interest-bearing financial instruments and it is consistent with the enterprise's basis for managing interest rate risk (see Draft Standard paragraphs 139 and 140, Application Supplement paragraphs 382-390, and Basis for Conclusions paragraphs 6.46-6.77).

(a) Do you agree that interest income and expense should be separately presented?

We agree with this proposal.

(b) Do you agree with the proposed method of determination? If not, how would you propose that interest revenue and interest expense be determined in a fair value model?

We are unclear why consideration of both yield to maturity and current market expectations for interest-bearing instruments is permitted in paragraph 30 and in paragraphs 282 and 382 for purposes of recording of interest in income statement. We believe that yield to maturity is the proper measure as it reflects the instrument that the enterprise is holding.

(c) Is the guidance clear and operational? If not, what additional guidance is necessary?

The guidance appears to be clear and operational.

Hedges

Q27. The Draft Standard would not permit any special accounting for financial instruments entered into as part of risk management activities (see Draft Standard paragraph 153 and Basis for Conclusions paragraphs 7.1-7.22). Do you agree? If not, why not? How would you address the issues raised in paragraphs 7.1-7.22 of the Basis for Conclusions?

We do not believe that hedge accounting for anticipated or forecasted transactions should be precluded. Although deferral of gains and losses on financial instruments is contrary to the basic premise of the Draft Standard that all changes in the fair value of financial instruments be recorded in income, we believe that it is important to reflect the proper matching of an enterprise's operations and risk management strategies. Eliminating hedge accounting may place undue or unwarranted significance on the amounts reported in the income statement. Additionally, we believe that hedge accounting will not hinder a movement to fair value because the financial instrument will be recorded at fair value on the balance sheet. We believe that a significant interim step towards a full fair value model will be achieved by permitting hedge accounting.

Disclosure

Q28. The Draft Standard would require disclosure of an enterprise's significant financial risks and of the enterprise's financial risk management objectives and policies (see Draft Standard paragraphs 154-163, Application Supplement paragraphs 393 and 394, and Basis for Conclusions paragraphs 8.5-8.12). Do you agree that this information is necessary to provide the context for understanding and evaluating information about the enterprise's actual financial risks and performance of its financial instruments? If not, how would you change these disclosures?

We generally agree with the disclosure requirements in paragraphs 154-163.

We question the notion in paragraph 156 that financial instruments can create or change the risks of an enterprise in the context of the Draft Standard. We do not believe that it is correct to characterize financial instruments as creating risks in an enterprise, unless those instruments are used for purely speculative purposes and are not matched, in some manner, to items currently on the enterprise's balance sheet. Financial risks of an enterprise result from its business operations (financings, manufacturing, etc.) and not from an enterprise's willing involvement with financial instruments. Typically, financial instruments are entered into to manage the ongoing risks of an enterprise. It is unclear in the context of the Draft Standard whether an enterprise has created or changed its financial risk if that enterprise purchases a financial instrument (for example, an interest rate swap) to manage the interest rate risk associated with debt that it has issued and the terms of the interest rate swap differ in some way from the terms of the debt.

Q29. The Draft Standard would require disclosures about financial instruments used to manage risks associated with transactions expected to occur in future reporting periods only when an enterprise separately discloses gains or losses on those financial instruments (see Draft Standard paragraphs 181 and 182 and Basis for Conclusions paragraphs 8.36-8.43). Do you agree with this approach? If not, how would you change it?

We agree with the disclosures about managing future risks with financial instruments.

Q30. The Draft Standard encourages, but does not require, disclosures about the extent to which fair values of financial instruments and income and cash flows could change as a result of changes in underlying financial risk conditions (see Draft Standard paragraphs 179 and 180, Application Supplement paragraphs 409-411, and Basis for Conclusions paragraphs 8.30-8.35). Do you agree that these disclosures should be encouraged? If not, why not, and what alternative would you propose?

We generally agree with the encouraged disclosures as they will provide insights into the inherent risks in an enterprise's operations.

Q31. Do you agree with the other disclosures proposed in Draft Standard paragraphs 164-178 and 183-189 (see also Application Supplement paragraphs 391 and 392 and 395-408 and Basis for Conclusions paragraphs 8.13-8.29 and 8.44-8.56)? If not, how should the disclosures be amended, while maintaining a balance between the need to inform users about an enterprise's financial risk position and the concern of causing competitive harm to the enterprise or unnecessary burden for preparers?

We generally agree with the disclosure requirements.

We are unclear, though, why the disclosures in paragraphs 168 and 169 are relevant. We assume that if such external restrictions were present, the enterprise

would reflect those restrictions in its estimate of fair value. Therefore, the effects of the restriction would already be apparent in the financial results of the enterprise.

Similarly, we do not agree with the disclosures required by paragraphs 177 and 178. The quantitative disclosures required by these paragraphs will have already been reflected in the financial results of the enterprise.

The disclosures required by paragraph 183 give validity to some of our arguments regarding the relevance and reliability of fair value calculations. If disclosure is required of the different ways that an enterprise has calculated the fair value of various financial instruments, it seems that this information is relevant to users of the financial statements. It follows, then, to question whether all fair value changes in financial instruments should be recorded in the income statement.

Because the estimate of the fair value of retained interests in transferred assets is one of the more subjective estimates that will be made, we encourage additional disclosures in paragraph 188 of the assumptions used by an enterprise in estimating these fair values.

Implementation Recommendations

Q32. The JWG proposes that about two years is a suitable period of time between issuance of a final standard and the effective date to balance preparation time with the need for standards (see Basis for Conclusions 9.1-9.4). Do you agree? Do you believe that certain enterprises need additional time to prepare for implementation? If so, please specify which enterprises and how they should be differentiated from those that apply a final standard initially. Also, please specify why these enterprises may need more time and the length of time that may be required.

We encourage the JWG to consider the interim steps that we have proposed. We believe that they will provide significant steps towards reporting all financial instruments at fair value and will permit sufficient time for fair value methods and results to be evaluated. In this respect, enterprises will be reporting all financial instruments at fair value on the balance sheet. However, enterprises will not reflect those effects in the income statement when those effects may not be reliable or useful to users of financial statements.

If the provisions of the Draft Standard are retained, the implementation time depends highly on the resolution of other issues that we have identified. For example, if the provisions related to "normal" remain, we believe that there are many issues that should be resolved and incorporated into the Draft Standard before releasing a final document. In the three years since SFAS 133 was issued, the FASB in the United States has addressed, and is still addressing, many interpretive issues related to "normal" contracts. This delay in resolving many significant issues has made implementation extremely difficult for many enterprises.

Q33. Some suggest that a comprehensive fair value model for financial instruments should be first introduced in supplemental financial statements, presented in parallel with financial statements prepared in accordance with existing practices. Only after a period of time would such financial statements replace financial statements prepared in accordance with existing practices (see Basis for Conclusions paragraphs 9.5-9.7). Do you believe that supplemental financial statements should be introduced before replacing financial statements prepared in accordance with existing practices? If so, how would you overcome the disadvantages of such an approach, which are identified in Basis for Conclusions paragraph 9.6?

We believe that presentation of the fair value of financial instruments in supplemental financial statements could be advantageous. Many preparers, users and auditors of financial statements do not have deep backgrounds in the financial and economic consequences of fair value. As we indicate in our responses to Q20 and Q35, we believe that there are significant issues related to the valuation of many financial instruments and to the understandability of fair value.

Q34. The Draft Standard includes a number of transitional provisions to be taken into account in adopting it (see Draft Standard paragraphs 192-195 and Basis for Conclusions paragraphs 9.8-9.21). Do you agree with these provisions? If not, why not? How would you amend them?

We agree with the transition provisions described in paragraphs 192-195.

Q35. What steps need to be taken to assist in implementing a comprehensive fair value model for financial instruments? Please comment on any significant legal or other obstacles to implementing a final standard based on this Draft Standard and on how they might be best addressed.

We believe that there is considerable subjectivity and complexity associated with the recognition of fair values for financial instruments:

- *Market information is not available in many instances,*
- *Valuation methods often are complex and*
- *Different valuation methods can be used.*

As a result, amounts represented to be fair values can vary over a wide range. Impacts on the auditability of financial statements and on the understandability of the financial statements to users should be considered.

Additionally, questions around securing legal isolation should be studied and considered. In the United States with the application of SFAS 125 and 140, many issues have arisen when trying to obtain legal isolation letters internationally. Different legal systems may have different laws and interpretations. In some cases there may be no concept of isolation related to bankruptcy and if isolation from creditors has been achieved. Also, the applicability of legal isolation related to

components of financial assets transferred should be studied in an international environment.

Q36. Are there other issues that must be resolved before the Draft Standard could be implemented? If so, what are they and what steps should be taken to resolve them?

We do not believe that one reporting enterprise can have multiple functional currencies as indicated in paragraph 29. We are unclear about the distinction between an "entity" and a "reporting enterprise".

As we indicate in our introductory comments, we believe that consideration should be given to amending IAS 39, as we believe that such amendments will further the goal of reporting financial instruments at fair value. Although what we have proposed for investments, originated loans and financial liabilities only addresses recognition of these financial instruments at fair value on the balance sheet, we believe that implementing these changes will provide a significant movement towards reporting financial instruments at fair value. We also believe that an amendment related to accounting for hybrid instruments is another step that will further the goal of reporting financial instruments at fair value. If a hybrid instrument contains an embedded financial instrument that should be carried at fair value, considerable complexity could be eliminated by requiring that the entire hybrid instrument be carried at fair value. By considering accounting for all investments, originated loans, financial liabilities and hybrid instruments at fair value on the balance sheet, the JWG will achieve an interim goal of recognizing all financial instruments at fair value.