WRITTEN STATEMENT OF SIR DAVID TWEEDIE
CHAIRMAN, INTERNATIONAL ACCOUNTING STANDARDS BOARD,
TO THE
COMMITTEE ON ECONOMIC AND MONETARY AFFAIRS
OF THE
EUROPEAN PARLIAMENT

BRUSSELS, BELGIUM– 22 SEPTEMBER 2004

Mme Chairwoman and Members of the Committee:

My colleagues and I welcome this opportunity to meet the Committee to discuss the latest work of the International Accounting Standards Board (IASB) on IAS 39, the accounting standard on financial instruments. It is my hope that this meeting will lead to regular contact between the Committee and the IASB. (For reference purposes, I have attached, as Appendix A, a brief outline of the structure and history of the IASB and its oversight body.)

The Committee asked the IASB to appear to discuss progress with IAS 39 and the proposals of the European Commission. In this statement, I shall focus on IAS 39, because the IASB has not taken a position on the proposals for endorsement. But I should emphasise at the outset that full endorsement of all of the IASB's standards, including IAS 39, is our preferred option. Although we are aware of the challenges that endorsement would pose, we are concerned that piecemeal approval of any of the IASB's standards risks undermining the coherence and integrity of the standards and making them more difficult to apply consistently.

Background on IAS 39

Over the past three years, the IASB has heard many criticisms used to argue against the endorsement of IAS 39. We have listened carefully to suggestions and we have made adjustments to the standard, where feasible. Before discussing the changes that we have made, I should like to comment on two common criticisms—first, that IAS 39 is too complex and prescriptive (and thus flawed), and second, that the standard, both as originally issued by our predecessor, IASC, and as modified by the IASB, is the result of inadequate consultation and due process.

IAS 39: Bridging two accounting models

It is true that IAS 39 is a complex standard, but the complexity results from an attempt to bridge the worlds of traditional cost-based accrual accounting and a system that is more reliant on market values. The resulting combination of methodologies is what accountants call a mixed attribute model. Undoubtedly, a standard that was based solely on cost or on market values would provide simplicity, but neither solution would be satisfactory

either in attracting broad support or in providing sufficient transparency for the investing public.

When it comes to derivatives, cost accounting is inappropriate, because the cost of derivatives is generally zero, while the potential exposure and risk to a company's financial position can be huge. Large losses can be obscured from both management and investors until the point of realisation. We have seen several cases in Europe (eg, Metallgesellschaft and Barings) and in the United States (eg, Orange County) where the use of derivatives has caused the collapse of seemingly financially stable entities. At the same time, few would accept marking all financial instruments to market and requiring gains and losses to be shown in the income statement. Therefore, we are at present bound to a mixed model, such as IAS 39 or the similar standards that apply in Canada, Japan, or the United States.

In this mixed attribute model, IAS 39 allows similar financial instruments to be accounted for differently depending on management's designation or its stated or intended use of the instruments. Its use of alternative accounting methods necessitates detailed rules to limit the extent to which management can defer losses and manage earnings by the selective recognition of gains and losses and compromises our primary objective of providing of principle-based accounting standards.

IAS 39: A carefully crafted approach

Some commentators and constituents have noted that the IASB has called for a replacement for IAS 39, in an effort to reduce the complexity of the accounting rules for financial instruments. In that light, those commentators have called for the implementation of IAS 39 to be postponed until a better alternative could be found. I believe that finding such a replacement will not be easy and will probably take a long time—a luxury that we did not have in preparation for the adoption of international standards in the European Union. In the absence of an alternative that would provide sufficient transparency, IAS 39—already tested in the marketplace—remained the best option.

Indeed, the existing standard is the result of work begun by our predecessor, IASC, in 1988, and has been subject to several rounds of public consultation and input. After years of deliberation, and the publication of a discussion paper and a subsequent exposure draft, IASC finalised the original IAS 39 in 1998, and companies in Europe and elsewhere have been using the standard since then. A more detailed summary of the due process on IAS 39 is in Appendix B.

When the IASB was formed in 2001, we decided to give priority to addressing some of the implementation problems identified by existing users of IAS 39 in an effort to have an improved standard ready for European companies by 2005. It was the process of consultation initiated by our proposed improvements that provided the opportunity for concerns expressed most notably by the European banking community to come to light.

Responding to constituents' concerns

The 170 comment letters received in response to our initial proposed improvements to IAS 39, published in June 2002, indicated a desire on the part of many respondents for the

IASB to broaden its examination of the standard. We did so after holding a full week of public round-tables discussions with more than 100 organisations in Brussels and London in March 2003.

As a result of the round-tables and other discussions over the following months and our analysis of comment letters, the IASB made numerous changes to the exposure draft before issuing the revised standard in December 2003. The IASB has continued to work on five remaining areas of concern to constituents, particularly among the banking community. These areas included:

1. Macro hedging for banks
2. Mismatch of insurance companies' assets and liabilities resulting from IAS 39
3. Accounting for shares in co-operative entities
4. Fair value option
5. Hedge accounting for banks

I am happy to report that through consultation and collaboration with the affected parties the IASB was able to reach a conclusion on the first three issues that preserved the principles of IAS 39, but addressed the concerns of industry. In March this year the IASB issued an amendment to IAS 39 that permits a form of macro hedging. The IASB worked with the insurance industry to mitigate the problems that might arise from differing valuation techniques of assets and liabilities. Lastly, the IASB's interpretative body, the International Financial Reporting Interpretations Committee (IFRIC), is finalising an interpretation that clarifies the treatment of members' shares.

The discussion that is continuing, both at the IASB and with the European Commission, relates to the last two issues, on which I comment in more detail below.

Fair value option

In response to criticisms about the complexity of the requirements of IAS 39 and the possible introduction of unnecessary accounting volatility in the financial statements, the IASB included a provision to its improved IAS 39 to enable any financial instrument, subject to certain limitations, to be carried at fair value with changes in fair value recognised in profit or loss. The standard allows the fair value measurement of financial instruments on the basis of management's designation of them for that purpose, but to protect against manipulation the IASB limited the use of the fair value option by requiring the fair value designation to be made at the point when the derivative was acquired. Once the designation is made, it cannot be withdrawn throughout the life of the instrument.

In response to concerns expressed by banking supervisors and the European Central Bank, the IASB published an exposure draft of an amendment to limit further the circumstances in which an instrument could be designated for fair value measurement. Generally, banking supervisors were concerned that the designation for fair value measurement could be used to inflate earnings; they also commented that it did not make sense to recognise gains from a decline in the fair value of liabilities resulting from credit deterioration. They were also concerned that the designation might be another step toward the comprehensive use of fair value measurement for financial instruments. Our intention

was not to signal a commitment to move to a full fair value model, but to provide a means of reducing compliance costs.

We have only just received the responses on the proposal to restrict the option and will begin to redeliberate the issues associated with the fair value option this week. The large majority of responses to the exposure draft do not support the proposed tighter restrictions on the grounds that the proposal is excessively complex, would be difficult to make operational, and might reduce the benefits originally envisaged when the original option was introduced into the standard. At the same time, discussions with banking supervisors indicate that their concerns continue.

The IASB recognises that it must bring this matter to a resolution as soon as possible if some form of the fair value option is to be available to first-time adopters in Europe. (The Australian Accounting Standards Board has approved the use of the existing option for Australian companies.). Therefore, we will seek to arrange meetings between representatives of the IASB and interested parties, including the ECB and the Basel Committee, so that we can all exchange views in order to understand the various concerns, with a view to trying to find a solution.

Hedge accounting for banks

As mentioned above, a particular area of contention in IAS 39 is hedge accounting related to banks. In the absence of IAS 39, the banks' prevalent practice was to account for derivatives used for risk management purposes on an accrual basis of accounting. The IAS 39 requirement to account for derivative financial instruments at fair value introduces volatility in profit and loss when the fair values of the derivatives change. However, to the extent that the derivatives are used in a qualifying hedging relationship and are effective in offsetting risk, changes in their fair values do not create volatility in profit and loss under IAS 39. This is because they are either offset in profit and loss with the changes in the fair value of the items being hedged or they are recognised in equity when the hedged items consist of expected future cash flows that will provide the requisite offset in future periods.

The IASB understands that the hedge accounting provisions are not aligned with the way in which banks manage their interest rate risk, the objective of which is to reduce the variability of their accrual basis net interest income (margin). The IASB also understands that banks want more flexibility in measuring the effectiveness of hedging relationships so that the changes in the fair value of derivatives used to reduce the variability of their net interest margin do not create volatility in the financial statements.

The IASB is seeking a solution that is consistent with the principles it has identified that relate primarily to hedge accounting, namely, that derivatives should be measured at fair value; all material hedge ineffectiveness should be identified and recognised immediately in profit or loss; and only items that are assets and liabilities should be presented as such in the balance sheet. Deferred losses are not assets and deferred gains are not liabilities. However, if an asset or liability is hedged, any change in its fair value that is attributable to the hedged risk should be presented in the balance sheet.

However, identifying a satisfactory solution consistent with these principles is difficult. To align hedge accounting with risk management practices would require that such practices be made uniform so that the accomplishment of the objective can serve as a basis for accounting. Banks, however, manage interest rate risk differently and there is no standard or convention for assessing whether a bank's objective of reducing the variability of its net interest margin is in fact being accomplished. Also, fair value accounting used for derivatives is incongruent with the accrual basis of accounting when it is used for assessing interest rate risk management activities. The effectiveness of a hedging relationship cannot be assessed appropriately unless both the derivative hedging activities and interest rate risk management activities are evaluated on the same basis, either on a fair value basis or on a cash flow basis. Also, the IASB is concerned about compromising the effectiveness requirements of IAS 39. Introducing flexibility to effectiveness measurement would defeat the purpose of requiring derivative financial instruments to be carried at fair value and would introduce an undisciplined accounting alternative that could obfuscate in the financial statements the true nature of derivatives activities.

Representatives of the IASB have been working with representatives of the European Banking Federation (FBE) for more than a year to develop improvements to IAS 39. Those meetings resulted in the new hedge accounting solution contained in the amendment issued as *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*. Although the FBE encouraged the IASB to issue this amendment, it also proposed, a few weeks before its publication in March 2004 that another hedge accounting proposal should be considered by the IASB for adoption in addition to the amendment.

Representatives of the IASB have held several meetings with representatives of the FBE to discuss and develop this proposal, which is referred to as the interest margin hedging proposal. At each meeting the IASB representatives have raised important concerns about the proposal, including the ability it would give management to identify a non-existent exposure as a hedged risk. The major concerns were set out in a letter sent to representatives of the FBE on 25 August, and copied to the Commission. The letter asked the FBE to respond to each of these concerns at the next meeting of the IASB and FBE representatives scheduled for later this month. The IASB intends to continue to work with representatives of the FBE to search for a better hedge accounting solution, but it does not believe that the present interest margin hedging proposal is a viable alternative unless major changes can be made to it.

Banks have also expressed concern about the volatility shown in equity under IAS 39 resulting from cash flow hedge accounting. In response to this concern, representatives of the IASB and the FBE have met several times and have corresponded to explore alternatives for presenting cash flow hedge accounting results in equity to better communicate the related risk management activities. We also have explored various footnote disclosure possibilities to describe these activities more fully. We continue to work on the presentation and disclosure possibilities.

Where do we go from here?

The IASB wants to find a better accounting solution for financial instruments that will produce meaningful results without undue complexity and dependence on detailed rules, but experience shows that an ideal solution will take several years to develop. During the

past two years, the IASB has engaged in numerous meetings with constituents to understand better their concerns and to listen to their suggestions for improvements. In response, it has already made changes and has published proposed changes to IAS 39 for public comment to improve the standard in the short term. The IASB has also established a financial instruments working group with the objective of continuing to improve IAS 39 on an ad hoc basis while working toward an ideal solution. The first meeting of that group is scheduled to take place at the end of this month.

The IASB understands the concerns relating to IAS 39, particularly about its complexity, but believes that until a better solution can be identified and developed the discipline required by the provisions of IAS 39 is essential to provide credibility to financial statements prepared under International Financial Reporting Standards and to the development of a common European capital market.

Appendix A – Structure and History of the IASB

The International Accounting Standards Committee (IASC) Foundation, based in London, is the oversight body of the International Accounting Standards Board (IASB). The governance of the organisation rests with 19 Trustees, chaired by former US Federal Reserve Chairman Paul A Volcker. The IASC Foundation is funded by contributions from the major accounting firms, private financial institutions and industrial companies throughout the world, central and development banks, and other international and professional organisations.

The IASB began its work in 2001. The IASB is committed to developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements. In pursuit of this objective, the IASB co-operates with national accounting standard-setters and regional bodies, such as the European Financial Reporting Advisory Group, to achieve convergence in accounting standards around the world.

Appendix B – IAS 39 Due Process

Accounting for financial instruments is a difficult and controversial subject. The International Accounting Standards Board's predecessor body, the International Accounting Standards Committee (IASC), began its work on the issue some 16 years ago in 1988. During the next eight years it published two exposure drafts, culminating in the issue of IAS 32 *Financial Instruments: Disclosure and Presentation* in 1995. IASC decided that its initial proposals on recognition and measurement should not be progressed to a standard, in view of

- the critical response they had attracted,
- evolving practices in financial instruments and
- the developing thinking by certain national standard-setters.

In the meantime, IASC concluded that a standard on the recognition and measurement of financial instruments was needed urgently. It noted that although financial instruments were widely held and used throughout the world, few countries apart from the United States had any recognition and measurement standards for them. In addition, IASC had agreed with the International Organization of Securities Commissions (IOSCO) that it would develop a set of 'core' International Accounting Standards that could be endorsed by IOSCO for the purposes of cross-border capital raising and listing in all global markets. Those core standards included one on the recognition and measurement of financial instruments.

In March 1997, IASC, jointly with the Canadian Institute of Chartered Accountants, published a comprehensive Discussion Paper *Accounting for Financial Assets and Financial Liabilities* and invited comments on its proposals. IASC held a series of special consultative meetings about those proposals with various national and international interest groups and in numerous countries. Those meetings and analysis of comment letters on the Discussion Paper confirmed that IASC faced controversies and complexities in seeking a way forward. While some acceptance existed of the view put forward in the Discussion Paper—that measurement of all financial assets and liabilities at fair value was necessary to obtain consistency and relevance to users—application of that concept to some industries and to some kinds of financial assets and liabilities continued to present difficulties. Concerns focused on reliability, volatility, and the presentation of the effects of changes in values—issues that still exist. Widespread unease was also evident about the prospect of including unrealised gains, particularly on long-term debt, in income as proposed in the Discussion Paper. Furthermore, although several national standard-setters had undertaken projects to develop national standards on various aspects of recognition and measurement of financial instruments, no country had in place or proposed standards that were similar to the proposals in the Discussion Paper.

Completion of a single comprehensive International Accounting Standard on financial instruments based on the Discussion Paper for inclusion, before the end of 1998, in the core standards to be considered by IOSCO was not a realistic possibility. Nonetheless, the ability to use International Accounting Standards for investment and credit decisions and securities offerings and listings was urgent for both investors and business enterprises.

Accordingly, in 1997 IASC decided:

(a) to join with nine national standard-setters to form a Joint Working Group (JWG) to develop the proposals in the 1997 discussion paper. The ultimate aim was an integrated and harmonised standard on financial instruments that would reflect the best research and thinking on the subject worldwide. IASC recognised that this would take several years to develop. The JWG took the first step in the form of a draft standard published in 2000, before the IASB had been constituted.

(b) at the same time, to develop an International Accounting Standard on the recognition and measurement of financial instruments that would serve until an integrated comprehensive standard was completed. This standard would be based on US GAAP—the only major GAAP with comprehensive requirements for financial instruments. The result was IAS 39 *Financial Instruments: Recognition and Measurement*, issued in 1999 after a period of exposure and comment.

In August 2001 the International Accounting Standards Board (IASB) announced, as part of its initial agenda, that it would undertake a project to improve IASs 32 and 39 to simplify their application and implementation.

The IASB invited the IAS 39 Implementation Guidance Committee (IGC) to function as an Advisory Committee to the Board in identifying and reviewing issues that should be addressed. The IGC consisted of senior experts in financial instruments with backgrounds as accounting standard-setters, auditors, bankers and preparers from a range of countries as well as observers from the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO) and the European Commission.

In June 2002 the IASB published an exposure draft of proposed improvements to IASs 32 and 39. In response the IASB received over 170 comment letters. In view of this response, the IASB decided to extend the consultation by conducting a series of public round-table discussions with constituents.

Round-tables are not a routine part of the IASB's due process, but are used when they would assist the development of a standard. The IASB decided to use the round-table format to allow a free and open exchange of views between the IASB and respondents and among respondents who might hold differing views. The IASB's ultimate goal was to determine whether there were better alternative applications of the principles underlying IASs 32 and 39, or whether these existing applications could be simplified. Because of time constraints imposed by the 2005 adoption in some jurisdictions, the IASB did not have sufficient time to reassess the fundamental principles behind existing practices. The round-table participants included 108 of the over 170 individuals, companies, regulatory bodies and other organisations that had commented on the exposure drafts of proposed amendments to IASs 32 and 39.

After the round-table discussions the IASB began the process of public discussions by reviewing the round-table material with its Standards Advisory Council and with its partner national standard-setters.

In March 2003 the IASB began its deliberations, in open Board meetings, of the issues raised on the Exposure Draft, keeping in view the insights obtained from the consultation process. There was one issue that had emerged from the consultation process which the Board decided warranted further debate. Many constituents, particularly in the banking industry, expressed

concern that portfolio hedging strategies that they regarded as effective hedges would not qualify for fair value hedge accounting under IAS 39.

In the light of these concerns, the IASB launched intensive discussions with the banking industry, represented by the European Banking Federation (FBE) to see if a way could be found within the principles of IAS 39 to accommodate macro hedging. As a result, in August 2003 the IASB published a second exposure Draft, *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk,* on this one aspect of IAS 39, proposing an important advance by permitting macro hedging. More than 120 comment letters were received.

However, in order to help those companies preparing to adopt the revised IASs 32 and 39 in 2005, the IASB decided not to delay the finalisation of the rest of those standards for this one issue. Accordingly, the IASB issued the revised standards, subject to any amendments it might make for macro hedging, in December 2003. In March 2004 the IASB finalised the proposal to permit macro hedging and issued the amendment.

In April 2004, the IASB published an exposure draft of a proposed limited amendment to IAS 39, *The Fair Value Option*. This proposal was a direct response to concerns expressed by prudential supervisors of banks, securities companies and insurers that the fair value option might be used inappropriately. The exposure draft proposed to limit the financial assets and financial liabilities to which the option may be applied, while preserving the key benefits of the option. The IASB is now considering the comment letters received on this proposal.