Organismo Italiano di Contabilità – OIC (The Italian Standard Setter)
Italy, 00187 Roma, Via Poli 29
Tel. 0039/06/6976681 fax 0039/06/69766830
e-mail: presidenza@fondazioneoic.it

Mr. Patrick Mommens
Project Manager EFRAG
Avenue des Arts 41
B -1040 Brussels

5 July 2004

Re : Adoption of IAS 32: "*Financial Instruments: Disclosure and Presentation*".

Dear Mr. Mommens,

We are pleased to provide our comments on the Adoption of IAS 32 "*Financial Instruments: Disclosure and Presentation*".

Yours sincerely

Prof. Angelo Provasoli
(OIC – Chairman)

Adoption of IAS 32 “Financial Instruments: disclosure and presentation”

1. Introduction

IAS 32 defines how to represent financial instruments in the financial statements and to this end it requires detailed and important disclosures.
As far as the disclosure requirements are concerned, we cannot say that there are any unacceptable points. However, concerning the requirements referring to the representation of financial instruments in financial statements, some considerations are necessary, especially regarding the two items also indicated by the EFRAG in its own draft document on the adoption of IAS 39 by the European Commission.

2. Unsolved issues

The observations made by the EFRAG referring to the representation in financial statements of preference shares and puttable instruments require further consideration.

Referring to preference shares, it should be pointed out that in order to consider a financial instrument as a financial liability, for the definition of financial liability indicated in IAS 32, there must be a “contractual obligation to deliver cash or another financial asset”. If this requirement is not met, the financial instrument is considered as an equity instrument.
This definition does not appear to be fully in line with what the EFRAG stated when referring to shares for which the issuer has an obligation or a free choice in assigning dividends to shareholders.
According to the EFRAG’s interpretation, in order to be able to consider those shares as a liability instead of equity instruments, it is sufficient that the statutes of an entity envisage the obligation to correspond a dividend to preference shareholders in the presence of income.
However, we consider the necessity of a positive income as a condition for assigning dividends to such shares sufficient to justify claiming the non-existence of an “obligation to deliver cash” as required in the IAS definition of financial liability.
The absence of a positive result implies no obligation for the issuer. Therefore, it is our opinion that the financial instrument should be considered an equity instrument.

Concerning puttable instruments, we agree with the need expressed by the EFRAG to follow the evolution of the explanatory document that the IFRIC is currently preparing.

3. Conclusions

Although we consider a resolution of the abovementioned issues essential, we believe that IAS 32 satisfies the requirements for adoption by the European Commission.
However, we would point out that as IAS 32 is systematically linked with IAS 39 and as it contains numerous cross-references in this sense in the definitions and dispositions, its adoption should be linked with that of IAS 39. Otherwise, should IAS 39 not be adopted, some aspects of IAS 32 would not be applicable.

Organismo Italiano di Contabilità - OIC
(The Italian Standard Setter)
Italy, 00187 Roma, Via Poli 29
Tel. 0039/06/6976681 fax 0039/06/69766830
e-mail: presidenza@fondazioneoic.it

Mr. Patrick Mommens
Project Manager EFRAG
Avenue des Arts 41
B -1040 Brussels

12 July 2004

Re : Adoption of IAS 39: "*Financial Instruments: Recognition and Measurement* The Fair Value Option".

Dear Mr. Mommens,

We are pleased to provide our comments on the Adoption of IAS 39 "*Financial Instruments: Recognition and Measurement* The Fair Value Option".

Please find herewith attached EFRAG's draft reply to the IASB document together with the comments of the OIC.

Yours sincerely

Prof. Angelo Provasoli
(OIC – Chairman)

Question 1

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

Draft Response

In our comment letter dated 18 October 2002 EFRAG welcomed the fair value option in so far as it simplified the application of IAS 39 and facilitated the use of natural hedges. We note that the exposure draft, limiting the use of the fair value option, has been introduced to address the concerns of prudential supervisors and other regulators. We have studied the proposals to see whether they achieve their objective efficiently and if not what alternatives can be put forward.

One effect of the current proposals is that the criteria that need to be met if a change in fair value is to be recognised immediately in the profit or loss now vary depending on whether the item is *required* to be accounted for at fair value through profit or loss or whether it is *permitted* to be accounted for at fair value through profit or loss. EFRAG does not believe that a convincing case has been made in the exposure draft for such “double standards” and is concerned that this will lead to considerable confusion and difficulties of application in practice. For instance, it should be noted that the *verifiable* notion does not exist in other areas of measuring fair values in IFRS.

The proposed limitations introduce the *verifiable* notion which is explained as a stricter test than the *reliable* notion. The Basis for Conclusions (BC 25) explains that the notion *verifiable* has been proposed by analogy to its usage by other standard setters, for example the US standard setter FASB. We were unable to reconcile the IASB’s proposed definition of *verifiable*, which we do not support, with the FASB definition of the term and fail to see how the FASB definition would result in a stricter test than the reliable notion. Following the quoted definition from FASB’s concept statement, we believe that such verifiability would need to be applied to any fair value measurement. We are therefore not persuaded by the IASB’s reasoning for the introduction of the *verifiable* notion. Furthermore, we consider the three examples (a – c), illustrating when the fair value option can be used, redundant since they are merely a repetition of the existing application guidance in IAS 39 (see AG 74 and 76).
In general, we believe that the use of the word *verifiable* in the attempt to introduce a stricter test than *reliable* is not achieving its objective because it is generally accepted that if something is reliable, it should also be verifiable.

More fundamentally, it is our understanding that the objectives of the proposed amendments (to address the inappropriate use of fair values, reduce volatility in profit or loss and avoid recognition of gains or losses in profit or loss for changes in an entity’s own creditworthiness) will not necessarily be met. For instance, where a debt instrument contains an embedded derivative, it would still be possible to apply the fair value option. Similarly, the original fair value option allows (partially) offsetting assets and liabilities to be accounted for in the same way while the proposed limitations introduce criteria such as “contractually linked” and “substantially offset” thereby reinstating some of the stringent hedge accounting rules. As a result, an entity could be required to measure certain items at amortised cost while (partially) offsetting items would need to be measured at fair value, leading to full accounting volatility, despite the fact that from an economic point of view a partial offset exists. Finally, because IAS 39 often mandates the use of fair value, an inappropriate application thereof cannot be excluded.

It is our understanding that the five criteria for applying the fair value option (paragraph 9 (b)) need to be read sequentially. This means for instance that a loan (excluded by the fourth criterion)

could be eligible for the fair value option as long as it contains an embedded derivative (criterion i) or is part of a natural hedge (criterion iii).
The proposals limit the December 2003 improvement of IAS 28 *Investments in Associates* as regards the option to measure investments in associates at fair value in accordance with IAS 39, with changes in fair value recognised in profit or loss in the period of the change. Such a limitation seems in conflict with the underlying reason for the IAS 28 option that fair value information is considered by the Board to be often readily available because fair value measurement is a well-established practice in the venture capital entities, mutual funds and unit trusts (see BC 7 of IAS 28).

EFRAG does not support the reference to prudential supervisors and other regulators because such a reference could lead some to believe that regulators have authority to amend or overrule IFRS for the purposes of financial reporting. While we note that the IASB stresses in its Basis for Conclusions that this is not the case, we do not support the reference to supervisors because EFRAG strongly believes that there should be a clear dividing line between IFRS and prudential requirements.

We support the IASB's attempt to accommodate the concerns raised by prudential supervisors and other regulators while trying to retain the main thrust of the original intention of the fair value option. Therefore, taking into account our comments, we recommend the IASB to reconsider its approach in meeting the concerns in order to make IAS 39 acceptable to those regulatory organisations.

OIC Response

OIC also welcomed the fair value option in so far as it simplified the application of IAS 39 and facilitated the use of "natural hedges", noting the concerns raised by prudential supervisors and other regulators, which have led to the issue of this exposure draft restricting the original proposal.

We agree in finding the proposals "rules based" and not effective in meeting their stated objectives (i) to address the use of inappropriate fair values, (ii) reduce volatility in profit or loss and (iii) avoid the recognition of gains or losses in profit or loss arising from changes in an entity's own creditworthiness. We are as well concerned that the limitation of the use of the fair value option can have the effect of reintroducing artificial volatility in cases of "natural hedges".

OIC also agrees with the statement that the proposed limitations introduce the *verifiable* notion which is explained as a stricter test than the *reliable* notion. We do also agree about the difficulty to reconcile the IASB's proposed definition of *verifiable*, with the FASB definition of the term and fail to see how the FASB definition would result in a stricter test than the reliable notion. Following the quoted definition from FASB's concept statement, we agree that such verifiability would need to be applied to any fair value measurement. Therefore we are also not persuaded by the IASB's reasoning for the introduction of the *verifiable* notion in the attempt to introduce a stricter test than *reliable.*
Moreover, the original fair value option allows instead partially offsetting assets and liabilities to be accounted for in the same way while the proposed limitations introduce criteria such as "contractually linked" and "substantially offset" thereby reinstating some of the stringent hedge accounting rules.

Question 2

Are you aware of any financial instruments to which entities are applying, or are intending to apply, the fair value option that would not be eligible for the option if it were revised as set out in this Exposure Draft? If so:

(a) Please give details of the instrument(s) and why it (they) would not be eligible.

(b) Is the fair value of the instrument(s) verifiable (see paragraph 48B) and if not, why not?

(c) How would applying the fair value option to the instrument(s) simplify the practical application of IAS 39?

Draft Response

It is our understanding that certain financial institutions intend to apply the fair value option to their loans in order to reduce accounting volatility. Further, certain (other) financial institutions intend to apply the fair value option to asset and liability positions that offset each other partially in order to reflect economic exposures and reduce accounting volatility. Under the proposed amendments such a designation would become subject to the stringent hedge accounting requirement of "substantial offset". If the IASB were to adopt the proposed amendments, the "substantially offset" requirement should be replaced by "partially offset". After all, it is our understanding that the 80% - 125% prospective effectiveness test does not apply in the case of the fair value option.

(N.B. While EFRAG is seeking comments on all the points raised in this letter, as well as any other concerns commentators might have, we explicitly ask commentators to let us know of any financial instruments to which entities are applying, or are intending to apply, the fair value option that would not be eligible for the option if it were revised as set out in the exposure draft.)

OIC Response

OIC also believes that certain financial institutions intend to apply the fair value option to asset and liability positions that offset each other partially, in order to reflect economic exposures and reduce accounting volatility. Under the proposed amendments such a designation would become subject to the stringent hedge accounting requirement of "substantial offset". If the IASB were to adopt the proposed amendments, the "substantially offset" requirement should be replaced by "partially offset".

In some other cases, it is true that some entities might intend to apply the fair value option to financial instruments that would not be eligible for the option if it were revised as set out in the exposure drafts. For instance:

Hybrid Instruments: The Fair Value Option contributes to avoiding the need to bifurcate embedded derivatives and, furthermore, to reducing the administrative burden associated with hedge accounting. The current bifurcation rules are overly complex. The cost and administrative burden

associated with maintaining hedge documentation and effectiveness testing (both prospective and retrospective testing) are significant.

If the "verifiable" requirement would be introduced it would become doubtful if it is possible to designate hybrid instruments that do not qualify for bifurcation at fair value. The perverse effect might be that bifurcation would be needed but that it would not be allowed to measure the host contract itself at fair value.

Internal contracts: Often when hedging risk, internal contracts are utilized to exploit the internal market maker expertise, thereby minimizing transaction costs and counterparty exposures. These internal contracts are then accumulated within the centralized department (Treasury) which in turn passes the risk onwards to external parties. Under the IAS 39 rules internal contracts do not qualify for the special hedge accounting treatment. Instead, as part of the documentation requirements, banks would need to link the internal contracts to the external contracts transacted.

The use of the fair value option would avoid this problem to a large extent since there is no requirement to link the internal contracts to the external contracts. The Fair Value Option enables economic hedges (which are disqualified under current hedge accounting rules due to the inability to document the internal-external contracts linkage) to be properly accounted for in the financial statements. As a result, volatility to the financial statements is reduced to a considerable extent.

Question 3

Do the proposals contained in this Exposure Draft appropriately limit the use of the fair value option so as to address adequately the concerns set out in paragraph BC9? If not, how would you further limit the use of the option and why?

Draft Response

EFRAG is content with the original fair value option, since it simplifies the application of IAS 39 and facilitates the use of "natural hedges". Our comments on the means used to limit its application are mostly made in our response to Question 1. We would, however, point out that the proposed amendments do not specifically address the concern of recognition of gains or losses in profit or loss for changes in an entity's own creditworthiness (see BC9 (c)). For instance, as long as a debt instrument contains an embedded derivative, it will be possible to apply the fair value option.

OIC Response

OIC welcomed the fair value option since it simplified the application of IAS and facilitated the use of "natural hedges". For comments on the means used to limit its application, please refer to responses to questions 1 and 2.

Question 4

Paragraph 9(b)(i) proposes that the fair value option could be used for a financial asset or financial liability that contains one or more embedded derivatives, whether or not paragraph 11 of IAS 39

requires the embedded derivative to be separated. The Board proposes this category for the reasons set out in paragraphs BC6(a) and BC16-BC18 of the Basis for Conclusions on this Exposure Draft. However, the Board recognises that a substantial number of financial assets and financial liabilities contain embedded derivatives and, accordingly, a substantial number of financial assets and financial liabilities would qualify for the fair value option under this proposal.

Is the proposal in paragraph 9(b)(i) appropriate? If not, should this category be limited to a financial asset or financial liability containing one or more embedded derivatives that paragraph 11 of IAS 39 requires to be separated?

Draft Response

Since we are in general supportive of the current fair value option because it eases the application of IAS 39 and allows the reduction of accounting volatility we do not favour any (further) restriction. As regards our comments on the proposed limitations, we refer to our response to question 1.

OIC Response

As already pointed out, OIC is supportive of the current fair value option which eases the application of IAS 39, reducing volatility. Therefore, OIC does not favour any other restriction. As regards our comments please refer to response to question 1.

Question 5

Paragraph 103A proposes that an entity that adopts early the December 2003 version of IAS 39 may change the financial assets and financial liabilities designated as at fair value through profit or loss from the beginning of the first period for which it adopts the amendments in this Exposure Draft. It also proposes that in the case of a financial asset or financial liability that was previously designated as at fair value through profit or loss but is no longer so designated:

(a) if the financial asset or financial liability is subsequently measured at cost or amortised cost, its fair value at the beginning of the period for which it ceases to be designated as at fair value through profit or loss is deemed to be its cost or amortised cost.

(b) if the financial asset is subsequently classified as available for sale, any amounts previously recognised in profit or loss shall not be reclassified into the separate component of equity in which gains and losses on available-for-sale assets are recognised.

However, in the case of a financial asset or financial liability that was not previously designated as at fair value through profit or loss, the entity shall restate the financial asset or financial liability using the new designation in the comparative financial statements.

Finally, this paragraph proposes that the entity shall disclose:

(a) for financial assets and financial liabilities newly designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the previous financial statements.

(b) for financial assets and financial liabilities no longer designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the current financial statements.

Are these proposed transitional requirements appropriate? If not, what changes do you propose and why? Specifically, should all changes to the measurement basis of a financial asset or financial liability that result from adopting the amendments proposed in this Exposure Draft be applied retrospectively by restating the comparative financial statements?

Draft Response

EFRAG supports the pragmatic approach as regards the transitional requirements – i.e. no retrospective application when an entity changes the measurement from *at fair value through profit and loss* to amortised cost.

OIC Response

OIC agrees with EFRAG in supporting the pragmatic approach as regards the transitional requirements, i.e. no retrospective application when an entity changes the measurement from *at fair value through profit and loss* to *amortised cost*.

Question 6

Do you have any other comments on the proposals?

Draft Response

If, despite our comments expressed above, the IASB decides to move forward with the introduction of the *verifiable* notion, we recommend that it should require companies to disclose information on how they have met the verifiability test (e.g. by obtaining several independent estimates).

OIC Response

OIC also agrees with EFRAG that if the IASB, despite the comments expressed above, should decide to introduce the verifiable notion, disclosing information on how entities have met the verifiability test would be required.

Organismo Italiano di Contabilità – OIC (The Italian Standard Setter)
Italy, 00187 Roma, Via Poli 29
Tel. 0039/06/6976681 fax 0039/06/69766830
e-mail: presidenza@fondazioneoic.it

Mr. Reinhard Biebel
Project Manager EFRAG
Avenue des Arts 41
B -1040 Brussels

5 July 2004

Re : ED Proposed Amendments to IFRS 3 Business Combinations: *Combinations by Contract Alone or Involving Mutual Entities.*

Dear Mr. Biebel,

We are pleased to provide our comments on ED Proposed Amendments to IFRS 3 Business Combinations: *Combinations by Contract Alone or Involving Mutual Entities.*

Yours sincerely

Prof. Angelo Provasoli
(OIC – Chairman)

DRAFT LETTER BY OIC ON IFRS 3

OIC considers IFRS 3 a significant improvement over the now superseded IAS 22 and also an important steps towards convergence with USA gaaps.

However we continue to have a strong concerns on some matters already raised in our comment letter of March 4, 2003 on ED3. We are therefore extremely disappointed that our proposals for changes have not been accepted by the Board.

We refer particularly to the recognition of contingent liabilities of the acquiree as part of allocating the cost of a business combination. We reiterate that this recognition is inconsistent with IAS 37 and with the Framework. It is inconsistent also with the fact that contingent assets of the acquiree are not taken into account. While we are of the opinion that contingent assets should not be part of the allocation exercise we nevertheless note the inconsistency with contingent liabilities and such inconsistency has no justifiable reason.

We are also disappointed with the provision that negative goodwill should always be recognised to profit and loss. We continue to believe that when negative goodwill is a "premium" against future losses, this negative goodwill should be deferred to offset expected losses when these materialize.

In our comment letter to ED3 we also suggested to consider amortization of goodwill in those circumstances where future cash flows cannot be reliably determined. Our suggestion, which we still believe appropriate, has not been accepted by the Board.

We also had a suggestion to consider time value (i.e. discounting) deferred taxes in those cases where it is possible to reasonably estimate timing of reversal and to amend IAS 12 accordingly. Our suggestion, regrettably not accepted, would have avoided a mismatch in measurement whereby assets and liabilities assumed in a business combination are measured taking into account time value but the related tax effect does not take into account time value.

The above comments denote a number of disagreement with IFRS 3 as promulgated but considering that it is nonetheless an improvement over IAS 22, we recommend its adoption by Efrag. We however urge the Board to reconsider our comments above in future so that the Board can correct what we consider intellectual mistakes.

We also urge the Board to complete Phase II of the project on Business Combination given the importance of the subject.

Organismo Italiano di Contabilità – OIC (The Italian Standard Setter)
Italy, 00187 Roma, Via Poli 29
Tel. 0039/06/6976681 fax 0039/06/69766830
e-mail: presidenza@fondazioneoic.it

Mr. Patrick Mommens
Project Manager EFRAG
Avenue des Arts 41
B -1040 Brussels

5 July 2004

Re : Exposure Draft of proposed Amendments to IAS 19 *Employee Benefits:* Actuarial Gains and Losses, Group Plans and Disclosures.

Dear Mr. Mommens,

We are pleased to provide our comments on the draft reply of EFRAG to the European Commission, which deals with the Exposure Draft of proposed Amendments to IAS 19 *Employee Benefits:* Actuarial Gains and Losses, Group Plans and Disclosures.

General comments by EFRAG on the Exposure Draft of *proposed Amendments to IAS 19 Employee Benefits: Actuarial Gains and Losses, Group Plans and Disclosures are totally shared by OIC* and consequently on *IAS 1.* We fully agree with EFRAG comment not to support the proposed core amendment to recognise actuarial gains and losses as they occur in the balance sheet and in the so called SORIE (Statement Of Recognised Income and Expense).
EFRAG's general comments have correctly underlined that splitting the statement of changes in equity in two parts, one of which deals with transactions other than with shareholders, causes a negative impact on comprehensive income that consequently would be pre-empted.

We make also a further consideration. This new option on the recognition of actuarial gains and losses outside profit and loss keeps difficult to compare different balance sheets. Actually, actuarial gains and losses are just part of income and expense. Please remind IASB that comparability is the essential target that is at the basis of all new principles and too many options are not consistent with this outcome.

Yours sincerely

Prof. Angelo Provasoli
(OIC – Chairman)

<u>Question 1 - Initial recognition of actuarial gains and losses</u>

IAS 19 requires actuarial gains and losses to be recognised in profit or loss, either in the period in which they occur or on a deferred basis. The Exposure Draft proposes that entities should also be allowed to recognise actuarial gains and losses as they occur, outside profit or loss, in a statement of recognized income and expense.

Do you agree with the addition of this option? If not, why not?

OIC Response

We totally agree with the answer.
We also consider that the provision under the current IAS 19 to determine an amortisation period within the residual average life of beneficiary workers does not mean a lack of transparency in the balance sheet but rather it increases the transparency on the respect of the compliance with the future commitments towards those workers.

<u>Question 2 - Initial recognition of the effect of the limit on the amount of a surplus that can be recognised as an asset</u>

Paragraph 58(b) of IAS 19 limits the amount of a surplus that can be recognized as an asset to the present value of any economic benefits available to an entity in the form of refunds from the plan or reductions in future contributions to the plan (the asset ceiling). The Exposure Draft proposes that entities that choose to recognise actuarial gains and losses as they occur, outside profit or loss in a statement of recognised income and expense, should also recognise the effect of the asset ceiling outside profit or loss in the same way, i.e. in a statement of recognised income and expense.*

Do you agree with the proposal? If not, why not?

OIC Response

We agree with EFRAG's answers

<u>Question 3 - Subsequent recognition of actuarial gains and losses</u>

The Exposure Draft proposes that, when actuarial gains and losses are recognised outside profit or loss in a statement of recognised income and expense, they should not be recognised in profit or loss in a later period (i.e. they should not be recycled).

Do you agree with this proposal? If not, why not?

OIC Response

We agree with EFRAG's answers

Question 4 - Recognition within retained earnings

The Exposure Draft also proposes that, when actuarial gains and losses are recognised outside profit or loss in a statement of recognised income and expense, they should be recognised immediately in retained earnings, rather than recognised in a separate component of equity and transferred to retained earnings in a later period.

Do you agree with this proposal? If not, why not?

OIC Response

We agree with EFRAG's answers

Question 5 - Treatment of defined benefit plans for a group in the separate or individual financial statements of the entities in the group

(a) The Exposure Draft proposes an extension of the provisions in IAS 19 relating to multi-employer plans for use in the separate or individual financial statements of entities within a consolidated group that meet specified criteria.

Do you agree with this proposal? If not, why not?

(b) The Exposure Draft sets out the criteria to be used to determine which entities within a consolidated group are entitled to use those provisions.

Do you agree with the criteria? If not, why not?

OIC Response

We agree with EFRAG's answers

Question 6 - Disclosures

The Exposure Draft proposes additional disclosures that

(a) provide information about trends in the assets and liabilities in the defined benefit plan and the assumptions underlying the components of the defined benefit cost and

(b) bring the disclosures in IAS 19 closer to those required by the US standard SFAS 132 Employers' Disclosures about Pensions and Other Postretirement Benefits.

Do you agree with the additional disclosures? If not, why not?

OIC Response

We agree with EFRAG's answer on b) but we consider that having more information on the assumptions underlying the components of the defined benefit cost would be helpful to balance sheet's users.

<u>Question 7 – Further Disclosures</u>

Do you believe that any other disclosures should be required, for example the following disclosures required by SFAS 132? If so, why?

(a) a narrative description of investment policies and strategies;

(b) the benefits expected to be paid in each of the next five fiscal years and in aggregate for the following five fiscal years; and

(c) an explanation of any significant change in plan liabilities or plan assets not otherwise apparent from other disclosures.

SFAS 132 also encourages disclosure of additional asset categories if that information is expected to be useful in understanding the risks associated with each asset category.

OIC Response

We believe that having more qualitative information on strategies, changes in plans and workers' residual life would be helpful. On the contrary further quantitative data - as the benefits expected to be paid- which are based only on expectations could cause confusion to the users.