Deloitte.

Deloitte Touche Tohmatsu
2 New Street Square
London EC4A 3BZ
United Kingdom

Tel: +44 (0) 20 7936 3000
Fax: +44 (0) 20 7583 1198
www.deloitte.com

Direct: +44 20 7007 0907
Direct Fax: +44 20 7007 0158
kwild@deloitte.co.uk

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

Email: commentletters@iasb.org

14 September 2009

Dear Sir David,

Re: Exposure Draft 2009/7 Financial Instruments: Classification and Measurement

Deloitte Touche Tohmatsu is pleased to respond to the Exposure Draft, ED/2009/7, *Financial Instruments: Classification and Measurement* (the "ED"). IAS 39 *Financial Instruments: Recognition and Measurement* has proven to be a complex standard that has been both difficult to understand and apply and therefore we welcome the Board's effort to replace it with an improved standard, of which this ED forms part of.

We acknowledge the political and regulatory environment in which the IASB is operating. Requests for action by the G20 leaders on a replacement to IAS 39 that is available for use in 2009 have led to the acceleration of the classification and measurement aspects of this project. We commend the IASB for proposing an ED within such a short space of time with the aim of trying to fulfill this objective. Assessing the relative merits of the replacement to IAS 39 in parts clearly limits our ability to evaluate the proposals comprehensively as there are many areas that are yet to be finalised with which the classification and measurement proposals will interact. We therefore look forward to the issue of EDs on the other aspects of this project in order for us to understand and fully assess the replacement to IAS 39 in its entirety.

We note that the US FASB is currently deliberating its preferred model for financial instrument accounting. Tentative decisions to date indicate that the FASB are reaching different conclusions on some critical areas. We strongly encourage the IASB and FASB to work together over the coming months with the aim of ultimately agreeing to a single converged standard for financial instrument accounting. We appreciate that the IASB is managing multiple objectives such as revising financial instrument accounting within a short time frame and at the same time pursuing global convergence.

We support the IASB's approach for a mixed measurement model for both financial assets and financial liabilities. We believe amortised cost is a meaningful measurement attribute for certain financial instruments in certain circumstances when it is accompanied by fair value disclosures. Focusing on whether financial instruments have basic loan features and how the entity manages those instruments is a meaningful approach to determining whether an

instrument can be measured at amortised cost. We have specific concerns and recommendations about how to make the amortised cost criteria more relevant and meaningful which are included in the appendix to this letter. Our more significant concerns with the ED are with respect to:

- Embedded derivatives. We broadly support the removal of embedded derivatives in financial instruments, however, we have concerns about the increasing use of fair valuation of own credit risk for those financial liabilities that fail the basic loan features criterion. As stated in our response to *Credit Risk in Liability Measurement*, dated 1st September 2009, we propose alternative measurement methods that limit the extent to which own credit risk is included in current measurement. Until resolution of this aspect of liability measurement our preference would be to retain the option for an entity to apply bifurcation of non-closely related embedded derivatives in financial liabilities only.
- Credit risk/subordination. Our preference is to assess whether credit risk/subordination is a basic loan feature based on an assessment of the exposure to credit risk of the assets in the issuing entity. Multiple contractually subordinated tranches may be regarded as containing basic loan features if those tranches pass the credit risk of referenced assets that the issuing entity owns and those assets have basic loan features. Where a tranche(s) is junior relative to other tranches and absorbs variability that is significantly in excess of the credit risk associated with direct investment in the underlying assets, for example an ‘equity tranche’, that tranche should not be considered as having basic loan features.
- Acquisition of distressed debt. We believe a debt instrument that has incurred impairment losses at the date of acquisition should not automatically fail amortised cost measurement criteria. If the terms of the instrument are basic and the acquirer manages the contractual cash flows of the instrument amortised cost measurement is appropriate.
- Reclassifications. If the business model overlay in the amortised cost criteria is a matter of fact, and is not generally expected to be subject to change, we consider it reasonable that should there be a change in the business model that this event should *require* reclassification of those instruments if they contain basic loan features.
- Fair value disclosures. Where financial instruments are measured at an amount other than fair value the disclosure of fair value is an important disclosure that compliments the measurement in the statement of financial position. Disclosure of fair values should be sufficiently prominent in the financial statements and be presented in a timely manner to provide users with a comprehensive picture of financial performance.
- Fair value through other comprehensive income. Our preference is for investments in equity investments to be FVTPL. However, should the IASB pursue an alternative to FVTPL for investments in equity instruments that are not held for trading our preference would be to retain the current AFS category for those investments and make changes to the impairment requirements.
- Transition. It should be clear that those entities that choose to early adopt the classification and measurement proposals should not be disadvantaged relative to those that choose to defer adoption until the mandatory effective date. A clear signal is needed from the IASB whether an early adopter of this proposal will be forced to early adopt the other parts of the wider project, and whether classification and measurement decisions undertaken prior to the other parts of the project being complete can be reconsidered. Such uncertainties provide a disincentive to early adoption of the classification and measurement standard.

Financial instruments accounting is critical for those entities that are subject to IFRS 4 *Insurance Contracts*. As insurance liabilities are funded by investments in financial

instruments it is important that insurance entities are able to present meaningful financial performance after finalisation of Phase II of the insurance project on insurance measurement. We recommend that the Board consider how the replacement to IAS 39 will interact with the finalisation of insurance measurement when the latter project is complete. Reliefs that aim to minimise the extent of accounting mismatch between the measurement of financial instruments and insurance contracts could be considered.

Our detailed responses to the questions for respondents are included in the Appendix to this letter.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907 or Andrew Spooner in London at +44 (0) 207 007 0204.

Sincerely,

Ken Wild
Global IFRS Leader

Appendix 1

Question 1
Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

We believe amortised cost is a measurement attribute that provides useful information in certain circumstances. We support amortised cost measurement for non-derivative debt instruments (both assets and liabilities) with basic loan features where the focus of the business model is on receiving/paying the contractual cash flows, not on the cash flows that can be generated or would be payable from disposal of the financial instrument. In such cases disclosure of fair value in the financial statements should be required.

Question 2
Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a contractual yield basis'? If not, why? What additional guidance would you propose and why?

We do not believe that "managed on a contractual yield basis" is the most appropriate business model condition to identify instruments that can qualify for amortised cost accounting. Instead, we would amend the condition to be "not managed on a fair value basis or its performance not primarily evaluated on a fair value basis". We also disagree with conclusions reached on acquired debt with incurred credit losses as explained below. We believe the ED requires a clear principle as to why an instrument with basic loan features and managed on a contractual yield basis can be measured at amortised cost. In addition, as set out below, we believe that the principle behind <u>what</u> constitutes a basic loan feature should be stated more clearly with specific reference to leverage and supported by examples of common instruments.

Managed on a contractual yield basis

We support the introduction of a business model criterion in addition to the basic loan features criterion. We also agree that if the entity's business model is focused on receiving or paying the contractual cash flows of the instrument, rather than focused on the cash flows from selling an asset (or payments to transfer or settle a liability) that the instrument should be eligible for amortised cost measurement. However, we do not believe "managed on a contractual yield basis" is the most appropriate description. The term 'managed' can imply there is active management of the contractual yield, when in many cases, there is not. For example, with short term payables/receivables most entities do not consider the time value of money (and therefore the yield) and equally do not actively manage the cash flows, rather they await receipt of cash flows (and manage the credit risk for late receipt) in the case of receivables, and in the case of payables determine the cash payment date based on the wider liquidity management of the entity. For longer term liabilities, such as issued debt, management is not always active, rather the entity pays its obligations when due and in many cases has no ability to buy back the debt outside the contractual terms. If the intent of the ED is to ensure that amortised cost is not appropriate if management decisions are primarily based on what an asset or liability is worth (i.e. its fair value), we suggest the amortised cost criteria in paragraph 4(b) could be amended to: "*the instrument is not managed on a fair value basis or its performance not primarily evaluated on a fair value basis*".

Due to the application difficulties of the term 'managed on a contractual yield basis' discussed above, if the term is retained then more application guidance is needed. We note

that paragraph B12 contains examples of what does and does not meet the criterion, but that guidance is not sufficient to explain the principle, as the guidance focuses on scenarios at the two extremes of the spectrum, e.g. trading versus receiving/paying all contractual cash flows until maturity. We suspect that many business models fall somewhere in the middle between these two extremes. It is not clear whether the following practices meet the criteria:

- Investment in debt instruments held by a central treasury operation to provide a return on surplus funds where sale of the instruments may occur prior to maturity depending on whether the entity finds alternative investment opportunities, e.g. business combinations, or sale due to unexpectedly high operating costs or falling revenues.
- Investment in debt instruments where the entity expects to hold the instruments in order to fulfill insurance obligations, yet, the entity stands ready to sell the debt instrument based on higher than expected levels of claims under the insurance contracts.
- Investments in debt instruments held for long term investment purposes and primarily managed on a contractual yield basis but within the trading department of a bank that also monitors fair value performance on a secondary basis (by including the instruments in the reporting of its trading book). Some of these investments may be sold in certain circumstances based on their fair value performance, however, the primary strategy would be to hold the instruments to earn the contractual yield.
- Financial institutions that manage their business on a *net* contractual margin basis (i.e. net financial asset and financial liabilities), rather than focus on the gross contractual yield. An example would be a deposit-taking financial institution using the proceeds from deposit taking for mortgage lending.
- Investment in debt instruments where the business unit will secure finance by selling the debt instruments to a special purpose entity (SPE) as part of a securitisation. If at initial recognition it is intended that the anticipated transfer will result in derecognition will the entity be able to meet the criterion for managed on a contractual yield basis? In addition, if the derecognition guidance is subject to change, will this change impact the extent to which amortised cost measurement can apply?
- Management focus on the net (synthetic) post-hedging yield, rather than the contractual yield of the instrument. It is not uncommon when an entity has issued or lent fixed or floating rate debt that is hedged with interest rate swaps (or options) for management information to focus on the yield that includes the effect of hedges. Such information is not based on the contractual yield of the non-derivative debt instrument that the ED requires.
- Certain entities outsource the investment management function to professional fund managers. The fund manager performance is generally assessed on a total return basis, which may not equate exactly to the contractual yield basis.

As stated above, the criterion “managed on a contractual yield basis” should be replaced with “not managed on a fair value basis or its performance not primarily evaluated on a fair value basis” as we believe this will be more operational in practice.

We also believe that the ED is not clear as to whether parts of a single financial instrument can be classified differently based on one part meeting the “managed on a contractual yield basis” criterion and the other part not. For example, it is very common that a lead lender will originate funds to a borrower with the intention of sub-participating (selling) a significant amount of the loan to other banks. This is either predetermined prior to the original lending, i.e. during the period of the loan commitment, or determined at the date the amount is lent. This practice will be evident from the entity’s business model. Assuming that a loan held to be sub-participated is not managed on a contractual yield basis, does this mean that the *entire* instrument must be classified as at FVTPL, even though the lead lender does not have the business objective to sell all of the lending and will retain a proportion?

Debt with incurred credit losses

We disagree that a financial asset that is acquired at a discount that reflects incurred credit losses cannot be managed on a contractual yield basis. If this criterion is to be retained we suggest the IASB reconsider their position on the accounting for loans with incurred losses. We believe the proposed approach has the effect of different accounting treatments depending on whether the holder has originated a loan or acquired the loan in the secondary market. This distinction does not exist elsewhere in the ED.

While we accept that the holder of 'distressed debt' has the potential benefit of gaining due to a reduction in the borrower's non-performance risk, we believe this potential benefit should not be the reason the holder is deemed not to manage the instrument on a contractual yield basis. The reduction in non-performance risk, thereby increasing the probability of payment under the contractual terms, also exists in originated loans, particularly in cases where the risk of non-payment is significant at origination.

Certain entities acquire distressed receivables with the objective to maximise the contractual recoverable cash flows via their perceived better credit risk processes. Such instruments are managed on a contractual yield basis, i.e. buying and holding, as opposed to buying to sell. Similarly, if a financial institution is acquired, there are likely to be loans within the business which do have incurred credit losses. The acquirer may well have the intention to hold the instrument and receive the contractual cash flows. It does not seem appropriate that the acquirer should be forced to measure such loans at FVTPL post the business combination if the business model is not to sell the loan book.

We also consider that assessing whether an instrument has incurred credit losses is not practical in some cases. In the cases of an acquisition of a portfolio of assets the incurred losses may not be specific to an asset, rather the portfolio is subject to a portfolio impairment provision based on statistical default data representing incurred but not reported losses. In such cases, it is not clear whether the ED would require all loans (or none of the loans) acquired in the portfolio to be measured at FVTPL as individual loans with incurred losses cannot be identified.

Further, complexity will be introduced should the IASB pursue an expected loss model for loan loss impairment as the standard will need to retain incurred loss guidance in order to assess the classification of distressed debt. We do not believe retaining two impairment loss models in the standard, one for loan loss measurement, one for initial classification, is necessary or would qualify as an improvement.

If an entity's business model is to acquire distressed debt with the objective of receiving the contractual cash flows on the asset, without the intention to realise any potential improvement in credit quality through sale, then we believe the entity can be deemed as managing on a contractual yield basis, and that amortised cost measurement provides meaningful information.

Basic loan features

To make the principle of what constitutes a basic loan feature clearer we would propose that the first two sentences of paragraph B1 illustrate a principle (being compensation for time value of money and credit risk of the borrower) and that this principle should be separated out from the remainder of that paragraph. Additionally, the principle should state that the instrument must not contain leverage, a term which should be defined in the standard. The lack of leverage is a principle referred to once in the basis of conclusions in paragraph BC21 and should be made clearer and more prominent in the main body of the standard.

Once the principle is established, we believe the remaining application guidance paragraphs should illustrate the application of that principle and include the examples as previously set out in paragraph B3. We note paragraph B3 provides examples of basic loan features and therefore it would be beneficial for the standard to say that paragraph B3 is not an exhaustive list of basic loan features. A clear principle, that includes reference to leverage, preceding the list, will make the guidance more operational as terms not included in the list in paragraph B3 can be assessed against the principle, not the list.

When assessing the classification of instruments issued by an entity the guidance for applying the basic loan feature principle should make it clear that it is not required to look through the contractual terms of the instrument to the underlying assets and liabilities of the issuing entity, except for the purposes of identifying credit risk leverage as described in our response to Question 4(b). For example, if an SPE is set up to construct a particular asset its debt finance should not automatically be considered as failing the basic loan feature test simply because the performance the debt is indirectly derived by the performance of the asset in the SPE. Whether an instrument contains wholly basic loan features is determined by assessing the terms of the instrument only.

We believe some further examples of common instruments should be added to paragraph B3 to make the application guidance more useful. These should include certain:

- Inflation-linked debt
- Interest only and principal only strips
- Dual-currency bonds
- Perpetual debt instruments

The reasons for their inclusion are explained below. We also believe that it would be useful to confirm that the following features in certain cases would not prevent an instrument from being analysed as having basic loan features: choice of market rate of interest, term extension options and prepayment options triggered on change of control. Equally, it would be useful to confirm that the following instruments do not satisfy the basic loan features criterion: derivatives, inverse floating rate bonds and financial guarantees.

Inflation-linked debt

Paragraph B3(iii) refers to “single reference quoted or observable interest rate (such as LIBOR)”. We also note in the proposed consequential amendments of other standards that IAS 39.AG99F(c) is amended to make it clear that an inflation-linked bond may be measured at amortised cost provided the principal of the debt is protected from erosion by negative inflation. We agree that such an instrument has basic loan features if the inflation linking is not leveraged and the inflation rate is consistent with the denomination of the instrument. The example of inflation-linked debt should be included in paragraph B3.

Interest only and principal only strips

Interest only and principal only strips are common, some of which are prepayable and some are not. We suggest including a sub-paragraph in paragraph B3 describing the accounting for these instruments. Our conclusion, based on the principle described in paragraph B1 and the need for a lack of leverage, is that a non-prepayable fixed rate interest only strip could meet the definition of basic loan features as it is merely an amortising loan. Similarly, a non-prepayable principal only strip could meet the definition of basic loan features as it is simply a zero-coupon bond. However, a floating rate interest only strip is not basic, as it appears to meet the definition of a derivative. Also, a prepayable fixed rate interest only strip where

prepayment on the referenced principal results in the interest only strip terminating for nil consideration, or a prepayable zero coupon bond where prepayment results in acceleration of the principal (i.e. the interest of future periods not yet earned) are not basic as the payments on prepayment are leveraged. Clarification of the application of the principle in paragraph B1 by including these instruments in the list in paragraph B3 would be helpful.

Dual-currency bonds

Paragraph B2 states that an entity assesses basic loan features in the denomination of the instrument. With the removal of IAS 39.AG33(c) on dual-currency bonds we suggest this instrument is included in the list in paragraph B3. Otherwise, based on the principle that the interest is compensation for the principal inherent in the instrument, dual-currency bonds would not be considered basic as the bond represents an interest only strip that is priced off a notional that is different to the principal of the instrument. With the exception of a non-prepayable fixed rate dual currency bond, which could be characterised as an amortising loan and zero coupon bond in different currencies, one would conclude that dual-currency bonds do not have basic loan features.

Perpetual debt instruments

The inclusion of perpetual debt instruments should be added to the list of paragraph B3. These are common instruments but it is not clear whether they can contain only basic loan features. If a non-prepayable perpetual debt instrument results only in a fixed or floating contractual interest return (i.e. non-discretionary for the issuer) then would the instrument fail the basic loan features test as the instrument does not result in a principal repayment? Also, in the case where the holder has the ability to require the borrower to prepay, i.e. force the issuer to repay the notional upon which perpetual interest is based, does the instrument have basic loan features as it has repayment of interest and principal? Clarity on the treatment of such instruments would be beneficial.

Instruments with choice of market rate

Some variable rate debt instruments permit the borrower (or lender) to choose the market rate on an ongoing basis. For example, at each reset date the borrower can choose to pay 3m LIBOR, or 1m LIBOR. At each payment date the interest on the debt instrument is reset to a market rate that will apply for the next period and so on. Therefore, at each quarter the borrower will choose for the next quarter whether it will pay 3m LIBOR or 1m LIBOR, payable in arrears. If the entity chooses 3m LIBOR it can choose at the next payment date to stick with 3m LIBOR or instead pay 1m LIBOR for the 3 months within that next quarter. This results in an equivalent interest rate that would have been payable had the entity issued debt with a 3 month term based on 3m LIBOR, and then chose to reissue debt with a 3 month term based on 3m LIBOR or a 3m term based on 1m LIBOR. We note that paragraph B3(a)(iii) refers to a "single referenced quoted or observable interest (such as LIBOR)". It is unclear whether the above instrument would be basic as it is linked solely to LIBOR which is a single referenced rate, even though within LIBOR there are many different frequencies, e.g. 1m, 3m, 6m LIBOR etc.

Some instruments also permit the borrower to choose a predetermined fixed rate of interest for the remaining term of the loan or for an extended period (see also term extension options below). Guidance as to whether this would represent a basic loan feature would also be beneficial.

Prepayment options

It is unclear whether the reference to contractual terms that "protect the creditor or debtor (see paragraphs B3(c))" in paragraph B1 relates only to prepayment provisions in paragraph B3(c). We suspect it does, and if so, it should either be made clearer in paragraph B1, or instead deleted from paragraph B1, and retained only in paragraph B3(c).

Paragraph B3 refers to examples of contingent events that permit prepayment that protect the lender. The paragraph refers to 'taxation, law and similar factors'. We believe 'change of control' should be included in the list. It is very common for lenders to be able to elect to demand early repayment from the borrower in the case where the borrower has a change of control. This prepayment option protects the investor in the case where the acquirer has a worsening credit quality than the acquiree (borrower) as it ensures the lender can cease its lending arrangement and not be disadvantaged by the new owner of the borrower.

In our view issuer prepayment options that are contingent on the entity obtaining new equity finance or raising cash from the sale of a significant asset should not be considered to be contingent on future events for the purposes of applying paragraph B3(c). Also, non-substantive contingent features should be ignored in the assessment of an instrument for basic loan features.

Term extension options

Paragraph B3(c) focuses on prepayment options but does not refer to term extension options. We presume extension options, i.e. options that permit the borrower to extend the term of the borrowing at a pre-specified rate(s) (which may or may not be a market rate(s) in the future) may also be considered a basic loan feature. Instruments with a maturity plus an option to extend are substantially similar to a fixed term instrument with an option to prepay. We suggest paragraph B3(c) includes such terms with the restriction that the terms of the debt instruments following exercise of the term-extension option must result in the instrument always having basic loan features, i.e. the interest following the extension could not be linked say to an equity, commodity price, etc. If the entity cannot establish whether the terms of the instrument following exercise of the term extension option will contain only basic loan features then at initial recognition of the instrument that includes the term extension option that instrument cannot be regarded as having basic loan features.

Derivatives

The ED requires an entity to assess whether *all* financial instruments shall be measured at amortised cost under paragraph 4 (i.e. whether they have basic loan features and are managed on a contractual yield basis). It is not clear in the main body of the standard that derivative financial instruments in the scope of the standard fail this criterion.

Paragraph B5 justifies why an interest rate swap, forward contract or option do not contain basic loan features. Critical to this conclusion is that the instrument's contractual cash flows are not payments of principal and interest on the principal outstanding. We question whether this statement is equally applicable to a gross settled cross-currency swap with the gross exchange of principals at inception and at maturity. We do not believe it was the intention of the IASB to permit such derivatives to be measured at amortised cost.

To avoid the risk of such an interpretation and to improve the structure of the proposals we suggest the term "non-derivative" be inserted at the start of paragraph 4 as it is only non-derivative financial instruments that can be measured at amortised cost. Therefore, a derivative will automatically fall into paragraph 5 to be measured at fair value (with gains and losses recognised in profit or loss unless prescribed otherwise by specific rules, for example hedge accounting). Our proposed drafting is included in Appendix 2 of this letter.

Inverse floating rates

We believe paragraph B3(a)(iii) should also make clear that the interest rate should be directional with the amount of principal due or payable. For example, a variable return on a lending will result in the interest due/payable rising when the single referenced quoted or observable interest rate rises (and vice versa). This should avoid the inclusion of 'inverse-floating' terms being regarded as basic loan features. This clarification would also be consistent with the IFRS for SMEs upon which the basic loan features criterion is based[1].

Financial guarantees and loan commitments

Paragraph 5 should be amended to reflect that some financial instruments that meet the definition of a derivative (so do not have basic loan features) and also are not investments in an equity instrument are *not* measured at fair value, specifically written financial guarantee contracts and loan commitments to provide a loan at a below-market interest rate that are in the scope of IAS 39. Paragraph 5 as currently drafted would *require* issued financial guarantee contracts and loan commitments that are in the scope of IAS 39 to *always* be subsequently measured at fair value. Our proposed drafting is included in Appendix 2 of this letter.

Furthermore, it is not clear how an entity still has the ability to be able to designate a loan commitment as at FVTPL under IAS 39.4(a) and to designate an issued financial guarantee contract as at FVTPL under paragraph IAS 39.AG4, as the fair value option appears to only be available for instruments that would be required to be measured at amortised cost. Paragraph 9 of the ED needs to be amended to reflect that loan commitments and issued financial guarantee contracts can also be designated as at FVTPL. Our proposed drafting is included in Appendix 2 of this letter.

Constant maturity swap bonds

It would be beneficial if the principle, or in the examples, states whether a floating interest can be derived from a single referenced quoted interest rate where the rate is derived from instruments with a different term to maturity than the instrument being assessed. For example, the interest rate on a debt instrument that has a 5-year term at origination can be a single referenced quoted 5-year constant maturity rate, (i.e. the contractual interest rate will be equal to a yield for a debt instrument that always has 5 years until it matures). Such a term would not appear to be basic as the interest rate payable in all periods (except for the first period) is disconnected with the term to maturity of the instrument. We believe the intention of the Board was to permit a floating rate based on the spot rate that is applicable at the date of reset for the period to the next reset as a basic loan feature. However, in other cases like the instrument described above the guidance is less clear and therefore clarification would be beneficial.

Financial liabilities arising from a failed derecognition

It is not clear how financial liabilities arising upon a failed derecognition transaction should be classified. Firstly, it is not clear how an entity should assess whether they have basic loan features and are managed on a contractual yield basis when in many cases the cash flows on the financial liability are imputed for accounting purposes as a result of failed derecognition, i.e. the entity has not issued a financial instrument, rather it has failed to derecognise an asset

[1] IFRS for SMEs paragraph 11.9(iv) states: "some combination of such fixed rate and variable rates (such as LIBOR plus 200 basis points), provided that both the fixed and variable rates are positive (e.g. an interest rate swap with a positive fixed rate and negative variable rate would not meet this criterion).

and the recognised financial liability is the contra-entry to the proceeds received on the failed sale. This is important irrespective of whether the model for derecognition changes.

Under the current derecognition model in IAS 39 there are specific rules about measuring a continuing involvement liability which will be retained for an early adopter of the classification and measurement standard or, if following deliberations, the existing derecognition requirements are retained. The ED as drafted would likely result in failure to meet basic loan features which would require FVTPL which is inconsistent with the objective of continuing involvement measurement that the sum of the transferred asset and continuing involvement liability shall only represent the net exposure. Similarly, for reverse repos, it is not clear whether the imputed collateralised lending would be regarded as having basic loan features when the interest and principal is imputed from the repo contract. It is also of note that paragraph 24A of the ED on *Derecognition* states that if "… an entity measures at amortised cost a financial asset that it continues to recognise following a transfer, it shall not apply to the associated liability the option in this Standard to designate a financial liability as at fair value through profit or loss", yet under the classification and measurement ED the entity might be forced to FVTPL as the failed sale liability fails one of the criteria for amortised cost measurement.

Question 3
Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost? If so,

(a) what alternative conditions would you propose? Why are those conditions more appropriate?

As discussed in our response to Question 1, we support the use of amortised cost measurement for certain instruments and, as set out in our response to Question 2, we believe the requirement for no leverage should be clearer in the basic loan features criteria. Also, "managed on a contractual yield basis" should be expressed as "not managed on a fair value basis or the performance not primarily evaluated on a fair value basis". In addition, more specifically, we believe certain financial instruments may qualify for amortised cost measurement as described in our response to Question 2, however the ED as currently drafted is not clear. These include certain: inflation-linked debt; interest only and principal only strips; and perpetual debt instruments, and also that prepayments triggered on a change of control of the borrower and term extension options are basic loan features.

(b) if additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in information that is more decision-useful than measurement at fair value?

As set out in our response to Question 2 we believe that measurement at amortised cost is an appropriate measure for certain investments in distressed debt where the business model objective is not to realise the instrument's fair value through sale but is instead to maximise the receipt of the contractual cash flows of the instrument.

Based on our response to Question 4 our proposed changes to the ED would result in certain investments in contractually subordinated interests (i.e. tranches) qualifying for amortised cost accounting that would otherwise not qualify under the ED as currently drafted. However, it should be noted that our proposed treatment is consistent with current IAS 39.

(c) *if financial assets or financial liabilities that the exposure draft would measure at amortised cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?*

Based on our response to Question 4 our proposal would result in certain investments in contractually subordinated interests (i.e. tranches) not qualifying for amortised cost accounting that would otherwise qualify under the ED as currently drafted. However, it should be noted that our proposed treatment is consistent with current IAS 39.

As described in our response to Question 2 there are certain financial instruments that we believe should be measured at fair value where we consider the ED is not clear. These include: inverse floating debt instruments, floating interest only strips and prepayable principal only strips.

Question 4

(a) *Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.*

We recognise that the requirement to assess and separate out embedded derivatives in financial instruments within the scope of IAS 39 has been a source of complexity. We support removing complexity if it results in the standard being easier to apply and the financial performance of the entity being more meaningful and easier to understand. We have reservations about whether the removal of the ability to bifurcate an instrument into an embedded derivative and a host contract will result in more meaningful information about financial performance for financial liabilities due to the requirement to fair value for own credit risk. We therefore propose retaining an option to bifurcate non-closely related embedded derivatives in financial liabilities until the Board finalises its approach to fair valuation of own credit risk in liability measurement.

We believe the introduction of the basic loan features criterion and the removal of the embedded derivative notion will result in a greater number of instruments being recognised in their entirety at FVTPL than under IAS 39 whereby part of the fair value gains/losses are recognised in equity (e.g. available-for-sale debt host contracts) or not recognised at all (e.g. amortised cost debt host contracts). We have particular concern about whether this outcome will result in more meaningful financial performance in the case of financial liabilities due to the requirement to fair value for own credit risk. As described in our response to *Credit Risk in Liability Measurement*, dated 1st September 2009, we consider that a fair value measurement that includes the fair valuation of own credit risk should be limited to certain arrangements and that other alternative measurement bases should be sought, e.g. current measurement with a frozen credit spread. Until there is resolution of this important aspect of liability measurement our preference would to retain the option for an entity to apply bifurcation of non-closely related embedded derivatives in financial liabilities only in the case where an instrument as a whole is managed on a contractual yield basis but fails the basic loan features criteria.

(b) *Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (i.e. tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach*

simplify the accounting requirements and improve the decision usefulness of information about contractually subordinated interests?

We do not agree with the classification approach in the ED for contractually subordinated interests. As discussed below we would instead support a look-through approach that is consistent with the current treatment of such instruments when assessed for embedded credit derivatives under IAS 39.

Look through approach

Although the approach in the ED in accounting for contractually subordinated interests is a simplification of the current standard we do not believe it results in an improvement in the accounting for such instruments. We believe that an investment in a tranched note issued by an entity that invests in cash instruments can qualify for amortised cost accounting if the business model of the reporting entity is to hold the instrument for the purpose of receiving its contractual cash flows and not to realise its fair value through sale or derecognition. Under this ED, amortised cost is only permitted if the issued tranche is the most senior tranche which we do not agree with. In addition, we believe that an investment in a tranched note that is issued by an entity that invests in credit derivatives (for example synthetic collateralised debt obligations) or a mix of cash instruments and credit derivatives of third parties should not qualify for amortised cost accounting in its entirety. Under the ED this would be permitted for the most senior tranche of the entity if it has basic loan features and is managed on a contractual yield basis, which we do not agree with.

Where a tranche(s) is junior relative to other tranches and absorbs variability that is significantly in excess of the credit risk associated with direct investment in the underlying assets, for example an 'equity tranche', that tranche should not be considered as having basic loan features. In some cases it may not be practical for the holder of a note (including a tranched note) issued by a SPE to 'look through' the instrument to the assets and liabilities of the issuing entity. In such a case we believe the instrument should not qualify for amortised cost measurement.

We observe that the proposals in the ED could be open to structuring opportunities that avoid fair value accounting for any tranched notes. This could be achieved by multiple special purpose entities investing in junior tranches of notes issued from other special purpose entities and themselves issuing a single tranche that would qualify as the most senior tranche issued from that entity and could qualify for amortised cost accounting if the other criteria were met.

The proposed approach to credit risk also appears over-simplistic in that it only allows amortised cost accounting for the most senior tranche on the basis that it is the only tranche not to write credit protection to other tranches. However, other tranches could have very similar risk exposures and may be net receivers of credit protection when compared to a direct fully proportional investment in the assets of the issuing entity.

Non-recourse lending/borrowing

It is not clear whether non-recourse lending/borrowing and other lending/borrowing that is secured on specific assets would be caught by the subordination restriction. We do not believe the referencing to the same collateral by multiple lenders that specifies the subordination of their claims on the collateral in itself should be considered a breach of the basic loan features test. The amount or type of security on the lending arrangement affects the non-performance risk in case of default, but does not impact the contractual cash flows that are due in the absence of default. This is the case whether the lender has recourse to no security, specific security, or has recourse in a winding-up with other general creditors.

Pass-through instruments

Where the instrument is a contractual right to cash flows on a specific asset(s) (like in a pass-through arrangement), as opposed to a right to collateral in case of default by the borrower, we believe an entity should be required to assess whether the contractual right to cash flows is on an asset that itself, if acquired directly, would meet the basic loan features criteria. A purchase of an instrument that gives the holder the right to cash flows on receivables would be considered basic if the contractual terms of the receivables are themselves basic if the purchaser acquired them directly. Similarly, a purchase of an instrument that gives the holder the right to cash flows on say the proceeds from the sale of a property would not be regarded as basic as the interest in cash flows is not generated entirely from instruments that have exclusively basic loan features.

Question 5
Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?

We agree with the ED that an entity should have the ability to designate at initial recognition a debt instrument as at FVTPL if it meets the requirements for FVTPL. We believe, though, if the Board's intention is to reduce complexity, which we support, our preference is to make the fair value option unrestricted. We believe retaining the accounting mismatch criterion is not necessary. Rather, we prefer an unrestricted fair value option that is supported with disclosure that explains why the entity has chosen to designate a particular financial instrument at FVTPL (which may of course include eliminating or significantly reducing an accounting mismatch). We note that the IASB's original fair value option in 2005 was unrestricted, as is the fair value option introduced in US GAAP in FAS 159 in 2007.

Question 6
Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

We believe the fair value option should be unrestricted as detailed in our response to Question 5.

Question 7
Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

We do not agree with the proposed prohibition of reclassification described in the ED. We believe reclassification should be *required* when the business model of an entity changes causing the classification previously determined for a debt instrument to no longer be appropriate. In such a case the instrument should be reclassified based on the business model at the date of reclassification and detailed disclosures should be provided as to the change in business model and the impact of the reclassification.

Based on our view, an instrument with basic loan features that was originally managed on a contractual yield basis and measured at amortised cost would be reclassified to FVTPL when the business model changed such that the instrument was no longer managed on a contractual

yield basis. Conversely, instruments with basic loan features that were not originally managed on a contractual yield basis and hence measured at FVTPL, would be reclassified to amortised cost when the business model changes such that the instruments become managed on a contractual yield basis.

We believe there is a significant difference between a change in the business model which is a matter of fact and a change in management intent in using a single financial instrument or group of financial instruments. We view the business model to represent a formally established business strategy for a business unit that is approved and implemented by key management personnel and evidenced with regular reporting to key management personnel based on the business model's objectives. We would expect changes in business model to be infrequent, require formal approval by key management personnel and be evidenced by changes in the reporting to key management personnel.

Question 8
Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

Yes, we believe fair value is the most decision-useful measurement attribute for investments in equity instruments.

Question 9
Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

It is very difficult to perform a cost/benefit analysis to determine whether the benefits of reporting fair value exceed the cost of determining fair value. It is inherently a qualitative judgement whether the benefit is greater than the cost. Also, as the cost is incurred by the preparer, but the benefit accrues to a wide variety of third parties, i.e. the users, a simple comparison cannot be performed. Although we recognise that the cost of determining fair value may be significant and accessing information that support assumptions within the fair value calculation may prove difficult in some cases, on balance we agree with the ED that it is preferable to remove the fair value exemption for investments in equity instruments (and derivatives that may require delivery of an equity investment) as fair value is the most decision useful measurement attribute.

Question 10
Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

We believe recognising gains or losses in other comprehensive income (OCI) can be meaningful, though appreciate that the presentation of OCI is part of the IASB's other project on Reporting Financial Performance which we have previously commented on. However, we are not supportive of the FVTOCI category as described in the ED as we do not believe it is meaningful to recognise fair value gains and losses on equity investments in OCI without subsequent recognition in the income statement. Although our preference is for the measurement of investments in equity instruments at FVTPL we believe that, should a measurement category other than FVTPL be retained, like for the AFS category, dividends on investments in equity instruments are recognised as

revenue in accordance with IAS 18 *Revenue* and the gain/loss initially recognised in OCI is reclassified to profit or loss on derecognition of the instrument.

We believe the removal of the AFS category for equity investments and introduction of the FVTOCI category as described in the ED is not an improvement. We believe the effect of designating as at FVTOCI will in most cases prove so unattractive for an entity that in practice it is unlikely to be used. Should the IASB decide to retain a category other than FVTPL for investments in equity instruments, it would be better to retain the existing AFS category and instead focus on what should be the basis for determining impairment for an investment in an equity instrument. We do not support the approach in the ED that attempts to solve impairment of equity investments by removing the need to test for impairment by ensuring either all fair value gains/losses (and dividends) are included entirely in the income statement or in OCI. We believe that if a measurement category other than FVTPL is retained then both dividends and the gain/loss on disposal are relevant information for users and we would not wish to see them removed from the income statement.

If a measurement category other than FVTPL is retained our preference is that, similar to current rules on AFS investments, dividends are recognised as revenue in accordance with IAS 18 *Revenue* and the gain/loss initially recognised in OCI is reclassified to profit or loss on derecognition of the investment. However, rather than retaining the existing requirement in IAS 39.61 to record an impairment when there is a significant or prolonged decline in fair value below its cost, we would propose an alternative approach. In our view, an impairment should only be recognised (and associated reclassification of a fair value loss from equity to the income statement) in the case where the investment's carrying value will be recovered principally through a sale transaction rather than through continuing use (the same basis as in IFRS 5.6) or when the instrument clearly has little or no value as demonstrated by severe financial difficulties of the issuer such as default on its obligations, bankruptcy or liquidation. The requirements for determining a highly probable sale should be based on the same guidance in IFRS 5.7-10 & 12. In addition, like IFRS 5, the equity investment's balance sheet caption should change to "Investments in equity investments held for sale" and all future gains/losses should be recognised in profit or loss (not OCI) until derecognition.

Disclosure of FVTOCI

Our proposed approach would also require the amendments to IFRS 7.11A(b) to disclose the reasons why the entity chose the FVTOCI presentation alternative. In addition, we believe IFRS 7.11A(b) should be extended to require an entity to disclose why it believes FVTOCI is an improvement when compared to the default measurement of FVTPL and in addition explain what additional non-financial benefits the entity perceives it will achieve from the investment, this usually being the primary benefit for a substantial strategic investment in a third party. This additional information would allow the user to understand that although the gains/losses on the equity investment are initially recognised in OCI, other gains are intended to accrue to the entity in the income statement as a result of having that investment.

If the ED were to be adopted in its current form we set out below our suggestions for refining the guidance to make it more operational in practice.

Definition of equity instruments

The interaction of the definition of IAS 32 and the ability to designate an investment in equity instruments needs to be considered. As currently drafted, it would appear that any financial instrument that meets the definition of equity can be designated as at FVTOCI. We do not believe this should be the case, nor do we believe this is what the Board intended. As currently drafted, a derivative over own equity, for example a standalone written call option from the perspective of the issuer, could be classified as at FVTOCI for the holder. We

believe such an instrument is a derivative for the holder and therefore should be required to be measured at FVTPL.

Prepaid forward purchase of shares

Contracts that fail to meet the definition of a derivative, but still meet the definition of equity of the issuer should not necessarily be available to be designated as at FVTOCI. For example, a prepaid forward purchase of shares (from the perspective of the holder) is a right to receive the issuer's shares in the future yet meets the definition of equity for the issuer. Such an instrument we do not believe is an investment in an equity instrument, rather it is a right to receive an equity investment in the future.

Puttable financial instruments

We believe a puttable financial instrument that permits the holder to require the issuing entity to acquire the instrument should not be eligible for FVTOCI for the holder as the holder has a right to receive cash flows from the issuer that are non-discretionary from the issuer's perspective. However, we believe there are arguments in favour of permitting designation as at FVTOCI for the holder for a financial instrument that from the issuer's perspective has no obligation other than an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation (IAS 32.16A & B), and therefore is *entirely* presented as equity for the issuer. In this case the holder cannot demand payment from the issuer other than at the issuer's liquidation and therefore has no other rights to cash flows other than a conventional ordinary shareholder during the instrument's life and at the issuer's liquidation. Our proposed drafting to amend paragraph 19 is included in Appendix 2 of this letter.

Derecognition of instruments designated at FVTOCI

As the designation as at FVTOCI can be made on an instrument by instrument basis, and therefore, an entity may have some investments in the *same* equity instruments at FVTPL and FVTOCI, it would be beneficial if the standard provided a clear basis for determining which instrument should be derecognised if some are disposed of and some are retained. If some of the same equity instruments are derecognised should there be a rebuttable presumption that the instruments derecognised are those in the FVTPL portfolio, or the FVTOCI portfolio? This is relevant as this will impact where gains/losses are recognised on the equity investments that are not derecognised and continue to be fair valued.

Question 11
Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not,

(a) *how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?*

As described in our response to Question 10 we do not support the FVTOCI classification as described in the ED. However, if the IASB were to pursue a measurement basis where fair value gains and losses are recognised in OCI our proposed approach would retain the AFS classification (including amendments to the impairment guidance). Consistent with AFS classification, we do not believe that special rules are needed to identify those investments for which presentation in OCI is appropriate (other than it does not meet the definition of held for trading). However, we do believe that extensive disclosures should be required as described in our response to Question 10.

(b) *should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?*

Under our preferred approach, once an entity has chosen to designate at FVTOCI this classification should be retained. However, as noted in our response to Question 10, in the instance when the entity determines its carrying value will be recovered principally through a sale transaction rather than through continuing use (as in IFRS 5) or when the instrument clearly has little or no value as demonstrated by severe financial difficulties of the issuer (including default on its obligations, bankruptcy or liquidation), we believe any accumulated loss should be reclassified to profit or loss as an impairment and all future gains/losses should be recognised in the income statement along with any amounts retained in OCI that should be reclassified on disposal.

Question 12
Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

We agree with the disclosure requirements proposed for early adopters in IFRS 7.44H, however, we also believe these should be required for all other adopters except those that qualify as first-time adopters of IFRS. We also believe the ED should make it clear whether early adopters of the proposals would be required to early adopt the remaining parts of the replacement to IAS 39 (i.e. impairment, hedge accounting and scope). We also believe that entities that choose to early adopt the classification and measurement proposals should not be disadvantaged relative to those that choose to defer adoption until the mandatory effective date.

Non-early adopters

We believe the disclosures relating to designation and de-designation of financial instruments under the fair value option are of particular importance for all existing IFRS reporters adopting the proposals for the first time. This is due to the potential for ‘cherry-picking’ the application of the fair value option by choosing any date after the date of issue of the standard as an entity’s *date of initial application* (see our response to Question 13).

Early adoption of other replacement parts of the standard

We believe entities that choose to early adopt the classification and measurement proposals should not be disadvantaged relative to those that choose to defer adoption until the mandatory effective date. It is not clear in the ED whether an early adopter of the classification and measurement standard would be forced to be an early adopter of the remaining parts of the project to replace IAS 39 (i.e. impairment, hedge accounting, and scope) that are expected to be finalised in 2010. Nor is it clear whether classification and measurement decisions undertaken prior to the other parts of the project being complete can be reconsidered. While we acknowledge that the transitional requirements of those future standards are not yet known, it is important that entities know whether they would be forced to early adopt the other parts of the wider project if they choose to early adopt classification and measurement. If such a rule is intended, it should be made clear in the classification and measurement standard, as this may well influence their decision to early adopt the classification and measurement requirements in 2009, particularly, bearing in mind the work and change to systems that would be required to introduce an expected loss impairment model

in a short period should the Board pursue such an approach. Such uncertainties reduce the appeal of early adoption of the classification and measurement standard.

If the ED is adopted in its current form we suggest further guidance on the application of paragraph 44H(d) that requires "the amount" of any financial assets or financial liabilities that were previously designated as at FVTPL that are no longer designated as at FVTPL. It is not clear what 'amount' this refers to. Is it the carrying value before or after the application of transition requirements, or is it both?

Question 13
Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

We agree with the principle of retrospective application, however, we have some specific concerns set out below about the transitional guidance, particularly, the use of the term "date of initial application".

Date of initial application

Paragraph 24 of the ED defines the 'date of initial application' as "the date when an entity first applies the requirements in this [draft] IFRS". We believe it is not clear what this date can be. We understand from dialogue with some IASB Board members and staff that it was intended that the date of initial application is any single date after the issue date of the IFRS. The final standard needs to be clearer in this respect.

Assuming the date of initial application is any single date after the issue date of the IFRS we have the following concerns.

We believe, as a general rule, the date of initial application should be the start of a reporting period, and only in cases where it is not practical, should a date within an accounting period be permitted (e.g. for early adopters when the issue date of the standard is in the current or comparative period). If it is assumed that the mandatory application date for the IFRS is for annual periods beginning on or after 1 January 2012, the following illustrates our proposal (assuming one year of comparatives is required):

- 31 December 2012 year-end would have a date of initial application being the start of a reporting period (either 1 January 2012 or 1 January 2011).
- 31 December 2011 year-end would have a date of initial application being the start of a reporting period (either 1 January 2011 or 1 January 2010 as it assumed *either* one of these dates are practical).
- 31 December 2010 year-end would have a date of initial application being the start of a reporting period (1 January 2010) or an alternative if not practical and clearly justified.
- 31 December 2009 year-end would have a date of initial application being a date of its choosing between the issue date of the standard and 31 December 2009 as there has not been a start of a reporting period since the issue date of the standard.

To the extent an entity chooses a date of initial application other than the start of a reporting period presented then the entity must disclose the reason for the date of initial application in the first year of adoption.

We believe it is reasonable that an entity can select a date of initial application that is the start of a reporting period (as long as this date is after the issue date of the standard) as many entities will not choose to early adopt the classification and measurement IFRS until they

understand the final IFRSs for the other parts of the replacement of IAS 39 (i.e. impairment, hedge accounting and scope). For example, an early adopter may make its decision to early adopt classification and measurement in the latter half of 2010 once all the IFRSs on financial instruments are complete. Should the entity decide to adopt the standard in 2010, if it is practical, the date of initial application will be the start of that reporting period. If it is not practical, say, because the information is not available at that date, only then can it choose an alternative date and it is required to disclose the reason for the date selected. We do not believe it is reasonable that an entity that chooses not to early adopt, i.e. adopts for the first time in 2012, can pick a date of transition as far back in time as the issue of the classification and measurement standard, e.g. quarter 4/2009, and then claim the impracticability exemption in paragraph 30. We believe our proposed transition requirements will strike the right balance at not discouraging early adoption but equally not encouraging entities to select a date that could be used to cherry-pick fair value option designations and the impracticability exemption in paragraph 30.

Designation at FVTOCI

Paragraph 28 of the ED is clear that designation of an equity instrument at FVTOCI is made based on facts and circumstances at the date of initial application. It is not clear what relevance the date of initial application has because the only condition that could prevent such designation would be if the equity investment were "held for trading". Yet, the definition of held for trading (other than for derivatives) refers to circumstances at the date of initial recognition. Therefore, an assessment based on circumstances at date of initial application does not appear to make any difference to the classification of the investment in the equity instrument.

Impracticability to determine amortised cost

We believe paragraph 30 could be clearer. It is our understanding that in accordance with paragraph 30 if an entity cannot determine amortised cost it may regard the fair value at the start of the comparative period, and throughout the period until the date of initial application, as being its amortised cost. We find it confusing to use the "… as being its amortised cost" when the instrument is being fair valued. This confusion will be exacerbated in the financial statements as the accounting policy applied is amortised cost measurement, yet it is not measured during part of the reporting period on that basis. It should be required that the accounting policies state clearly the measurement attribute that is applied to financial instruments that are *classified* at amortised cost but are *measured* at fair value up to the date of initial application. The amount of fair value gains/losses that are included in the financial statements due to the application of this practical expedient should be separately disclosed.

De-designation of hedge relationships

We consider paragraph 31 on de-designating hedge relationships should be clearer. It would be beneficial if there were some example hedge relationships that are expected to be impacted by the new classification and measurement model and the appropriate accounting treatment that results from adopting the new standard.

In a cash flow hedge the underlying cash flows of the hedged item are generally not impacted by the classification of the hedged item. One exception we considered was the forecast sale of an AFS equity investment that is classified as at FVTOCI under the new standard and therefore no longer qualifies as a hedged item as it will no longer impact profit or loss. It is not clear whether the amount in the cash flow hedge reserve is retained as the transaction may still occur (i.e. the forecast sale) or whether the gains/losses on the derivative previously recognised in the cash flow hedge reserve would be restated with the restatement impacting current and comparative profit or loss and retained earnings. We presume it is the latter, and if

so, the scenario seems very unlikely in practice as the entity would not choose to designate the investment as at FVTOCI, rather require it to be FVTPL, to ensure a natural offset with the derivative.

As all fair value hedge relationships result in the derivative being FVTPL we would not expect the accounting for the derivative to be affected by a change in classification and measurement. In a fair value hedge the hedged item will either continue to be eligible for hedge accounting as its measurement has not changed (or at least continues not to be classified as FVTPL in the case of an AFS debt instrument that is reclassified to amortised cost) or changes to FVTPL and any fair value hedge adjustment will be reversed. One area that we consider could be complex is portfolio fair value hedge accounting where some of the portfolio ceases to be eligible for hedge accounting as under the new measurement guidance the instrument is classified as at FVTPL. Guidance on how paragraph 31 applies in such instances would be beneficial.

Question 14
Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortised cost, specifically: (a) in the statement of financial position? (b) in the statement of comprehensive income? If so, why?

We do not believe the alternative approach provides more decision-useful information. The alternative approach mainly restricts amortised cost to those instruments that meet the amortised cost criteria in the ED and are not quoted in an active market. We do not consider that the latter additional distinction is relevant to classification. Should the fact that an instrument is quoted in an active market impact the entity's management of the asset then this behaviour will already be captured by the amortised cost criteria in the ED. If an entity intends to manage on a contractual yield basis then the fact the instrument happens to be quoted in an active market should not impact how the instrument is measured. Also, consistent with our response to Question 10 we do not support impairment losses being permanently recognised in OCI without reclassification to profit or loss.

Question 15
Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

Consistent with our responses to the other questions above we do not favour measuring all financial instruments at fair value, even with the disaggregation of fair value gains/losses from other gains/losses (such as interest, impairment, etc).

Where financial instruments are measured at an amount other than fair value the disclosure of fair value is an important disclosure that compliments the measurement in the statement of financial position. We acknowledge that fair value disclosures in the financial statements are sometimes presented at a later date than the announcement by the entity of its summary financial performance. We encourage both Boards to work with securities regulators to ensure that disclosure of fair values are sufficiently prominent in the financial statements and are presented in a timely manner so to provide users with a comprehensive picture of financial performance.

Other comments

Disclosure of investment in equity instruments designated as at FVTOCI

If the Board proceed with the proposed model for designating certain investments in equity instruments at FVTOCI we would suggest supplementing the disclosures in IFRS 7.11A and 11B with disclosure of:

- the original cost of each investment (to enable comparison with fair value at end of reporting period under 11Ac)
- dividends received in the period in relation to FVTOCI investments

Clarification of the reconciliation required by IFRS 7.20A

It is not clear what reconciliation of the gain or loss on derecognition of amortised cost financial instruments is required by IFRS 7.20A. Is a reconciliation of the gain/loss on disposal calculation required as follows:

Proceeds received/consideration paid on derecognition (net of fees)	X/(X)
Amortised cost carrying value at date of derecognition	(X)/X
Gain/loss on derecognition	X

Or, a reconciliation of the gain/loss on derecognition that illustrates the amount of the gains/losses that arise on derecognition and the amount of the gains/losses that arise from amortised cost measurement immediately prior to derecognition.

Opening carrying value	X/(X)
Interest income / interest expense in the period	X/(X)
Impairment in the period	(X)
Proceeds received/consideration paid on derecognition	X/(X)
Gain/loss on derecognition	X

We suggest the reconciliation required by IFRS 7.20A is included for each class of financial instruments. Otherwise, we do not see how of a reconciliation that aggregates assets and liabilities together, and does not distinguish between different type of assets and liabilities is that meaningful. The benefit of isolating the gain/loss on derecognising amortised cost financial instruments is to inform the user of the extent to which instruments that are managed on a contractual yield basis are derecognised prior to the instrument's maturity.

Appendix 2

Proposed drafting:

4 A non-derivative financial asset or financial liability shall (unless paragraph 9 applies) be measured at amortised cost if both of the following conditions are met:

(a) the instrument has only basic loan features, and
(b) the instrument is managed on a contractual yield basis.

Paragraphs B1–B13 provide guidance on these conditions.

5 A financial asset or financial liability that does not meet the conditions in paragraph 4 shall be measured at fair value, except for issued financial guarantee contracts and loan commitment measured in accordance with paragraphs 47(c) and (d) of IAS 39 respectively. Changes in fair value shall be presented in profit or loss or other comprehensive income in accordance with paragraphs 19, 21 and 22. Loan commitments in paragraph 4(c) apply the measurement requirements of paragraph 47(d) in IAS 39.

9 At initial recognition, an entity may designate a financial asset or financial liability that would otherwise be measured subsequently at amortised cost, a purchased or issued loan commitment, or a issued financial guarantee contract, as measured at fair value through profit or loss if such designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

19 A gain or loss on a financial asset or financial liability that is measured at fair value and is not part of a hedging relationship (see paragraphs 89–102 of IAS 39) shall be presented in profit or loss unless the financial asset is an investment in an *equity instrument* and the entity elects to present gains and losses on that investment in other comprehensive income in accordance with paragraph 21. Equity instruments for this purpose include instruments that from the perspective of the issuer entirely meet the definition of equity which are not: a derivative over own equity; a non-derivative right to receive equity in the future; or an instrument that contains any obligation to deliver cash or another financial instrument except a pro-rata share of net assets on the issuer's liquidation.