DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 3 September 2009

XX September 2009

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sir / Madam

Re: Exposure Draft Financial Instruments: Classification and Measurement

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft *Financial Instruments: Classification and Measurement* ('the ED'). This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issues.

The IASB is carrying out a project to improve IAS 39 *Financial Instruments: Recognition and Measurement ("IAS 39")*. This is a multi-phase project, and the first phase involves a review of IAS 39's existing classification and measurement requirements for financial instruments. The ED is part of that first phase of work. It proposes that all financial assets and financial liabilities should be allocated to one of two categories: those that are measured at fair value and those that are carried at amortised cost. It sets out criteria to be used to achieve this allocation. It also proposes various limited exceptions to this approach (for example, a fair value option and a presentation choice for equity investments).

EFRAG's detailed comments are set out in the appendices to this letter but to summarise:

- We agree that a mixed measurement model should be retained.
- We agree that the existing classification model should be simplified so that there are only two categories (amortised cost and fair value) and that instruments should be allocated to categories in a way that will enable useful information to be presented.
- We agree with the proposals that the classification of financial instruments should be based on whether the cash flows on an instrument have a close relation to the amount advanced under the instrument. However, we have some important concerns about how that principle is translated by the standard into detailed tests.

In some cases these concerns can be addressed by providing more guidance, and in some cases we think different guidance is needed.

- However, we do not support the proposals in the ED:
  - on the treatment of embedded derivatives;
  - prohibiting reclassification of instruments from one category to another. In our view a classification system is most transparent if, when an instrument that previously met the criteria for a particular classification no longer does so, reclassification is required;
  - to omit the reliability exemption from the requirement to measure all equity instruments held (and all derivatives on such instruments) at fair value; and
  - prohibiting the recycling from OCI to profit or loss of gains and losses arising from equity investments.
- We think the IASB ought to consider the possibility of allowing a "phased" adoption of the final standard so as to make it possible to implement the proposals for equity investments separately from, and earlier than, the remaining parts of the standard.

If you wish to discuss our comments further, please do not hesitate to contact Svetlana Boysen, Kristy Robinson or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Note for EFRAG's constituents

The proposed amendments to the existing requirements in IAS 39 on the classification and measurement of financial instruments will have a fundamental effect on the way in which financial instruments are reported in financial statements. This draft comment letter reflects EFRAG's analysis of the proposals in the ED to date. That analysis is not complete and will continue; however, EFRAG has decided to issue a draft letter at this stage because, in view of the IASB's comment deadline, time is of the essence. EFRAG will finalise its position based on its further analysis and on the input from constituents that it will receive to this draft comment letter.

Appendix 1
EFRAG's general comments on the proposals in the ED

1 In appendix 2 we have set out our responses to the questions asked. However, because we have found it difficult to express our views clearly within the confines of those questions, we thought it would be useful to make a few general comments first. That is the purpose of this appendix.

2 The views we express in this appendix can be summarised as follows:

- We agree that a mixed measurement model should be retained.
- We agree that the existing classification model should be simplified so that there are only two categories (amortised cost and fair value) and that instruments should be allocated to categories in a way that will enable useful information to be presented.
- Although we have some detailed concerns about both the business model test and the characteristics of the instrument test, we think that, broadly speaking, the ED is heading in the right direction in proposing that only instruments that are both managed on a contractual yield basis and have basic loan features should be measured at amortised cost.
- We suggest that the classification model proposed is refocused as being based on whether instruments are managed on a contractual yield basis, with an exception so that instruments managed on a contractual yield basis that do not have basic loan features are measured at fair value.

3 The IASB explains in the ED that many of its constituents have told it that the number of categories of financial instruments in IAS 39 creates unnecessary complexity in the reporting of financial instruments. Fewer categories and a better rationale for those categories could improve the usefulness of the information provided and also make IAS 39 easier to apply. We agree.

4 The existing IAS 39 measurement model is a mixed measurement model. The IASB considered the possibility of introducing a single measurement category for all financial assets and financial liabilities but concluded, as paragraph BC13 explains, "that measuring all financial assets and financial liabilities at fair value is not the most appropriate approach to improving the financial reporting for financial instruments." It is therefore proposing that a mixed measurement model be retained. We agree with this decision and reasoning.

5 The ED is as a result proposing that the classification requirements in existing IAS 39 should be simplified, and that there should be just two categories of financial instruments: those that are measured at fair value and those that are carried at amortised cost. We agree that this would greatly simplify the existing requirements, and therefore would support such an approach if it proves achievable in a way that improves the information provided to users.

6 The ED proposes to introduce a clear rationale for distinguishing between the two categories of instruments. It proposes that instruments should be allocated to the two categories on a basis that ensures that the information presented is useful to users in making assessments about future cash flows.

(a) The IASB believes that amortised cost can provide useful information only if the cash flows on the instrument have a close relation to the amount advanced under the instrument and the instrument is managed on the basis of the contractual cash flows generated. Accordingly, the ED proposes that only instruments that have so-called basic loan features and are managed on a contractual yield basis in accordance with the business model shall be carried at amortised cost. (For short-hand we will sometimes refer to this as being 'the characteristics of the instrument' or basic loan features test and 'the business model' test although they are really two components of one test.)

(b) The IASB believes that, in the case of other instruments, amortised cost would not produce useful information, since the cash flows are likely to represent some other feature (ie leverage or a derivative) or will not represent the use to which the entity is putting the instrument. Accordingly, the ED proposes that such instruments should be measured at fair value.

7 We think the IASB is thinking along the right lines, because we agree that some instruments are best measured at amortised cost and some at fair value, and that the best test is what is useful for users. The key issue though is whether the ED's proposals draw the line between amortised cost and fair value in the right place, and it is clear that this issue will be much debated.

(a) One view we have heard is that the test based on the characteristics of the instrument should be omitted because whether an instrument is allocated to the amortised cost category should depend solely on the business model test. Although we can see some merit in such a view, on balance we would prefer an approach that also takes into account the characteristics of the instrument because we think those characteristics can be relevant in determining whether amortised cost provides useful information about an instrument. For example, we believe that, regardless of how a derivative is used in the reporting entity's business model, the amortised cost of the derivative will not provide useful information for making assessments about the future cash flows arising from the derivative.

(b) Some commentators are suggesting that the ED in effect treats the characteristics of the instrument as the primary test and the business model test as the secondary test, and that the approach would be better were this reversed so that the business model test was the primary test. In fact, the order of the tests will have no effect on the accounting result. We nevertheless think it would be preferable for greater emphasis to be given to the business model test. There are three main reasons for that.

(i) We think that giving greater emphasis to the business model test will help the IASB to draw the most appropriate line between amortised cost and fair value by better identifying those financial assets or financial liabilities for which amortised cost provides useful information. That is because, by identifying the types of instruments that are generally managed on amortised cost basis as a starting point, the IASB may be able to understand better whether its current definition of basic loan features should be nuanced to move the boundary between amortised cost and fair value slightly.

(ii) We think such an emphasis would make the approach easier to understand. For example, it would mean that it could be described as a business model approach that has some exceptions based on the characteristics of the instrument. We find that way of looking at the proposed approach quite appealing.

(iii) We think that giving greater emphasis to the business model test than the characteristics of the instrument test reflects how the tests will be applied in practice in most cases. First, the business model test will be applied to identify which instruments might qualify as amortised cost instruments, then the characteristics of the instrument test will be applied to those instruments to narrow down the number that are allocated to the amortised cost category. We think requirements are generally easier to understand if they reflect the way they will usually be implemented.

(c) Another view we have heard is that the business model test proposed in the ED (ie whether the instrument is managed on a contractual yield basis) is not the appropriate way of distinguishing between business models. This is discussed further in paragraphs 8 - 11 below.

(d) We have also heard commentators question whether the basic loan features test described in the ED is the most appropriate way of distinguishing between the characteristics of instruments. This is discussed further in paragraphs 13 and 14 below.

The business model test (ie whether an instrument is managed on a contractual yield basis)

8 As mentioned above, some are questioning if basing the business model test on whether the instrument is managed on a contractual yield basis is an appropriate way of distinguishing between business models. For example, some argue that test should be whether the instruments are traded (or maybe tradeable). Some argue that the focus on whether an instrument is managed on a contractual yield basis fails to align the business model approach in the ED with the trading book/banking book model used by many banks. Some argue that in many business models it is not instruments that are managed but risks.

9 This is a difficult issue. We note also that the less the business model test is aligned with actual practice the more complex it is likely to be to implement. Also, the more optionality there is in the test, the more necessary it is to impose restrictions on reclassifications.

10 We have raised some detailed issues later in this letter about aspects of the business model test (see some of our comments in response to questions 2 and 3 for example) and we are still carrying out further analysis of this aspect of the proposal. We think it might be necessary to make some changes to the test and to the wording used to describe it to address the concerns raised in this letter and to address any other concerns that become apparent as we carry out our further analysis. Nevertheless, our current view is that, broadly speaking, the business model test described in the ED is heading along the right lines.

Question for EFRAG's constituents

11 As has just been explained, how the ED describes the business model test is fundamentally important to the classification approach being proposed. Currently the test is expressed in terms of whether instruments are managed on a contractual yield basis. EFRAG would particularly welcome views on whether this is the best way to express the test, bearing in mind the purpose for which it is being used.

12 Therefore, if a constituent believes that a different classification approach to that proposed in the ED could result in more useful information being provided to users, we would be particularly interested in understanding the reasoning involved including, or example, how that approach would ensure that leverage and economic ineffectiveness of a business model is reported to investors in a transparent way.

The characteristics of the instrument test (ie whether an instrument has basic loan features)

13 As already mentioned, some commentators are questioning whether the basic loan features test described in the ED is the most appropriate way of distinguishing between the characteristics of instruments. For example, some believe the ED is itself not consistent as to what a basic loan feature is, in that:

(a) whilst paragraph B1 of the ED explains that "basic loan features are contractual terms that give rise on specified dates to cash flows that are payments of principal and interest on the principal outstanding,"

(b) the same paragraph goes on to state that "contractual terms that change the timing or amount of payments of principal or interest on the principal outstanding are not basic loan features <u>unless they protect the creditor or debtor</u>". (emphasis added)

It could be argued that contractual terms that change the timing or amount of payments of principal or interest on the principal outstanding are not basic loan features as described in (a) regardless of whether <u>they protect the creditor or debtor</u>.

14 We raise some further specific concerns about the basic loan features test in our response to questions 2 and 3.

15 The basic loan features test is another area where we will be carrying out further analysis because it seems to us that it is probably the key to achieving the optimal weighting between the business model and basic loan features components of the amortised cost classification, and therefore in ensuring that the classification applies to an appropriate range of financial instruments. Again the issues identified so far and the ones further analysis might reveal could require some changes to the test as described in the ED, but overall we think that, broadly speaking, it is also heading along the right lines.

Relationship of these proposals to the IASB's other work

16 Having said all that, we do find it difficult to assess the proposed classification and measurement proposals in isolation from the other aspects of IAS 39 replacement project—impairment recognition and hedge accounting—as well as some of the other active IASB projects that have a significant bearing on the information that will be provided on financial instruments, such as the insurance contracts project and the project on financial statement presentation.

17 We suspect that will also mean that preparers will be reluctant to make definitive decisions on some of the accounting choices these proposals allow without knowing what the 'overall package' will be. For that reason we think it will be very important that the IASB allows entities to reconsider some of the accounting choices made while implementing these proposals (for example, the presentation choice for equity instruments or application of the fair value option) when implementing later phases of the replacement project and standards such as the replacement for IFRS 4 *Insurance Contracts*.

Global convergence of accounting standards

18 We note that on 15 July 2009 FASB agreed to propose that all financial instruments will be presented on the balance sheet at fair value with changes in value recognised in net income (ie profit or loss) or other comprehensive income (OCI). It also agreed to propose that there should be an optional exception for own debt in certain circumstances, which could instead be measured at amortised cost. These proposals when finalised will be issued by the FASB in an ED.

19 Although we make no comment on the content of FASB's proposals, we note that, given the IASB's intention to issue a final Classification and Measurement standard in 2009, there seems to be insufficient time for the two boards to analyse the two sets of proposals in the light of the comments received and agree on a converged approach. That is unfortunate but probably inevitable.

Appendix 2
EFRAG's response to the questions asked in the ED

CLASSIFICATION APPROACH

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?

Notes for EFRAG's constituents

1 The proposal is that there should be just two categories of financial instruments: those that are measured at fair value and those that are carried at amortised cost. Furthermore, instruments should be allocated to those categories on a basis that ensures that the information presented is useful to users in making assessments about future cash flows.

2 The IASB believes that amortised cost can provide useful information when the instrument produces predictable returns based on its contractual terms and is managed on the basis of the contractual cash flows generated. Accordingly, the ED proposes that instruments that have basic loan features and are managed on a contractual yield basis in accordance with the business model shall be carried at amortised cost. Instruments that do not meet the above conditions are measured at fair value.

EFRAG's response

EFRAG's view:

- We agree that amortised cost provides decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis.
- However, we also believe that amortised cost would provide decision-useful information in other circumstances as well.

3 The IASB is proposing that the existing classification model should be simplified so that there are only two categories (amortised cost and fair value) and that instruments should be allocated to categories in a way that will enable useful information to be presented.

4 Paragraph BC17 explains that the IASB believes that "amortised cost can provide useful information only when the instrument produces predictable returns based on its contractual terms and is managed on the basis of the contractual cash flows generated if it is held rather than sold or transferred. Accordingly, a financial asset or financial liability would be measured at amortised cost if two conditions are met:

(a) the instrument has only basic loan features; and

(b) the instrument is managed on a contractual yield basis."

5 We agree with the IASB's reasoning that in such circumstances amortised cost will provide useful information for users, for the reasons the IASB has given.

6 However, we do not believe that those are the only circumstances in which amortised cost will provide useful information. So, although we support

classification between two categories, we have some concerns about how the IASB's proposals allocate financial instruments between those categories. Those concerns are discussed in our responses to Questions 2-4 below.

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?

Notes for EFRAG's constituents

7 The ED defines basic loan features as contractual terms that give rise on specific dates to cash flows that are payments of principal and interest on the principal outstanding. The ED sets out examples of contractual terms that meet the definition and those that do not.

8 The ED states that financial instruments are managed on a contractual yield basis only if they are managed, and their performance evaluated by the entity's key management personnel, on the basis of the contractual cash flows that are generated when held or issued. The basis for conclusions further explains that this condition is a matter of fact, not choice.

9 The ED further states that whether an instrument is managed on a contractual yield basis does not depend on management's intentions for an individual instrument. As paragraph B10 explains, "it depends on how management manages the instruments, which is unlikely to differ for an individual financial asset or financial liability in isolation. Accordingly, this condition is not an instrument-by-instrument approach to classification."

10 The ED proposes that whether an instrument is managed on a contractual yield basis need not be determined at the reporting entity level; it can be determined at a lower level.

11 The ED explains that, if an entity sells financial instruments that it classified as being managed on a contractual yield basis, it will not prevent the entity from measuring other financial assets and liabilities at amortised cost if they meet the conditions for this category. In other words, there are no 'tainting rules'.

EFRAG's response

EFRAG's view:

- We have a number of concerns about the material describing the basic loan features note.
  - As a result, it is not always clear what is a basic loan feature. We need a principle-based notion that is clearly described and consistently applied.
  - We are concerned about the structuring opportunities available under the basic loan features test as currently described.
  - We think some more guidance is needed, and in some cases different guidance is needed, on how to apply the 'basic loan features' in practice.
- We have some concerns with some of the detail of the ED's description of the managed on a contractual yield test. In some cases these concerns can be

addressed by providing more guidance, and in some cases by amending the guidance provided.

- We have concerns about the implications of the proposals for financial liabilities.
  - The proposals seem likely to mean that many more financial liabilities will be measured at fair value through profit and loss, meaning that changes in own credit risk will have a much greater impact on the financial statements. This concerns us.
  - We think further consideration should be given to the treatment of long-term debt that is used by entities to finance operations.

Basic Loan Features

12 The ED describes the idea behind the notion "basic loan features" in the following terms: an instrument has basic loan features if its contractual cash flows represent principal and interest on that principal and the interest is consideration for the time value of money and the credit risk of the issuer of the instrument. That sounds simple, clear and principle-based. However, in our view the way the ED proposes to make this notion operational is not always clear and in some cases is quite rule based. We think the result is that the operational guidance provided broadens the basic loan feature notion beyond that described in the opening sentence of this paragraph; and that a consequence is that the principle as described has become muddied. Yet we also think some further broadening might be necessary. (The sub-paragraphs below give some examples of the uncertainties arising from the existing guidance and issues that perhaps need to be dealt with by further broadening.) For these reasons we think the underlying principle and proposed guidance needs to be looked at again. The objective should be a principle that is appropriate, clearly expressed and consistently applied.

(a) We think it is not clear how the basic loan feature test is to be interpreted in relation to trade receivables and payables, and other balances that are not generally viewed as contractual cash flows representing interest and principal.

(b) We do not think the ED is clear as to how the payment of fees (upfront or over the life of the instrument) or incentive payments should impact the assessment of basic loan features. These are contractual features that are not interest as defined (i.e. consideration for the time value of money or credit risk of the borrower as set out in paragraph B1). They are however contractual features that give rise to cash flows.

(c) We also consider that some tranched debt and certain hybrid instruments and/or the financial host contracts could have basic loan features. Our concerns regarding the classification of these instruments under the proposals are addressed in our response to Question 4.

(d) Our understanding is that the ED does not intend entities to look through structured entities when applying the basic loan feature test. In other words, if an entity that contains nothing but instruments that do not have basic loan features issues paper that does have basic loan features, the ED will require holders of that paper to be treated as holding instruments that have basic loan features. We accept that this is a very simple approach to apply and we recognise that the requirements would become much more complex were entities required to 'look through' certain structures (not least because of the need to describe which structures should be looked through and which should not). However, we are concerned that it might be so easy to use special purpose vehicles to create instruments with basic loan features out of instruments that do not have such features that the basic loan feature test might not be able to fulfil its objective.

Other comments

13 We think the reference to the word 'loan' in the phrase "basic loan features" is confusing because the term is intended to be applicable to a wide range of instruments—for example receivables, own debt, certain types of preference shares, prepaid interest rate swaps—that are not seen as loans.

14 The example in paragraph B3(a)(i) of a fixed payment could be made clearer by stating that the payment of a fixed amount must relate to interest or principal.

15 In the sentence in paragraph B3(a)(iv) that reads "for fixed and variable rate interest rate, interest returns, interest is calculated by multiplying the rate for the applicable period by the principal amount outstanding during the period", we think the reference should be to "the *effective* rate for the applicable period".

Question for EFRAG's constituents

16 It has been suggested to us that the basic loan features notion itself, and the way it is described in the ED, might implicitly be making some important assumptions about the sort of loan-related activity entities undertake, and those assumptions might not apply universally in all jurisdictions. One possibility would be to carry out extensive field-testing to establish whether there might be any jurisdictional difficulties but, under the timetable the IASB is working to, that is not possible. We would therefore be particularly interested in any comments you have about the applicability of the notion and of the proposed application guidance in your jurisdiction.

Instrument is managed on a contractual yield basis

17 In Appendix 1 we discussed the classification and measurement model proposed in general terms and said that, although we had some concerns about the detail and were still analysing aspects of the proposal, our current view is that, broadly speaking, the business model test described in the ED is heading along the right lines. In the paragraphs below we highlight some of the concerns we have with the detail. In some cases these concerns can be addressed by providing more guidance, and in some cases by amending the guidance provided.

Business units v how the instrument is managed

18 Paragraph B10 of the ED explains that whether financial instruments are managed on a contractual yield basis does not depend on management's intentions for an individual instrument; rather it depends on how management actually manages the instruments. The ED also explains that how management actually manages the instruments is unlikely to differ for an individual financial asset or financial liability in isolation. We agree with this analysis.

19 The paragraph then goes on to talk about trading versus banking versus investment banking business. We are not sure this guidance is sufficiently clear. For example:

(a) Consider the example of an entity that does not separate its trading business from its banking business but does nevertheless hold some portfolios of instruments for trading purposes and some others for yield purposes. We do not think it is clear whether the ED would require that all portfolios—those that are held for trading and those that are held for yield purposes— would need to be measured at fair value.

(b) Consider the example of an entity that has a separate trading business and within that business has instruments that it never intends to trade. (An example of this could be a portfolio of liabilities that are funding the trading book. Another example is the practice that some financial institutions have been following of classifying certain instruments as held for trading even though they were not—and in some cases could not be—traded.) Would these instruments be required to be measured at fair value?

20 The question illustrated in these examples is how far do you go down to determine how you manage financial instruments? We think the cause of this confusion is the guidance on the one hand referring to business units and at the same time talking about "how management manages instruments". In other words, it is not clear at which level the ED intends the condition "managed on a contractual yield basis" to be applied. Does it have to be based on business units or should it be applied more narrowly than that, say on a portfolio basis?

<u>Selling some or all of an instrument that is managed (entirely or in part) on a contractual yield basis</u>

21 We agree with the ED's proposal that the condition 'managed on a contractual yield basis' should not be subject to 'tainting provisions'. Appropriate disclosures highlighting the amounts of instruments sold, the effect on profit or loss and the reason for selling the instruments that were being managed on a contractual yield basis until they were sold should provide sufficient information to users about such sales.

22 However, we do not think it is clear how the proposals should be applied if management, while holding a portfolio of instruments for yield, tries to maximise the yield by say selling some instruments in the portfolio and acquiring other with a higher yield. Also, what if an entity actively manages the interest rate element of an instrument through some hedging strategies? Or, if an entity matches durations of the assets and liabilities in asset/liability managed portfolios rather than orienting itself for holding instruments in such portfolios until maturity, would the 'managed on a contractual yield basis' still be met? We think part of the issue here is that many institutions manage the risks arising from instruments, rather than the instruments themselves, yet the ED is proposing that an instrument-based test should be applied.

<u>Transfers of financial instruments</u>

23 We do not think it is clear how instruments used as collateral in a repo transaction or how factored receivables are to be accounted for under the proposals. Paragraph B11 states that carrying instruments at amortised cost would not be prohibited "as long as the financial assets or financial liabilities are primarily held for the purpose of receiving or paying the contractual cash flows rather than realising fair value changes by sale or transfer of the financial asset or financial liabilities." The fact that a sale or transfer has to involve "realising fair value changes" presumably means that the sale or transfer of financial assets as collateral through many repo and factoring transactions would not be treated as sales or transfers for the purpose of paragraph B11.

24 It would be helpful to clarify this. It would be also helpful to consider the interaction of the proposals developed in the project on derecognition and the requirements on classification of financial instruments more generally.

<u>Instruments acquired at a discount that reflects incurred credit losses</u>

25 Paragraph B13(b) states that an example of a financial asset that is not managed on a contractual yield basis is a financial asset that is acquired at a discount that reflects incurred credit losses. This would mean that, for example, impaired loans sold under new rules adopted by Governments to help resolve the crisis would be required to be measured at fair value. We question whether this treatment is appropriate. We also wonder whether the treatment is consistent with the thinking underlying the expected loss model that the IASB is working on in another part of the IAS 39 replacement project. In our view, although it could perhaps be argued that a literal interpretation of the words in the ED would lead to the conclusion that such assets are not managed on a contractual yield basis, we think either that interpretation or the wording itself is wrong because measuring such assets on an amortised cost basis would result in useful information.

26 We also have concerns about the reasoning given in the ED for the proposals in this area.

(a) We think the reasoning is confused. On the one hand, paragraph B13 of the ED says such loans are an example of instruments that do not meet the condition of being managed on a contractual yield basis in the corresponding application guidance. However, paragraph BC29 of the Basis for Conclusions states that such instruments do not have basic loan features.

(b) Furthermore, paragraph BC29 explains that such instruments do not have basic loan features by saying "An investor acquiring an instrument at such a discount believes that the actual losses will be less than the losses that are reflected in the purchase price. Thus, that instrument creates exposure to significant variability in actual cash flows and such variability is not interest."

(i) We think what "the investor believes" is not a characteristic of the instrument, and therefore has nothing to do with whether the instrument has basic loan features.

(ii) In our view what "the investor believes" seems to be more an attempt to capture the business model. If that is the case, when the investor does believe that "the actual losses will be less than the losses that are reflected in the purchase price" paragraph B13 is right to say that such loans are not managed on a contractual yield basis—so the requirements in the ED seem to be in line with this reasoning rather than explanations in the Basis for Conclusions. However, we do not think it is appropriate to presume that investors acquiring instruments at discounts that reflect credit losses always believe that the actual losses will be less than the losses that are reflected in the purchase price.

(iii) In any case we find paragraph BC29's explanation confusing. Generally, an entity issuing even a 'normal' loan would have different expectations as to the actual cash flows compared to the contractual cash flows due to a risk of default. We are not convinced that there is a difference of substance between such instruments and instruments acquired at a discount that reflects incurred credit losses that justifies the use of different measurement bases.

Other comments

27 Paragraphs B12 and B13 start by stating: "The following are examples of financial assets or financial liabilities that are (not) managed on a contractual yield basis". The reference to examples of financial instruments is confusing because this wording seems contradictory to the intention that the condition "managed on a contractual yield basis" should reflect entity's business model rather than management intentions with regard to individual instruments. It would be clearer if those paragraphs referred to circumstances where the condition of managed on a contractual yield basis is (is not) satisfied.

Application of the tests to financial liabilities

Own credit risk

28 Under existing IAS 39 structured liabilities and convertible bonds are generally bifurcated, with the embedded derivative measured at fair value and the host at amortised cost. Under the proposals in the ED, bifurcation is not permitted; the instrument needs to be classified by considering it as a whole. As the embedded derivative would generally mean the instrument as a whole does not have basic loan features, the liabilities would be measured at fair value through profit and loss. On the basis of the IASB's current thinking on fair value measurement, that would mean measuring such instruments at amounts that reflect changes in own credit risk.

29 We recognise that this is an area on which the IASB is doing further work—hence the recent IASB discussion paper *Credit Risk in Liability Measurement*—but the proposals in this ED make that other further work all the more important and relevant because the result of the ED's proposals seem likely to be many more financial liabilities being measured at fair value; in other words, own credit risk having a much greater impact on the numbers in the primary financial statements than hitherto.

Long-term debt that finances the reporting entity

30 We think further consideration should be given to the specific nature of financial liabilities, in particular long term debt that is used by entities to finance operations. For example, we think it is arguable that most treasury functions would manage long term debt on contractual yield basis in the context of financing the entity, even in circumstances where debt contains embedded derivatives or other "non-basic" features. We therefore consider that the interaction between being managed on a contractual yield basis and the definition of basic loan features needs to be revaluated for liabilities that serve a funding purpose. This could be achieved in a number of ways, including perhaps:

(a) extending what is meant by a basic loan feature specifically for long term debt issued by an entity;

(b) making the business model (i.e. financial liabilities used for long-term funding) the sole test for liability classification purposes. We recognise that this may require the development of additional criteria; or

(c) addressing the bifurcation rules for financial liabilities (see our response to Question 4(a)).

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

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

(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?**

(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?**

EFRAG's response

EFRAG's view:

- We broadly agree with the classification model proposed and that the business model and the characteristics of the instrument tests are appropriate conditions for determining which financial asset or financial liabilities should be measured at amortised cost.
- As we explained in our response to Question 2, we have some detailed concerns about both the business model test and the basic loan features test described and with the application guidance provided.
- We believe that more appropriate conditions to identify which financial liabilities and financial hosts in hybrid instruments should be measured at amortised cost should be developed.

31 As we explained in Appendix 1, we broadly agree with the classification and measurement model proposed in the ED. In particular, although we have some detailed concerns about both the business model test and the characteristics of the instrument test, we think that, broadly speaking, the ED is heading in the right direction in proposing that only instruments that are both managed on a contractual yield basis and have basic loan features should be measured at amortised cost.

32 In our response to Question 2, we highlighted areas where we believe the current proposed descriptions of, and related guidance on, basic loan features and managed on a contractual yield basis need clarification or amendment. In addition, we consider that the IASB may need to revise or extend the definitions to more appropriately reflect the following areas:

33 In our response to Question 4(a) below, we highlighted another area of concern: the treatment of host contracts in which derivatives are embedded.

EMBEDDED DERIVATIVES

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, explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

Notes for EFRAG's constituents

34 The ED explains that the existing embedded derivatives requirements are rule based, involve exceptions on exceptions and are complex to understand and implement. For that reason, the IASB considered various alternatives to the existing approach and is proposing to amend that existing approach.

35 The proposed new approach is that:

(a) *if the host contract of a hybrid contract is within the scope of IAS 39— the proposed classification approach would apply to the entire hybrid contract and the host contract would not be separated from the embedded derivative(s). Thus, if the host and embedded derivative together do not exhibit basic loan features, the whole instrument will be measured at fair value.*

(b) *if the host contract of a hybrid contract is not within the scope of IAS 39—the existing requirements for embedded derivatives in IAS 39 would continue to apply, pending a review of the scope of IAS 39 in a later phase of this project.*

36 Thus if a hybrid instrument has features that do not meet the condition of basic loan features, under the proposals the whole instrument would need to be recognised at fair value even if the host instrument would be considered to have basic loan features and the instrument is managed on a contractual yield basis.

EFRAG's response

EFRAG's view:

- Although we would support improvement of the existing embedded derivatives requirements, we do not support the proposals in the ED on the subject.
- We suggest instead that bifurcation is retained and that consideration is given to requiring bifurcation to be carried out on a basis that is consistent with the notion of "basic loan features".
- We think that bifurcation should remain optional. For that reason, we believe that it should be possible under the new standard to apply the fair value option to hybrids with financial hosts for which bifurcation of an embedded derivative is otherwise required.

37 We share the concerns about the existing embedded derivatives requirements and therefore agree that it is appropriate consider whether some sort of bifurcation requirements are needed and, if they are needed, what form they should take.

38 However, we believe that the proposal to eliminate bifurcation and require hybrid instruments to be assessed together for classification purposes has drawbacks too. To give some examples:

(a) Under the proposals in the ED, many types of convertible debt (for example, those with equity features that do not meet the definition of equity) will be required to be measured in their entirety at fair value through profit and loss. In other words, the entity would no longer have the ability to separately account for the embedded derivative and the funding component. This will result in entities including in profit and loss changes in fair value, including changes relating to own credit risk, of instruments primarily used to finance the entity.

(b) We are concerned that it will be difficult to apply this principle beyond those situations that are addressed in the application guidance. For example, it is not clear to us whether a host financial instrument with an embedded guarantee has basic loan features. We think it is similarly unclear how to treat maturity extension options and interest indexed to inflation (both of which are addressed under the existing embedded derivative rules).

39 Furthermore, the proposals mean that contracts could be measured differently depending on whether they are standalone contracts or part of a hybrid contract (ie have derivatives embedded in them). We think this is the sort of inconsistency that makes information about financial instruments difficult for users to understand. There needs to be a simple principle that is consistently applied. For that reason, we think the IASB should retain bifurcation but should explore the possibility of bifurcating on a basis that is consistent with the basic classification model; in other words, should explore the possibility of the bifurcation of embedded derivatives requirements being based on the basic loan features notion.

40 We envisage that a bifurcation test based on basic loan features would operate broadly as follows.

(a) After determining that a hybrid instrument with a financial host is managed on a contractual yield basis, the hybrid will be assessed to see if it has basic loan features.

(b) If the hybrid in its entirety does have basic loan features then it is eligible to be measured at amortised cost;

(c) If the hybrid instrument does not have basic loan features in its entirety then the contractual terms would be reviewed to determine whether one or more embedded derivatives could be separately identified and measured, resulting in a financial host that has basic loan features only. If this is the case, then the entity would be required to bifurcate the embedded derivative or derivatives and report them separately at fair value through profit or loss. The financial host would then be eligible to be measured at amortised cost.

41 However, we also think that bifurcation should be optional; in other words, that those entities that believe it is more appropriate to measure the whole hybrid instrument at fair value should be able to do so. To achieve that, we think that the circumstances in which an entity is able to use the fair value option need to be extended to include hybrid instruments that have financial hosts with embedded derivatives that require bifurcation.

Question 4(b)—Do you agree with the proposed approach regarding the application of the proposed classification approach to contractually subordinated interests (eg 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?

Notes for EFRAG's constituents

42 Application guidance in paragraphs B7 – B8 of the ED discusses the application of the proposed new classification model to structured investment products issued by structured investment vehicles. Such vehicles typically create a waterfall structure that prioritises the payments from a pool of assets (such as mortgage loans) to the holders of the different tranches. The waterfall structure specifies the order in which any losses that the issuer incurs are allocated to the different tranches. Put simply, the result might be that the first tranche entitles the holder to the first million Euros of cash received, the second tranche entitles the holder to the second million Euros and so on, with the final tranche entitling the holder to what is left after the other tranches entitlement has been met in full.

43 The Basis for Conclusion (paragraph BC27) notes that the waterfall structure means that lower tranches provide credit protection to higher tranches. The ED concludes that all tranches that give protection to other tranches do not meet the condition of having only basic loan features because such tranches are leveraged. Consequently, only the most senior tranche that receives credit protection would meet the condition of having only basic loan features.

44 Paragraph BC26 of the Basis for Conclusion further notes that the waterfall structure is not the same as ranking of an entity's creditors which is a common form of subordination. While the Basis for Conclusion acknowledges that there is a degree of leverage resulting from such a subordination, it notes that the commercial law that usually governs this subordination does not intend to create leveraged credit exposures for general creditors.

EFRAG's response

EFRAG's view:

- EFRAG does not support the proposals as currently drafted. Although we agree that some subordinated tranches would not exhibit basic loan features, we think it is an oversimplification to suggest that only the most senior tranche can have basic loan features.

45 We note that currently investments in waterfall structures would qualify for amortised cost measurement if markets for such instruments become inactive and such investments as a result qualify for the loans and receivables category or if the entity can demonstrate that it holds such instruments until maturity. The proposals in the ED do not use either market activity or ability to hold instruments until maturity as a distinguishing factor between those instruments that qualify for the amortised cost measurement and those that qualify for fair value measurement. The proposals are in effect that the instruments that are to be carried at amortised cost are those whose cash flows have a close relation to the amount advanced under the instrument. The ED concludes that subordinated tranches in waterfall structures do not have that close relationship (ie they do not have basic loan features).

46 We can understand why it is difficult to view instruments whose value depends on the performance of other instruments as instruments with basic loan features. We also accept that cash flows under such instruments in many cases may be very different from the amount advanced under the instrument: the waterfall structures usually result in changes of the payments under such instruments. In addition, many debt instruments issued by structured investment vehicle that are subordinated to other debt instruments in the waterfall will have a better credit quality than the financial assets that are held by the vehicle issuing the debt.

47 Nevertheless, we have concerns about the proposal. In particular, although subordinated tranches often do not have basic loan features and often will not have cash flows that have a close relation to the amount advanced under the instrument, we nevertheless think amortised cost might still be an appropriate measure for at least some of those tranches. In other words, we think the IASB's proposal of affording basic loan feature status to only the most senior debt in the waterfall (the most senior tranche) might be an over simplification of a difficult issue. For example, we think it is relevant that many investments in these vehicles are held on a long-term basis and do have cash flows that can be managed on a contractual yield basis (i.e. cash flows similar to the financial assets held by the vehicle). We think it is also relevant that a number of the subordinated tranches will generally have a lower credit risk than the underlying instruments; in other words, that a key effect of the structuring is to reduce the volatility of cash flows from instruments that themselves have basic loan features. We would therefore encourage the IASB to carry out further analysis of this difficult issue, and one possibility might be to consider whether other characteristics can be used to differentiate between tranches for classification purposes.

48 We acknowledge that this is a difficult issue and stems from the problems caused in determining when you should "look through" structured investment vehicles and when should you treat such vehicles as substantive entities. It is a hard line to draw, particularly when one is trying to devise an approach that improves the information being provided and reduces complexity. We suggest that the IASB include a review of how to treat debt issued by structured investment vehicles and other special purpose entities as part of its deliberations in this area.

49 We also think difficulties may arise in distinguishing subordination of investors due to waterfall structures from ranking of creditors in an entity.

Question to EFRAG's constituents
50 Although EFRAG has concerns about the proposed treatment of structures involving waterfall arrangements, we have so far not reached any views as to how best to resolve the issue. We are continuing to research the topic and would particularly welcome views and other input from constituents on the matter.

FAIR VALUE OPTION

Question 5—Do you agree that entities should 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?

Notes for EFRAG's constituents

51 The existing IAS 39 permits entities to elect to measure at fair value through profit and loss an instrument that would otherwise be measured differently if certain *circumstances apply and the election is made on initial recognition. Once made, that election remains in place until the instrument is derecognised.*

52 There are three circumstances in the existing IAS 39 in which the fair value option is available, and one of those circumstances is when applying the option would result in more relevant information because it eliminates or significantly reduces an accounting mismatch.

53 The ED proposes to retain the fair value option for use when applying the option would result in more relevant information because it eliminates or significantly reduces an accounting mismatch. The ED like existing IAS 39 requires the option to be exercised on initial recognition and does not permit subsequent reclassifications.

EFRAG's response

EFRAG's view:

- EFRAG supports the proposal to retain the fair value option to mitigate an accounting mismatch, although it believes a further review of the requirements will be necessary when the IASB starts working on hedge accounting.
- EFRAG has not yet formed a view as to whether reclassifications 'out of the fair value option' should be prohibited as proposed. Nor has it yet formed a view on whether use of the option should as proposed be possible only on initial recognition.

54 Under existing IAS 39 there are, as explained above, three circumstances in which an entity is permitted to apply the fair value option. EFRAG agrees that the new Classification and Measurement system proposed in the ED makes the use of a fair value option in two of those circumstances unnecessary. EFRAG agrees that the fair value option should be retained for use in the third circumstance; ie when its use would eliminate an accounting mismatch.

Question to EFRAG's constituents

55 Under existing IAS 39, if the fair value option is to be exercised, it needs to be exercised on initial recognition and cannot be revoked (in other words, reclassification is not permitted). Over the last few years there have been a number of calls for the IASB to change its requirements so that reclassifications were possible even when the fair value option has been used. Some have also questioned whether it is appropriate that the option should be available only on initial recognition. The ED nevertheless proposes no changes to this aspect of the option. EFRAG members are divided on whether the fair value option should be an irrevocable option available only at initial recognition. And, if reclassification is to be allowed, there is also the question of whether it should merely be permitted or required.

56 Those in favour of reclassifications generally argue that the decision to exercise the option is based on the circumstances at the time, those circumstances can change, and, if they do change, it is appropriate to revoke or invoke the fair value option to reflect that change.

(a) Under the proposals the option can be used only if it would eliminate or significantly reduce an accounting mismatch. It is feasible that, because of changed circumstances, either that an accounting mismatch would no longer arise if the option was not exercised or that exercising the option would not eliminate or significantly reduce an accounting mismatch. Similarly, it might be that there was not an accounting mismatch on initial recognition or using the option would not have eliminated or significantly reduced an accounting mismatch; but circumstances have since changed. For example as an alternative to hedge accounting, some entities elected to use the fair value option for highly rated financial instruments so as to offset the change in fair value of interest rate derivatives. During the credit crisis, some of those entities found that unexpected changes in fair value of those highly rated assets were arising (predominantly from a lack of liquidity) and that, because those changes were not offset, they were resulting in significant earnings volatility. If the lack of liquidity had existed at initial recognition electing the fair value option would have produced as much accounting mismatch as it offset.

(b) Those in favour of reclassifications also argue that the prohibition on reclassification is primarily anti-abusive. EFRAG does not believe in the accounting requirements being driven by anti-abuse considerations. In its view good principles should mean that anti-abuse provisions are not necessary.

(c) Some would in addition argue that, if reclassifications are to be allowed and if it is to be possible to use the fair value option subsequent to initial recognition, the fair value option should not be an option; rather its use and its revocation should be mandatory when circumstances dictate.

57 Those who oppose allowing reclassifications involving the fair value option consider that allowing reclassifications in this circumstance would lead to less comparable financial statements and could result in abuse by entities selectively reclassifying those instruments that result in a favourable impact to income i.e. cherry picking.

58 EFRAG does not believe in the accounting requirements being driven by anti-abuse considerations. In its view good principles should mean that anti-abuse provisions are not necessary. Nevertheless, it also recognises that, even if the current proposal is to be varied to allow reclassifications and perhaps also post-initial recognition use of the option, it is important to introduce some discipline to prevent there being a 'free-for-all'. We would be particularly interested in the views of constituents on these issues.

59 Having said all that, we wish also to highlight that we think that, when the IASB works on the third phase of the replacement project dealing with hedge accounting, the fair value option would need to be addressed again because both the fair value option and hedge accounting deal with offsetting risks and minimising the accounting mismatch, so changes to the hedge accounting requirements might make it necessary to make changes to the fair value option requirements at the same time.

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

Notes for EFRAG's constituents

60 In addition to the circumstances described in Question 5, IAS 39 permits designation of financial assets and financial liabilities at fair value through profit or loss (ie the fair value option to be used):

(a) *when the option's application would result in more relevant information because a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis; or*

(b) *for some contracts that contain one or more embedded derivatives*

61 The ED does not propose to make the fair value option available in either of these circumstances because it believes that, under the classification approach proposed in the ED, the option is not needed in those circumstances. When the circumstances in (a) apply, the ED would require the use of fair value through profit or loss anyway and, as the ED does not propose the bifurcation of hybrid contracts, (b) is unnecessary.

EFRAG's response

EFRAG view

- Based on EFRAG's response to Question 4(a)—where we supported the continued bifurcation of hybrid instruments—we think the application of the fair value option should be extended to apply to hybrid instruments that have financial hosts and that contain one or more embedded derivatives that require bifurcation.

62 Earlier in this letter we explained that we do not agree with the ED's proposed treatment of embedded derivatives. We suggested an alternative approach that would still involve bifurcation of hybrid contracts. However, we are also of the view that such bifurcation should be optional and that entities that wish to measure the whole hybrid contract at fair value should be able to do so. EFRAG considers that the most operational way to achieve such optionality is to continue to make the fair value option applicable to hybrid instruments that have a financial host and contain at least one embedded derivative that requires bifurcation.

RECLASSIFICATION

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?

Notes for EFRAG's constituents

63 The ED proposes that on initial recognition, financial instruments should be classified (as measured at amortised cost or at fair value) and no subsequent reclassification will be permitted. The Board cited the following reasons as to why it is proposing not to permit reclassifications:

(a) Reclassifications will make financial statements less understandable for users.

(b) Reclassifications reduce comparability between entities and even between financial instruments held by the same entity.

(c) Reclassifications could enable some entities to manage profit or loss by managing the timing of when future fair value gains and losses will affect profit or loss.

(d) Reclassifications increase complexity since allowing reclassifications will require detailed guidance about when they would be appropriate.

64 Until recently, IAS 39 also did not permit reclassifications from one category to another. However, in October 2008 the IASB amended the standard to allow some reclassifications of financial assets from the held-for-trading and available-for-sale categories.

EFRAG's response

EFRAG's view:

- We do not support the proposed prohibition on reclassification. In our view a classification system is at its simplest and most transparent if an instrument is required to be reclassified if it no longer meets the criteria for its current classification.
- We do not believe it should be necessary to reclassify equity investments between the 'fair value through profit and loss' and the 'fair value through OCI' sub-categories.

65 The ED proposes that reclassifications between the amortised cost and fair value categories should not be permitted. The ED argues that this proposal improves comparability and eliminates the need for complex reclassification requirements.

66 EFRAG agrees neither with the proposal nor with the reasoning behind it. Focusing first on the proposal, in our view, although there will never be a need to reclassify an instrument because of the basic loan features part of the test, there could be a change in the business model that would mean that instruments that were previously being managed on a contractual yield basis are no longer being managed on that basis or vice versa. In our view, when such a change occurs, reclassification should be required. That will ensure that the only items that are measured at amortised cost are those that met the criteria for the amortised cost category at the time the financial statements were prepared. We recognise that there might be a concern that this could result in entities having a free choice as to the measurement basis they use, but do not believe that would be the case if the contractual yield test is drafted in a way that emphasises that changes in business model are rare, rather than an everyday occurrence. We also consider that comprehensive disclosures should accompany any reclassification.

67 We suspect that one reason for the difference in view between ourselves and the IASB on this issue is a difference of view as to what is an entity's or unit's business model. We agree that the business model changes only rarely. However, we believe it can change. We also believe that over the last couple of years a number of financial institutions (or business units within those institutions) have changed their business model. For example, those businesses that sold mortgages to securitisation vehicles may have a very different business model going forward. Indeed it may be a very fine line between a change in business model and the cessation of an old business and replacement with a new business. In our view it makes no sense to have a standard that requires amortised cost to be used if certain circumstances exist at initial recognition but has no scope for change if those circumstances do not exist at any time thereafter.

68 We recognise that users have had some difficulties with the reclassifications made as a result of the October 2008 amendment to IAS 39, partly because of a perceived lack of clarity but also because of the additional complexity it creates. Indeed, we have heard users argue that the classification system will always be imperfect, and prohibiting reclassification helps to impose discipline on how the instruments are classified. We think this might be too pessimistic. In our view, a

significant part of the complexity and lack of transparency that users believe is created by reclassifications is in fact created by the complexities of the existing classification system. In our view, simplifying that system—which is what the ED is proposing to do—will significantly reduce the complexities that surround reclassifications, and will make it much easier for disclosures to be designed that will address any transparency concerns that would otherwise exist.

69 Turning now to the reasoning given in the ED for proposing to prohibit reclassifications:

(a) We do not agree that prohibiting reclassification will enhance comparability. Instead, what it means is that two entities that have the same business model and are managing a financial instrument in exactly the same way might be measuring it in fundamentally different ways because one acquired the instrument before a change of business model and one afterwards. Comparability requires that like things look alike and unlike things look differently.

(b) We do not agree that it necessarily follows that, if reclassification is to be allowed, there need to be complex requirements to police reclassification. In our view, if the classification system being used is based on good principles, the requirements and guidance that apply to classifications on initial recognition should be sufficient for reclassifications too—probably with the addition of some disclosure requirements. It may be sufficient to say that reclassifications are expected to be rare and can only result a change in the way a business is managed, not in the way an individual financial instrument is managed or used.

INVESTMENTS IN EQUITY INSTRUMENTS THAT DO NOT HAVE A QUOTED MARKET PRICE AND WHOSE FAIR VALUE CANNOT BE RELIABLY MEASURED

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?

Notes for EFRAG's constituents

70 Existing IAS 39 requires all investments in equity instruments and all derivatives to be measured at fair value, except that, if an equity investment that does not have a quoted market price in an active market has a fair value that cannot be reliably measured, it shall be measured at cost, as shall any derivatives based on such equity investments.

71 The proposal in the ED is to omit this cost exemption. Henceforth all equities (and all derivatives on equities) would be required to be measured at fair value. The IASB's reasoning is that:

(a) *IAS 39 requires such investments to be monitored for impairment; which involves estimating amounts that are based on a calculation that is similar to fair value. Some believe that the impairment calculation is not more reliable or less costly than measuring the equity investment at fair value.*

(b) *Measuring all investments in equity instruments in the same way would improve decision-useful information about equity investments for users of financial statements, would simplify the accounting requirements and improve comparability.*

EFRAG's response

EFRAG view
• We do not support the proposal. We believe there should continue to be a reliability-based exemption from the requirement to measure all equity investments (and all derivatives on such instruments) at fair value.

72 We think it is very difficult to make any general statements about the measurement at fair value of equity investments that do not have a quoted market price in an active market because the facts and circumstances will vary from case-to-case. As a result, in some cases it will be possible to estimate a reliable fair value at a cost that is exceeded by the benefits to be derived from using a fair value measure, and in some cases it will not. (Partly that will depend on an entity's individual abilities to estimate fair value.) We are therefore not comfortable with the omission of the exemption. In our view the proposal will result in the much greater use of fair value numbers that are highly judgemental and extremely difficult to verify effectively. We are not as sure as the IASB that this is what users want.

73 It seems to us that an effect of the proposal might be that some equities will be carried at cost unless and until there is evidence that fair value (or the impaired value) is different. Although that is perhaps not an unacceptable approach, we are not sure such a measure should be described as fair value.

74 We have two final comments. Firstly, whatever model the IASB adopts (cost or fair value through OCI) it will need to consider how to deal with embedded derivatives in an equity investment host. Under the proposals, it would appear possible that gains and losses on a derivative embedded in an equity investment could be reported in OCI and never recycled. We are not certain that is the intention.

75 Secondly, we think it important to emphasise that EFRAG does not believe that this 'exemption from fair value' is some sort of 'amortised cost option'. It is an exemption that must be applied when circumstances dictate, and cannot be applied in other circumstances. If a fair value that previously could not be reliably determined becomes reliably (for example because the entity has listed its shares under an Initial Public Offering), the exemption is no longer applicable. We would support any efforts the IASB could make to reinforce this message.

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

EFRAG's response

76 As we said in responding to the previous question, it is difficult to make any general statements on this issue because the facts and circumstances will vary from case-to-case. However, we think there could well be circumstances in forcing entities to try to estimate fair value when there are very significant reliability issues might not result in <u>any</u> "improved decision-usefulness". There could well be other circumstances in which it would still result in improved decision-usefulness but the benefits of that would not outweigh the costs of providing the information.

77 It seems to us that the second part of the question assumes that, if the benefits of improved decision-usefulness do not outweigh the costs of providing this information, something other than fair value would need to be used in the

impairment test. We do not think that is necessarily the case; the benefits might differ when an impairment is involved.

INVESTMENTS IN EQUITY INSTRUMENTS THAT ARE MEASURED AT FAIR VALUE THROUGH OTHER COMPREHENSIVE INCOME

Question 10—Do you believe that improved financial reporting results when fair value changes for particular investments in equity instruments are presented in other comprehensive income? If not, why?

Notes for EFRAG's constituents

78 An investment in equity instruments does not meet the conditions to be measured at amortised cost because it does not have basic loan features. All equity instruments held will therefore be measured at fair value under the proposals.

79 However, the ED proposes to allow an instrument-by-instrument presentation choice: either all gains and losses (including all dividends received) on an equity investment are to be presented in profit or loss or they are all to be presented in OCI. If they are presented in OCI, those gains and losses will not be recycled to profit or loss, not even on derecognition. On the other hand, it will also not be necessary to carry out separate impairment tests on such items.

80 The genesis of this proposal lies in the IASB being told that some equity instruments are purchased for strategic purposes and are not held with the primary objective of realising a profit from increases in the value of the instrument and dividends. The IASB therefore sought to develop proposals that would permit an entity, on initial recognition of investments in equity instruments that are not held for trading but are held for purposes other than realising direct investment gains, to make an irrevocable election to present the return on those investments in other comprehensive income. However, it proved difficult to define 'strategic investments', so the IASB broadened the option.

81 This proposal is intended to assist users of financial statements to identify separately the gains and losses on equity instruments that are held for purposes other than realising direct investment gains and to assess the implications of such fair value changes accordingly.

EFRAG's response

EFRAG view

- We do believe that more useful information can sometimes be provided by presenting fair value changes on equity investments in OCI.
- EFRAG supports the proposal that there should be an instrument-by-instrument option to present the total return on an equity investment in OCI rather than in profit and loss.
- However, EFRAG considers that entities should be required to recycle gains and losses (including dividend income) through profit or loss when the investment is derecognised.

82 We agree that some equity instruments are purchased for strategic purposes (ie they are not held with the primary objective of realising a profit from increases in the

value of the instrument and dividends) and, where that is the case, it can be helpful to present the return on such investments outside of profit and loss (ie in OCI).

83 However, we also recognise that such a proposal raises issues that go far beyond financial instrument reporting. In particular, it raises financial statement presentation issues about the role of the OCI and of recycling that the recent DP on the subject did not address because they are difficult to resolve quickly. For example:

(a) There is no principle that currently underlies the requirements in IFRS as to which items are presented in profit or loss and which in OCI. As such, it is not possible to state categorically whether all or any of the components of the total return on equity investments are items that should be presented in OCI.

(b) Similarly, there is no principle that currently underlies the requirements in IFRS as to if and when gains and losses presented in OCI are recycled (or reclassified) to profit or loss. For example, although some stakeholders believe that all OCI items should at some point be presented in profit or loss, that is not the position under existing IFRS. Similarly, although some believe that items should be recycled from OCI when they are realised, that also is not the position under existing IFRS. As such, it is again not possible to state categorically whether it is appropriate that none of the components of the total return on equity investments will be recycled from OCI (if that is where they have been presented).

The proposal also raises some insurance-related issues about the desirability of adopting the same accounting treatment for insurance liabilities and for the assets on which those liabilities are based.

84 Bearing this in mind, we think that it is unrealistic to expect this ED to resolve these deep underlying issues. In our view, all that can reasonably be expected is that the ED should propose a broadly satisfactory pragmatic solution to the issues involved. It is against that benchmark that we have evaluated the proposal in this area.

85 We have a number of observations about the accounting treatment of investments in equity instruments.

(a) We agree with the basic premise on which the IASB started to work in developing the proposals in this area: that some equity instruments are purchased for strategic purposes and are not held with the primary objective of realising a profit from increases in the value of the instrument and dividends. Furthermore, we understand that there are differing views amongst stakeholders as to whether it necessarily follows from that that it is inappropriate to recognise such profits and dividends in profit or loss. Bearing that in mind, allowing a choice has its attractions. On the other hand, we are generally not in favour of new or amended standards introducing additional choice into IFRS.

(b) Taken in isolation from other issues, we think there is considerable merit in presenting all elements of the total return (ie value changes, dividends and impairments) in a single place because they can be closely related to each other. If, for example, the presentation approach adopted required dividends to be presented in profit or loss and other parts of the total return in OCI, this would open up the possibility of all debits being recognised in OCI and all credits in profit or loss, which would not be acceptable. The problem is that it is difficult to resolve this issue “in isolation from other issues”. For example, we are aware that in some jurisdictions insurance companies are required to allocate all realised gains and losses on certain of their insurance funds to policyholders. Such allocations will result in changes in liabilities that will typically be recognised in profit or loss. If the related realised gains and losses are not also recognised in profit or loss at the same time, an accounting mismatch will result.

(c) An alternative to the proposals in the ED for the treatment of investments in equity instruments that is being suggested by some might be to continue to apply the existing Available-for-Sale model, amended to address its most significant weaknesses. Thus, dividends and impairments would still be recognised in profit or loss, but entities would have a choice as to where to present changes in fair value: in profit or loss or in OCI. Adopting such an approach would of course focus attention on 'the most significant weaknesses'. Some would see the prohibition on reversals of impairments as a significant weakness. Some would see the use of an impairment test that is different from the held-to-maturity impairment test as a significant weakness. However, the IASB has decided to propose fundamental changes to the existing IAS 39 model in order to avoid the need to make such 'micro' changes to the existing standard.

(d) Some might argue that allowing entities to present the total return on some or all of their investments in equity instruments in OCI will mitigate the effect on profit or loss of the proposal in the ED to omit from the revised standard the exemption from requiring all such equity instruments to be measured at fair value. Under the proposals, gains and losses arising on equity investments that are difficult to value will not have to be presented in profit or loss.

(e) A key objective that the IASB is pursuing in this project is to reduce the complexity of the existing financial instrument reporting model, and retaining the existing AfS model or allowing some sort of presentation choice for investments in equity instruments both seem contrary to that objective.

86 Considering these arguments and others, EFRAG's tentative view is that what the ED is proposing is a pragmatic solution to a complex problem and should be supported. The one exception to that concerns the prohibition on recycling. We realise that IFRS is not consistent on recycling and that, as a result, there are some gains and losses that are never recycled from OCI to profit and loss. Nevertheless, we think that the current expectation of users is that things are recycled and we think that, until the IASB has time to consider the underlying concepts, the pragmatic thing to do would be to require gains and losses on equity investments that have been presented in OCI to be recycled to—and separately presented in—profit and loss on derecognition of the instrument. We recognise that such an approach does not address the concerns that some have about not recognising dividends in profit or loss on receipt and about the possibility that an equity investment could be fully impaired but still no losses would be recognised in profit or loss. Despite these issues, we think the proposal has merit since it will allow the recognition in profit or loss of cumulative gains and losses held in OCI based on an objective and verifiable event. We urge the Board to consider this proposal and would be willing to work further to address the issues raised.

Question for EFRAG's constituents

87 We would particularly welcome constituents' views on our suggestion that the gains and losses (including dividends) presented in OCI should be recycled to profit and loss, though only on derecognition.

88 Some EFRAG members are concerned about the implications our suggestion would have for fully impaired assets that are neither sold nor otherwise derecognised, and we would be particularly interested in suggestions on how to deal with that issue.

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

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

(b) **Should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet that principle?**

Notes for EFRAG's constituents

89 As explained above, the IASB is proposing to allow a choice as to where the return on an equity investment is presented: in profit and loss or in OCI. Although the IASB initially intended to permit this choice of presentation only for certain equity investments (strategic investments), it eventually decided to make the presentation choice available for all equity investments and to permit an instrument-by-instrument choice. That choice would have to be made on initial recognition, and no subsequent reclassification would be possible.

EFRAG's response

EFRAG view

- EFRAG believes it is appropriate to make the presentation choice available for all equity investments at the current time, and therefore agrees with the proposal.
- We support the ED's proposal to require a once-and-for-all decision to be taken about presentation on initial recognition.

90 EFRAG believes that the ED is right to make the presentation choice available for all equity investments at the current time. However, as stated above, in order to make this choice applicable to all instruments, the restriction on recycling needs to be lifted in certain circumstances, for example upon derecognition as suggested in our response to Question 10 above. Perhaps this is an area where, as practice evolves, the option can be narrowed.

91 The proposal in the ED is that the choice of presentation is to be made on initial recognition, and thereafter is irrevocable (in other words, reclassification from the 'presentation in OCI' to the 'presentation in profit or loss' or vice versa is not possible). We support this proposal. Unlike the criteria for determining whether a financial instrument is "managed on a contractual yield basis"—which is based on facts and circumstances that exist at a point of time—an election to present fair value gains or losses on an equity investment through OCI is a purely optional election. We do not consider that it would be appropriate to base a reclassification solely on a change in management intent and therefore support the ED's proposal to require a once-and-for-all decision to taken on initial recognition.

EFFECTIVE DATE AND TRANSITION

Question 12—Do you agree with the additional disclosure requirements proposed for entities that adopt the proposed IFRS early? If not, what would you propose instead and why?

Notes for EFRAG's constituents

92 *The ED proposes that, if an entity early adopts the final standard, it shall disclose for each class of financial assets and financial liabilities at the date of initial application the following:*

(a) *the original measurement category and carrying amount determined in accordance with IAS 39;*

(b) *the new measurement category and carrying amount determined in accordance with the final standard;*

(c) *the amount of any financial assets or financial liabilities designated as at fair value through profit or loss that have been reclassified in accordance with the provisions on embedded derivatives in the final standard, and their original measurement basis and presentation method; and*

(d) *the amount of any financial assets or financial liabilities that were previously designated as at fair value through profit or loss that are no longer so designated, distinguishing between those that final standard requires to reclassify and those that an entity elects to reclassify.*

EFRAG's response

EFRAG view

- EFRAG agrees with the proposal that these disclosures should be provided on transitioning to the new standard, but does not agree that they should be provided only on early adoption.

93 The proposals in this ED will, if implemented, involve some fundamental changes to financial instrument reporting. It is important therefore that they should be implemented in a way that causes minimum disruption for users. Requiring retrospective application of the new requirements will help here, but additional disclosures will still be necessary to help users to understand the changes that are being made and the effects that they have had and are likely to have in the future. For that reason, we support the proposal that additional disclosures are needed.

94 However, the ED proposes that those disclosures should be provided only by those entities that early adopt. We assume the reason for this is to ensure comparability between those entities that have early adopted and those that have not. Although we think this objective is worthy, we also think the disclosures have value in their own right and should in fact be required on transition, regardless of whether that is on the effective date or prior to it. We also think that requiring the disclosures on any transition date has the advantage of alleviating a potential concern that the disclosures could be seen as an additional burden for early adopters.

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

Notes for EFRAG's constituents

95 *An entity shall apply the final standard retrospectively, subject to the following:*

(a) *An entity assesses whether a financial instrument has basic loan features and is managed on a contractual yield basis on the basis of facts and circumstances that existed at the date of initial application;*

(b) *If the fair value of hybrid instruments cannot be determined for comparative periods an entity may use the sum of the fair value of the component parts. Any difference between the fair value in its entirety and the component parts at the date of initial application shall be reported as an adjustment to retained earnings or profit or loss depending on the initial application date;*

(c) *Designation at fair value through profit or loss can be made based on facts and circumstances existing at the initial application date and that classification shall be applied retrospectively;*

(d) *Designation of equity investments at fair value through OCI can be made based on facts and circumstances existing at the initial application date and that classification shall be applied retrospectively;*

(e) *An entity can revoke its previous designation at fair value through profit or loss based on facts and circumstances existing at the initial application date and that classification shall be applied retrospectively;*

(f) *If it is impracticable for an entity to apply retrospectively the effective interest rate method or impairment requirements of IAS 39 an entity shall use fair value as a basis for determining the amortised cost or impairment at the end of each comparative period. If an impairment loss is recognised using this approach or if it is impracticable for the entity to apply the effective interest method, the fair value of the financial instrument at the date of initial application shall be the new amortised cost of the instrument at the date of initial application;*

(g) *Investments in unquoted equity instruments (and derivatives linked and settled with those instruments) shall be measured at fair value at the date of initial application. Any difference is reported in opening retained earnings of the reporting period of initial application.*

(h) *Any hedge previously accounted for as a hedge under IAS 39 that is de-designated as a result of the final standard shall be accounted for a discontinuation of hedge accounting in accordance with the current provisions of IAS 39, from the date of initial application.*

(i) *For interim financial reports prepared in accordance with IAS 34 "Interim Financial Reporting", an entity is not required to comply with the final standard for prior interim periods if it is impracticable.*

EFRAG's response

EFRAG View
• As a matter of general policy, EFRAG much prefers new or amended standards to be applied on a fully retrospective basis because we think it is so much more useful for users.
• However, we have not yet had sufficient time to evaluate the transition guidance in the ED thoroughly, so are not yet able to make any further comment at this time. As soon as we have evaluated the transition provisions, we will update this letter.

96 Given the short time frame between the release of the ED and issuing this draft letter for public comment, we have not had the opportunity to review the transition provisions in detail. We are conscious that issues arising from transition provisions often only reveal themselves on thorough analysis and therefore we plan to take some time to understand the ED's transition provisions before forming a considered view. Therefore, we are issuing the draft letter now—to give constituents time to consider the other aspects of the letter—and will be updating our response to Question 13 as soon as possible. In the meantime, all the comments set out below in response to Question 13 should be regarded as tentative.

97 As a matter of general policy, EFRAG much prefers new or amended standards to be applied on a fully retrospective basis because we think it is so much more useful for users. For that reason, we agree with the ED's proposed principle of retrospectively applying new accounting guidance. However, we understand that applying the proposals in the ED will be a significant undertaking for many organisations, in particular financial institutions, and that whether the standard is to be applied fully retrospectively, prospectively, or somewhere in between could make a significant difference to when entities will implement it. These transition provisions need therefore very careful consideration.

98 Subject to our detailed review, we do have some initial comments:

(a) We think it is going to be very difficult to devise transitional arrangements that will satisfy everyone. There is no doubt that the changes proposed in the ED will take some entities considerable time to implement properly, and that suggests that a reasonably long lead time is needed, yet long lead times can create comparability issues for users. Similarly, the quality of the information provided is much greater if the revisions are applied retrospectively, but implementation will be quicker if they are applied prospectively. Some entities will want to implement the simpler, improved classification and measurement model as soon as possible, whilst others will wish to wait for the impairment and hedge accounting phases—and even related projects such as insurance contracts—to be finished so that they can implement an integrated set of changes.

(b) We think this last point is particularly important. Just as IASB has accepted that it would be unreasonable to expect entities to take irrevocable classification decisions about their financial instruments without knowing what the amended hedge accounting model will look like, so we think it is unreasonable to expect insurers to take those decisions without knowing what the revised, comprehensive version of IFRS 4 Insurance Contracts will require. In our view the IASB has a choice.

(i) It could extend the transition period for insurers up to the effective date for the new IFRS 4, or

(ii) It could grandfather the existing Available-for-Sale requirements for insurers until the effective date for the new IFRS 4, or

(iii) It could allow insurers the chance to reclassify their financial instruments on implementation of the new IFRS 4.

An advantage of option (ii) is that insurers would be able to change the way they account for their assets and the way they account for their liabilities at the same time. However, bearing in mind the timetable for the new IFRS 4, it might be that option (iii) is preferable.

(c) As we have just mentioned, the IASB has accepted that it would be unreasonable to expect entities to take irrevocable classification decisions about their financial instruments without knowing what the amended hedge accounting model will look like. However, it is proposing to address this by extending the transition period. Another approach might have been to allow reclassifications on implementation on the impairment phase and on implementation of the hedge accounting phase.

(d) We think the IASB ought to be considering seriously the possibility of allowing a "phased" adoption of the final standard. Specifically, we think it should be made possible to implement the proposals for equity investments separately from, and earlier than, the remaining parts of the standard. This ought to make it possible for those entities wishing to address issues relating to the impairment of Available-for-Sale securities early (in 2009 for example) to do so whilst still allowing entities to take the time needed to implement the remaining and more complex areas of the final standard in a considered and thought out way. It would also allow entities to wait until the remaining phases of the IAS 39 replacement project have been finalised, allowing adoption of all three phases at one time.

(e) It would be useful for the eventual standard to explain what should be done if it is impractical/impossible for an entity to fair value an instrument in comparative and prior periods. We think the standard should, in such cases, probably allow entities to take the adjustment between carrying amount and fair value at adoption.

(f) We question why the initial application date is a fluid date and not limited to the first day of a reporting period. We are concerned that such a free choice as to the initial application date could lead to manipulation with entities "shopping" for the best date, in terms of financial impact, within a particular period.

Question for EFRAG's constituents

99 We would welcome constituents' views on the transition provisions of the ED. In particular EFRAG would be interested in hearing any practical or feasibility concerns arising from the transition proposals.

AN ALTERNATIVE APPROACH

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?

Notes for EFRAG's constituents

100 The IASB explains in the ED that, in developing the approach proposed in the ED, it discussed a number of alternative approaches to classification and measurement and decided to describe a couple of them in the ED and ask for views.

101 *One of the alternative approaches involves a narrower amortised cost category for financial assets and a different presentation of the gains and losses arising on the instruments measured at fair value. In particular*:

(a) *financial assets would be measured at amortised cost only if they meet the two classification conditions set out in the ED (i.e. they have basic loan features and are managed on a contractual yield basis) and also are loans and receivables as defined in IAS 39. All other financial assets would be measured at fair value.*

(b) *Recognised fair value changes would be disaggregated and presented as follows:*

(i) *changes in recognised value determined on an amortised cost basis (including impairments determined using the existing impairment model applied to financial assets measured at amortised cost) would be presented in profit or loss. Impairments would be reversed in profit or loss; and*

(ii) *the rest of the recognised fair value changes would be presented in OCI. There would be no recycling of these amounts to profit or loss.*

The ED does not explain how financial liabilities would be treated.

102 The ED explains that some Board members think the approach would provide useful information because it disaggregates fair value between the profit or loss and OCI.

EFRAG's response

EFRAG view
• We do not believe that the alternative approach provides more-decision useful information than the approach proposed in the ED. In our view the amortised cost category under the alternative approach would be too narrow.

103 As explained above, the main differences between the alternative approach and the approach proposed in the ED are that the alternative approach involves a narrower amortised cost category and a different presentation of the fair value gains and losses arising on the instruments (with as cost-based gains and losses being presented in profit and loss and the remaining gains and losses in OCI).

(a) We do not support the narrowing of the amortised cost category in this way. In our view there are a wider range of financial assets for which amortised cost provides useful information than just loans and receivables that have basic loan features and are managed on a contractual yield basis. We note furthermore that the principle behind adding an additional classification test relating to loans and receivables is not clear and has not been articulated by the Board. In addition, we are uncertain how the alternative approach applies to financial liabilities.

(b) We agree that users find it useful for cost-based gains and losses to be presented separately from other gains and losses.

(i) However, presenting the cost-based gains and losses in profit or loss and other gains and losses in OCI (with no recycling) is only one way—and not necessarily the best way—of achieving that separate presentation.

(ii) The presentation proposed would require entities to carry out incurred loss impairment tests on financial assets measured at fair value. We are not sure whether it is intended that impairment tests would be carried out on all financial assets—including those that are being actively traded—or just some financial assets (for example, those that would be measured at amortised cost under the approach proposed in the ED).

- We doubt that much useful information is provided by carrying out incurred loss impairment tests of financial assets that are, for example, being actively traded.

- We agree that applying an incurred loss impairment model to other financial assets measured at fair value is probably preferable to the existing approach in IAS 39, but we find it difficult to judge whether it is better than the approach proposed in the ED.

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?

Notes for EFRAG's constituents

104 In Question 14's Notes for EFRAG's constituents, we described an alternative approach (to the one proposed in the ED) that is discussed briefly in the ED. The ED also explains that the IASB also discussed two variants on this alternative approach.

(a) The first variant would be to apply the alternative approach, but to present all gains and losses on financial assets in profit or loss, albeit presented separately so as to highlight the amounts described in (i) and (ii) above.

(b) The second variant would be to measure <u>all</u> financial instruments at fair value in the statement of financial position.

(i) *Gains and losses on financial assets and financial liabilities that, under the approach proposed in the ED, would be measured at fair value would be presented in profit or loss.*

(ii) *Gains and losses on financial assets and financial liabilities that, under the approach proposed in the ED, would be measured at amortised cost, would be disaggregated and presented as described above in (i) and (ii) of Question 14's Notes to EFRAG constituents.*

EFRAG's response

EFRAG view

- We do not believe that either of the possible variants of the alternative approach provides more decision-useful information than the approach proposed in the ED.
- In particular, we are not in favour of the introduction of a full fair value measurement model for financial instruments at this time, even if it is restricted only to the statement of financial position.

105 As explained above, instruments would be measured for statement of financial position purposes under the first variant in the same way as under the alternative approach. As we explained in responding to Question 14, we believe the alternative approach's amortised cost category is too narrow.

106 As explained above, the second variant would in effect require a full fair value statement of financial position, but with only some of the resulting gains and losses presented in profit or loss. As we made clear earlier in this letter, EFRAG supports the use of a mixed measurement system for reporting of financial instruments.