Australian Foundation
INVESTMENT COMPANY

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11th August 2009

The Chairman,
Australian Accounting Standards Board,
PO Box 204,
Collins Street West,
Victoria 8007

Dear Sir,

COMMENTS REGARDING ED 184 "FINANCIAL INSTRUMENTS: CLASSIFICATION AND MEASUREMENT"

We are submitting comments on the above Exposure Draft in our positions as Managing Director and Chief Financial Officer of Australian Foundation Investment Company Limited ("AFIC" or "the Company"), the largest Listed Investment Company ("LIC") in Australia. LICs are a widely recognised and popular way for retail shareholders to participate in the Australian share-market, and consequently have a high profile amongst the share-owning public. With nearly 90,000 shareholders, AFIC not only reports its financial performance to its', largely retail, shareholders but also reviews the reports of, and interacts with, the many Australian corporates that it invests in on behalf of its shareholders.

We are **supportive** of the proposal to allow us (and other long-term investors) to continue take fair-value movements on the stocks in AFIC's investment portfolio through Other Comprehensive Income.

We are also **supportive** of the proposal not to allow these changes in fair value occasioned by the sale or disposal of these assets to be recycled through profit. Movements in the invested capital of AFIC would therefore stay on the balance sheet, and not be regarded as profit for accounting purposes.

We are **not supportive** of, and **strongly oppose**, the proposal to not allow the income that these investments generate to be recorded as income through profit. For financial investors such as AFIC, the entity invests in order to be able to grow capital, like any other business, and to 'harvest' the dividends and income that this capital produces – again, like any other business.

We note in the Agenda paper (ref. 17A/63A) on "Financial Statement Presentation" submitted to the IASB/FASB meeting on 24th July (paper dated 14th July) that (para. 8) "FASB will consider an approach to classification of financial instruments that would require an entity to present within OCI changes in the fair value of a particular category of financial instruments. Dividends and interest income associated with those financial instruments would be presented in profit or loss." We understand that the situation described may not be completely analogous with equity instruments, but the principle is a sound one.

We **strongly support** this approach to equity investments that are not held for trading, and would urge the IASB/AASB to adopt this treatment.

As requested, we have commented on the relevant questions in the Exposure Draft below :

Q4 (a) Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated ?

Yes. A single classification approach is to be encouraged, providing that widely-quoted instruments that are held for investment purposes which contain a derivative element (i.e. convertible preference shares issued by corporates) can be treated as 'equity instruments' for the purposes of AASB 139.

Currently, AASB 139 requires either the derivative element to be stripped out and fair valued through profit and loss whilst the rest of the asset is valued through Other Comprehensive Income or for the entire instrument to be fair valued through profit and loss.

These financial assets are held for the same purpose as any other – namely to generate income, and have a market price that meets the definition of 'fair value' that does not require different elements of the asset to be identified and valued separately.

We therefore call on the AASB to allow all widely-quoted instruments, not just equity instruments, to be eligible for this treatment – i.e. quoted convertible notes issued by corporates and held as an investment not-for-trading to be fair valued through OCI.

To enable investors to account for these assets as they would for any other long-term financial asset would reduce complexity and in most cases reflect the intention of the entity in holding the asset.

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 ?

Yes. In most cases, particularly where the equity instrument is readily quoted and liquid (i.e. the market value is recent), fair value/market value is what a user would expect to see equity instruments valued at in an investor's portfolio.

We would argue that the fair value for an equity instrument should reflect the market price, which for most indices around the world is the 'last sale' price. Using 'last bid' results in a mismatch between the value of an equity investment in an investor's portfolio and the actual perceived 'market price' of that investment.

We note that paragraph 55 of ED 181 'Fair Value Measurement' notes that the ED does not 'preclude …other pricing conventions used by market participants as a practical expedient for fair value measurements within a bid-ask spread.' Should this be interpreted as supportive of the valuation of quoted securities at 'last sale', the common market practice, we would be supportive of this proposed treatment.

Question 10. Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting ?

Yes for fair value changes but No for dividends.

i) Dividends received as recurring income on capital invested are part of an entity's profit

There needs to continue to be a split between the recurring income that investors receive on the individual securities that they have invested in, such as dividends, and the non-recurring income such as realised gains or changes in fair value on those securities. Such a split should be between the Income Statement/Profit & Loss and Other Comprehensive Income.

By maintaining such a distinction, the accounting standards would also continue to recognise what the Company regards as the fundamental distinction between revenue and capital.

Users of AFIC's accounts, and the Company's shareholders, regard the profit that the Company generates (i.e. dividends received less tax and expenses) as the recurring yield on the capital invested. This dividend yield of an investment is one of the primary metrics in terms of determining the allocation of capital, and is the first of the two valuation metrics that shareholders and users of the Company's accounts regard as important for the valuation of the Company.

ii) Unrealised gains or losses on long-term investments do not form part of a company's profit, but are movements in the value of the Company's invested capital (as opposed to revenue derived from that capital), and thus belong in Other Comprehensive Income

Users of the Company's accounts expect to see the fair value of such investments reflected in the net assets of a company. Other comprehensive income is the correct place to record the movement in this fair value, as these movements do not reflect realised income derived from the investments. It is important to note that the Company does not hold that the sale of an investment generates 'income', but rather represents a re-allocation of capital.

This movement in the net assets is the second performance metric that users of the Company's accounts look to.

To conflate the two metrics by presenting the unrealised gains or losses on the investment portfolio as part of this income 'yield' would be confusing and misleading to users.

iii) Realised gains or losses on investments represent a re-allocation of capital.

For an investment company such as AFIC, capital is invested in various portfolios (e.g. cash, equities etc.). The buying and selling of particular investments within these portfolios represents merely the re-allocation of capital (albeit with taxation consequences). It is therefore correct and more meaningful for the user that these movements are not recycled through profit and loss but continue to be accounted for through other comprehensive income.

iv) Dividends received on investments have not historically been regarded by users or preparers of a long-term equity investors' financial statements as changes in fair value

Dividends are not recognised by either the Company or the Company's shareholders as changes in fair value. The dividends represent the cash income that the capital invested in these financial instruments has generated.

Distributions and dividends have been regarded as the income for investment companies such as AFIC's for over 80 years. To determine that that income, which is for many investment companies the only source of income, be excluded from their profit and loss statement, would be to render the entire financial statements misleading.

An example of the Company's Profit and Loss Account prior to the introduction of IFRS illustrates the format of the accounts, and the component of profit, that users of the Company's accounts recognise has been attached.

v) Other Accounting Standards highlight the difference between changes in fair value for assets and income derived from those assets

It should be noted that there is an argument that under the recent changes to AASB 127 there has been an implicit recognition that a dividend received on capital invested in a subsidiary is income to be reported through profit and loss, rather than forming part of the 'fair value' of the investment, by removing the distinction between dividends paid out of 'pre-acquisition' and 'post-acquisition' profits.

In addition, AASB 116 allows capital invested in plant, machinery and equipment to be fair valued through the balance sheet, but income derived from those assets to be taken to the profit and loss account.

vi) The proposed ED draws a distinction between capital invested in equities and capital invested in other types of asset.

In determining that dividends not be treated as income, the ED draws an artificial distinction between income derived from capital depending upon the legal structure that has been used to produce that income – as the Company has invested in equities, income from that capital will not be shown as income in the profit and loss statement.

If the Company had invested its capital through a different type of ownership structure, income derived from that investment would be treated as income in the profit and loss statement.

For instance, if the Company purchased a mine, it would be able to treat income derived from that mine as profit and changes in the fair value of that mine as a movement directly in equity (until the reserve is exhausted). However, should the Company purchase equities in BHP Billiton which owns mines, the treatment is different.

vii) The proposed treatment can lead to a mismatch between income and expenses, leading to a profit figure that is misleading.

To exclude dividends received from income may lead to Investment Companies such as AFIC showing a profit figure that is after the expenses incurred in deriving the dividend income, and possibly the tax on that income, without showing the income itself – a profit figure that would be widely reported and noted as although in accordance with accounting standards bearing no relation to the actual recurring income yield of the Company's capital.

In the example given of the Company's own Profit and Loss Account for 2004 & 2003, 2004 under the current ED would show a small profit whilst 2003 would show a loss, neither of which is indicative of the real yield that the Company's capital has generated.

viii) A possible solution may be to distinguish accounting treatments for entities whose purpose is to invest their capital in other entities.

Investment companies, and other vehicles such as investment trusts, are very different from other entities as they produce no goods or services, and have no customers other than their shareholders.

A solution for these types of entities would be to revert to the previous accounting treatment : fair value movements on long-term investments through other comprehensive income, dividends on capital invested in that portfolio to be treated as income through the profit and loss account. Unlike UK investment companies, Australian LICs have not shown movements in fair value in their investment portfolios as part of their profit and loss – either under AIFRS or under previous Australian Generally Accepted Accounting Principles.

ix) Consistency of treatment is needed between types of investments that can be held by a long-term investor – widely-held/quoted debt securities or trust units should be accounted for on the same basis as equity instruments held for the same purpose (ie distribution yield).

It is important that for consistency that the definition of equities be extended to listed trusts and stapled-securities (which are unit trust and equity-instruments that cannot be sold separately but are valued and quoted on a unified basis), or as noted above that all widely quoted instruments held for investment purposes be eligible to be fair valued through OCI.

Should this not be affirmed, there is a real risk that although listed investments held by the Company are managed and recorded exactly the same way internally, the accounting requirements would force distributions and movements in fair value from listed trusts to be recorded through the income statement whilst the fair value movement on equities goes through other comprehensive income. Without this clarification, there is also a real risk that an over-zealous interpretation of the standard may force the Company to separate for accounting purposes the equity part of a stapled security from the trust element and force the two to be accounted for differently, even though they are listed and quoted as a single instrument.

Question 11. Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those held for trading), only if it elects to do at initial recognition ?

Yes (but see above for comments re. dividends). An equity instrument should be either classified as a long-term investment or held for trading on acquisition. In other words, no changes can be made retrospectively.

An entity should be able to 'sell' an asset from trading to investment. Any such 'sale' would need to be done at fair value on the date of sale, with the accumulated fair value movement remaining in retained earnings. This would thus mirror what would occur should the entity sell the trading asset on-market and then re-purchase it for investment. To disallow this would only cause entities that do wish to do this to incur additional costs such as brokerage and possible settlement risk due to a strict interpretation of an accounting standard.

Question 13. Do you agree with applying the proposals retrospectively ?

Yes. 'Retrospectively' will have to be with effect from the previous corresponding period. As the majority of Australian entities have a 30 June reporting date, it may be beneficial to expressly state that entities who have had a reporting date between 1 January 2009 and the date of the standard being issued would be allowed to restate their most recent accounts under the new Standard.

Yours sincerely

Ross Barker
Managing Director

Andrew Porter
Chief Financial Officer

cc : Australian Institute of Company Directors
cc : Mr Tony Reeves, President, Group of 100
cc : Mr Jeffrey Lucy AM, Chairman, Financial Reporting Council
cc : Mr James Gerraty, Australian Stock Exchange

PROFIT AND LOSS STATEMENT FOR THE YEAR ENDED 30 JUNE 2004

	Note	2004 $'000	2003 $'000
Income from investment portfolio		118,305	110,202
Income (loss) from trading portfolio		14,132	(4,054)
Income from deposits and bank bills		6,714	3,772
Other income		827	729
Total income from ordinary activities		**139,978**	**110,649**
Borrowing and related expenses		(983)	(979)
Administration expenses		(5,299)	(3,763)
Profit from ordinary activities before income tax expense	3	**133,696**	**105,907**
Income tax expense	4	**(9,449)**	**(3,107)**
Net Profit		**124,247**	**102,800**

		Cents	Cents
Basic earnings per share	18	14.3	13.2
Ordinary Dividends		13.25	12.25
Special Dividends		1.00	2.00