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Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

16 September 2009

Dear Kevin

AASB ED 184 and ED 186, Invitation to Comment ITC 21 and Discussion Paper AASB 139 DP

I am enclosing copies of the PricewaterhouseCoopers responses to the following International Accounting Standards Board's papers:

- IASB Exposure Draft ED/2009/7 *Financial Instruments: Classification and Measurement* [AASB ED 184]
- IASB Exposure Draft ED/2009/9 *Classification of Rights Issues (Proposed amendments to IAS 32)* [AASB ED 186]
- IASB Discussion Paper DP/2009/2 *Credit Risk in Liability Measurement* [AASB ITC 21], and
- IASB Request for Information *Impairment of Financial Assets: Expected Cash Flow Approach (Expected Loss Model)* [AASB Discussion Paper - AASB 139 DP]

The letters reflect the views of the PricewaterhouseCoopers network of firms and as such include our own comments on the matters raised in the exposure drafts and the discussion papers.

We would welcome the opportunity to discuss our views at your convenience. Please contact me on (02) 8266 8350 if you would like to discuss this further.

Yours sincerely

Regina Fikkers

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

14 September 2009

Dear Sir

Exposure Draft Financial Instruments: Classification and Measurement

We are responding to your invitation to comment on the above Exposure Draft on behalf of PricewaterhouseCoopers.

Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms who commented on this exposure draft. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We recognise the significant efforts that the Board is making to respond promptly to current economic events and the requests of the Financial Stability Forum and, in particular, to ensure that reporting entities are given the opportunity to apply the new principles of classification and measurement for 2009 financial reports. As a general rule, we do not support a phased approach to the development of accounting standards as this creates uncertainty for preparers and risks confusion for users. However we understand that this has been an inevitable result of the perceived urgency of the issue. We therefore welcome the opportunity to comment on Board's proposals on the first phase of this important topic.

We are disappointed to note that the urgency of the project has meant that the Board has been unable to work to the same timetable as the FASB on this topic. The recent crisis has illustrated the importance of ensuring convergence in reporting exposure to financial risk. We were therefore pleased that the Boards held joint roundtables to discuss their proposals before the end of the consultation period. Accounting for financial instruments is an important area of accounting with far reaching consequences and dynamics. We will continue to monitor developments in this debate globally and we will consider any new information that may emerge. We encourage the IASB to do the same. In particular we urge the Boards to engage in continuing dialogue with each other and with constituents and to work together to develop a single model of classification and measurement as the basis for a high quality single converged standard for financial instrument accounting.

The application of a mixed measurement model

As indicated in our comment letter dated 5 September 2008 in response to the Discussion Paper on Reducing Complexity in Reporting Financial Instruments, we support the continued application of a mixed measurement model for financial instruments but recognise the need for the removal of excessive complexity from the current model. Accounting standards should be based on principles rather than rules and result in clear and transparent financial statements that faithfully represent the economic consequences of transactions and set results in the context of the entity's business model. We therefore welcome the Board's proposal that accounting should reflect, at least to some extent, the different objectives for originating, acquiring, issuing or holding financial instruments. We also support the proposal that the model should be simplified to require, in essence, two measurement models for financial instruments: fair value and amortised cost.

In our view, the business model employed by a reporting entity should be the primary factor in determining how best to report the amount, timing and uncertainty of cash flows for financial instruments. The strategy behind entering into a financial instrument should affect its classification and ultimately its accounting and reporting. In other words, the accounting for financial instruments should primarily reflect the way the business is run and managed and not be pre-determined solely by contractual characteristics. We therefore support the notion that amortised cost is an appropriate measurement attribute for financial instruments that are held predominantly for the collection or payment of the contractual or expected cash flows rather than to sell or settle with a third party. On the other hand, we believe that fair value is the most appropriate reporting basis for instruments which are held with a view to realisation through sale.

We recognise, however, that there are some financial instruments that, by their nature, are unsuited to an amortised cost model because they contain features that do not compensate the holder solely for the time value of money or credit risk. It is unlikely that such instruments can be managed solely on the basis of cash flows. Consequently we support the inclusion of a secondary criterion, based on the characteristics of the instrument, for determining its classification. As indicated in our detailed responses in the Appendix, however, we believe that the principle set out in the exposure draft needs some modification to be suitable for this purpose.

In addition to the comments made above, we address some more detailed concerns about the Board's proposals in the attached appendix. In particular, we believe that it is essential that the criteria relating to the business model and basic loan features are clearly defined as a principle to ensure that they can be consistently applied in practice. Furthermore, we do not agree with the proposals to require fair value treatment to all financial assets acquired at a discount or to all tranches of debt issued by structured vehicles below the most senior tranche. As discussed in more detail in the appendix, we believe that a more precise articulation of the principles for classification will ensure that these instruments will be classified and accounted for appropriately.

Reclassification

In view of our support for the business model as the primary factor behind the classification of financial instruments, we do not support the prohibition on any subsequent reclassification. In fact, we believe that this is inconsistent with the use of the entity's business model as a criterion for classification, even where the characteristics of the instrument carry equal weight. We assume that this prohibition is intended to be an anti-abuse provision but do not agree that this is either necessary or appropriate in a principles-based standard.

As indicated in paragraph BC32 of the Basis for Conclusions on the Exposure Draft, an entity's business model is not a voluntary designation but rather a matter of fact that can be observed from the way that an entity is managed. Consequently, a change in the way in which a portfolio is managed will equally be a matter of fact and should be reflected by a prospective reclassification of affected instruments into the appropriate category at the time of the change. Such reclassifications should be both from amortised cost to fair value and vice versa, as appropriate, and should be mandatory where the business model changes.

We do not expect the business model to change frequently but, where it does, any such changes should be reflected in the accounting. Furthermore where reclassifications are required there should be full and transparent disclosures to ensure that users have a clear understanding of how, and why, the business model of the entity has changed and the impact that this has had on the financial statements. Prospective application of changes in the business model as well as robust disclosures should alleviate any concerns over abusive reclassifications.

Equity investments

We recognise that equity investments lack contractually determinable cash flows and are held for appreciation in value realised either through discretionary dividends or an ultimate sale and hence that amortised cost is not an appropriate measure. We therefore support the proposal that these should be measured at fair value in the balance sheet. Nonetheless, as indicated in our response to the Discussion Paper on Reducing Complexity in Reporting Financial instruments, we believe that the current use of the available for sale category for equities allows for a better reflection of the business model for holding equity investments as a long term strategy than requiring income statement recognition of the movements in fair value.

The proposal in the exposure draft for a voluntary election to present in other comprehensive income all fair value changes, including dividends, on selected equity investments with no subsequent recycling achieves the objective of allowing such volatility to be excluded from the income statement. However by concluding that recycling of realised gains and losses is inappropriate, it pre-empts the debate around the purpose of the other comprehensive income statement that rightly belongs in the financial statement presentation project. Furthermore, the prohibition on the recognition of dividends on such investments in the income statement results in an accounting mismatch between dividend income and funding cost that is important for an understanding of the business model of long term investors in equities such as insurance companies. Consequently, we recommend that any decision to eliminate the available for sale category for equity investments is deferred until the financial statement presentation project has been fully debated and the role of the other comprehensive income statement has been established.

The retention of the available for sale category for equity investments means that it is not possible to eliminate one related source of complexity – impairment. We believe that much of the difficulty associated with determining the timing of impairment of such instruments could be eliminated if subsequent reversal of impairment losses were permitted. Consequently we recommend that all fair value movements below cost, including subsequent recoveries in value, should be recognised in the income statement once the impairment event (a significant or prolonged decline below cost) has occurred.

As far as the Board's proposal is concerned, we note that the decision not to allow any recycling through the income statement has the effect of excluding dividend income from net income. This is counter-intuitive since the payment of dividends is not contractual and is outside the control of the investor. As stated above, it can also result in an accounting mismatch between dividend income and the associated funding cost that may impair an investor's understanding of the financial performance of the entity. If the Board decides to proceed with this model, we would encourage them to address this issue, although care would need to be taken to ensure that the recognition of dividends in the income statement does not extend to returns of capital. However, in view of the additional complexity any such amendment would introduce, coupled with the difficulty of defining the circumstances when the optional treatment is appropriate and the risk of pre-empting the wider debate around the performance reporting model, we do not support the Board's proposal.

Financial liabilities

As indicated above, we support, in general terms, an approach which classifies financial instruments based primarily on the business model but also taking into account the characteristics of the instrument. We recognise, however, that this model, if not modified, would result in an increased use of fair value through the income statement for structured financial liabilities and in a consequential increase in the impact of movements in an entity's own credit risk on the income statement. We acknowledge the concerns expressed in the recent report of the Financial Crisis Advisory Group which recommended that "the Boards should reconsider the appropriateness of an entity's recognition of gains or losses as a result of fair value changes in the entity's own debt because of decreases or increases, respectively, in its creditworthiness". This debate has only just begun with the recent publication of the staff paper for comment.

The proposed treatment will also create income statement volatility for some long-term funding structures. In many cases non-financial entities issue structured debt for funding purposes where there is market appetite for such instruments making it easier to raise funds in this form. Such entities will usually hedge the resulting exposures to simulate the issuance of a 'vanilla' debt instrument. We do not consider that the income statement volatility created by the proposal for such instruments provides decision-useful information in these circumstances. However, any alternative model is inextricably linked with the ability to achieve hedge accounting which will not be addressed until the third phase of this project.

Finally we note that the Board is still deliberating on its proposals to amend the classification of debt and equity. This project may result in a change in classification for equity components of compound instruments which will then need to be accounted for in accordance with this standard.

In the light of the above we urge the Board to retain existing guidance for financial liabilities and to reconsider their proposals once the debates around movements in own credit, hedge accounting and the classification of debt and equity have been resolved.

Fair value option

The right to carry any financial asset or liability at fair value is important to many entities, particularly in the financial services sector, and therefore we continue to support an unrestricted fair value option. We note that the requirement to designate a financial asset or liability at inception and the prohibition on subsequent reclassification, which we support, impose stringent conditions on the selection of the option which reduces incentives for abuse.

We recognise, however, that an unrestricted fair value option has been opposed by many in the past and that it may not be practical to introduce it now. Therefore, if the Board decides to proceed with a restricted fair value option, we agree that, as a minimum these restrictions should not prevent an entity from applying the fair value option where there is an accounting mismatch. In general, we support the prohibition on subsequent reclassification of financial instruments under the fair value option but we believe that there should be some flexibility where an accounting mismatch is created or removed by a change in the accounting policy relating to the matching asset or liability. In such circumstances, a reporting entity should be allowed to apply, or cease to apply, the fair value option to existing assets and liabilities. This is particularly important since both hedge accounting and the treatment of insurance contract liabilities are currently under review by the Board and may result in future changes.

Transition

We note that one of the key objectives of the Board in publishing these proposals separately from its proposals to amend the impairment and hedging requirements of IAS 39 is to permit early adoption in 2009. Consequently we believe that it is important to ensure that the transition requirements are practical to adopt within a very short timescale. In particular, we believe that full retrospective application and the restatement of comparatives are likely to prove prohibitive for early adopters. We therefore recommend that reporting entities adopting the standard early are not required to restate comparatives.

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Our responses to the specific questions in the exposure draft are attached in the Appendix to this letter. If you have any questions on the content of this letter, please do not hesitate to contact Richard Keys, PwC Global Chief Accountant (+44 20 7212 4555), or Pauline Wallace (+44 20 7804 1293).

Yours faithfully

PricewaterhouseCoopers LLP

APPENDIX

Question 1

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

We believe that amortised cost provides decision-useful information for financial assets and financial liabilities that are predominantly held for the collection or payment of contractual or expected cash flows. For such financial instruments, the use of amortised cost reflects the way in which the business is run and managed and provides the user with information about the likely future cash flows that the reporting entity can anticipate. Consequently we believe that the underlying business model should be the primary driver for determining the classification and measurement of financial instruments.

We recognise, however, that financial assets that contain features that do not compensate the holder solely for the time value of money or credit risk, such as derivatives, equities and certain hybrid debt instruments, are unsuited to an amortised cost model even if the reporting entity's intention is to hold them for the longer term. Consequently, we believe that the characteristics of a financial asset should be a secondary consideration in determining its classification.

Furthermore, as we note in our response to question 2, we believe that there is a need for greater clarity and consistency in the definition of the principles that underlie this approach than is currently the case in the exposure draft.

Question 2

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

We believe that the terminology used and its application is insufficiently clear for it to be operational.

Basic loan features

The term "basic loan features" is not a generally understood term in accounting and it is not defined in the exposure draft. If this term is to be used as one of the key criteria driving accounting classification and measurement, it must be clearly defined, with a distinction made between the underlying principle and any illustrative examples. At present there is no clear distinction between the definition of the underlying principle which seems to be established in B1 and the examples set out in B3. Furthermore, many of the examples seem to rely on aspects of the definition of basic loan features that are not set out in B1, particularly the concept that any leverage is prohibited. The concept of leverage is currently only referred to in the Basis for Conclusions (BC21) which points out that "leverage amplifies the variability of cash flows with the result that those cash flows do not have the economic characteristics of interest". To enable consistency of interpretation it is essential that the principle is explained fully.

We therefore recommend that the term "basic loan features" is defined either in the main part of the standard or in the definitions section as follows: "Basic loan features are unleveraged contractual terms that give rise on specified dates to determinable cash flows that are solely payments of principal and interest on the principal outstanding. In this context, interest is consideration for and directionally consistent with the time value of money and the credit risk associated with the principal outstanding."

We support the use of examples as application guidance but it needs to be clear that these are intended to be illustrative only. Limiting examples to obvious features (such as LIBOR based interest) and omitting the rationale for the conclusion suggests that the list is intended to be exhaustive and does not encourage interpretation by analogy. An alternative approach would be to create examples that are clearly selective (ie by not covering all the obvious examples) and including the rationale behind the application of the principle. This might address the less obvious instruments such as inflation linked instruments, perpetual instruments with mandatory coupons, extension options, and caps, floors and collars, all of which appear to meet the criteria for instruments that have contractually determinable cash flows and which should be capable of being carried at amortised cost.

Managed on a contractual yield basis

We do not believe that the term 'managed on a contractual yield basis' is a well understood concept, nor that it appropriately describes the typical business model for which amortised cost provides decision-useful information. In paragraph B9, the Board clarifies the term as referring to management and evaluation "on the basis of the contractual cash flows that are generated when held or issued". We would prefer to see more focus on the way in which the instruments will be realised or settled rather than on active management of yield. We do not believe, for example, that most entities would consider that they manage accounts receivable on a contractual yield basis since the only active management involved in the process of holding such assets is the management of credit risk. Furthermore, a bank that actively hedges the exposure to interest rates in its loan portfolio does not manage on the basis of contractual yield but rather on the basis of the hedged yield. Nonetheless, in both cases we believe that amortised cost is the appropriate measurement model since the assets are held to recover the contractual cash flows.

The Basis of Conclusions (BC 31) indicates that the Board's intention was to capture a business model whereby financial instruments are held predominantly for the collection and payment of contractual cash flows. This is consistent with the terminology used in the FASB Summary of Decisions and is easier to understand and apply. We believe, however, that this would better articulate the way in which financial instruments are managed if it referred to the collection and payment of contractual or expected cash flows, since this recognises that entities also manage credit risk and prepayment risk.

In addition, we believe that it is important for any definition of the business model to recognise that sales of financial instruments should not in themselves taint the presumption that the predominant purpose is to hold the assets for the collection of contractual or expected cash flows. We therefore recommend that the guidance set out in BC33 regarding sales of financial instruments with basic loan features should be elevated to the application guidance section of the standard.

Question 3

Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost? If so,
(a) what alternative conditions would you propose? Why are those conditions more appropriate?
(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?

We have set out in our response to question 2 our proposals for the clarification of the conditions that are necessary to identify the financial assets and liabilities that should be measured at amortised cost. We believe that these proposals are likely to result in clarity around the interpretation of the categories rather than a significant shift in the classification methodology itself. However, there are three specific topics that we would like the Board to reconsider: financial assets that are acquired at a discount that reflects incurred credit losses, non-derivative financial liabilities (both of which are discussed below) and the impact of subordination on classification (see our response to Question 4 below).

Financial assets acquired at a discount

We do not agree that it is appropriate for all financial assets acquired at a discount due to incurred losses to be carried at fair value. The timing of acquisition of the assets does not change the basic characteristics of the instruments which continue to have basic loan features. Rather we believe that the classification of the instruments should depend on the assessment of the entity's business model for their subsequent management. In our view, there is a difference between the acquisition of a portfolio of distressed assets at a very significant discount due to credit impairment, where the investor is subsequently hoping to realise cash flows significantly in excess of the consideration, either through subsequent resale or improvements in market conditions, and the normal acquisition by one bank of a portfolio of retail loans from another bank, with a view to improving the recovery of cash flows through active credit management. In the former case the entity is unlikely to manage the assets on the basis of the collection of contractual or expected cash flows from the assets themselves so amortised cost is unlikely to provide decision-useful information about the asset. In the latter case, however, the acquiring bank is likely to manage the portfolio in conjunction with other similar originated loan portfolios, and therefore amortised cost appears to be the most appropriate way to reflect the manner in which the entity plans to recover the value of the underlying assets. Similar considerations would apply to a loan portfolio acquired as part of a business combination.

We note that the exposure draft itself is unclear as to the rationale for excluding these assets from the amortised cost category. In paragraph B13, such assets are identified as an example of financial assets that are not managed on a contractual yield basis. In the Basis for Conclusions (BC29), however, the Board states that such a financial asset cannot have basic loan features. We believe that the contractual features of an instrument are established at the inception of the instrument and therefore cannot change based on the timing of acquisition. Furthermore, the concept of incurred losses as defined in IAS 39 recognises that they may arise on a portfolio basis and that it may not be possible to identify immediately the specific asset that has been impaired. This is consistent with the way in which transactions in loan portfolios or portfolios of debt securities are priced. In such circumstances it would be impossible to determine which assets have incurred losses and should be carried at fair value and which can continue to be accounted for at amortised cost.

We believe that, in those circumstances where a portfolio truly consists of distressed loans and is acquired with the view to realise value through a subsequent sale, the application of the business model principle will be sufficient to determine that fair value is the appropriate measurement attribute. In all other cases, the existence of incurred losses in an acquired loan portfolio should not override the general principle that acquired assets with basic loan features that are held for the collection of contractual or expected cash flows can be carried at amortised cost. This would be consistent with the Board's conclusion set out in BC16 that some entities manage originated and purchased loans in the same portfolio and that distinguishing between originated and purchased loans for accounting purposes would add complexity to the accounting model and involve systems challenges. In addition, the Board's current proposal appears to perpetuate the use of the incurred loss model for assessing impairments at the same time as the Board is considering the adoption of a new impairment model to address the shortcomings of the current approach.

Financial liabilities

As discussed in our covering letter, we note that the proposed model is likely to result in the increased use of fair value for structured financial liabilities. In particular, convertible debt instruments with equity features that do not meet the definition of equity under IAS 32 or structured debt (such as debt indexed to equity or commodity prices) will be recorded at fair value with changes in fair value, including those related to changes in interest rates or own credit risk, being taken to the income statement, regardless of the business purpose of the debt issuance. We note that, in the majority of cases, non-financial entities that issue this type of debt do not do so to create an exposure to an unrelated risk, but because at the time of issuance investors are looking for these features and therefore it is easier to raise funds in this form. In order to avoid taking on the unrelated risk, the issuing entity will usually swap the debt back to floating or fixed rate, thus creating a synthetic "vanilla" debt instrument, and include this in its overall funding portfolio which is managed on the basis of the settlement of contractual cash flows. Under current accounting, the embedded derivative is accounted for separately from the host debt instrument and offset against the fair value movement in the hedging derivative, resulting in little, if any, volatility in the income statement.

Requiring non-financial entities to include in profit or loss changes in fair value (including changes related to interest rate fluctuations or own credit risk) of instruments used for funding purposes represents a significant change to the present standard and will not in our view improve the decision usefulness and comparability of financial statements. In addition, recording the fair value change due to interest rate movements in the income statement will cause companies which generally issue fixed (as opposed to floating) rate debt to face significantly higher earnings volatility than those generally issuing floating rate debt. The choice between fixed or floating rate debt is a factor largely driven by a company's business model and industry sector, and we believe it would be inappropriate to put issuers of fixed rate debt at a disadvantage. Any alternative model, however, is inextricably linked with the ability to achieve hedge accounting which will not be addressed until the third phase of this project.

More generally, we acknowledge the concerns expressed in the recent report of the Financial Crisis Advisory Group around the inclusion in the income statement of gains or losses resulting from fair value changes due to movements in an entity's own creditworthiness. The recent publication of a staff paper on this topic has begun the debate and any increase in the use of fair value for financial liabilities should take the views of commentators on that publication into account.

Finally, we note that the Board is still deliberating on its proposals to amend the classification of debt and equity. This project may result in a change in classification for equity components of compound instruments which will then need to be accounted for in accordance with this standard.

In the light of the above, we believe that the Board should retain its existing guidance for financial liabilities and to reconsider their proposals once the debates around movements in own credit, hedge accounting and the classification of debt and equity have been resolved.

Question 4

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

(a) Yes, we agree that the embedded derivative requirements for hybrid contracts with financial hosts should be eliminated. These requirements are essentially rules-based and add unnecessary complexity to financial reporting. However we do not agree that paragraph 11A should be deleted as an inevitable result of this change. Paragraph 11A was the subject of the August 2008 annual improvements exposure draft which proposed to specify that the fair value option was only applicable to financial instruments within the scope of IAS 39. As we indicated in our response letter to that exposure draft we do not agree with that proposal. As indicated in the Basis for Conclusions to IAS 39, the objective of paragraph 11A was to reduce the cost and complexity of complying with IAS 39. This objective applies equally to non-financial host contracts with embedded derivatives and therefore we do not believe that the right to use the fair value option for such contracts should be removed. We note that the amendment was never finalised based on the comments received so we urge the Board to reconsider the deletion of this paragraph. This would also be consistent with the Board's decision set out in BC 47 not to amend the requirements around embedded derivatives for non-financial host contracts at this time.

(b) No, we do not agree with the proposed classification approach for contractually subordinated interests. The prohibition on amortised cost accounting for all tranches of debt issued by structured investment vehicles other than the most senior tranche is an arbitrary rule that would be susceptible to structuring in order to achieve an accounting result. In our view, the Board should rely on the same criteria of business model and basic loan features in determining the appropriate classification of such instruments as they apply to other instruments. It is wrong to conclude that the existence of subordination in a particular tranche of debt is sufficient in its own right to create leverage and therefore cannot meet the definition of an instrument with basic loan features. In addition, we do not accept the Board's arguments in BC26 and BC27 discussing the difference between subordinated debt issued by a normal operating entity and subordinated debt issued by a structured investment vehicle. .

We recognise that certain tranches of debt issued by structured investment vehicles may contain a degree of leverage by comparison with the underlying assets and therefore should not be eligible for amortised cost treatment. Moreover the financial instruments held within the vehicle may themselves not meet the definition of instruments with basic loan features and therefore the debt issued by the vehicle should also not be capable of achieving amortised cost treatment. If an amortised cost basis is deemed appropriate for the underlying instruments, then it should be an appropriate basis for an investment in a pool of such instruments, provided that the investment has the same or less exposure to credit risk compared to holding the same notional of underlying assets within the pool. Consequently, we believe that an entity should be required to look through the vehicle to assess the nature of the underlying assets and the extent to which debt is leveraged by reference to those assets in order to determine whether amortised cost treatment is appropriate.

We recognise that it may not always be practical to "look through" a structure to the underlying investments. However, since the proposals in the exposure draft presume that financial instruments will be carried at fair value through profit and loss unless the instrument meets the two specified criteria, entities would effectively have to apply that accounting unless they could demonstrate that the instruments meet the basic loan criteria by looking through the vehicle to the underlying assets.

Question 5

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

The right to carry any financial asset or liability at fair value is important to many entities, particularly in the financial services sector, and therefore we continue to support an unrestricted fair value option. However, we recognise that an unrestricted fair value option has been opposed by many in the past and that it may not be practical to introduce it now. Therefore, if the Board proceeds with a restricted fair value option, we agree that these restrictions should not prevent an entity from applying the fair value option where there is an accounting mismatch. This option is particularly important both for insurance companies and for entities that do not want to apply the complex hedge accounting rules. We therefore believe that this option continues to be valuable for many entities and to provide more decision-useful information to users provided that its application is transparent and there is adequate disclosure about its use.

In general we support the continued prohibition on subsequent reclassification of financial instruments under the fair value option. However, we believe that there should be some flexibility where an accounting mismatch is created or removed by a change in the accounting policy relating to the matching asset or liability. In such circumstances, a reporting entity should be allowed to apply, or cease to apply, the fair value option to existing assets and liabilities. This is particularly important since both hedge accounting and the treatment of insurance contract liabilities are currently under review by the Board and may result in future changes.

Question 6

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

As discussed in greater detail in the covering letter and in our response to question 5 above, we continue to support an unrestricted fair value option for all financial instruments.

Question 7

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

No, we do not believe that reclassification should be prohibited. On the contrary we believe that the prohibition is inconsistent with the use of the entity's business model as one of the principal criteria for classification. As indicated in our covering letter, we believe that accounting standards should be designed to set results in the context of the business model of the reporting entity. To the extent that the business model changes, this change should equally be reflected in the accounting treatment of the financial instruments managed on that basis. We do not expect the business model of entities to change frequently but we believe that any such change should be reflected in the accounting. We agree with paragraph BC 32 in the Basis for Conclusions which recognises that the way in which a portfolio of financial instruments is managed is a matter of fact that can be observed. Consequently we do not expect it to be difficult to identify when this has changed and thus when reclassification is required. Such reclassifications should be both out of the amortised cost category into fair value and vice versa, as appropriate, and should be mandatory when the business model changes. Where reclassifications are required, there should be full and transparent disclosures to ensure that users have a clear understanding of how, and why, the business model of the entity has changed and the impact that this has had on the financial statements.

We believe that such reclassifications should be reflected on a prospective basis at the time of the change in the business model. As the reclassifications will arise only when a business model changes it would be inappropriate to restate comparatives which properly reflect a different business model. If the instruments are reclassified from amortised cost to fair value then the adjustment to fair value should be reflected in current period profit or loss. If the instruments are reclassified from fair value to amortised cost then fair value should be treated as the deemed cost from that date onwards.

We believe that accounting for changes in the business model prospectively together with the transparency of the required disclosure will be sufficient to address any risk of abuse.

Question 8

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

Yes, we believe that all investments in equity instruments should be measured at fair value. Equity investments cannot be held for the collection of contractual cash flows and can only be realised by sale, so fair value provides the most decision-useful information to users. However, as discussed in our response to question 10, we do not believe that the changes in fair value in each period should be reflected in profit or loss for all equity investments.

Question 9

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

Whilst we recognise that there may be significant challenges involved in obtaining the necessary information, especially in developing countries, and significant costs incurred in determining fair values, we support the removal of the cost exemption for unquoted equities since we believe that amortised cost does not provide relevant information for such instruments. We believe that in most cases the fair value of such instruments can be determined reliably using well-developed models. We also note that small unsophisticated entities which often encounter most difficulties in determining fair values will still have cost exemption available under the SME IFRS.

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Question 10

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

As indicated in our covering letter, we believe that it is not appropriate to require all equity investments to be carried at fair value through the income statement since this will result in the recognition in income of volatility from fair value movements in equity investments which are held as a long term business strategy. We believe that the current use of the available for sale category for equity investments that are not held for trading allows for a better reflection of the business model for holding such equity investments.

The proposal in the exposure draft for a voluntary election to present in other comprehensive income all fair value changes, including dividends, on selected equity investments with no subsequent recycling achieves the objective of allowing such volatility to be excluded from the income statement. However by concluding that recycling of realised gains and losses is inappropriate, it pre-empts the debate around the purpose of the other comprehensive income statement that rightly belongs in the financial statement presentation project. Furthermore, the prohibition on the recognition of dividends on such investments in the income statement results in an accounting mismatch between dividend income and funding cost that is important for an understanding of the business model of long term investors in equities such as insurance companies. Consequently, we recommend that the elimination of the available for sale category for equity instruments is deferred until the financial statement presentation project has been fully debated and the role of the other comprehensive income statement has been established.

The retention of the available for sale category for equity investments means that it is not possible to eliminate one related source of complexity – impairment. We believe that much of the difficulty associated with determining the timing of impairment of such instruments could be eliminated if subsequent reversal of impairment losses were permitted. Consequently we recommend that all fair value movements below cost should be recognised in the income statement once the impairment event (a significant or prolonged decline below cost) has occurred.

As far as the Board's proposal is concerned, we note that the decision not to allow any recycling through the income statement has the effect of excluding dividend income from net income. This is counter-intuitive since the payment of dividends is not contractual and is outside the control of the investor. As stated above it can also result in an accounting mismatch between dividend income and the associated funding cost that may impair an investor's understanding of the financial performance of the entity. If the Board decides to proceed with this model, we would encourage them to address this issue, although care would need to be taken to ensure that the recognition of dividends in the income statement does not extend to returns of capital. However, in view of the additional complexity any such amendment would introduce, coupled with the difficulty of defining the circumstances when the optional treatment is appropriate and the risk of pre-empting the wider debate around the performance reporting model, we do not support the Board's proposal.

Question 11

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

(a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?
(b) should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

As noted in our response to question 10, we support keeping the available-for-sale category for investments in equity instruments that are not held for trading until such time as the Board finalises its financial statement presentation project. Since this is essentially a business model approach, to be consistent with our view on the reclassification of instruments with basic loan features we would support a requirement to reclassify equity investments into or out of this category if the business model were to change.

However, should the Board decide to proceed with the proposals as set out in the Exposure Draft, essentially adopting a voluntary election to present investments in equity instruments in the statement of other comprehensive income, we would not support reclassifications into or out of that category. This would be consistent with the Board's decision to prohibit reclassifications of financial instruments for which the fair value option has been elected.

Question 12

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

Whilst we agree with the additional disclosure requirements, we suggest they are not limited to entities that apply the proposed IFRS before its mandated effective date but should be required by all entities when they first apply the proposed IFRS.

Question 13

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

Since one of the key objectives of the Board in publishing these proposals separately from its proposals to amend the impairment and hedging requirements of IAS 39 is to permit early adoption in 2009, it is essential to ensure that the transition provisions are practical to adopt within a very short timescale. Requiring full retrospective application is likely to prove prohibitive in practice for such entities. Consequently we would recommend that the Board considers eliminating the requirement for full retrospective application and for restatement of comparatives in the first year of application for early adopters, although we would support its retention on an optional basis. Entities that take advantage of this exemption should provide additional disclosures to ensure that users understand the effect of the changes. This would mean that entities that adopt the new standard in 2009 would apply the requirements from 1 January 2009 and would not be required to restate comparatives for 2008.

We support the proposed requirement that classification of the financial instruments is driven by the conditions existing at the date of initial application. This is consistent with the business model approach. We note however that the "date of initial application" is not clearly defined in the exposure draft and could be interpreted in a number of different ways. We suggest that paragraph

24 is redrafted to state that "the date of initial application is the later of the date of publication of this standard and the beginning of the earliest period when an entity first applies these requirements".

If the treatment of financial liabilities proposed in the exposure draft is adopted, it will have a significant impact on entities that have issued structured debt since many more liabilities will be at fair value. In such a case, we recommend that the Board introduce grandfathering procedures for these liabilities such that, where they are already separated into a debt host and an embedded derivative, this accounting can be retained until the debt is settled. Consequently, the requirement to fair value such instruments would only apply to debt issued after the date of publication of the standard. This will enable companies to assess the accounting implications of their funding decisions prior to issuing debt and will not force them to renegotiate or refinance existing debt in order to avoid the accounting consequences.

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?

No, we do not believe the alternative approach set out in this question provides more decision-useful information than measuring those financial assets at amortised cost. The model would require the retention of the definition of loans and receivables, thus introducing additional complexity, and would be inconsistent with the business model of holding the instruments predominantly for the collection of principal and interest. Under IFRS 7 there is already a requirement for the presentation of fair value information in respect of financial instruments carried at amortised cost and, in addition, the exposure draft requires the separate presentation of gains and losses realised on the disposal of such financial instruments.

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?

No as noted in our response to question 14 we do not support either the alternative approach or the possible variants to that approach.