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14 October 2002

CL 31

Dear Sir David

Exposure Draft of Proposed Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement

We appreciate the opportunity to respond to the International Accounting Standards Board's exposure draft of proposed amendments to IAS 32 and IAS 39. This letter represents the views of KPMG International.

We feel that there is an urgent need to finalise this improvements project as quickly as possible. Depending on the timing of the final standards being released, we also would support optional adoption as of the date of issue in order to ensure an all or nothing rather than a "cherry picking" implementation.

We understand that certain of the proposals may prove to be contentious, for example the new approach to derecognition and the framework for derivatives on an entity's own equity. If further debate proves necessary in certain areas, then we would recommend removing those issues from this amendments project and proceeding as quickly as possible to issue revised standards based on what remains. Issues removed from this amendments project should be dealt with as separate projects in order to ensure a due process can be followed.

We also understand that the Board's recent meeting with the Board of the FASB may lead to a convergence project that may further amend IAS 32 and IAS 39 before 2005. Once again, we would urge the Board not to delay the issue of standards based on the current proposals, but to issue them as soon as possible and then to deal with other proposed amendments later. For the many entities planning to implement IAS 39 between now and 2005, we believe it is important that the proposed amendments are confirmed as soon as possible, in particular those that will ease application, such as increased use of fair values.

Executive summary of views

This section highlights our views on the key issues we have identified in the IAS 32 and IAS 39 exposure drafts. There are also references to where a more detailed discussion of the matter can be found later in the appendices to this letter.

1 Derecognition approach – We do not support the proposed "continuing involvement approach" that would replace the current principles in IAS 39. We feel that the new approach is far too abrupt of a change to the requirements necessary to achieve derecognition of financial assets, in particular assets that are originated from the operations of an entity. It moves away from an approach that required an analysis of which party to a transaction controls and has the risks and benefits incident to the transferred assets. Especially now in light of the current accounting environment where aggressive accounting policies are a focus of public attention, this proposed change seems to give more opportunities to entities for financial engineering based on the form of transactions rather than their economic substance. [Refer to page 12]

2 Interaction between IAS 39 (derecognition) and SIC-12 – The proposals include rules about "pass-through" arrangements and the conditions that must be satisfied in order for these not to be considered continuing involvement. We believe that these rules effectively will allow entities to derecognise assets transferred to special-purpose entities (SPEs) while still retaining substantially all the residual benefits and risks of those assets. We do not agree that an issue as fundamental as consolidation of SPEs, as interpreted in SIC-12, should be effectively circumvented by including these new derecognition proposals in IAS 39. This applies especially to situations where various classes of instruments are issued and third-party investors take no risks other than those of lenders. [Refer to page 13]

3 Classification of financial instruments – We support the changes proposed which would allow designation of financial assets and financial liabilities to a category that allows measurement at fair value with changes recorded to profit or loss. Even though this leads to an increased use of "intention" in accounting for financial instruments, we feel that the benefits of such a change justify this. This proposal helps to avoid certain measurement mismatches that arose under IAS 39 due to the mixed measurement model in the standard. [Refer to page 14]

4 Presentation of financial instruments recorded at fair value – Although in general presentation issues are not dealt with in IAS 39 we believe there should be some minimum guidance about how to present the various categories of financial instruments in order to ensure some consistency among peer institutions. [Refer to page 14]

5 Impairment of financial assets – On balance we support the conceptual changes proposed to IAS 39 in respect of measuring impairment in a portfolio of financial assets. Although we agree with the assumptions for the calculation of impairment, which is meant to avoid an entity recognising impairment upon origination of a financial asset, we feel that the calculation for determining the discount rate is going to be very difficult for users to

understand and for preparers to apply in practice, and also lacks underpinning in finance literature (this also applies to discount rates used for other impairment calculations). Also this moves impairment calculations too much into a fair value approach rather than an inherent risk approach. [Refer to page 16]

6 Reversals of impairment of AFS assets – We do not support prohibiting reversals of impairment losses on available-for-sale assets. This would be inconsistent with the principles in IAS for recognising impairment losses on other assets. Also the proposals would result in an inconsistent treatment of impairment losses for debt securities that are carried at amortised cost and those that are carried at fair value. [Refer to page 19]

7 Cash flow hedges – Rather than the proposed change to leave cash flow hedge adjustments in equity, we would prefer that entities have an option to record basis adjustments. In our view this does not lead to more flexibility than already exists in the hedge accounting guidance. We believe that the accounting under the current version of IAS 39 is more practical to apply and therefore less prone to error, for example, in subsequent measurement of impairments. However we recognise that the proposed change would allow entities that also report under US GAAP to avoid a reconciling difference with IAS. [Refer to page 20]

8 Derivatives on own shares – We found the proposed approach to accounting for these instruments complex to understand and to apply. After extensive consideration, we prefer an approach whereby an instrument that can only be settled by physical delivery of a fixed number of shares in return for a fixed amount (of cash or another financial asset) is equity and all other transactions in own equity are treated as derivatives. In our view this approach would be clear and simple to apply and would provide an appropriate presentation of the economic rights and obligations related to such transactions. [Refer to page 9]

9 Probabilities of how financial instruments will be settled – We support the view that probabilities of the manner of settlement should not influence whether an instrument is initially classified as a liability or as equity. [Refer to page 7]

10 Puttable instruments – The proposed amendment clarifies that an instrument that gives the holder the right to put the instrument back to the issuer, even when the legal form of the instrument provides the holder with a residual interest in the assets of the entity, meets the definition of a financial liability. We agree that puttable instruments conceptually meet the definition of a financial liability, however such treatment calls for a significant change to current practice which, especially for mutual funds and similar entities, we feel is not intuitive in terms of presentation and accounting and will not be understood by many users. There are numerous issues requiring further guidance that need to be addressed in order to make these proposed changes workable in practice. [Refer to page 10]

11 Consistency of approach to accounting for financial instruments - IAS 32 and IAS 39 seem to adopt a mixture of the following three approaches:

- considering individual components of a contract: *components approach* (embedded derivatives, derecognition, presentation of hybrid instruments);

- viewing the economic substance of a contract as a whole: *contract as a whole approach* (equity or liability classification, transactions in own equity);

- viewing the combined economic substance of individual contracts in combination: *linkage approach* (forward and written put on own equity).

There are no clear principles that determine why and when to apply the various approaches. The amendments seem to increase the inconsistencies in approach. In our view these inconsistencies make IAS 32 and IAS 39 difficult to apply and will lead to inconsistent application in practice of in substance similar transactions. We believe that added principles are necessary on when it is appropriate to apply which approach. [Refer to page 49]

12 Insurance contracts definition – IAS 32 (and IAS 39) includes a definition of insurance contracts to distinguish insurance contracts from financial instruments. The definition differs from the definition of insurance contracts included in the DSOP on insurance contract accounting and leads to interpretation issues in practice. The definition in the DSOP has resulted from a long debate in the insurance contracts accounting advisory committee. We recommend that the Board considers an amendment of the definition in IAS 32 and considers the definition and the related guidance of the DSOP in that respect. It is important that the definition chosen can be consistently applied in the interim period until an insurance contracts standard is available and is not later changed so that insurance entities would have to go through a conversion process twice. Irrespective of a change in definition, many contracts that are in form insurance will have to be accounted for under IAS 32 and 39. We therefore recommend that further guidance is included in the standards on some measurement issues in respect of those contracts. Please also refer to the paper submitted by KPMG to the IASB staff on 5 September 2002 discussing the application of IAS (and in particular IAS 39) to long-term insurance contracts in the absence of an insurance standard.

13 Hedge accounting criteria - Hedge accounting is generally considered the most complex area of financial instruments accounting. Also the extensive rules and requirements regarding the application of hedge accounting add to the complexity. We would therefore have expected that other and more changes would have been proposed in this area. We would recommend that the guidance provided in IAS 39 on when to apply hedge accounting and when this is not allowed is more clearly linked to the main criteria for the application of hedge accounting: designation, measurability and effectiveness. We recommend to reconsider whether any unnecessary rules and exceptions to rules may be deleted. We have included a number of examples in our specific comments to IAS 39. [Refer to page 39]

14 Hedge accounting and internal transactions – Apart from the use of two models for hedge accounting and the many requirements restricting the use of hedge accounting in specified circumstances, one of the most difficult issues to deal with in the application of hedge accounting is the interpretation in practice of the prohibition to use internal transactions as hedging instruments. Internal transactions are used by most financial institutions and larger corporate treasuries. The interpretation guidance provided on IAS 39.134 & 121 describes how, under certain circumstances, a portfolio approach using internal derivative contracts is

acceptable, and why and how it is determined that balance sheet and income statement effects of internal derivatives are effectively eliminated. We recommend that the principles of the implementation guidance included in the IGC Q&A's are further simplified and clarified in the standard. This will significantly ease the implementation of hedge accounting in practice, and also address many of the industry concerns that have been strongly expressed about the standard not reflecting current rational risk management practice. [Refer to page 52]

15 Disclosure requirements – We are troubled by the proposed additional disclosure requirements in IAS 32 in terms of the cost benefit to entities and users of the financial statements. Though the additional disclosure is meant to give users a clearer picture of fair values and exposures to various financial risks, we are concerned that the information may be overwhelming rather than meaningful. It would be very helpful however to clarify generally what level of aggregation of information is acceptable in order to prevent unnecessary levels of disclosure in an entity's financial statements.

We assume that the remaining Implementation Guidance Committee Questions and Answers (Q&A's) will continue to have the same authority as they do at the moment. We feel their status should be clearly defined and also that the remaining 's are included in the same document when the revised standards are issued. The appendix guidance should further clarify which Q&A's will remain, which will be amended and which will be withdrawn. The authority of future interpretations of these standards should also be addressed. Based on discussions within our firm and with clients, we believe there will be a need for additional interpretation after the amendments to these standards are made.

Detailed comments on the exposure drafts

The remainder of our comments are organised as appendices to this main letter in the order noted below:

Please contact Petri Hofste at 020 7694 8978 if you wish to discuss any of the issues raised in this letter.

Yours faithfully

KPMG

Appendix A

Responses to invitation to comment (IAS 32)

Question 1 – Probabilities of different manners of settlement

Definition of liability: no consideration of probabilities

We agree that the classification of a financial instrument as a liability or equity should be made without regard to the probability of settlement. Given that a financial liability is defined as a contractual obligation and that a financial liability is recognised when an entity becomes party to the contract, we do not believe that the Framework probability recognition criteria is relevant for financial liabilities.

We are aware of a few cases in which an equity classification was made applying SIC-5 on the basis that the probability of cash settlement was "remote" but where a liability has subsequently arisen, for example due to:

- an unanticipated and significant decrease in the share price making conversion unattractive;
- an unanticipated and significant currency devaluation making (foreign currency denominated) redemption attractive;
- a share price reaching a certain level at which point a convertible instrument becomes redeemable; and
- an anticipated IPO not occurring due to unfavourable market conditions.

These cases, although not common, have had an extremely significant impact on the financial statements. In each of these cases, with hindsight, the conclusion of remoteness was questionable. In fact we think that situations in which strict application of the remoteness test would result in an equity classification are rare, and the example mentioned in SIC-5 of an equity issue that is subject to legal formalities is an exceptional case.

Disregarding probability may seem inconsistent with the Framework recognition criteria for a liability or with the principles in IAS 37. However we believe this is a consequence of the contractual nature of a financial liability and note that the remoteness approach also was not consistent with the Framework and with the IAS 37 recognition threshold.

If the Board should decide to retain the remoteness approach we believe additional guidance should be given on when a remoteness conclusion is appropriate. The guidance should include the consideration of historical volatility before concluding on remoteness to limit misapplication.

We note that paragraph 6 of SIC-27, which addresses when to recognise assets and liabilities resulting from leaseback transactions, refers to the Framework definitions, but seems to apply a remoteness test (paragraph 6(b)). We suggest that further consideration be given to the consistency of SIC-27 with the proposed amendments to IAS 32.

We also note that the FASB issued an exposure draft "Accounting for Financial Instruments with Characteristics of Liability, Equity or Both" in October 2000. It would seem in line with the Board's convergence objectives to explore these issues as a parallel project with the FASB.

Economic compulsion

We do not agree with the proposal to delete guidance on economic compulsion in the classification as liability or equity without considering further clarification of the notion of discretion. The issue of economic compulsion is closely related to the issue of discretion. An economic compulsion notion would not be necessary if it can be clearly defined when contractual terms give rise to a liability and when they do not because payments are at the discretion of the issuer.

In our experience, interpreting whether a requirement to make payments is discretionary gives rise to significant difficulty in practice. Therefore we believe that there is a need for guidance, in the body of the standard, on when contractual terms to make dividend or other payments give rise to an obligation. We do not find the proposed guidance added to paragraph A21 helpful. It is not clear to us how the situations listed in paragraph A21 would affect the classification. Also, the paragraph seems to address only dividends on preference shares; we believe it should have more general application.

In our view a liability exists in all cases where the issuer has a contractual obligation that cannot be avoided, even if that obligation is contingent on the outcome of future events. That interpretation is consistent with the added guidance in paragraph 22A. For example we believe that a contractual obligation to make specified dividend payments gives rise to a liability even if the dividends will be paid only if there are profits (A21d and e) as long as an entity is able to ensure that dividends can be paid. We believe contractual terms that require specified payments give rise to a liability unless the issuer has freedom to choose to make or not to make payments in all circumstances.

If the Board does not believe it is possible to define sufficiently when payments are considered discretionary and when they give rise to an obligation, then we believe that the notion of economic compulsion should be retained as this notion is helpful in identifying whether payments are discretionary. In our view economic compulsion is a notion that is consistent with the definition of a financial liability, as it is the substance of the terms and conditions that gives rise to the economic compulsion.

We are concerned that deleting the example in paragraph 22 may create the wrong impression. We do not believe however that liability classification of an instrument with the terms and conditions described in the example that is proposed to be removed requires consideration of an economic compulsion notion. The example refers to a "contractually provided accelerating dividend". The contractual obligation to pay dividends should result in (at least part) of the instrument being classified as a liability. Therefore we request that an example be retained, although revised to include a discretionary dividend and we would support moving it to an appendix as has been done with the other examples.

The words remaining in IAS 32.22 are unclear. It is difficult to understand how the terms and conditions of a preference share could "indirectly" establish a *contractual* obligation. If the Board intends that only contractual obligations should give rise to liability classification, then it should explain how such an obligation could be established indirectly. It is not clear in either the standard or the appendix how these principles apply to certain types of preference shares, such as (perpetual) cumulative shares.

Question 2 – Separation of liability and equity elements

We support an approach of measuring the liability component first. At the same time, the issuer should also assess whether the implied value of the equity component makes sense as a check that assumptions used in calculating the liability component were appropriate.

We suggest including a reference to the applicable paragraphs of IAS 39 on how to determine the carrying amount of the liability component.

Also, we suggest it be clarified in this section that embedded derivatives in compound instruments are subject to the normal principles in IAS 39 and may need to be bifurcated.

Question 3 – Transactions in own equity

We do not agree with part of the guidance proposed on transactions in own equity. In addition to specific comments on the proposals below, we believe that they require a change to the drafting of the definitions of financial instruments. We also have concerns that the proposals generally consider individual contracts but in some cases adopt a linkage approach. We have included detailed comments in this regard in separate appendices E and F respectively.

We support a substance over form approach and agree that the manner of settlement should not affect the treatment of a financial instrument. However after careful consideration we find the proposals very complex, not always clearly following from the definitions and difficult to apply. Subject to resolution of our concerns regarding the definitions, we support the conclusions with respect to equity and derivative treatment. However, we do not support the presentation of a gross liability, wherever a derivative on own equity creates a future obligation, or a potential future obligation, to settle in cash. We have concerns that the complexity of the requirements and the detailed guidance provided encourages a "rule book" approach, rather than consideration of the economic substance of the instruments.

In our view the linking of written puts and forwards to buy own shares and the underlying own equity to achieve a gross liability treatment of the transaction may create internal inconsistencies. In other cases the proposals require individual rather than a combination of contracts to be considered, unless they are part of an integral series of contracts. We are particularly concerned by the possibility that a gross liability should be established for a written put option which may be deeply out-of-the-money at the date of the transaction, and that the reclassification is later reversed if the option is not exercised.

We would prefer an approach that is clearer and simpler to apply than these proposals, and suggest the following as a practical expedient:

- if a derivative can only be settled by physical delivery of a fixed number of shares in return for a fixed amount of cash (or other near-cash financial assets), or if the issuer has a choice to settle by physical delivery of a fixed number of shares in return for a fixed amount, the derivative is classified as equity; and

- all other derivatives on own equity are accounted for as derivative assets or liabilities.

However we acknowledge that the approach of recording a gross liability when there is an obligation to purchase an entity's own shares has merit. We feel that this approach should be explored in more depth by the Board rather than in the context of a quick improvements project. We understand that the FASB is looking at this issue as well and we recommend that it is reconsidered in conjunction with a convergence project between the IASB and FASB.

Puttable instruments

We agree that puttable instruments, when viewed as a whole, meet the definition of a financial liability under a consistent interpretation of IAS 32, and therefore should be presented as liabilities. However this application fundamentally changes current practice in terms of presentation and accounting for puttable instruments. Presenting residual interests as a liability is not intuitive to users of funds' financial statements. We note that the proposals lead to a difference with US GAAP, which presumably would have to be readdressed in a convergence project with US GAAP . There is a valid risk that investment funds that have a choice will, rather than apply IAS, turn to other GAAPs as a result of this revision. We suggest that the IASB considers the above in deciding on the change. In particular, it would not be helpful to change industry practice now if there was a significant risk of that decision being reversed through convergence in the short term.

We have some questions that we propose are clarified given the significant change the proposals would bring to the presentation in financial statements of open ended investments funds. The guidance provided in A12A and B8 is in our view not sufficient in that respect.

- In paragraph A21A it is stated that a liability to repay unitholders' interests may be presented as "net asset value available to unitholders". This description uses terminology that is very close to the definition of equity, and therefore may be confusing. This should be addressed in the guidance. Also, can an investment fund still present the "net asset value" as a subtotal of total assets less total (other/operational) liabilities?

- It would be helpful to explain further that either the host contract is a debt instrument and an embedded derivative needs to be separately identified or that the "net asset value" can be presented as one instrument measured at fair value with changes included in profit and loss.

- The result of having to present the change in the net assets available to unitholders (excluding acquisitions/redemptions and sales of such net asset values) in the income statement is that the performance statement would always result in a net income of nil. The presentation should in our view be such that a clear distinction continues to be made between the performance from operational and investment activities on the one hand and the change in the net asset value on the other hand so that the relevant information on the performance of the fund is clear from the income statement.

- In our view the income statement should be supplemented by a statement of changes in 'net asset value'.

Question 4 – Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard

We believe that the text in IAS 32 and IAS 39 should be combined into one comprehensive standard, particularly given that the amended presentation and disclosure requirements in IAS 32 are not understandable separately from the recognition and measurement principles in IAS 39. However we are concerned that the scope of the two standards is not yet consistent. Certain financial instruments are scoped out of IAS 39 but remain within the scope of IAS 32, for example loan commitments. If the text is integrated, the scope must be further clarified to ensure that instruments are not excluded from presentation and disclosure requirements.

Although ideally it would be best if the original paragraph numbers could be retained, we do not believe that this is workable given the extent of the proposed changes and the degree of reorganising. We find the paragraph numbering in the exposure draft confusing and believe it is also for that reason preferable to renumber and integrate the two standards.

Appendix B

Responses to invitation to comment (IAS 39)

Question 1: Scope: loan commitments

We agree with this proposal. The previous solution under which such commitments could sometimes be excluded as “regular way” transactions was unsatisfactory.

We note that the impact of not recognising a derivative for the loan commitment is that loans will be issued at less than market interest rates. The standard should clarify whether it is intended that a loss should be recognised on initial measurement of loans arising from unrecognised loan commitments in accordance with paragraph 67. For example a fixed rate loan commitment will result in a loss on issuance of the loan if interest rates increase during the commitment period. This would effectively reverse the effect of the scope exclusion for loan commitments. We assume the intent is that the cost of the loan on initial recognition will be taken as being the fair value at the date of commitment, so that no loss would be recognised.

We also note that the proposed amendment creates an inconsistency with the treatment of embedded options to extend the term of loans at fixed interest rates, which are and will continue to be embedded derivatives excluded only if closely related to the host contracts.

Question 2: Derecognition: continuing involvement approach

We do not support the proposed approach for derecognition. We do not agree that the continuing involvement approach provides a superior answer in terms of application of the derecognition principles. The risks and rewards approach present in the current IAS 39 requires an answer that is based on the substance of a transaction rather than its legal form. This latter approach acknowledges that it is possible to derecognise entire assets or components of assets if the risks and rewards relating to the assets, or the components thereof, are transferred to another entity.

Considering whether control over components of assets has been transferred is appropriate when there is a whole or proportionate transfer of rights to *portions of cash flows* which can be identified from the contractual terms of a financial asset. For example, this approach would provide the right answer in a transaction where a transferor strips out and transfers the interest on bonds.

We fail to see that the continuing involvement approach is an improvement of the current treatment under IAS 39. In our view the approach lacks conceptual underpinning and would raise many interpretation issues. The approach is not easier to apply than the current model and leads to the recognition of assets and liabilities and measurement issues that are difficult to understand and that do not meet the criteria of the Framework for such items. (Refer to the specific comments on paragraphs 37-56 in Appendix D).

Although we see that the current approach in IAS 39 is complex and that implementation issues have arisen in practice, we suggest not to change the approach as, in our view, the proposed change is not an improvement. Rather we recommend to clarify the current text on derecognition along the following lines:

- If there is no continuing involvement at all, the instrument is derecognised;
- If there is continuing involvement, consider whether *any* significant risks and rewards have been transferred:
  - If no significant risks and rewards are transferred, the instrument is not derecognised at all;
  - If significant risks and rewards are transferred, a components approach is applied to evaluate derecognition.

Transfers to special purpose entities (SPEs)

The proposed requirements will have a significant impact on many securitisation transactions where rights are transferred to investors in the form of beneficial interests in the assets of an SPE. The SPE may have to be consolidated under SIC-12 (often by the transferor), but the granting of beneficial interests to various tranches of investors seems to lead to derecognition of portions of the SPE's assets with no liability recognised by the SPE. Assuming this result is the Board's intention, this represents a fundamental change to existing practice, and we strongly disagree with such a change. This area is particularly high profile in the current environment where the use of SPEs is under intense scrutiny. Our view is that granting beneficial interests in the assets of an SPE is not the same as transferring rights to "portions" of cash flows that can be identified in the contract that comprises the financial asset. Further consideration should be given in the separate project on SPEs as to when the issue of a tranche of beneficial interests should be considered as a disposal of a portion of the assets.

Generally for assets originated by the transferor we believe there is a higher hurdle to overcome to achieve derecognition as such assets often come with more strings attached to them. Often the transferor is one of the parties investing in the SPE (especially in the high risk classes of instruments issued). If the transferor is required to consolidate the SPE under SIC-12 according to the risks and rewards approach to control, under the proposals the transferor would only consolidate the empty shell, rather than the transferred assets and issued beneficial interests. We believe the standard should state that issuing beneficial interests by an SPE does not lead to derecognition by the transferor unless there is transfer of significant risks and rewards in the transferred assets to parties other than the transferor.

We do not agree that an issue as fundamental as consolidation, as interpreted in SIC-12, should be circumvented by including these derecognition proposals in IAS 39. This applies especially to situations where various classes of instruments are issued and most of the interest-holders do not take risks other than those of lenders. There is a basic question of how to determine if a transaction is merely providing financing or if it is "creating" a beneficial interest. We feel this issue should be addressed as part of this project otherwise the result will be an inconsistent application of these rules.

As part of an ongoing discussion on derecognition and consolidation, the continuing involvement approach may be tested on a number of common SPE/securitisation structures to determine their impact. However for this project, we do not recommend any substantive changes be made to the current IAS 39 derecognition model and propose that Q&A's issued relating to derecognition are amended to remove any reference to derecognition by SPEs through issuing beneficial interests.

Question 3: Derecognition: pass-through arrangements

We agree with this approach only when there is a clear pass-through of portions of cash flows that are identifiable from the terms of the contract that comprise the asset. However in many cases the arrangement is not an immediate pass through of cash. For instance, in a securitisation of financial assets via an SPE, often there is a specified priority of cash distributions to the beneficial interest holders based on the tranche of securities issued to them by the SPE. The result is that only certain beneficial interest holders receive cash distributions when the SPE collects and distributes cash. Also the SPE may have to hold back cash in reserve accounts to be used against future defaults on repayment of the underlying financial assets. This very typical sort of arrangement seemingly would fail the criteria set out in paragraph 41 of the revised standard. Therefore it is crucial to understand when, if at all, a beneficial interest can be viewed as a direct pass through of cash flows. We feel that the Board should provide a clear view on this matter in order for there to be appropriate consistent application. We also feel that the example of derecognition of assets in paragraph 42 should be deleted from the standard.

Question 4: Measurement: fair value designation

We agree that an entity should be permitted to designate any financial instrument as an instrument carried at fair value with changes in fair value recognised in the income statement. This amendment will help to avoid certain mismatches that arise under IAS 39 because an entity is precluded from adopting a fair value through income model for some financial assets and liabilities. We also expect that the proposals will provide more opportunity for real life testing of fair value accounting.

An important drafting issue that we want to point out is that paragraph 10 contains an option to *designate any financial instrument as trading* (not to apply "fair value through the income statement" as described in the Board's question 4). This is an important distinction and is relevant to certain financial instruments that do not have a reliably measurable fair value and are therefore carried at cost. We recommend redrafting paragraph 10 so it is clear that only financial instruments whose fair value can be reliably measured are eligible for this designation option.

We feel that describing fair value through income financial instruments as "trading" if they are not held for that purpose is inappropriate. Paragraph 18A deals with this by suggesting a label other than "trading" be used for the non-trading fair value through income category. However, this seems to contradict the wording in paragraph 10. We suggest instead to use the following names to refer to the categories to be measured at fair value on the basis of designation: *fair value through income* and *fair value through equity*. The fair value through income category would include instruments held for trading, derivatives and financial instruments designated for accounting at fair value through income. The fair value through equity category will include financial assets that are not classified as loans and receivables originated by the entity, held-to-maturity investments, or financial assets designated to be measured at fair value through income.

We understand that this proposal results in an increased use of "intention" in a standard that is already complex and mixed with respect to measurement issues. This leads to a concern that there may be less comparability of financial statements resulting from this flexibility of designation. Despite this, we support this proposal as we see the benefits from this proposal outweighing these concerns.

We support the proposal to prohibit transfers out of the fair value through income category after initial recognition. While it is clear that transfers out should not be permitted to avoid manipulation, we believe there are both risks and advantages involved in allowing transfers into this category. For example, if liabilities could be transferred into the fair value through income category, this could be used by entities with deteriorating credit ratings to recognise gains resulting only from applying a higher borrowing rate when discounting. On the other hand, allowing an entity to transfer a liability into this category when it subsequently enters into a hedging instrument (such as an interest rate swap) would provide a significant opportunity to avoid the complex hedge documentation and effectiveness requirements. The Board should consider these and other respondents' examples in weighing the merits of allowing transfers into the fair value through income category. If this is allowed we recommend that disclosure about such transfers should be required.

In addition, we think it would be appropriate to require entities to disclose in their accounting policy notes information about which instruments and for what reasons are designated as carried at fair value through income versus fair value through equity in order to provide some discipline to the usage of this category. It should be emphasised that the categories are for measurement purposes only, and entities should follow the appropriate presentation and disclosure requirements when presenting and disclosing financial instruments in the financial statements.

We also note that while the option to designate items carried at fair value through income applies to liabilities, no guidance is provided on an important issue raised, the measurement of own credit risk, in comments by our firm and many other respondents on the JWG draft standard in September 2001. We have interpreted that credit risk, including own credit risk, is included in fair value measurement. In our view this issue should be addressed in the revised standard.

Question 5: Fair value measurement considerations

We agree in principle with the proposals regarding measuring fair value. However we feel there are additional factors that have not been considered that are relevant considerations in determining fair value. We believe guidance should be included in the standard regarding adjustments to fair value to take into account the size of the holding, both in cases where there is an active market and where there is not as well as any contractual restrictions on the sale of a holding.

In addition, we feel that guidance should be provided with regard to the use of bid, mid, ask or closing prices for assets held by mutual funds. Current accounting guidance on this issue diverges. Under US GAAP the last quoted sales price (the closing price) is considered the appropriate quoted price (AICPA Audit and Accounting Guide for Investment Companies, section 2.30). In many other countries the same is applied in practice. Also the Joint Working Group of Standard Setters had reached a similar conclusion and considered the closing price to be the best quoted price (JWG paragraph 77) and the mid-price acceptable when closing prices are not reported, but differences between bid and offer prices are small (JWG paragraph 80). IAS 39 however refers to current bid and offer prices.

As the pricing at bid or offer rates poses a significant issue for the investment management industry we propose that the IASB adopts the JWG proposals which are consistent with other GAAPs and many local practices.

An alternative way to address the issue is the following. The standard contains the guideline that when an entity has matching asset and liability positions, it may appropriately use mid-market prices as a basis for establishing fair values. It seems that this guideline would be applicable to many mutual funds because the units of funds are (under the proposals) classified as liabilities and therefore there is a matching position between the assets and liabilities.

Question 6: Collective evaluation of impairment

Individual financial asset determined to be not impaired

In principle we support a portfolio approach to evaluating impairment of financial assets. We agree that a non-impaired financial asset should be considered for impairment within a portfolio of similar assets that are collectively evaluated for impairment. We agree with a proposal for setting up an impairment provision for inherent risks in a portfolio of assets.

However there needs to be clarification of what is deemed to be a “portfolio” as otherwise this may lead to inappropriate groupings of financial assets for impairment testing purposes. This clarification should provide enough guidance for an entity to determine what is an appropriate portfolio, including deciding when a financial asset should not be included in any portfolio but rather assessed individually because it does not fit into a portfolio. There may be situations where the resulting portfolio is so small that a collective evaluation is impossible. It should be clarified that a portfolio evaluation would then not be required.

We note that the discussion of portfolio assessment is included only in the section dealing with financial assets carried at amortised cost which presumably means impairment testing of other instruments must be done on an individual asset basis. We do not support this and feel that a portfolio assessment should also apply to available-for-sale debt securities. For equity securities however, we agree that it should not be possible to apply a portfolio approach.

Impairment methodology

We agree with the principles underlying the methodology for the measurement of impairment:

- No recognition of an immediate impairment on granting a loan, and

- Discounting expected cash flows at an appropriate discount rate that is consistent with the measurement at either cost or fair value of the impaired asset.

The proposed methodology for portfolio assessment is very different from the approach applied by entities prior to implementing IAS 39. It moves away from a model that measures inherent losses at the balance sheet toward a fair value / expected losses model. We feel that the calculations are rather complex and will be difficult for entities to apply in practice. It will be very difficult to collect historical data to assess expected cash flows on individually significant non-homogeneous loans.

The proposed paragraph 112 states that only financial assets that are individually assessed for impairment could be included in a group of assets for collective assessment of inherent risk. In our view however, financial assets that have not been individually assessed but are collectively assessed for impairment, also should be eligible for an assessment of inherent risk. The standard as currently drafted seems to prohibit that.

Whether or not inherent risk is addressed in the portfolio assessment and measurement depends on the methodology applied in practice. Often inherent risk in portfolios would not be addressed, for example because the financial assets are internally rated as ‘not impaired’, ‘watch list’ and ‘impaired’ and the portfolio approach would focus on the impaired category. We propose that the portfolio assessment of inherent risk is extended to include loans that are not individually significant and that are tested for impairment on a portfolio basis, under the condition that no double counting of inherent risk provisioning occurs. In the example given, it means that an inherent risk provision is measured for the loans that are categorised as ‘watch list’ and possibly even ‘not impaired’. Currently that often is done on the basis of a migration analysis.

The proposed amendments are a mixed approach that go in the direction of applying a fair value approach (based on expected future cash flows) rather than an inherent losses approach (based on losses existing at the balance sheet date). In our view, that needs to be better explained and justified in the Basis for Conclusions. We furthermore recommend to consider the draft US AICPA Statement of Position on this issue, as the approach proposed therein in our view is more in line with a inherent loss approach than the proposed approach in IAS 39.

Impairment calculation (discount rate to be applied)

The discount rate to be applied on the measurement of impairment in *individual* financial assets is the original effective interest rate (assuming the loan is measured at cost) applied to expected cash flows. However, from an academic standpoint, when using this discount rate profits may be recognised in future periods if expected cash flows happen, representing the original risk premium built into the loan, since the original discount rate would include a premium to cover expected losses, which are now reflected in the expected cash flows of the impaired loans. The discount rate applied instead should be the rate that is appropriate given the risk of the expected cash flows. This would be the risk-free rate if the expected cash flows are certain and all the risks have been reflected in these cash flows. If the expected cash flows still are sensitive to some risk, the risk premium in the discount rate should reflect this level of risk. It is unlikely that the level of risk will be equivalent to that in the initial risk premium.

In respect of the risk-free part of the discount rate to be applied, as stated above, we agree that this should be consistent with the measurement. However, the discount rate should take note of changes in timing of cash flows. If cash flows are expected or agreed to be paid at later moments than originally contractually agreed, the use of the original yield curve is appropriate, but not the use of the original discount rate itself.

Because of the above, our recommendation is to adjust the standard to refer to the principle that <u>"a discount rate should be applied that appropriately reflects the risk of the expected cash flows and the timing of these cash flows, which will depend on the certainty of the expected level and timing of these cash flows"</u>.

In applying these concepts to the measurement of impairment of a *portfolio* of financial assets, further issues arise. As a result of the proposed calculation, some of the losses may be absorbed by the margins on the unimpaired loans. Other changes that are not reflected in the expected cash flows also could lead to changes in the appropriate risk premiums in the discount rate, e.g. economic changes.

It seems that the Board's intention is only to require an adjusted original effective interest rate to be calculated for impairment measurement purposes for those assets that are tested for inherent risk impairment as part of a portfolio. However, this will result in inconsistent measurement of impairment losses in subsequent periods when doing the individual impairment tests (using the original effective interest rate) and when doing the portfolio test (using the adjusted effective interest rate). To illustrate: using the example in B35 – if one of the loans is tested for impairment individually, a rate of 12% would presumably be used in determining if it is impaired. But if it were found not to be impaired, it would also be included in the portfolio, and discounted at the calculated rate of 10.86%. The difference in approach assumes that the original expected impairment losses are not included in the cash flow estimations as individual impairment; rather they are already reflected in the credit spread.

We feel it is not appropriate for the standard to be so prescriptive in specific aspects of a complex impairment methodology when other areas, such as the degree to which a fair value methodology is applied, are left open to interpretation and best practice developments. Also here we prefer that the standard includes the principles that should be applied, rather than providing detailed rules.

Question 7: Impairment of investments in available-for-sale financial assets

We do not support prohibiting reversals of impairment losses on available-for-sale assets. This would be inconsistent with the principles in IAS for recognising impairment losses on other assets. Also the proposals would result in an inconsistent treatment of impairment losses for debt securities that are carried at amortised cost and those that are carried at fair value. This becomes an added incentive to use the held-to-maturity classification for debt securities, which would go against the IASB's intention of promoting greater use of fair values.

For equity securities we understand that there is significant judgment involved in determining both impairment losses and reversals of impairment losses. We believe that the most appropriate way to deal with this is to have a rebuttable presumption that declines in market prices are impairment indicators and consistently to have a rebuttable presumption that a subsequent increase in the market price is an impairment reversal. We also feel that these subsequent increases should be recorded to the profit and loss up to the amount of cost of the asset. We are far more comfortable with recognition of an impairment loss, and then reversal if the market decline reverses, than delaying recognition until it is "permanent". We agree with the Board's basis set out in paragraphs C72(c) and C72(d) however we believe that the proposed approach for impairment of equity securities in paragraph 110A is not fully consistent with this in respect of the "significant and prolonged decline in fair value".

We understand that the intent is to promote convergence with US GAAP, but there are many differences between the IAS approach and the US GAAP approach to accounting for impairment losses so that aim should not be the only reason supporting the proposed amendment. Also it should be noted that US GAAP does not allow for any impairment reversal once an instrument is written down, while IAS 39 would still allow this for amortised cost financial assets meaning there would still be some differences between IAS and US GAAP in this respect.

We support the prohibition on reversals of impairment losses for instruments carried at cost because fair value is not reliably measurable. We believe it would be inconsistent to be able to measure a reversal of an impairment loss if fair value is not reliably measurable.

Question 8: Hedges of firm commitments

We agree with the proposal. We assume, however, that the guidance in Q&A 137-10 is still applicable. This means that entities that enter into firm commitments in foreign currency can choose to designate the foreign currency exposure of the future receivables in a cash flow hedge instead of designating the firm commitments in a fair value hedge. The example removed from paragraph 139(a) and included instead in paragraph 140 is one which, in our view, could be accounted for either as a fair value hedge or a cash flow hedge. Paragraph 140 now states that it is a hedge of an exposure to a change in fair value. We understand that US GAAP also would permit a firm commitment in a foreign currency to be accounted for as a cash flow hedge.

When an entity enters into derivatives and designates a hedge of expected currency exposure prior to a firmly committed agreement it could only use a cash flow hedge accounting model. It is not clear from Q&A 137-10 that the designation made at the initiation of the hedge in these circumstances should not be changed when the forecast cash flows become firm commitments and we would suggest that this is clarified. Requiring a forecast foreign currency cash flow to be redesignated as a fair value hedge when it becomes a firm commitment would create a significant accounting burden with no apparent benefit for entities hedging such cash flows.

Paragraph 139 has been changed in accordance with the proposed change to the accounting treatment of firm commitments. However, we believe the paragraph should still include an example of a cash flow hedge for forecast transactions, for example hedges of forecast sales, since in our view this is a very common type of cash flow hedge.

Question 9: Basis adjustments

On balance we agree with the proposed changes, although we did not find the arguments in the Basis for Conclusions for eliminating basis adjustments to be particularly convincing. We note that the proposed treatment creates differences in the accounting result between forecast transactions and firm commitments. Under the proposed amendment, firm commitments will be treated as a fair value hedge which effectively means that basis adjustments will be recorded for those transactions.

Further, we are concerned that the tracking of gains/losses recognised in equity might cause problems in practice, including difficulties when doing impairment testing of previously hedged items.

In practice the distinction between firm commitments and forecast transactions is not always clear. The proposed changes to hedge accounting will make it more important for entities to distinguish correctly between the two classifications as it impacts what accounting entries are recorded. As a result we expect that more interpretative guidance will be needed relating to the effect on firm commitments of delayed transactions, termination of hedges and other issues.

As a compromise, we would prefer that entities are given an *option* in how to present the fair value changes of the hedging instrument i.e. record basis adjustments or leave in equity. This would allow those entities that report under US GAAP to eliminate one reporting difference, and would also be helpful in arriving at the elimination of internal transactions in applying hedge accounting. Allowing entities to choose their presentation is not a significant issue in this particular case, as there is much flexibility allowed in IAS 39 for the application of hedge accounting, and this one only impacts the balance sheet presentation rather than performance.

Question 10: Prior derecognition transactions

We do not support a retrospective application of the derecognition requirements for practical reasons. We feel that at a minimum retrospective application should be capped at 1 January 2001, the effective date of the current version of IAS 39.

Appendix C

IAS 32 specific comments

Definitions

- Paragraph 1(a): The scope paragraph specifically mentions an example of situations where IAS 39 applies to the measurement of the investments and adds that disclosure requirements of both IAS 32 and IAS 27, 28 or 31 respectively should be adhered to. We think that an example is better placed in either a non black-letter paragraph or in an appendix. With respect to disclosure requirements, we do not see why an entity would have to make the measurement disclosures under both standards if measurement under IAS 39 is justified.

- Paragraph 1(e): We do not agree that these contracts should be exempted from disclosure requirements about their financial risk exposure.

- Paragraph 12: This paragraph introduces the notion of a probable outflow, which is inconsistent with the definition and recognition criteria for financial liabilities. Therefore we suggest adding the words "a contractual obligation to pay" before cash.

Liabilities and equity

- Paragraph 17: This paragraph explains that any instrument classified as equity of a subsidiary would be presented as minority interest or equity in the consolidated financial statements of the group. In the past we have seen financing structures where this was not necessarily the case. In those instances at the level of the subsidiary, generally a special purpose vehicle issuing preferred shares, treatment as equity seemed appropriate. However, at the group level the presentation of the transaction as liability rather than minority interest in our view was correct, given that the parent provided a guarantee or an in-substance guarantee to the counterparties to the transaction. We recommend that this issue is addressed in this paragraph.

- Paragraph 19: In our view the classification as either equity or liability should be changed when terms and conditions change such that the substance of the transaction is revised. The last sentence of paragraph 19 prohibiting reclassification contradicts the proposed guidance on derivatives on own equity since an entity entering into a forward to buy or a written put option results in a reclassification of equity to liability. It is also inconsistent with the requirements of IAS 17.10 which requires consideration of revised terms and conditions in determining the lease classification.

- Paragraph 22A: The wording in the second set of parentheses is confusing. We suggest deleting this and perhaps adding the wording from the definition "exchange financial instruments under potentially unfavourable conditions".

- Paragraph 22A: The revised wording states that in any situation where the manner of settlement would depend on the outcome of uncertain events or circumstances, the instrument is classified as a financial liability. What is not addressed is the situation where the uncertain events or circumstances are related to the entity's own share price, such as in the case of a contingent convertible bond, where the option is exercisable only if the share price reaches a certain level. Previously SIC-5 and now the proposed changes to paragraph 22A seem to require the classification of the whole instrument as liability, although in substance the instrument is not different from other convertible bonds and the classification of the conversion option as equity would be appropriate.

- Paragraph 22C: The requirement to classify the described instrument as a liability seems to disregard the embedded derivative that is present in the instrument.

- Paragraph 22D: We have a conceptual difficulty with determining whether an obligation to settle in own shares is a financial liability by looking to the position of the holder of the instrument. The basis for the issuer classifying an instrument settled in own equity as a financial liability should be that it gives the issuer a liability, rather than the holder not having a residual interest. Therefore we recommend changing the wording of this paragraph to clearly state that.

Treasury shares

- Treasury shares are sometimes held for trading purposes. A requirement to account for these shares as a deduction from equity and not to recognise any gains or losses seems inconsistent with:

  - the proposals to account for transactions in own equity as derivatives in certain cases;

  - the proposals that some contracts, e.g. commodity contracts settled by physical delivery and loan commitments, are treated as derivatives if the assets are sold immediately after delivery; and

  - the definition of trading instruments being those acquired and held with a short-term profit making intention.

  The trading activity involving treasury shares may be likened to a "near derivative" situation where, rather than settling net, the entity settles gross by taking delivery of its own shares and may sell immediately thereafter. Gains and losses on derivatives on own shares are recognised in the profit and loss, while traded treasury shares gains and losses are through equity which we feel is an inconsistent treatment.

  We recommend that the IASB consider whether treasury shares held for trading purposes, including holdings held on behalf of clients and to meet obligations for client positions (e.g.

certain insurance products), should be treated as trading instruments under IAS 39 or be subject to the IAS 32 treasury share principles.

- Paragraph 29A: The exemption from the requirements for accounting for treasury shares held in respect of employee share ownership plans in SIC–16 is not included in the proposed amendments. Therefore these treasury shares would be accounted for in the same way as any other treasury shares. Although we agree, entities reporting under IAS sometimes recognise these treasury shares as assets and therefore we recommend that the change in scope be mentioned in the Basis for Conclusions.

Derivatives based on own equity

- Paragraph 29D: The difference between gross physical settlement and net cash settlement in some instances will be negligible. For example an entity may write a put and pay a fixed amount to take delivery of a fixed number of treasury shares when the put is exercised (and therefore account for the transaction as an equity transaction) but immediately sell the shares in the market for cash, assuming they are readily convertible to cash. The economic result is basically the same as net cash settlement. This result is inconsistent with, for instance, the proposed scope inclusion for commodity contracts that will be settled by physical delivery if the commodity will be sold shortly after delivery and loan commitments under similar circumstances. Another case we have seen is an instrument that is puttable subject to approval of shareholders in a general meeting. It would be useful to clarify whether the approval mechanism removes the obligation or whether it would be necessary to consider history and practice and use a remoteness test.

- Paragraph 29E: If a forward purchase of shares gives rise to a financial liability, it seems that conceptually the holder of the instrument should show a financial asset for the right to receive cash. Equally, a forward sale of shares seems to give rise to a financial asset, although we acknowledge that the proposals are intended only for distinguishing equity and liabilities. Intuitively recording a financial asset does not seem correct, but we suggest that these issues be addressed in the Basis for Conclusions if the proposals regarding the accounting for forwards to buy and written puts are retained.

- Paragraph 29E: The issue of "remoteness" of settlement alternatives may arise for transactions in own equity too. Although we do not support it, if probability is considered in liability classification, there should be a consistent approach in this section.

- Paragraph 29E: We believe more interpretive guidance is necessary on what constitutes an "established practice". Further questions that are sure to be raised in practice include: If this is the first transaction, is it acceptable to consider intention? We believe so but if not, this should be specified. Is a single previous transaction enough to establish past practice? And if there is a history of such transactions, would a single transaction that was settled in cash rather than gross physical settlement result in "tainting" of the established practice? What if the intention and the actual outcome differ? If the Board decides to accept the "gross liability" method, we suggest the presumption about established practice should be turned around so that if an entity has "no history or past practice of net settlement" then the contract should be an equity instrument.

- Paragraph 29E&F: It is not sufficiently clear from the standard, from the overview of derivatives on own shares in the Basis of Conclusions and from the discussion of the multiple settlement alternatives (A56) what is the presentation of the written put and forward purchase in case of a counterparty choice for settlement of the derivative. The example in A56 would require a full liability to be recorded by reclassifying the settlement amount of shares as a liability where there is gross physical settlement at the counterparty's choice. Principles explained elsewhere in the standard would suggest presentation of the written put where the counterparty has a choice as a derivative. However measuring the written put as a derivative in this case would lead to double-counting since the shares are to be reclassified to liability. It should be clarified here and in A56 that the premium received on the written put would be recorded as equity in the case of gross settlement.

- Paragraph 29F: This establishes a principle therefore we believe it should be a black letter paragraph.

Interest, dividends, losses and gains

- Paragraph 30: We suggest specifying that distributions to equity holders should be recognised in equity net of the related tax benefits consistent with the requirement for transaction costs related to equity transactions.

- Paragraph 31B: We have experienced problems in practice with allocating transaction costs on a "rational and consistent" basis. Some argue that the allocation should be on the basis of the number of shares and others believe it should be on the basis of the marginal costs, which results in most of the costs being deducted from equity.

Offsetting

- Paragraphs 33-41: We recommend that the offset rules should be amended to insist that the ability of the right of set off should survive insolvency. Further we feel the Board should consider removing the reference to management's intended method of settlement. In several jurisdictions in Europe, for example, offsetting rules are based on similar criteria except for intention as this was not found to be a useful criteria. For example, master settlement agreements in banking currently do not meet the IAS 32 test because settlement is gross rather than intended net settlement. However this answer does not give the better picture about the entity's true risk exposure, therefore we feel that the basic principle itself is not correct.

- Paragraph 33: We support the proposal to prohibit offset of transferred financial assets and the related liabilities. However we believe that additional explanation in the Basis for

Conclusions is necessary as to why offset is not permitted since the contractual terms of the transfer may meet all of the criteria for offsetting under IAS 32.

- Paragraph 34: We believe guidance is necessary on income statement presentation of items in respect of offsetting. We believe that gains and losses from items that have been offset in the balance sheet under paragraph 34 should be offset in the income statement too. But IAS 1 does not allow income statement offset of these items in the absence of a specific requirement in IAS 32.

Disclosure – General comments

- We have observed a relatively low level of compliance in practice with both the general disclosure requirements in IAS 32 and the specific requirements in IAS 39. We believe this could be addressed by providing additional guidance on the application of the disclosures, the level of aggregation and on presentation issues. This would ensure consistency and allow comparability and increased understandability of the effects of compliance with IAS 39. We have provided some specific suggestions in this regard below.

Disclosure – Specific comments

- Paragraph 43 and 60: The standard identifies as separate risk categories fair value interest rate risk and cash flow interest rate risk. The distinction is more an accounting distinction resulting from the mixed approach to measurement of interest bearing instruments than a distinction that is used in finance. For other risk types a somewhat similar distinction between exposure from current positions and exposure from future positions can be made.

  We recommend in paragraph 43 to only define interest rate risk as a subcategory of price risk and to adjust paragraph 60 to address not only exposure from current and future interest rate positions (as a result of instruments being fixed rated, floating or revolving facilities) but also current and future exposures from other risks (foreign currency, commodity and equity price risk).

  Currently the disclosure requirements mainly address interest rate and credit risk, however they should be more broadly applicable to all relevant financial risks.

- Paragraph 46A: We believe that (qualitative) risk management disclosures should apply to all economic hedging transactions – not only to forecast transactions to which hedge accounting is applied.

- Paragraph 61: The statement that the effective interest rate for an instrument carried at fair value is a current market rate, although correct in itself, appears to be inconsistent with the requirement in paragraph 93A(a)(i) to disclose total interest income on a historical cost basis (which applies also to interest bearing instruments carried at fair value as clarified in the amendments to IAS 39.103(b)).

- Paragraph 77B: Disclosure of ranges and sensitivity information is generally dangerous without additional information such as the assumptions on which the analysis is made. In subpoints (b) and (c) does disclosure of "extent" include numerical values? If so, this should be made more clear.

- Paragraph 77B(e): This requirement is not sufficiently clear. We believe it would be more practicable and useful to disclose gains and losses recognised in profit and loss relating to derivatives still held at the end of the reporting period.

- Paragraph 93A: The disclosures regarding derecognition transactions do not seem particularly meaningful. Also the disclosure requirement included in (i) regarding the effective interest on the liability element seems to be a repetition of the requirement included in paragraph 56.

Effective date and transition

- Paragraph 96: For consistency with the effective date and transition paragraphs in the general improvements exposure draft, only the effective date should be specified. The transition specified is the same as the transition in IAS 8.14 (improvements) and therefore it is not necessary to repeat the transitional treatment.

- Paragraph 96: If early adoption will be permitted (we recommend that it is) disclosure of early adoption should be required.

Appendix A: Application Guidance

- Paragraph A7: This paragraph has not been clearly aligned with the new principles on accounting for derivatives on own shares (i.e. there must be gross physical settlement or the instrument is not equity).

- Paragraph A8: The conclusions in this paragraph have not been adequately explained in terms of the definitions of equity and financial liability (see the appendix to this letter addressing definitional issues for further comments).

- Paragraph A15 and A16: We suggest mentioning the embedded derivatives that are present in these instruments.

- Paragraph A20: The last sentence requires that when notification of redemption has been given to shareholders, the shares are reclassified as a financial liability. We agree with this conclusion. However, this seems to contradict the statement in paragraph 19 that a presentation as equity or liability is never changed (see also our comment on that paragraph).

- Paragraph A21: We support incorporating guidance on when dividend terms should result in an instrument being classified as a liability, but we find the guidance in paragraph A21 inconclusive. If there is a contractual obligation to pay dividends for a finite period, it is not clear whether the entire instrument should be classified as a liability or the instrument should be treated as a compound instrument. It is important to clarify when (and to what extent) obligations to pay dividends create a liability. For instance, cumulative dividends may only be discretionary in the timing of payment but it is not clear from this guidance what their classification would be. In addition the paragraph specifically mentions preference shares and therefore may be interpreted as applying to only preference shares. We believe that the guidance is applicable for all instruments and that this should be clarified.

- Paragraph A21: Some of the examples describe situations where there is an economic compulsion to pay a dividend, in particular the situations included in (c) and (f). In case of structures where the parent must ensure there are sufficient distributable reserves available to a special purpose vehicle/subsidiary that has issued preference shares, the substance of this seems to be a financial liability rather than equity.

Examples of transactions in own equity

The recognition and measurement principles illustrated in the examples are not always intuitive to us from the general recognition and measurement principles in IAS 39. We believe that additional explanation is necessary as to how the IAS 39 principles apply in these cases. For example:

- Where entering into a forward to buy or a written put leads to reclassification of the shares to a financial liability at the present value of the future cash payment, it may be unclear how the counterparty to the transaction that currently holds the shares and will deliver those under the forward or written put will account for these positions. In our view these should be separate transactions. We recommend to clarify this.

- Explain in example 6(d) that initially the premium of the written put would be included in equity.

Other areas not included in the IAS 32 exposure draft for consideration by the IASB:

Transactions in equity of subsidiaries or minority interests

Neither the proposed amendments nor the current standards address the accounting for transactions in subsidiaries' equity or minority interests. We believe additional guidance is necessary on how to account for these transactions, in particular as to when these transactions should be accounted for under IAS 32 or IAS 39 and when they should be accounted for as minority interests under IAS 27. Often the distinction between transactions in minority interests and those in own equity is very fine.

This issue has been discussed by IFRIC and also links closely to the proposals regarding treatment of minority interests as equity and other issues that arise in applying IAS 27, including the conclusions in SIC-33.

Also questions of whether or when equity shares of a subsidiary should be presented as a liability in the parent's consolidated financial statements are not addressed. The wording of IAS 32.17 leaves little room for a substantive approach, suggesting that equity treatment at the subsidiary level should lead to equity treatment at the consolidated level.

Liability / equity classification and embedded derivatives

The interaction between the components approach adopted in IAS 39 for evaluation of embedded derivatives and the contract as a whole approach under IAS 32 for classification of instruments as debt or equity is not clear. Refer to appendix F for a further discussion of this.

We believe that clearer principles need to be included to specify whether liability or equity classification of an instrument that includes an embedded derivative should be made considering the contract as a whole (including the embedded derivative) or whether it should be done on a components basis and how this affects the subsequent evaluation of the embedded derivative.

In our view the contract as a whole should first be evaluated under IAS 32 for classification as equity or liability. Thereafter the embedded derivative should be evaluated under IAS 39.

We also believe that clarification or guidance is necessary on when a host contract (issued instrument) has the nature of debt and when it has the nature of equity. We do not find the guidance added in paragraph A1 of IAS 39 helpful. We suggest specifying the characteristics that would make the host contract a debt instrument and stating that if the host does not have the features of a financial liability, as defined in IAS 32, then it is an equity instrument, consistent with the definition of equity as a residual.

Puttable instruments: investors' perspective

We believe it would be helpful to include guidance on the implications of the proposed treatment of puttable instruments for investors in such puttable instruments. In particular:

- Does the investor have a separable embedded derivative?
- Is the investment a monetary rather than a non-monetary item?

Although IAS 32 only deals with distinguishing equity and liability, we think it would be helpful to clarify that the classification as a financial liability by the issuer should not necessarily change the presentation as a residual-interest equity-type investment by the holder of such an instrument.

Accounting for derecognition of convertible bonds by the issuer

In practice we have encountered a number of issues as to the appropriate accounting treatment by the issuer of a convertible bond on the subsequent repurchase, redemption or conversion of the bond, in particular the amount of gain or loss, if any, that should be recognised when an instrument is redeemed, purchased or cancelled in exchange for a combination of cash/other assets and equity as well as where (i.e. equity or profit and loss) We would like to have more guidance on this issue.

Disclosure

We believe additional clarity on the following disclosures would be helpful:

¦ We believe the following additional disclosure requirements would provide meaningful information to users of financial statements:

  - An explanation in the accounting policy notes of the basis used to designate instruments as carried at fair value with gains and losses recognised in the income statement.

  - Presentation of hedge ineffectiveness recognised in the income statement.

  - Information about transactions in own equity.

  - Information about securities borrowing and lending agreements. In practice, very few if any disclosures are provided.

Presentation

We believe additional guidance on the following issues relating to presentation would be helpful to ensure that financial statement presentation is consistent and appropriate:

¦ Presentation of various categories of financial instruments in the balance sheet. We believe that this is particularly important given the proposals to allow any instrument to be designated as an instrument carried at fair value with gains and losses reported in the income statement. In our view, "designated" instruments should not be presented as trading unless they meet the original definition in IAS 39 based on intent to trade.

¦ Presentation of hedging gains and losses and gains and losses on derivatives in the income statement. IAS 32 is silent on how gains and losses on hedging activities should be presented in the income statement. In our view there are several possibilities. For a fair value hedge:

  - The entire change in fair value of the hedging instrument may be presented in the same line item in the income statement as the adjustment to fair value in respect of the risk being hedged of the hedged item.

- The effective and ineffective portion of the gain or loss on the hedging instrument may be presented in the same line item as the adjustment to fair value in respect of the risk being hedged of the hedged item, with the portion excluded from the assessment of hedge effectiveness included with the income statement effect of non-hedging derivatives.

- The effective portion of the gain or loss on the hedging instrument may be reported in the same line item as the adjustment to fair value in respect of the risk being hedged of the hedged item, with the balance of the change in fair value of the hedging instrument in the same line item as the income statement effect of non-hedging derivatives.

The same possibilities also currently apply for presenting gains and losses on cash flow hedging instruments at the time they are recognised in the income statement.

¦ Income statement offset in particularly with regards to:

- trading income;

- foreign exchange gains and losses; and

- gains and losses on hedging instruments and gains and losses on the underlying hedged items

The proposed improvements to IAS 1.32 help to some extent in this regard but the proposed guidance in IAS 1.32 is not consistent with the principle in IAS 1 paragraph 29.

¦ Presentation of embedded derivatives in general, and derivatives embedded in puttable instruments in particular.

Appendix D

IAS 39 specific comments

Structure of the standard

- We feel that the formatting of the authoritative literature on financial instruments has become cumbersome to use as its sources are in different places. Besides the revised standards themselves there are now various appendices with different levels of authority (refer to next comment) as well as IGC Q&A's that are not incorporated into the revised standards. In order to clarify exactly what constitutes authoritative guidance, we recommend that the improved standards, plus all other relevant guidance that remains, be issued in a single package. This should include a positive statement that any guidance not brought forward into this package no longer has authority.

- We are not satisfied with the structure of Appendix A of IAS 39 as an "integral part of the standard". If there is text that is an integral part of the standard, we feel that it should be located there. Even though the (proposed) revised IAS 8 notes the hierarchy of authority of appendices that do and do not form a part of a Standard and implementation guidance, we feel that the distinction is particularly confusing in IAS 39 given that standard's complexity.

Scope

- Paragraph 1(b): In addition to lease receivables being subject to the derecognition and embedded derivatives principles of IAS 39, the impairment principles should also apply. As IAS 17 does not cover impairment, the scope of IAS 39 should be extended to cover lease receivables in this respect.

- Paragraph 1(f): The new text implies that upon initial recognition, a financial guarantee must be recorded in accordance with IAS 39 but thereafter is accounted for under IAS 37. We wonder if this is the intended result. Also we feel such a requirement could sometimes result in a strange answer as recognition under IAS 39 and recognition under IAS 37 are based on different principles (ie, an obligation versus a probable outflow of resources). For example, an entity that writes a single financial guarantee contract would measure it at fair value upon initial recognition. Assuming a payment under the guarantee is not probable, subsequent measurement under IAS 37 would be zero. This would imply a gain immediately following initial recognition, which we assume is not the intended result. As IAS 37 does not distinguish between initial and subsequent measurement, we do not believe it is clear which standard's measurement principles should be applied initially.

- Paragraph 1(f): The proposed change may also impact certain types of credit insurance that may have to be recognised initially under IAS 39, but are subsequently scoped out because they are viewed as financial guarantees. Due to the scope exclusion for insurance contracts in

IAS 37 such contracts then could be scoped out of both IAS 39 and IAS 37 for purposes of subsequent measurement.

- Paragraph 1(g): The scope should also address contractual commitments in a business combination when the purchase price has been agreed prior to control passing. This probably would have to be accounted for under IAS 39 as a forward contract derivative but for pragmatic reasons, such as impracticability of measuring a change in fair value, should be excluded from the scope.

Definitions

- Paragraph 10: Effective interest rate – We notice that the definition of the effective interest rate in this paragraph has some inconsistencies with the definition of the effective interest rate in other standards. This paragraph is cross referenced with IAS 32.61, which says that the effective interest rate for a floating rate instrument and an instrument carried at fair value is the current market rate while for a fixed rate instrument carried at amortised cost the effective yield is a historical rate. While the definition of the effective interest rate in IAS 39 may be understood as being in line with IAS 32.61, IAS 32.93A implicitly requires interest income and expense for all financial instruments including available-for-sale to be determined on a historical cost basis. This is also stated in IAS 18.31. We recommend that the definition of the effective interest rate in IAS 39 be clarified by deleting the reference to IAS 18.31 from this paragraph and eliminating the inconsistencies in IAS 32.93A.

- Paragraph 10: Effective interest rate – According to this paragraph, the effective interest rate should be calculated based on the *contractual* stream of future cash payments for individual instruments. It is only for a group of assets that are subject to prepayment risk and that are collectively evaluated for impairment that the effective interest rate is calculated based on the *estimated* stream of cash receipts. We believe that it is appropriate that the effective interest rate in all cases should be based on estimated cash flows which, in case of instruments containing for example prepayment or call and put options, may be different from the contractually stated payments. This treatment would be also consistent with the definition of the effective yield in IAS 18 which refers to expected (and not contractual) cash flows. In addition, we feel that the reference to calculation of the interest rate for impairment purposes should be moved from this paragraph to a separate one. The calculation of interest rate in case of impairment is based on different principles, therefore referring to it in this paragraph is confusing.

- Paragraph 10: Effective interest rate – The paragraph does not clearly distinguish between the two different senses of "expected"/"estimated". One sense refers to the case where the cash flows payable under a contract are uncertain (e.g. an option) such that the *contractual* amounts have to be estimated. The second sense refers to an estimate that allows for the fact that amounts contractually due may not be recovered.

- Paragraph 10: Transaction costs – The change in definition requires only external incremental costs to be considered transaction costs. We do not agree with this change and feel this is not consistent with other standards (eg, initial direct costs of leases in IAS 17). As long as a cost is incremental, we believe that both internal and external transaction costs should be capitalised.

Embedded Derivatives

- Paragraph 22: A comment has been added stating that the presentation of embedded derivatives is not addressed here. We do not find this statement helpful. Generally, IAS 39 does not refer to presentation. We believe that the comment should be deleted and specific guidance on the presentation of embedded derivatives should be added to IAS 32.

- Paragraph 23: The guidance on when embedded derivatives are considered closely related is not obvious from the text. Therefore we think that a clearer principle should be included in the body of the standard and only then would it be appropriate to move examples to an appendix.

- Paragraph 23: It would be helpful to clarify that embedded derivatives only should be evaluated for separation at initial recognition and that this evaluation would not have to be done each reporting period.

Initial recognition

- Paragraph 29(b): Issues also commonly arise with this exemption when derivatives are embedded in normal sales and purchase transactions (particularly foreign currency derivatives). The exemption for normal purchases and sales is often interpreted to mean that a derivative embedded in a normal sales and purchase transaction is not required to be recognised. It would be helpful to clarify that embedded derivatives guidance still must be followed.

Derecognition

- Paragraph 37(b)(ii): In our view, retaining an equity or residual interest in the transferred assets (or in the SPE into which they are transferred) that may be used to cover losses in substance is similar to a credit guarantee or a total return swap and should be added in this paragraph.

- Paragraph 40: There appears to be a logical flaw in this paragraph. One of the risks of any financial asset is that its current value will not be recovered in full. Therefore, if the transferor retains a partial interest in the asset that contains "all" the risk of the entire asset, the transferor must have effectively guaranteed recovery of the entire asset. In that case there can be no portion of the asset for which the transferor has no continuing involvement, therefore no portion of the asset qualifies for derecognition.

- Paragraph 42: We feel that the proposals could have unintended effects on certain types of entities, such as investment funds that have similar features to SPEs. We feel that this approach should be tested on various types of entities to determine whether the answer makes sense in all cases.

- Paragraph 43: We agree that servicing assets and servicing liabilities are not financial instruments. But there is no guidance on the subsequent measurement of these assets and liabilities. We agree with the deletion of the comment in the old paragraph 50 about servicing assets being treated as intangibles, however other guidance is necessary. Because the main risk affecting the value of a servicing asset or liability is prepayment risk due to changes in interest rates, we would support accounting for these as financial instruments for purposes of measurement and impairment.

- Paragraph 46: The calculation of the amount of profit or loss on disposal does not include an adjustment for the fair value of the new assets or new liabilities (the requirement to adjust the profit or loss for the fair value of new assets or liabilities previously included in paragraph 51 has been deleted). We believe that this requirement is necessary to correctly calculate the profit or loss on disposal, unless the proceeds are adjusted for the fair value of new assets or liabilities. If the latter is the Board’s intention then this should be specified.

- Paragraph 47: The section on derecognition of a portion of a financial asset does not mention how to treat new assets or liabilities. Unless this section is redrafted, we recommend repeating in these paragraphs the principles on recognition of new assets and liabilities so that it is clear that the requirements related to new assets and liabilities apply in all derecognition situations, rather than only to situations where an *entire* asset is derecognised. (Currently it only is included in the section on derecognition of an asset in its entirety.) In paragraph 47, the previous requirement to consider the fair value of new assets or liabilities in calculating profit or loss on derecognition has been deleted. We believe that new assets and liabilities must be included to calculate the correct profit or loss on disposal.

- Paragraph 47: It is not clear on what basis any gain or loss in equity should be allocated between the portion retained and the portion sold.

- Paragraphs 52-57: We generally agree with the principles proposed in this section. On balance we do not believe it is appropriate to recognise a separate synthetic option in these cases because this would involve imputing terms into the transaction that are not stated in its contractual terms. Although complex, we agree that the solution proposed is appropriate. However we note that the treatment that results from a failed sale of an asset according to IAS 39 is not consistent with the accounting of an in substance comparable transaction e.g. a so-called exchangeable or reverse convertible. In the case of an exchangeable, both a host debt and an embedded derivative are recognised, while in a failed sale no embedded derivative is identified. We recommend considering whether this difference is justifiable and appropriate.

- Paragraph 54: The proposals will sometimes result in exceptions to the general measurement rules. For example, in this paragraph the subsequent measurement of an available-for-sale asset combined with a call option results in remeasurement of the AFS instrument at an amount other than fair value.

- Paragraph 56: Where there is an exchange of non-cash assets for non-cash assets (e.g. securities loan secured by pledge of securities), how does one determine who is the transferor and who is the transferee?

- Paragraphs 65A and 65C: The gain or loss should be adjusted by the fair value of any new or secondary liabilities taken on.

Initial measurement

- Paragraphs 66-67: We believe that adjustments should be made to these paragraphs to make it absolutely clear that initial measurement is required to be at fair value even when the cost is not an arm's length cost. Paragraph 66 is currently widely interpreted literally as follows:

  Paragraph 66 states that the cost is the fair value of the consideration given (for an asset) or received (for a liability). Therefore, if a bank makes a low-interest or interest-free loan to customer, the "cost" amount given by the bank (which recognises an asset) and the amount received by the customer (which recognises a liability) is often interpreted to be the cash transferred. Using this literal interpretation, the "fair value of the consideration" would be equal to the amount of cash transferred. This same issue often arises in relation to low or no-interest intercompany loans or intercompany current accounts. Further clarification on the application of this paragraph is needed, especially in respect of the latter instrument, where there may be a permanent core balance maintained without a maturity nor agreed interest rate.

  We suggest amending the wording of paragraph 66 and 67 as follows:

  > 66. When a financial asset or financial liability is recognised initially, an entity shall measure it at its cost ***in a market-based transaction***, which is the fair value of the consideration given (in the case of an asset) or received (in the case of a liability)***. If the transaction is not based on market terms, paragraph 67 discusses how to determine a market-based price.*** Transaction costs that are directly attributable to the acquisition or issue are included in the initial measurement of the financial asset or financial liability.

  Further, we note that the IASB should address whether it is intended that intangibles should be bifurcated and separately assessed for capitalisation. Examples where this is relevant include client intangibles included in core deposits, savings accounts and credit card receivables, all of which have a value to the originator. We feel this should not be required, but these paragraphs could be interpreted otherwise.

- Paragraph 67: We believe paragraph 67 should also clarify that a borrower receiving an interest-free or low-interest loan should recognise a gain on initial recognition unless there is reason for deferral under other standards.

Subsequent measurement

- Paragraph 80: While we agree with the statement that a significant risk of non-payment does not in itself preclude held-to-maturity designation, we suggest adding that if volatile credit risk increases the likelihood that the asset would be sold and those conditions are already known on the date of acquisition, then the entity is less likely to be able to state the positive intent to hold the instrument to maturity.

- Paragraph 83: It is not clear whether "for example, less than three months" and "for example, 90 per cent" are meant to be definitive thresholds or just examples. If the intention is to provide definitive thresholds then "for example" should be deleted. If not, then it would more appropriate to either delete the numeric statements, as generally in IAS quantitative criteria are not given, or to move the examples to the appendix and provide more guidance on how to determine the thresholds in the text of the standard.

- Paragraph 86(c): We believe that this paragraph should include the guidance from Q&A 86-1 which clarifies that a mere change in management is not an instance where sales or transfers from held-to-maturity are allowed.

- Paragraph 92: Subpoints (a) and (b) should be amended to allow for the case where a financial asset is subsequently impaired.

- Paragraph 99: The description of an active market introduced here is not consistent with the definition of an active market in IAS 36, IAS 38 and IAS 41 (a market where willing buyers and sellers can be found at any time, the items traded in the market are homogeneous and prices are available to the public). It might create confusion using terminology defined in other standards but with a different meaning. We recommend either addressing this inconsistency or using different terminology.

- Paragraph 100: For markets where there is a lack of liquidity to readily absorb large holdings of shares it is difficult to establish whether a quoted market value is actually the fair value of the holding. We can envision that in certain markets a discount for lack of liquidity / marketability might be appropriate. Further the guidance in this paragraph does not take into account other factors that may affect tradable securities, such as a mandatory holding period. We believe that in certain situations such as these, there are factors that impact a holding's fair value that must be taken into account as an adjustment to the market value.

- Paragraph 103B: We believe this paragraph is inconsistent with IAS 21 and treatment of foreign exchange differences for monetary items. We feel that the recommendation to separate foreign exchange differences as proposed is difficult in practice. Most entities make the assumption that the entire instrument is considered to be monetary and follow the guidance in IAS 21. We recommend to consider whether as a practicable compromise the entire fair value change of available-for-sale assets, including that related to foreign exchange differences, is recorded in equity. Additionally, this would be a consistent approach with US GAAP.

- Paragraph 103B: For trading instruments separate disclosure of foreign exchange gains and losses as required by IAS 21 does not add benefit and, therefore, an exception in this case is appropriate. We suggest to include a guideline in the standard that an entity is not required to disclose separately foreign exchange gains and losses on financial instruments measured at fair value through income. A consequential amendment should be then made to IAS 21.

Impairment

- Paragraph 109: The criteria for recognition of impairment losses of the various types of assets for which impairment has to be assessed, could be clarified and brought more in line with each other: paragraph 109 mentions as a criterion objective evidence; 111 states in addition "it is probable that an entity will not be able to collect all amounts due"; 116 provides only for the objective evidence criterion and 117 mentions apart from objective evidence, a decline in fair value recognised in equity.

  We recommend that the following steps (in the order stated) are included as a common basis for recognising impairment, rather than making distinctions between the types and measurements of financial instruments:

  - Objective evidence that the asset is impaired;

  - Probability that the entity will not be able to collect all amounts due or that the fair value will not be recovered (cash flow expectations of the acquirer when entering into the transaction are assessed to have to be adjusted downward)

- Paragraph 113: The proposals regarding modification or renegotiations of a loan refer to those in situations of *financial difficulties* of the borrower or issuer. This seems to indicate that if the renegotiations are not the result of financial difficulties (objective evidence of impairment) then another interest rate would be used. IAS 39 does not provide guidance on how in the historical cost model such modification should be accounted for, while it does provide guidance on the accounting for a modification of a financial liability.

- Paragraph 113: The guidance on what is objective evidence of impairment for loans is not consistent with the recognition of impairment on equity instruments, as objective evidence for the latter includes significant and prolonged declines in fair value which is not necessarily based on the issuer's financial difficulties or other relevant circumstances when there is a significant overall market decline.

- Paragraph 113: The improvements proposed may in some instances lead to inconsistent answers. For example, if the modifications of a loan result in a change of the interest to a current (lower) market interest rate, then on the basis of applying the historical effective interest rate an impairment loss would have to be recognised, although a market interest rate would be recovered. However if the practical exception were applied and the impairment was based on the fair value of the loan, then no impairment loss needs to be recognised. We think that the practical exception is not consistent with the cost model. We recommend that this inconsistency is eliminated.

- Paragraph 113D: The drafting of the paragraph implies that a gain or loss should not be recognised on the initial recognition of an asset or liability, which would be the case if a loan is granted at market terms. However as drafted, this paragraph is inconsistent with the principle of recognising an interest-free loan at the present value of the future cash flows and recognising a gain or loss on initial recognition introduced in paragraph 67. We suggest clarifying the drafting.

- Paragraph 115: The added word “individual” in this paragraph could be misinterpreted to mean that it is only in situations of impairment of individual assets that interest should be imputed, ie that suspending interest on a portfolio would be acceptable. The paragraph should be redrafted to clarify that is not the intention.

- Paragraph 116: We do not see how there could be a “current market rate of *interest*” for an asset similar to an unquoted equity investment or related derivative.

- Paragraph 118: We suggest changing “acquisition cost” to “initial recognition amount” to ensure that the impairment recognised on instruments with “off-market” terms is correct..

Hedge accounting

- Paragraphs 122, 127B: The IASB proposes to remove some guidance and clarification in these paragraphs. We believe that the reasons for the principles stated in these paragraphs is better placed in the Basis for Conclusions.

- Paragraph 124: The paragraph precludes applying a written option as a hedging instrument unless it is designated as a hedge to offset a purchased option. Unless the purchased option is an embedded derivative that should not be separated out (because it is clearly and closely related to the host contract) we do not believe that there is a need to qualify the written option as a hedging instrument in these cases since both the written option and the purchased option will be measured at fair value with changes recorded in the income statement and applying hedge accounting therefore is unnecessary.

- Paragraph 126A: This explanation and conclusion seems inconsistent with the new requirements on derivatives on own shares in the IAS 32 draft amendments.

- Paragraph 126C: There are cases where the components of a derivative are separately measurable – for example the interest and foreign exchange components of a cross currency and interest rate swap. We do not agree with the prohibition in those cases – for example if a held-to-maturity instrument is fully hedged with a cross currency and interest rate swap, hedge accounting is not allowed for the transaction in its entirety because of the prohibition on hedge accounting for hedges of interest rate risk on held-to-maturity instruments combined with this exclusion on treating components of the instrument as the hedging instrument. The identical result can be achieved with an interest rate swap and a separate currency forward contract and in these cases the forward contract would be eligible for hedge accounting.

- Paragraph 126D: Hedge relationships may not be designated for a portion of the time period in which the hedging instrument will remain outstanding. This is not a requirement in US GAAP. For reasons of convergence and risk management practice, we recommend to consider whether hedge accounting should be permitted also for a portion of the term of a hedging instrument as long as the effectiveness requirements are met. We note that currently a similar result can be achieved by de-designating a derivative at a later point. Also for this reason we feel that there is insufficient basis for this restriction.

- Paragraph 126F: This new paragraph incorporates Q&A's 122-1 and 124-1, although the latter not fully. We suggest that it either be fully incorporated in paragraph 126F or that the Q&A remains.

- Paragraph 127: Hedge accounting for held-to-maturity instruments in respect of interest rate risk is not allowed. The reason provided in the standard is that instruments classified as such are not exposed to interest rate risk since they will be held to maturity. However IAS 32 and 39 define risk exposure in terms of cash flow risk as well as fair value risk. If exposure was only defined as a risk of changes in fair values, we would understand the rationale. For example, a positive intent to hold a floating rate instrument to maturity means that the interest income of the investor is subject to cash flow risk during that period and hedging this risk would be consistent with the investor's intent to hold. The standard allows for a change in risk profile for all other instruments by either applying cash flow hedge accounting or fair value hedge accounting and does not prescribe risk reduction in terms of one type of exposure. Given this, and that generally (especially in financial institutions) all financial instruments, including held-to-maturity instruments will be part of a risk exposure analysis of the total balance sheet, we feel that the exclusion of held-to-maturity instruments is not appropriate. We therefore recommend that the requirements in this respect are reconsidered.

- Paragraph 129-130: These paragraphs state that non-financial assets and liabilities can only be hedged in their entirety or separately with respect to foreign exchange risk. The reason given is that other risk components generally do not have a predictable, separately measurable effect on the price of the item and therefore should not be allowed as hedged item by themselves.

We believe that in some circumstances other risk components than foreign currency risk may be separately measurable and as a result should be eligible for hedge accounting. Examples include: a basis price risk inherent in certain commodity contracts, and interest rate risk in operating leases (eligible for hedge accounting under US GAAP).

We note that in practice a number of issues have arisen regarding commodity hedging especially when the hedged item is a commodity of which derivatives are traded in a standardised form on a commodity exchange, such as coffee beans, cocoa beans and crude oil future contracts. Entities often enter into derivatives for the standardised commodity prior to determining the quality of the commodity they require for production; this may depend for example on consumer demand and harvest circumstances.

IAS 39 requires that the item that is being hedged can be identified. In these cases only a standard commodity component can be identified at the time the futures contract is entered into. If entities are not allowed to designate the price risk related to only a portion of the future purchase (i.e. the standard commodity that is identifiable and probable) then entities may not be able to identify a hedged item for hedge accounting purposes. The price of the standard commodity is a portion of the price of the actual commodity and the prices of the actual commodities are priced off the standard price. The price risk of a commodity can be isolated and measured reliably because of the status of development of the derivatives market and as a result of that hedge accounting should be allowed. We believe it would be appropriate to permit a component of a non-financial asset or liability to be designated as a hedged item when the appropriate element of fair value or cash flow within the hedged item as a whole can be clearly identified and measured by reference to a price in an active market.

Another example of the above is as follows: The price of jet fuel is a derived from the price of the components that make up jet fuel. Each of the components is traded and market prices are available for each of the components. The quantity of each of the components in a metric ton of jet fuel is always fixed. However, the relative value of each of the components differs as the prices of the components move more or less independently. Various hedging strategies are possible when hedging jet fuel purchases. The entire fuel price exposure may be hedged, or only the exposure to one or more of the price components. The costs of hedging, the relatively more liquid nature of brent and gas oil derivatives, the fact that brent and gas oil are the most significant component of jet fuel prices, and the independent nature of the pricing of the various components, means that entities sometimes choose to hedge only certain of the components (brent or gas oil) and to retain an exposure to the price of the other components. The brent and gas oil swaps respectively are hedges of the corresponding brent or gas oil component of the jet fuel purchases only. This results in perfect hedge effectiveness: the critical terms of the derivative and the critical terms of the purchase match: the prices change in parallel and the notional amount of the derivative equates to the quantity of the component in the jet fuel basket. This economic hedge does not, however, qualify for hedge accounting because of the blanket prohibition in paragraph 129. The result is that, to qualify for hedge accounting, a correlation must be demonstrated between the price of the hedged component and the jet fuel price. If possible, the hedged item is considered to be the jet fuel purchase. As a result ineffectiveness arises. This result is not consistent with the economic effect of the hedge.

- Paragraph 130: This paragraph includes an example that relates to commodity hedging. In the example an entity expects to purchase Brazilian coffee and hedges this with a forward contract on Colombian coffee. The example addresses the assessment of effectiveness and should in our view not be included in this section of the standard. The example seems to be similar to one in FAS 133 and suggests that one commodity might be hedged with a forward on another commodity. The implicit assumption in the example is that the fair value change of the two commodities is closely correlated. We suggest that the paragraph explicitly mentions this. Also we recommend to include the example in an appendix if retained.

- Paragraph 137: The definition of a fair value hedge only includes firm commitments to buy or sell an asset at a fixed price. We believe the definition should also include firm commitments under leases or service contracts. This can be achieved by changing the wording to refer to firm commitments at a fixed price.

- Paragraph 147: The revised wording continues to suggest that the application of a "short cut" method is allowable. In our view, formalising the "short cut" method in the standard would significantly ease implementation without compromising the relevance of financial information. This would involve permitting the use of the short-cut method – i.e. assuming zero ineffectiveness in a hedging relationship – when the critical terms of the hedged item and the hedging instrument are identical. Entities would then be able to avoid the complexities of effectiveness testing if they choose to put in place hedges which are clearly fully effective.

- Paragraph 164 (b)(ii): The hedging instrument for a net investment hedge would normally be a foreign currency liability, which would be carried at amortised cost. Therefore the reference here to paragraph 103 is confusing/incorrect.

- Paragraph 165: If the hedged item is not a financial instrument, paragraph 103 is not relevant. Also, even if it is a financial instrument, if it is a monetary item exchange gains and losses must be reported in the income statement under IAS 21. We suggest instead to state that if a hedge does not qualify for special hedge accounting, it is accounted for under the measurement rules applicable if it had not been hedged.

Appendix A: Application Guidance

- Paragraphs A4 and A7: Many of the examples are practical expedients or exemptions rather than application of the general principles. We advise to include the more principle based guidance in the standard and to include as examples only illustrations of the principles.

- Paragraph A7(a): This indicates a specific threshold for leverage of the impact being at least double while elsewhere in IAS including IAS 39 numerical thresholds are usually avoided.

Therefore, we suggest to include clarification whether "at least double" is intended to be a definite threshold or is just provided as an example.

- Paragraph A7(c): A reason why no embedded derivative in a dual currency bond is separated, is added to the reference to IAS 21. We think that this is unnecessary and also not correct: a foreign currency is not closely related to an interest rate that otherwise would be denominated in the host contract's currency.

- Paragraph A7(d): We support the new exemption for a currency commonly used in the economic environment in which the transaction takes place. However, we suggest to clarify whether this guideline applies only to countries with unstable currencies, and not to other (small) countries which may also commonly use other currencies.

- Paragraph A7(d): Application issues still arise in interpreting what is a currency of international commerce. We believe it is appropriate to apply the international commerce exemption to transactions that are predominantly denominated in a particular currency, and for which only in exceptional circumstances a different currency is used. We suggest to include a clarification in this paragraph in this respect.

- Paragraphs A8-A9: We found the examples difficult to understand. The examples are theoretical in nature and seem to be a random list; it would be more useful if there was a series of examples that explain the principles of the revised standard.

- Paragraphs A8-A9: We question why these examples are included in Appendix A rather than Appendix B. If the reason is that they interpret the principles then inclusion here is appropriate, however this should be clarified. If they are meant to illustrate the principles they should rather be in Appendix B.

- Paragraph A8(c): This example also seems to contradict the general principle of fair value at initial measurement by linking the asset and the liability rather than focusing on the liability under the option.

- Paragraph A8 (d): Same questions as under paragraph A8(b).

- Paragraph A9: We suggest illustrating the application of the derecognition principles before illustrating the accounting mechanics for transactions.

- Paragraph A9(c): We agree with the answer but have difficulty reconciling the conclusion with the definition of a financial instrument. Also, we wonder where to draw the line as to what constitutes a "similar" asset.

- Paragraph A9(n): Presumably if the amount of the guarantee is unlimited, then none of the asset is derecognised, even if expected credit losses are minimal. This should be clarified; otherwise the "amount the transferor could be required to pay" could be interpreted to be the expected payments. Also it should be more clearly explained that a subordination is accounted for in the same way as a guarantee as it is in effect a limited recourse guarantee together with a pledge of the retained interest. However the description of "in effect repurchasing" the transferred asset is inaccurate – a guarantee has none of the upside or control of repurchase, and a subordinated interest does not involve the transferor "paying" anything further to the transferee.

- Paragraph A9(o): We suggest emphasising in the last sentence that derecognition is prohibited *for the entire asset*.

- Paragraph A10: This should be in body of the standard (as a black letter requirement) in paragraph 57A.

- Paragraph A11 and A12: No past practice approach is used here as there is for derivatives on own shares or commodities contracts. This inconsistency should be addressed.

- Paragraph A13 and A14: We recommend clearly specifying what is the timing of recognition of the gain or loss on disposal for trade date versus settlement date accounting and suggest amending A13(b) and A14(b) to state: "derecognition of an asset that is sold and recognition of any gain or loss on disposal….".

Appendix B: Illustrative Examples

- Paragraph B3: What should the subsequent accounting treatment of the failed sale be (the receivable and the debt instrument)?

- Paragraph B4-B17: The accounting proposed in this example is very complex and difficult to apply in practice. It is not sufficiently clear why the retained interests have an estimated fair value of 1,100 for purpose of allocating carrying value, and on a stand-alone basis have a different value of 1,304.

- Paragraph B9: Assuming that the retained interest is subsequently measured at fair value with changes through profit and loss. Does this example mean that on Day 2 when recording the instrument at fair value, the entity would recognise a gain (ie, difference between 1,100 and 1,304)?

- Paragraph B14: Under what principle in the standard are the retained interests measured at fair value subsequent to initial recognition? Why do they not retain their originated classification. And what is the principle for remeasuring the liability proportionately to reflect the retained interests, rather than remeasuring by the same amount as the retained interest. What is the nature of the "premium" income?

- Paragraph B34: It would be helpful to clarify that the trigger for this test is the fact that previous experience indicates losses in similar portfolios and that Entity A determines there are losses inherent in this portfolio. Otherwise even though there are no losses during year 1, Entity A records an impairment loss which might be interpreted as building up a reserve on performing loans.

- Paragraph B34: It seems counter-intuitive that interest income continues to be measured based on historical effective rates and nominal values, rather than carrying amounts. This is apparent from this Appendix example. The loss of 167 in the example results from recognising interest income at 12% of the nominal value; in other words a credit spread of 1.8% has been recognised as income when it compensates for future losses. Those future losses are effectively then recognised as an impairment. An impairment is not recognised on initial recognition, which is appropriate. However it is not appropriate to recognise impairment at the end of year 1 even though the expected cash flows are exactly the same as they were before.

- Paragraph B37: A few additions to the example would be helpful, specifically (a) state an assumption that the terms of the hedging instrument and hedged item are identical, which is why there is no ineffectiveness; and (b) illustrate the recognition of the interest income of the debt security in the example. In addition an example of accounting for a hedge of a firm commitment – to illustrate recognition of the fair value of the firm commitment in the balance sheet – would be helpful.

- Paragraph B42: Our understanding is that if actual effectiveness is outside the range 80:125, hedge accounting should stop from the date that effectiveness was *last demonstrated* – not from the actual date that the hedge becomes ineffective. And if the reason for not applying hedge accounting is that the prospective effectiveness test is not met then hedge accounting would stop from the *current* effectiveness measurement date but could be still applied for the period if the retrospective test is met for that period. This should be clarified.

Appendix C: Basis for Conclusions

- General: The Basis for Conclusions only addresses changes from current IAS 39 and is therefore not a comprehensive Basis for Conclusions. We would prefer that Appendix C addresses the whole revised IAS 39.

- Paragraph C105: The inconsistency with respect to available-for-sale investments remains – US GAAP does not allow free designation as trading.

Consequential Amendments

- IAS 18, example 14(b) in the Appendix: It would be helpful to provide an example of when this paragraph would be applicable, such as a standby facility granted by a financial institution to a commercial customer.

- IAS 18: There are several inconsistencies / overlaps with IAS 32 IAS 39 that should be removed which we have noted previously. These relate to the description of effective yield and to discounting future receipts using an imputed interest.

- IAS 17: The Board should consider amending the scope of IAS 37 to exclude all financial instruments that are accounted for under IAS 39. The drafting of the current scope exemption in IAS 37 for financial instruments does not seem to be appropriate given the amendments to IAS 39 and IAS 32.

Appendix E

Definitional issues in IAS 32

We do not believe that instruments that will be settled by delivering or receiving own equity meet the definition of financial assets or financial liabilities as the definitions are currently drafted. The view that an instrument settled in own equity is not a financial asset or financial liability is supported in IAS 32 (pre-amendment) paragraph A7 and in Q&A 11-1.

Paragraph 5 of IAS 32 and paragraph 11 of IAS 39 (pre-amendment) have specific requirements for instruments that can be settled in cash or in own equity at the option of the holder. We view these requirements as consistent with the definition of a financial liability because of the cash settlement alternative. In practice we have encountered a number of situations where an obligation will be settled in a variable number of own equity instruments, but where there is no cash settlement option. Under the current standards there are two views of the appropriate treatment of such instruments: an approach that applies the principle in IAS 39.11 by analogy and views this as a liability; or a strict application of the definition, which leads to the conclusion that it is equity.

We note too that the FASB, when it proposed liability classification for certain instruments settled in own equity, simultaneously proposed a change to its liability definition.

We see a number of possible solutions to address the inconsistency of the proposals with the definition of a financial liability:

1. Change the definition of a financial liability to specifically include own equity instruments as a settlement alternative. For example:

   A financial liability is a contractual obligation:

   (a) to deliver cash or another financial asset to another entity;

   <u>(b) to issue a variable number of the entity's own equity instruments</u>; or

   (c) to exchange financial instruments with another entity under conditions that are potentially unfavourable.

2. Clarify that the aspect of the definition "to exchange financial instruments with another entity under conditions that are potentially unfavourable" includes situations where the obligation will be settled in own equity if the number of shares to be issued is variable dependent on the value of the shares or an underlying other than own shares. We would prefer this clarification to be in the body of the standard rather than an appendix.

3. Leave the definitions unchanged and explain that the principles for accounting for transactions in own equity override the definitions.

Option 2 would be our recommended approach given that it is probably beyond the scope of the amendments project to change the definition of a financial liability.

Appendix F

Linkage versus components approach

General

IAS 32 and IAS 39 seem to adopt a mixture of the following three approaches:

- considering individual components of a contract: *components approach*;
- viewing the economic substance of a contract as a whole: *contract as a whole approach*;
- viewing the combined economic substance of individual contracts in combination: *linkage approach*.

Below we discuss how the approaches currently seem to be used and include some comments on the current approach.

There are no clear principles that determine why and when to apply the various approaches outlined above. The amendments seem to increase the inconsistencies in approach. In our view these inconsistencies make IAS 32 and IAS 39 difficult to apply and will lead to inconsistent application in practice and further need for interpretation. Although considering individual contracts or components of contracts is more in line with the definitions of financial instruments, it is not always clear whether a contract as a whole or a components approach should be used. We believe that a components approach should be applied whenever a "component" could be separately transacted (eg, bought or sold) or when it has economic relevance in terms of recognition, derecognition, measurement or presentation.

We believe that there are certain cases where it is necessary to apply linkage in order to achieve a meaningful result. In some cases considering each of a series of related contracts in isolation gives an accounting result that does not reflect the economic substance of the arrangement as a whole. It also results in economically similar arrangements being accounted for differently simply due to different legal forms or contractual structures (see also IAS 1.20(ii)). We support a linkage approach in cases where an individual contract is an integral part of an arrangement such that accounting for the individual contracts on a standalone basis does not provide a meaningful result.

The issues discussed above need to be addressed as part of a wider project. However, in order to make the proposals on liability equity classification, transactions in own equity and derecognition workable, as well as to ensure a consistent approach to accounting for structured products and synthetic instruments, we believe that principles-based criteria are necessary to determine when it is appropriate to apply each of the three approaches under IAS 32 and IAS 39.

Liability equity classification

A contract generally is currently evaluated as a whole when classifying instruments as liability or equity in IAS 32. For example: the optionality in instruments with contingent settlement provisions is not considered as a separate component; and it is clarified in the proposed amendments that a puttable instrument is evaluated as a whole in concluding on a liability classification. In a limited number of cases, for example for convertible bonds, a components approach with bifurcation is adopted.

It is not clear when a components approach should be applied. For example it is not clear whether a compulsorily convertible bond should be treated as (a) a liability in its entirety because of the contractual obligation to make interest payments until conversion; (b) a compound instrument with the interest payments until conversion recognised as a liability; or (c) an equity instrument because it is compulsorily convertible.

Derivatives on own equity

On the whole the proposals require a contract as a whole approach. However, paragraph 29F applies a linkage approach in cases where there is a potential obligation that will require gross cash settlement. We have concerns about applying a linkage in these cases since the separate contracts may not be part of a series of contracts that are entered into in contemplation of each other.

We can, however, think of cases where a linkage approach may be necessary to achieve meaningful presentation in accounting for derivatives on own equity, particularly in relation to derivatives on own equity included in structured products. We believe added guidance is necessary.

Embedded derivatives

Where the embedded derivative is not closely related to its host we believe that it is appropriate for the embedded derivatives principles to take a components approach in order to achieve consistency of measurement. In other cases there is a contract as a whole approach.

Derecognition

The proposals generally adopt a components approach, but in the case of a total return swap, the approach seems to be more in line with a linkage approach. In some respects, the application of the continuing involvement approach to a portfolio of receivables, rather than to each individual receivable, also implies a linkage approach. We believe additional explanation of these apparent inconsistencies would be helpful.

Synthetic instruments and structured projects

An individual contract approach to accounting for synthetic instruments and structured products is consistent with the definitions of financial instruments, and seems to be required according to IAS 32.A25 which specifically prohibits a linkage approach for synthetic instruments. Q&A's 23-6 and 25-1 also require an individual contract approach. On the other hand Q&A's 10-8 and 137-15 imply that linkage is appropriate in certain circumstances.

Although we support applying a linkage approach in some cases, it should be clarified in which cases a linkage approach is appropriate.

Appendix G

Hedge accounting and internal transactions

A major issue in the application of hedge accounting in practice is the use of internal contracts for risk management, especially in financial institutions and in groups with extensive treasury operations.

Current paragraph 39.126B (previously 134) explains that only derivatives that involve a party external to the entity can be designated as hedging instruments and that internal transactions between group entities as well as gains and losses on those transactions need to be eliminated. Q&A 134-1 (and a and b) explain that only if internal transactions are offset by derivatives with external parties, can hedge accounting be applied to those external derivatives. Also, several internal transactions that do not offset each other may be aggregated and offset by one single external transaction that would then qualify for hedge accounting assuming the other criteria for hedge accounting are met.

For hedges of foreign exchange risk, Q&A 134-1-b seems to provide an exception to the normal requirement that the internal derivatives eliminate on consolidation and that internal hedging relationships would need to be re-designated at the group level using the external derivative as the hedging instrument. The basis for that exception is explained as follows. Positions denominated in foreign currencies are measured at spot rates under IAS 21 and monetary assets and liabilities denominated in foreign currency are eligible hedging instruments under IAS 39. Therefore in certain circumstances it is possible that only the net exposure of a group is offset by entering into an external contract. One and the same hedge accounting model (cash flow hedge or fair value hedge model) is used for all (internal and external) derivatives involved. In that case the income statement impact of the internal transactions would be zero (see Q&A 134-1-b). Hedge accounting can be applied using the internal derivatives and only basis adjustments recorded would need to be eliminated. We note that if the proposed amendment on cash flow hedge accounting is accepted the latter condition is no longer necessary for cash flow hedges. The guidance implicitly seems to indicate that the documentation would include:

- documentation of the hedge relationship at the level of the internal derivative and the hedged position, and

- evidence that on a net basis (groups of) internal derivatives are offset by an external derivative, the same hedge accounting model is used for all hedge relationships and no basis adjustments are applied.

We propose that the Board clarifies in the standard that the above two-step documentation would be sufficient and that the hedge relationship need not to be documented as a hedge of the external contract with a part of the gross positions that the entity has hedged as described in IAS 39.133, but that the evidence of net offsetting validates the internal contracts as hedging instruments.

Q&A 134-1-a explains that for interest rate positions a similar approach could not be applied, as interest rate positions are generally measured at cost (and therefore require adjustments when included in a fair value hedge accounting relationship or basis adjustments when hedging forecasted acquisitions). However, in our view a similar approach is acceptable when applying the cash flow hedge accounting approach as explained in Q&A 39-121-2 and its appendix. In that case, hedged positions are not (basis) adjusted and as in foreign currency hedging the income statement effect of the internal transactions could be offset by a net external transaction. This would constitute an important simplification for interest rate hedging particularly for financial institutions when applying cash flow hedge accounting. The documentation to be provided would be similar to the one described above for foreign currency hedging , being the two-step documentation approach.

Applying the above to financial institutions would require that the trading desk or department that is the counterparty to the external transactions offsets all internal transactions on a net basis. Often however in practice, banks in particular require for risk management and internal control purposes that there is only one entity/department entering into transactions with an external party: the trading desk, that acts as the 'window' to the market. That department is furthermore the only department to take trading risk positions, an activity that is generally performed by banks.

We suggest the IASB considers whether the evidence provided for testing the offsetting of the internal transactions (included as the second step in the proposed documentation approach above) could be based on the following:

- internal transactions are concluded on exactly the same terms and applying the same (tested and reviewed) pricing models as applied for external transactions and are all measured on a fair value basis;
- the trading department is separately managed and operates under strict (relatively small) limits;
- the trading department is active on the external financial markets it is authorised to deal on, as evidence that the trading department is part of the financial markets and is not just engaged in being a counterparty to internal transactions;
- internal controls ensure compliance with the limits;
- when the limits are reached, the department always enters into transactions with external parties;
- the trading department operates in the fair value segment of the entity, functionally segregated from the banking/cost segment and separately managed and controlled.

A further step (which we do not think necessary) could be to require that a separately managed 'netting centre' is set up with the sole purpose of being the counterparty to the hedging activities within the bank on the one hand and the trading department with which the 'netting centre' would offset its positions on a net basis on the other hand.

The above discussion identifies organisational and internal control steps to provide necessary documentation for applying hedge accounting. This discussion would be best used as example application guidance rather than as part of the standard itself.

When applying one hedge accounting model (as described in Q&A's 121-1 and 2) and under the above mentioned conditions, gains and losses on internal contracts would be effectively eliminated, as in the examples provided in the Q&A's on foreign currency contracts, potentially except for (part of) the relatively small limit set for the trading department. In other words, the risk exposure in the internal contracts would be eliminated except to the extent that a separate, independently managed trading function chooses to retain some of that exposure as part of its own strategy. The retained exposure would be the net result of external and/or internal transactions, however limited based on a risk policy set for the department. The major advantages of this approach would be that the entity would be able to adhere to its business and risk management objectives and that hedge accounting is significantly simplified for interest rate risk, substantially in line with foreign currency risk hedge accounting.

Appendix H

Drafting / typographical comments

IAS 32

- Paragraph 22B: The end of the first sentence should read: "…potential to increase and/or decrease".
- Paragraph 29B: We believe that the last sentence should refer to equity instruments rather than shares.
- Paragraph 29G: The last sentence is not strictly correct – a contract is not only a derivative when it exposes an entity to potentially favourable or unfavourable changes in a variable other than its own equity. We suggest deleting the last sentence and instead ending the previous sentence as follows: and is treated as a derivative asset or derivative liability.
- Paragraph 32: Interest and dividends are also subject to the IAS 32 disclosure requirements. This should be mentioned.
- Paragraph 93A(b): We recommend to clarify the wording by noting "…either partly or fully…" rather than "in full or in part" as the wording could be misinterpreted to mean only those cases where there is no derecognition of any element of the transferred asset.
- Paragraph A18: The text on common shares does not consider the issue of puttable shares. This could be solved by adding the word "normally" immediately after "common shares" in the second sentence.

IAS 39

- "Available-for-sale" is hyphenated in the old text, but not in the new text. The same is true for "held-to-maturity". We recommend using a consistent approach.
- Paragraph 1(f): We do not think providing examples in a bold text scope paragraph is appropriate.
- Paragraph 10: The second subheading of "four categories of financial instruments" is confusing. We suggest deleting this or using a different description. In our view, there are two subcategories of financial instruments with fair value changes recorded in profit and loss: true "trading" instruments and those designated by the entity to be recorded in this manner.
- Paragraph 10: Originated by the entity – Part (i) refers to "short term". It should be "near term" to be consistent with the amended definition of the held-for-trading category.

- Paragraph 10: Effective interest rate method – The reference to IAS 18.31 and IAS 32.61 in the definition seems unnecessary and should be deleted.

- Paragraph 22: It seems appropriate to move the definition of embedded derivatives into paragraph 10.

- Paragraph 22: In order to be consistent with the revised definition of a derivative ("A derivative is a financial instrument or <u>other contract</u> ...") in IAS 39.10 and the first sentence in IAS 39.22 ("An embedded derivative is a component of a hybrid (combined) <u>instrument</u>") we recommend using the wording "hybrid (combined) instrument" instead of "financial instrument" in the third sentence of IAS 39.22.

- Paragraph 23: We think it is unnecessary to include the example in 23(c).

- Paragraph 28: The last sentence would be more appropriately included in the Derecognition section of the standard, probably as a black-letter paragraph.

- Paragraph 28: In order to be consistent with the rest of the standard, the examples should be included in the appendix.

- Paragraph 29(b): We find this paragraph cumbersome in its drafting and placement. This paragraph is not an actual example of applying paragraph 27. We recommend deleting it.

- Paragraph 35: We recommend redrafting this paragraph by deleting references to a portion of a financial asset in the introductory sentence and in (a) and (b) and then just dealing with "portions" in the closing part of the paragraph.

- Paragraph 37: The paragraph is not clear as a result of the double negative in the first sentence and again in (b)(ii).

- Paragraph 44: The portion of this paragraph dealing with servicing liabilities would be better situated immediately after paragraph 43, under the headline of "Servicing Assets and Liabilities".

- Paragraph 62: the last sentence should read "or direct**<u>ly</u>** to its original creditor" rather than "or direct to…."

- Paragraph 62: We suggest using "financial liability" rather than "debt obligation" in the last sentence.

- Paragraph 67: Since IAS 18 does not deal with financial instruments, the reference to IAS 18 is unnecessary. We suggest deleting this reference as there are more appropriate references would be to the fair value paragraphs in IAS 32 and 39.

- Paragraph 72A: We think it would be appropriate to extend the example to the treatment of transaction costs of an available-for-sale instrument.

- Paragraph 86(c): The term "disposal" should be used rather than "disposition".

- Paragraph 72A: All other numerical examples have been moved to appendix B. We propose to also move this paragraph as well.

- Paragraph 80: This paragraph says that "most equity securities cannot be held-to-maturity investments…". This statement might imply that some equity securities can be designated as held-to-maturity. We suggest to delete the word "most".

- Paragraph 84: Why are views on the appropriateness of fair value expressed as part of the standard? We propose to delete the first sentence or rephrase it.

- Paragraph 99: The sentence " When current bid and offer prices are unavailable, the price of the most recent transaction provides evidence of the current fair value provided…" should be deleted from paragraph 99 as this situation is now addressed in paragraph 100 under the heading "No Active Market: Recent Market Transaction".

- Paragraph 99: The sentence "If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts." should be moved in paragraph 100 under the heading "No Active Market: Valuation Technique."

- Paragraph 132: We recommend replacing the deleted word "will" with "must" as the current drafting could be misinterpreted.

- Paragraphs 138-140: We recommend moving paragraph 140 *before* paragraph 139. For paragraph 139, it would be helpful to include an example of a hedge of an anticipated future transaction in this paragraph.

- Paragraph 150: We suggest some minor wording changes to this paragraph. We would suggest to rephrase the last part of the paragraph to read *"a specific cash flow and/or specific asset or liability (or specific group of assets or liabilities or a specific portion thereof) giving rise to an exposure similar to the net exposure and hedge effectiveness is assessed against that cash flow and/or asset or liability".*

- Paragraph 157: This explains that when amortisation of adjustments to the carrying amount of a hedged interest-bearing financial instrument is initiated as soon as an adjustment exists, the adjustment should be based on a recalculated effective interest. We propose that the paragraph clarifies that the effective interest rate be adjusted every period when a new adjustment is made. This could be done by revising the last sentence to read *"The adjustment* *is based on a recalculated effective interest rate at the date amortisation begins and at each subsequent date when an adjustment is made. The adjustment shall be amortised fully by maturity".*

- Paragraph 159(a)(i): As a result of the revision, the paragraph has become inconsistent with paragraph 158. We suggest to modify the wording as follows: " …. the *effective portion of the* cumulative gains and losses …."

- Paragraphs A1-A7: A reordering of these examples (so they are grouped by type of host contract) would make the appendix easier to use. The current ordering is not very intuitive.

- Paragraph A4(f): Brackets not closed.

- Paragraphs A5 and A6: Although we agree with the principles, these paragraphs seem out of place here.

- Paragraph A7(a): Also we believe the intention in paragraph A7(a) is that each of the exceptions would individually lead to separation. Thus it should be drafted to read "…or…or…or…" not "or …or…and…".

- Paragraph A8(a): We recommend deleting the words "limited to" in the second sentence in order to clarify that the intention is "the higher of".

- Paragraph A9(g): The last sentence should read: "The probability of the transferor *or the transferee* exercising its option is not considered."

- Paragraph B14: The 172 should be moved across to the credit column.

- Paragraph B24: The last journal entry for the transferor: the interest expense notation should be against the margin as it is a debit.