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CIPFA RESPONSE TO IASB EXPOSURE DRAFT 'AMENDMENTS TO IAS 32 FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION, AND IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION & MEASUREMENT

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GENERAL COMMENTS – IAS 32/39

1. CIPFA welcomes the opportunity to respond to the consultation on the improvements to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement.* This response has been prepared by CIPFA's Accounting and Auditing Standards Panel ('the Panel').

2. Overall the Panel supports the IASB's ('the Board') approach of seeking improvements to these standards while the longer-term project to develop a new framework of accounting for financial instruments is under development. However the Panel considers that the improvements proposed do not address the more fundamental concerns with these standards, particularly IAS 39. It is the Panel's view that these changes should not be allowed to substitute for a more fundamental review. We therefore applaud the Board's commitment to make this a priority project.

3. The recognition provisions of IAS 39 remain a concern. Detailed comments on this issue are set out in response to the consultation questions. However the Panel wishes to highlight its view that derecognition criteria are crucial to ensuring the credibility of financial reporting. This is particularly true because the Enron affair has focused public attention on off balance sheet treatments.

4. The Panel welcomes the emphasis in the 'continuing involvement' approach on treating separable elements individually. The Panel also acknowledges that this is clearly a principles based approach. Nevertheless concerns remain that the 'continuing involvement' approach might allow contracts to be structured that would allow derecognition criteria to be met even while an entity is in substance exposed to contractual risks.

5. With regard to hedge accounting, although the Panel does not disagree with paragraph 146 as such, this area does give grounds for concern. The threshold prescribed for high effectiveness seems arbitrary. (Why not 79.5% or 90%?). This approach may lead to a 'compliance culture'

where this relationship is taken as conclusive proof of high effectiveness.

6. The threshold also seems incompatible with the statement in paragraph 151 that 'this standard does not specify a single method of assessing hedge effectiveness'. Hence the Panel concludes that the 80% test is meant to represent a minimum requirement for high effectiveness. The Panel would therefore prefer an approach that reworded these provisions to indicate unmistakably that the 80% test is a necessary, rather than a sufficient, condition of high effectiveness.

7. More generally, the Panel has substantial concerns about the 'user-friendliness' of these standards. It is accepted that the complexity of the transactions, and the mixed measurement model, make the requirements inherently complicated. However the structure and language of the standards are so complex and difficult as to make the already complicated requirements incomprehensible, even to many 'technical' accountants. The Panel therefore has grave concerns about the ability of many 'ordinary' practitioners to cope. Such impenetrability undermines compliance and brings the standards-setting process into disrepute.

8. These difficulties are particularly acute on first time application. Our concerns are therefore particularly timely as many European entities prepare to adopt IAS. In this context we note that experience shows that implementation can take some companies two years. The Panel therefore strongly advocates a 'usability' review of the revised standards prior to the publication. We would see two possible, and separable, elements to this review – a review to ensure the use of plain language and a degree of 'field-testing'. A small investment of time in this regard would pay significant dividends in improved comprehension and credibility for the standards.

ANSWERS TO SPECIFIC QUESTIONS – IAS 32

Q1 ***Probabilities of different manners of settlement (paragraphs 19, 22, and 22A)****—Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial* *instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).*

A The Panel considers that, where a financial instrument gives rise to an obligation to deliver cash or other financial assets and it is not within the reporting entities control to avoid the obligation or to settle the obligation in another form, the obligation should be classified as a liability. The amendments proposed will reinforce this general principle and are therefore welcome.

The Panel notes that the definition of a financial liability (paragraph 5) on which this passage depends continues to refer to 'a contractual obligation.' The Panel accepts that, in the field of financial instruments, contractual commitments will predominate. However it is the Panel's view that the standard would be significantly improved by widening the definition to expressly include constructive obligations.

Q2 ***Separation of liability and equity elements (paragraphs 28 and 29)****—Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?*

A The equity element of any compound instrument should be the residual amount after deduction of all liability elements.

Q3 ***Classification of derivatives that relate to an entity's own shares (paragraphs 29C – 29G)****—Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?*

A Agree.

Q4 ***Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard****—Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive*

Standard on the accounting for financial instruments? (Although the IASB Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)

A The Panel would welcome the integration of IAS 32 and IAS 39 into one standard as part of a project to improve the usability of the standards advocated in paragraphs 7 – 8 of our general comments.

ANSWERS TO SPECIFIC QUESTIONS – IAS 39

Q1 ***Scope: loan commitments (paragraph 1(i))****— Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?*

A Agree

Q2 ***Derecognition: continuing involvement approach (Appendix I, paragraphs 35-57)****—Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?*

A The Panel acknowledges that there is much in the 'continuing involvement' approach to be welcomed. The existing requirements of IAS 39 are, as the Board has recognised, an unsatisfactory compromise between the 'control components' approach and the 'risks and rewards' approach. As an approach to producing interim improvements to an existing standard the Panel is not opposed to a 'continuing involvement' approach.

In particular the Panel agrees that a components approach should be the basis of the derecognition model. The Panel also agrees that components in which the entity has no on-going involvement should be derecognised.

The fundamental weakness, however, in basing the derecognition model on 'continuing involvement' is that this only succeeds in recasting many of the problems around derecognition in terms of the question "what constitutes 'continuing involvement'?"

The Panel is concerned that the emphasis placed on contractual provisions in determining continuing involvement is unduly narrow.

Contractual provisions should certainly be the basis of any analysis. However in order to be sure of capturing the full economic substance of a transaction, the analysis should not be restricted to contractual terms alone. In particular the Panel is of the view that the quantum of the continuing involvement should reflect the reporting entity's full potential exposure to the retained elements. The Panel is also concerned that a reliance solely on contractual terms may present opportunities for 'creative finance' aimed only at avoiding financial reporting requirements.

The Panel therefore believes that the continuing involvement approach needs to be extended to capture the full economic effects of a transaction or its separable components. To validate derecognition of an asset it should be necessary to demonstrate that the reporting entity has in substance no continuing involvement in the asset.

Q3 ***Derecognition: pass-through arrangements (Appendix I, paragraph 41)****—Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?*

A Agree. The Panel compared the proposed treatment to the current treatment under UK GAAP. This would permit derecognition only when substantially all the risks and benefits in the asset had been transferred. The requirements of FRS 5 in relation to use of 'linked presentation' are similar to those in the draft revised IAS 39 for derecognition in the case of a pass-through transaction. The conditions outlined in paragraph 41 adequately describe the circumstances in which the entity has no continuing involvement, i.e. the risks and benefits of the asset (or relevant part of the asset) have transferred.

Q4 ***Measurement: fair value designation (paragraph 10)****—Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?*

A The Panel agrees with the Board's analysis that permitting any asset to be designated as held-for-trading (and thus measured at fair value) greatly simplifies the requirements and structure of the standard. The basic approach is therefore welcomed.

As currently worded the definition of held-for-trading appears to allow entities the scope to designate individual instruments as held-for-trading without adopting a consistent policy. The Panel is concerned that this could be abused to allow entities to 'cherry pick' favourable instruments. Consideration should be given to permitting designation only as part of a consistent policy applied to classes of asset.

Q5 ***Fair value measurement considerations (paragraphs 95 – 100D)****—Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95 – 100D of the Exposure Draft? Additional guidance is included in paragraphs A32 – A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?*

A Agree.

Q6 ***Collective evaluation of impairment (paragraph 112 and 113(a)-113(d))****— Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A-113D?*

A The Panel is concerned that collective impairment testing offers the opportunity for reporting entities to smooth results. It is acknowledged that, for many classes of asset, it is possible to predict with reasonable accuracy the overall level of impairment but more difficult to assess reliably for individual assets. However the Panel is of the view that the emphasis should be on individual impairment testing. It would be reasonable to restrict collective impairment testing to assets where there was reliable empirical evidence that a given level of impairment was predictable.

Q7 ***Impairment of investments in available-for-sale financial assets (paragraphs 117 – 119)****—Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?*

A Disagree. To the extent that impairments have been recognised in profit and loss they should be reversed out in the same way.

(The Panel notes that the treatment proposed in paragraphs 117 – 118 would require the recycling of gains recognised in equity to profit and loss on impairment. The Panel does not support the recycling of gains and losses. However we recognise that this is a pre-existing treatment not included within the scope of the improvements project. It is understood that this is being considered within the project on reporting performance being conducted in conjunction with the UK Accounting Standards Board. We welcome indications in the most recent project summary issued by the Board, which suggest that recycling of these gains and losses would be prohibited.)

Q8 ***Hedges of firm commitments (paragraphs 137 and 140)****—Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?*

A Agree.

Q9 ***'Basis adjustments' (paragraph 160)****—Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?*

A Agree.

Q10 ***Prior derecognition transactions (paragraph 171B)****—Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (i.e. that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?*

A The Panel accepts that this treatment is conceptually correct. The Panel is concerned that this may prove onerous in practice, but as the information requirements of disclosure are essentially the same that option cannot be considered superior.