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Dear Sir

**IASB EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO
IAS 32 FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION
IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT**

The Institute's Accounting Standards Committee has considered the above Exposure Draft and I am pleased to set out its comments below.

The Committee suggests that it would be desirable to incorporate all reporting requirements relating to Financial Instruments into a single Standard, as we believe that the present arrangements are disjointed and the cause of some confusion. However, we believe that the Board should act quickly in order to minimise uncertainty and to give users as much warning as possible of what requirements they will need to comply with. The Committee also wishes to point out that while we have agreed with some of the questions posed below, this should not be taken as an expression of concurring with the overall documents. We believe that it will be necessary to work with the Standards in practice in order to form a final opinion on them. While the Committee appreciates that a fundamental review has not been requested, we wish to point out that we disagree with the adoption of a rules based approach in preference to a principles based approach. The Committee believes that the status of the Implementation Guidance Committee IAS 39 Implementation Guidance needs to be clarified, as the content is fundamental to the interpretation of the Standard. The current situation where the Q&A have not been formally considered and approved by the Board but should be considered by entities selecting and applying accounting policies is likely to cause confusion.

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Responses to detailed questions - IAS 32

Our responses to the detailed questions in the exposure draft are set out below:

(i) *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?*

We agree that the classification should be made without regard to probabilities of the manner of settlement. However, we disagree with the deletion of the text in paragraph 22. We also believe that the guidance in A21 should give more clarification as to when a non-redeemable preference share should be classified as a financial liability.

(ii) *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?*

We agree.

(iii) *Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?*

We agree.

(iv) *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?*

We agree. However the exact status of the Application Guidance needs to be agreed. The guidance in IAS 32 is "illustrative only and does not form part of the Standard" yet the guidance in IAS 39 "forms an integral part of the Standard". Also the scope exclusions are different for each Standard and this needs to be addressed.

Other observations

Additional guidance on presentation and disclosure would be helpful to ensure more consistent financial statement presentation. Our specific points are set out below.

(i) Some guidance in categories of financial instrument in the balance sheet would be helpful, especially if any instrument can be designated as an instrument to be carried at fair value.

(ii) A number of alternative treatments are possible for hedging gains and losses in the income statement. It would therefore be helpful to clarify in what circumstances derivative gains and losses might be classified in the same line item as gains and losses on hedged items. Preferably, this would only be the case if the hedge relationship qualifies for hedge accounting.

(iii) In paragraph 34, further guidance is required on the income statement presentation of offsetting items. While we believe that income and expenses on items offset in the balance sheet should be offset in the income statement, IAS 1 does not permit this if there is no specific requirement in IAS 32.

(iv) Further guidance on the presentation of embedded derivatives would be helpful.

(v) In paragraph 46A, consideration should be given to requiring qualitative risk management disclosures in relation to all material economic hedging activities, rather than limiting these to forecast transactions to which hedge accounting is applied.

Responses to detailed questions - IAS 39

Our responses to the detailed questions in the exposure draft are set out below:

(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?*

We agree, subject to clarification on initial measurement of the loan. Paragraph 67 implies that, if interest rates rise between the bank offering a fixed rate loan and the loan being taken up by the borrower, then a loss should be recognised. We presume that this treatment was not the Standard's intention and believe that the cost of the loan should be recorded at fair value at the date of commitment.

(ii) *Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39?*

We disagree. We support the UK Accounting Standard Board's arguments in favour of a "Risks and Rewards" approach. We believe that the IASB should not be changing its approach at the present time and consider that this would be a fundamental change in what is supposed to be a non-fundamental review. We believe that the continuing involvement approach conflicts with SIC 12 in that it could derecognise securitised assets that SIC 12 could reverse. Furthermore, the derecognition rules could lead to derecognising assets from SPEs, leaving nothing in the SPE when it has to be consolidated.

(iii) *Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?*

We agree. However, our understanding is that the condition in paragraph 41(c) would mean that most existing securitisations would not satisfy the condition. Nevertheless, there are probably some forms of securitisation that should remain on balance sheet, as they are just a form of secured borrowing, but will be off balance sheet as a result of these proposals. We question whether, in the current climate the IASB should be advocating an approach that may make it easier for items to be taken off balance sheet.

(iv) *Do you agree that 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?*

We agree.

(v) *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?*

We agree, but believe that further guidance is required in valuing large holdings of investments. Paragraph 99 uses market price as a starting point but we believe that in the case of large holdings this may lead to an overstatement of the value.

(vi) *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?*

We agree.

(vii) *Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?*

We disagree. This is inconsistent with reversal of impairments in other IASs. We believe that impairment losses should be reversed if the reason for the impairment has gone.

(viii) *Do you agree that a hedge of an unrecognised firm commitment should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?*

We disagree. We consider that the treatment should be the same as for forecasted transactions and that the balance sheet asset and liability should not be grossed up at this stage.

(ix) *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?*

We disagree. We believe that the gains and losses should be included as part of the asset/liability as before.

(x) *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? 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?*

We agree with paragraph 171B as written in context as a transitional provision.

Other observations

Our additional comments on IAS 39 are set out below.

(i) Paragraph 10 states that the effective interest rate should be calculated on the basis of contractual cash flows. We believe that it would be more appropriate for the effective interest rate to be calculated using estimated cash flows, thereby taking into account prepayment and option features.

(ii) It would be helpful to clarify that derivatives embedded in normal sales and purchases transactions require to be recognised and that the normal sales and purchases exemption does not also exempt any embedded derivative features within such transactions from recognition.

(iii) Paragraph 126B states that only derivatives that involve an external party can be the subject of hedge accounting. However, Q&A 134-4 indicates that internal derivatives can be designated as hedging instruments in certain cases. We believe that this apparent conflict should be resolved due to the importance of internal derivatives in practice.

(iv) Paragraph 147 hints at the possibility of being able to apply the shortcut method described in FAS 133. The Standard should make absolutely clear whether or not this is permitted.

(v) We believe that hedge accounting should cease from the date effectiveness was last proven, rather than from the date the hedge becomes ineffective as detailed in paragraph B42 in Appendix B.

(vi) We believe that the opportunity should be taken to reassess a number of apparently arbitrary rules, including:

(a) The requirement that a hedge relationship may not be designated for a portion of the time period in which the hedging instrument is outstanding (paragraph 126D).

(b) The prohibition on hedge accounting in respect of interest rate risk on held-to-maturity instruments (paragraph 127). For wider balance sheet management reasons, entities do in practice hedge such risks.

(c) The requirement that non-financial assets and liabilities can only be hedged in their entirety or separately in respect of foreign exchange risk (paragraphs 129-130). In practice, other risk components are separately measurable and could be the subject of hedge accounting, such as basis risk in commodity contracts.

If you wish to discuss our comments further, please do not hesitate to contact me.

Yours faithfully

RICHARD ANDERSON
Assistant Director, Accounting and Auditing
Secretary to the Accounting Standards Committee