CL 132

Memorandum of comment submitted to the International Accounting Standards Board in November 2002 concerning the exposure draft of proposed 'Amendments to IAS 32 'Financial instruments: disclosure and presentation, and IAS 39, Financial instruments: recognition and measurement'.

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to respond to the Exposure Draft of amendments to IAS 32 *Financial instruments: Disclosure and presentation* and IAS 39 *Financial instruments: Recognition and measurement*, published by the International Accounting Standards Board in June 2002.

2. We have reviewed the Exposure Draft and set out below a number of comments. We deal first with significant matters, before commenting on the specific issues raised in the exposure draft and a number of points of detail. Particular issues arising on the application of the proposed revised standards to insurance contracts are highlighted below and in more detail in Appendix A.

MAJOR MATTERS

3. We welcome the IASB's initiative to review IASs 32 and 39 in light of experiences arising from the implementation problems caused by the standards' current text. However, we strongly support a more radical approach. We urge the IASB to expedite a complete reappraisal and re-write of IASs 32 and 39 to produce simplified, understandable, principles-based standards. We consider that such an approach would make IASs 32 and 39 more effective and usable. This would be of significant benefit to the many companies, for example in Europe and Australia, which will have to use them for the first time in 2005.

4. The details of the proposals that the IASB is now making are much more extensive than they first appear, and are not just small improvements. There is a significant need for field testing in the short period between now and the revised standards being published, particularly in the areas of derivatives on own shares and for recognition and derecognition. A small number of IAS users and their auditors now have a deeper understanding of applying IAS 39 in practice. We recommend that the IASB should establish a consultative group from these sources to provide detailed input and experience as it debates the amendments that will be made before the revised standards are published.

Debt / Equity distinction

5. We doubt that the current and proposed text of IAS 32 aids the identification of the true substance of financial instruments. Moreover, we consider that the proposed text provides greater opportunities for instruments to be structured that defeat the reality that, in substance, they are liabilities.

6. We consider that the criteria for determining the distinction between debt and equity could be conveyed more simply using principles and less complicated language. As an example, paragraph 18 of IAS 32 could be stated as follows:

   "Financial instruments, or their component parts, shall be classified on initial recognition as liabilities if they contain an obligation to transfer economic benefits, including a contingent obligation to transfer economic benefits. Financial instruments, or their component parts, that do not contain an obligation to transfer economic benefits shall be reported in equity."

7. We strongly recommend that the IASB review the concepts underlying the definitions of debt and equity as soon as possible.

Puttable instruments

8. The appropriate classification of puttable instruments has not been resolved by the proposed revision to IAS 32. There is a fundamental difference between a puttable instrument that, in substance, is entitled to the residual interest in an entity (for example, open-ended mutual funds, unit trusts, partnerships) and one that is solely entitled to a fixed return. In our view, the former is clearly equity, notwithstanding the right to be repaid, and the latter is clearly debt. We believe that this issue can only be properly resolved by a complete reassessment of the definitions of debt and equity.

Hedge accounting

9. This aspect of the current IAS 39 is by far the most criticised and one that the IASB should address urgently to simplify the accounting and resolve the difficulties met in practice. Where hedging is a valid commercial practice for managing risk it should not be curtailed by arbitrary and unnecessary rules.

10. In our view, the IASB should reduce the complexity of hedge accounting by focusing on three principles for hedge relationships in a fair value framework. Hedges from inception should be:

    a. clearly defined and documented in accordance with the entity's risk management objective and strategy for undertaking the hedge;
    b. reliably measurable; and
    c. effective.

    All the other rules in respect of hedge accounting (including the IGC Q&As) should be reappraised for their relevance and necessity in light of these criteria.

11. We agree that recording derivative hedging instruments at fair value is the correct approach. Therefore in a mixed model framework undoubtedly there will be compromises in the accounting for hedges in order to make economic sense of the transactions. However, we find the rules in respect of the accounting for both fair value hedges and cash flow hedges perplexing and unnecessarily complex. In our view the accounting for both types of hedge needs to be changed.

12. A significant improvement could be achieved by changing the reporting of the gains and losses on the hedging instrument in both types of hedge. Rather than reporting them in the profit and loss account immediately, they should be reported in an appropriate, separately disclosed, liability or asset category on the balance sheet and then transferred to the profit and loss account when and to the extent that gains or losses on the hedged item are recognised in the profit and loss account. Although there are reservations about the nature of such gains and losses and whether they meet the definition of assets and liabilities, we believe

that our proposal is pragmatic, readily understood and the least open to criticism.

13. For fair value hedges, our proposal would mean that the hedged item would not be adjusted for the change in value in the fair value of the hedged risk. This would leave them throughout the hedge period at amounts that preparers and users of accounts can more easily understand and ensure that they are consistent with the amounts reported internally.

14. For cash flow hedges, it would mean that the gains and losses are not reported in equity and thus the need to recycle them to the income statement is removed. Removal of recycling for cash flow hedges would be helpful as the IASB considers the issue generally in the context of its project on reporting performance. An additional benefit would be the consequent stability of an entity's net assets that are currently made volatile by the inclusion of the hedging gains and losses in equity.

Implementation guidance

15. Some of the issues addressed by the existing IAS 39 implementation guidance Q&As have been embedded in the proposed changes. However, this leaves a question mark over the status and application of the remaining guidance. We consider it dangerous for material that is inconsistent with the standard to be left unresolved. For example, in some cases the Q&As are more restrictive than the standard (for example IGC 147-1, which bans the so called short cut method for assessing hedge effectiveness in situations where it may be assumed that there is a 'perfect' hedge) and others that appear to relax the standard's requirements (for example, IGC 134-1 on internal hedges). We urge the IASB to include the remaining relevant IGC Q&As in Appendix A – Application Guidance of the revised IAS 39. This will ensure that the inconsistencies with the revised standard are removed.

16. The two inconsistencies that we have highlighted in paragraph 16 could be resolved by applying the IASB's stated objective of convergence with US GAAP on financial instruments. IGC 147-1 should be withdrawn as FAS 133 permits the short cut method for 'perfect' hedge effectiveness. In respect of the latter, the IASB could amend paragraph 126B by formulating a principle from the requirements of FAS 138 that would permit the use of internal derivatives provided that the net exposure is laid off externally in such a way that the net mark to market gain or loss on the external derivative fully offsets the net gain or loss arising on the internal derivatives.

Disclosure

17. To reduce the amount of disclosures in jurisdictions where a parent company has to publish its own individual accounts alongside its consolidated accounts, we suggest that there should be an exemption for the parent company from making its own IAS 32 and 39 disclosures. This exemption should only be invoked where the parent's own accounts are presented in the same document as its consolidated accounts.

Insurance

18. We have serious reservations about the practicality of applying the current IAS 32 and 39 requirements to those insurance and re-insurance contracts brought within the scope of the standards, and to embedded derivatives in all insurance contracts, as required by paragraph 1(c) of IAS32.

19. Paragraph 3 of IAS 32 states that 'the provisions of this Standard apply when a financial instrument takes the form of an insurance contract but principally involves the transfer of financial risks…'. Many insurance contracts that transfer significant insurance risks could also be said to transfer principally financial risks. The IASB's own definitions of insurance contracts, as set out in IAS 32 and the Draft Statement of Principles (DSOP), are mutually inconsistent.

20. It is extremely important that the definition of an insurance contract adopted as part of the current improvements project should not be subject to change as a result of the insurance project.

21. Little guidance is currently provided in IAS 39 for the measurement of those contracts that would, either under the current definition included in IAS 32 or under the DSOP's definition, be within the scope of IAS 39. Some insurance contracts are compound transactions that cannot be segmented into insurance and finance components: for example, endowment contracts with significant mortality risk transfer. Some are participating contracts. Again, the solution in the context of IAS 39 must not be at odds with the ultimate recommendation of the IFRS for insurance contracts.

22. We advocate that the IASB should develop, and expose for public consultation, guidance in this area. In our opinion, this guidance, which will have a fundamental impact on the results of insurers, particularly life assurers, should be developed and field-tested in as collegiate a manner as possible with the major insurers and professional accounting bodies. A more detailed discussion of our concerns in relation to insurance companies is set out in Appendix A.

RESPONSES TO SPECIFIC QUESTIONS - IAS 32

Qi ***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.*

23. **Probabilities of different manners of settlement:** No. We do not support the change to paragraph 19 because it will not result in the correct classification of an instrument based on its substance. The changes will muddle this important message. Paragraph 20 deals adequately with the issue of the manner of settlement and we see no reason to introduce the concept prematurely in paragraph 19.

24. More generally, we believe that the wording of paragraph 18 should be clarified. The tension between the single instrument and the component approach is not adequately resolved. Further, the phrase 'substance of the contractual arrangement' does not in our view sufficiently emphasise the need to put the substance of the arrangement before the legal form of the contract.

25. **Economic compulsion:** We do not agree with the proposal to delete the notion of economic compulsion. Its deletion will lead to problems in practice. Rather than deleting it, the IASB should place greater emphasis on when this characteristic should be addressed. Economic compulsion is an important principle in the determination of the substance of a financial instrument.

26. Removing the notion of economic compulsion will allow greater opportunities for instruments to be devised whose terms will result in them being inappropriately classified as equity. The current text of IAS 32 allows an equity classification to be rebutted where the instruments are priced as liabilities by investment banks and investors. The IASB must reinstate this important safeguard to ensure proper classification.

27. Paragraph 22 of the present IAS 32 should be revised and the current example improved and other examples added. A particular example would cover the situation where a contractual obligation to redeem can be established indirectly through the terms of and conditions of a preferred share. For example, an instrument that entitles the holder to liquidate the issuer in certain circumstances may effectively establish such an obligation.

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).*

28. We agree, except that the principle of remoteness should be retained where the future event is insolvency, or near insolvency. In such a case, this future event should be ignored until it occurs, as it is not relevant to the economic substance of the transaction determined on a going concern basis.

29. As drafted, the proposed amendment to the standard could be open to abuse with conditions constructed to ensure that an instrument is classified as a liability even though the future events are unlikely to happen and thus the condition is artificial or unrealistic. For example, a convertible debt instrument whose conversion is contingent upon the issuer's own share price increasing by a fixed percentage would be classified as a liability. However, a non-contingent convertible debt with a conversion price set at the same amount would have to be split-accounted. We note this potential to misclassify because, although entities are normally averse to increasing their liabilities, many instruments are engineered either to obtain favourable tax status from their accounting classification or to ensure exclusion from diluted EPS until the contingency is met. Hence entities may consider the use of such perverse instruments because such effects outweigh the classification disadvantages.

30. The examples of future events outside of the control of the issuer and holder provided in paragraph 22A would be enhanced if they included changes in tax status of the instrument. It is a common feature of many instruments that they have to be redeemed in cash when there is an unfavourable change in their tax status.

Qii ***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?*

31. Yes. However, it does not resolve difficulties where the compound instrument contains embedded put and call options that are dependent on movements in the issuer's share price. The example in IAS 32 paragraph A24A does not adequately deal with the methodology that should be used to determine the liability component.

32. Where it is not practical to value the liability component due to the complexity of the valuation of the embedded equity-related derivatives, the standard should allow an entity to value the equity component and attribute the residual amount to the liability, following the same approach as set out in proposed paragraph IAS39.26A.

Qiii ***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?*

33. We specifically agree with the basic treatment of treasury shares set out in paragraphs 29A and 29B. However, we have a number of reservations about the proposed treatment of derivatives based on an entity's own equity instruments.

34. Overall, we find the new guidance in paragraphs 29C to 29G difficult to relate to the fundamental principle that only contracts that result in the exchange of a fixed monetary amount for a fixed number of the entity's own equity instruments should be accounted for directly in equity, as set out in paragraph 29C and in Appendix B, paragraph B22. We strongly support this principle.

35. We do not agree that there should be any exceptions to this principle. Hence we specifically disagree with the exceptions in paragraphs 29E and 29F.

36. Although we agree in principle with the guidance about the classification of derivatives that relate to an entity's own shares, we question whether the classification as a liability or asset in paragraph 29D is consistent with the definitions of a liability and asset in the IASC Framework. The settlement of a liability / asset is expected to result in an outflow / inflow of economic resources of / to the entity (Framework, paragraph 49b / 49a). In the case of paragraph 29D the settlement of the contractual obligation does not result in an outflow or inflow of resources of the entity, but only in a dilution or enhancement of the shares of the other shareholders. 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 IGC 11-1.

37. Although we support the treatment as liabilities, we have similar reservations in respect of the analysis in paragraphs 22C and 22D that leads to the conclusion that the instruments are liabilities.

38. We recommend that the IASB should clarify this issue by amending the definition of a financial liability so that the expression "to exchange financial instruments with another entity under conditions that are potentially unfavourable" includes situations where the obligation will be settled in a variable amount of own equity.

39. We disagree with paragraph 29E. It takes no account of the interaction with IAS 37 with respect to items such as guarantees and call options. As drafted, it requires an 'established practice' in settling derivatives contracts (subparagraph (b)), thereby excluding first-time users of such derivatives without indicating how they can build up a track record; it also retains the element of 'intent' (subparagraph (c)).

40. We can see that there is risk that the provisions on linking in paragraphs 29C to 29G may be misinterpreted without adequate guidance on the subject. In our view, the consequence of such misinterpretation will be the emergence of instruments structured in a manner to achieve different accounting results despite having the same economics. We recommend that the proposals are reappraised to ensure that the same accounting result is obtained where the fundamental economics are the same no matter what form the instrument takes.

For example, as presently drafted, we do not believe the same end result would be achieved for convertible debt structured as:

a. debt with an embedded conversion option;
b. the issue of shares with a put option; or
c. debt with a mandatory conversion when a specified share price is met.

41. We note that the exemption in paragraph 1(a) for employee stock options has been deleted, but we question whether the provisions of new paragraphs 29C etc. deal with them satisfactorily in the absence of a dedicated standard. It would be preferable to exclude them and defer to the imminently expected standard on share-based payments.

42. The table in Appendix B, paragraph B27 'Overview of the proposed accounting for derivatives indexed only to the value of the entity's own shares', is difficult to reconcile with the guidance provided. We suggest that table is reviewed and improved. However, it might be better to eliminate the table, on the ground that it is moves too far in the direction of a rules-based approach rather than principles.

Qiv 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.)*

43. We can see some merit in having one standard that deals comprehensively with financial instruments and debt and equity classification. However, we see no point in simply 'bolting' together the two texts in one document, without genuine integration. Such a process would entail a fundamental rewrite and require re-exposure in order to ensure that the new text accurately reflects the provisions of its predecessors. This would be a lengthy process, and given the urgent need to finalise the improvements to these two standards, we do not advocate integrating them at this time.

44. Alternatively, there should be one standard that deals with the distinction between liabilities and equity and their presentation and another standard that deals with financial instruments (which by definition excludes own equity instruments). There is a case that a "liabilities/equity" standard should be combined with IAS 1 as the distinction between liabilities and equity is a crucial element of the structure and content of financial statements. IAS 1 already includes in paragraphs 60 to 65 detail that is relevant to the presentation of liabilities. Again such a project would need proper integration of the material.

DETAILED POINTS - IAS 32

Scope - Interests in subsidiaries, joint ventures and associates - paragraph 1(a)

45. Paragraph 1(a) refers to 'interests' in subsidiaries (and other undertakings). We believe that the text needs to be made clear whether the exemption from IAS 39 is confined to equity interests or whether the term includes all interests of whatever nature, including derivatives over equity interests. We believe that it should be the latter. The exemption should also include derivatives such as call options on additional interests in subsidiaries, joint ventures and associates. IASs 27, 28 and 31 will need consequential amendment to clarify the treatment of such interests.

46. Consideration should be given to the position in the consolidated balance sheet of the parent of its shares that are held by its subsidiaries. In our view, IAS 32 should be clear that such shares should be included in treasury shares in the parent's consolidated balance sheet. Furthermore, for those subsidiaries that prepare their individual accounts in accordance with IAS, they should also classify equity interests they hold in their parent as treasury shares.

Scope – employee benefits – paragraph 1(b)

47. The term 'employee benefit plan' is not defined in IAS. We recommend that the exemption from IAS 32 should apply to all employee benefits covered by IAS 19, including low interest rate loans to employees.

Minority interests - paragraph 17

48. We do not agree that minority interests in a set of consolidated financial statements should be determined solely by reference to the treatment as an equity interest in the subsidiary's own financial statements. This is too simplistic and does not give credence to the fact that there may be additional features, such as a guarantee by another member of the group that the holder will receive amounts equivalent to distributions or redemption of the principal, that change the nature of the instrument to a liability from the group's perspective. Paragraph 17 should be redrafted so that such instruments are classified as liabilities in accordance with their substance. If paragraph 17 is not changed this will mark a detrimental change to current UK GAAP.

49. Paragraph 17, when coupled with the proposed change to IAS 27, appears to challenge the principles underlying the current consolidation model. This model recognises that group accounts are produced for the benefit of the shareholders of the parent and that minority interests are different in nature. We do not subscribe to the model that treats parent and minority shareholders as indistinguishable. Hence IASs 39 and 27 should require minority interests to be reported outside of shareholders' equity on the face of the balance sheet and changes in their carrying value reported in the performance statement.

50. Investors in the equity of an entity need a clear understanding of the economic interests of other providers of equity capital and how they represent a burden on their rights to the final residual or a benefit. Until such time as the IASB has exposed any thoughts it has on changing the current consolidation model and those changes are reflected in the appropriate standards, IASs 39 and 27 should ensure that as much information as possible on the differing nature of the equity providers can be drawn from the existing primary financial statements.

51. If equity minority interests are to be reported within the equity section of consolidated financial statements, the revised text for paragraphs 22 to 22C and 29A to 29G should make clear that the same treatment is required in respect of derivatives over own shares and those over minority interests.

Delivery of own equity instruments - paragraphs 22C and 22D

52. Paragraphs 22C and 22D set out circumstances in which the settlement of an obligation by an entity by delivery of its own equity comprise a financial liability. This conflicts with paragraph 21 and with the definition of a liability. We support the conclusion that such instruments should be treated as liabilities but, as we have already commented, we consider that the definition of a financial liability needs to be changed to support the analysis.

53. Furthermore, the proposed text does not allow the separation of an instrument into its equity and liability components. There are instruments that are structured so that the fair value of the equity instruments to be issued is fixed within certain limits (between, say, below a floor and above a cap) and move in accordance with the obligation between the two. Such instruments contain both an equity and a deemed liability or derivative component. Paragraph 22D should explicitly recognise that such instruments should be split into their separate components.

54. Another example of where the text of paragraph 22D will cause difficulties is where the price of the shares to be issued is expressed as a discount to the prevailing market price. In such circumstances, the fair value of the shares will exceed but not equal the amount of the contractual obligation. As such, paragraph 22D would classify the instrument as equity despite the counterparty having no residual interest in the entity.

Compound instruments - paragraph 28

55. Paragraph 28 does not allow for a compound instrument of more than two embedded components, for example, convertible debt with another trigger, such as a call option. It should be permissible to fair value the whole instrument in accordance with the proposed amendment to paragraph 67 of IAS 39.

Transaction costs of equity transactions – paragraph 31A

56. This paragraph is inconclusive in respect to costs that relate to transactions that span two accounting periods. We consider that such transaction costs should be charged to the profit and loss account unless it is virtually certain at the

reporting date that the transaction will complete. If completion is virtually certain, the costs should be deducted from shareholders' funds.

57. Consideration should also be given in paragraph 31A to the costs of a demerger. These transactions frequently involve a capital reduction. However, to treat the expenses of a demerger as a deduction from equity because it involves a share-buy-back (an equity transaction) would be to deny the substance as a disposal of a business where the expenses should be charged to the profit and loss account.

Cost allocation – paragraph 31B

58. We do not agree. The principles should be that:

a. only external incremental costs related to the share issue can be carried forward; and
b. the total of such costs should always be allocated on the ratio of the fair value of shares in issue and the new shares created.

Offset - paragraph 33

59. Paragraph 33(b) brings the concept of intent to bear on whether assets and liabilities can be offset. We question whether intent is relevant, particularly in the light of paragraph 18, which effectively excludes it. Paragraph 29 of UK FRS 5 sets out an approach that is based more on the legal position actually achieved and tests whether the arrangements will survive insolvency of the counterparties. The FRS 5 approach has been shown to be effective in practice. We recommend that the IASB to adopt this approach.

60. Furthermore, this paragraph requires that both its criteria must be met to qualify for offsetting under a master-netting arrangement. This treatment causes a difference between IAS 39 and both US and UK GAAP in this area. The other two GAAPs reflect market practice and work well. We are not convinced that the IASB's approach based on gross cash flows provides a higher quality solution. Under the other two GAAPs, offset of multiple derivative contracts under a master netting arrangement whether or not the entity intends to settle all contracts net is permitted. This avoids grossing up the balance sheet and overstating the apparent credit risk by recognising the commercial benefits of the master netting agreements. We encourage the IASB to converge with US and UK GAAP on this issue.

Disclosure of risk

61. Financial instruments always engage future risks and an entity taking up a position in a financial instrument should disclose the relevant risk profile in the financial statements. This is true of all financial instruments, but particularly of derivative instruments. By their nature, derivative instruments modify future cash flows and if the user of financial statements is to have an ability to forecast those cash flows - their size, timing and certainty - and to make decisions on the basis of those forecasts, both qualitative and quantitative risk information must be clearly disclosed.

62. For example, a sensitivity analysis (such as an analysis which gives the change in the fair value of a financial instrument in the event of, say, a one percent movement in a currency) is a common way of providing information that will facilitate a judgment about the future cash flows of the company. Part B of UK FRS 13 provides such a disclosure model. Without such information we suggest that financial instruments and particularly non-linear derivatives will not be correctly and completely measured, even if they are shown in the balance sheet at fair value. In this regard, IAS 32 and 39 are incomplete.

63. We are aware that the IASB is preparing a further standard covering Disclosure and Presentation in the case of Deposit Taking, Lending and Securities Activities. If this proposed standard will contain qualitative and quantitative disclosure requirements for the risks that we have mentioned then IAS 32 and IAS 39 will be appropriately complemented. However, we hope that the new standard will interpret 'securities activities' to apply to all companies which engage in the use of the financial instruments and particularly derivative instruments. Many companies use derivatives on a large scale even though they may not be involved in securities activities as their underlying business.

Disclosures – paragraphs 44, 45, 46, 56 and 66

64. The lack of a prescriptive format to the required numerical disclosures does not aid the consistency and comparability of the disclosures. Allowing a free hand can assist those with an intent to hide information by encouraging voluminous detail that can be written in a manner intended to mask the facts and obscure a clear understanding. We recommend that IAS 32's numerical disclosures are reworked in the more prescriptive style of UK FRS 13.

65. Paragraph 44 implies that narrative and numerical data may be interchangeable. We disagree. Both narrative and numerical data are required. As with UK FRS 13, the standard should make clear that narrative is required to put numerical information into context and to explain where the numerical data portrays a position that is out of line with the stated risk management or hedging strategy. Similarly, narrative is required where the numerical information at the reporting date it is not representative of the position during the reporting period.

66. Paragraph 45 makes a serious omission in not dealing with currency risk disclosures. Neither the proposed changes to IAS 21 nor to IAS 32 adequately address the gaps in disclosure on currency risk, which for many entities is the most significant risk to which they are exposed. We recommend that the IASB rectifies this by requiring disclosures about spot and forward positions.

67. Paragraph 46 should include guidance on how derivatives used for long term hedging strategies should be allocated between current and non-current assets and liabilities for the purposes of IAS 1, in light of the conclusion in proposed paragraph 126C of IAS 39 that "there is normally a single fair value measure for a hedging instrument in its entirety".

68. Paragraph 66 on credit risk disclosures should require detail on assumptions underlying impairment provisions on a similar basis to those required by paragraph 77B on assumptions underlying fair values.

Fair value - paragraph 77B

69. Paragraph 77B requires fair-value information about assets which are not held at fair value. We believe that this may be onerous or impractical in certain circumstances, such as when the asset is held at cost and/or obtaining a fair value is not possible.

Classification of preferred shares – Appendix A, paragraph A21

70. The proposed revision of paragraph A21 dealing with "discretion" is inconsistent with paragraph 18 in the body of the standard. The latter paragraph requires classification based on the substance of the contractual arrangements, which involves an assessment of whether discretion can be, and is, exercised in practice not merely that it exists in legal form. The revised wording of paragraph A21 places undue emphasis on whether there is discretion in the legal documentation rather than whether there is actual discretion in practice. We do not agree that cumulative dividend rights can be ignored in an assessment of whether there is an obligation to transfer cash or other financial assets. All the entity has is an ability to defer payment; the obligation is not extinguished.

RESPONSES TO SPECIFIC QUESTIONS - IAS 39

Qi ***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?*

71. We accept the proposal on grounds of pragmatism. However, the standard should include a definition of a loan commitment making clear that it embraces long term banking facilities and credit lines and that it applies to both the holder and issuer of the loan commitment. The explanation in paragraph 1(i) only addresses the issuer's accounting.

72. In our view the theoretically correct treatment would be to determine the substance of the ultimate commitment and to value the derivative accordingly. That is, if the derivative can only be settled by conversion into an underlying instrument it should be accounted for in a manner consistent with the accounting treatment that will be applied to the underlying instrument. If the commitment can be traded it should be measured at fair value.

73. Applying this in practice would mean that an undertaking to issue a fixed interest rate loan should be accounted for at cost.

Qii *IAS 39 (ii) 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?*

74. Derecognition is a contentious area of accounting. Whatever approach is decided it must be clear so that it can be applied without substantial need for interpretation. Unless this happens the IASB will not secure a consistency of application. Unfortunately, the proposed 'continuing involvement' approach does not meet these criteria.

75. Although the continuing involvement approach has several attractive features we have a number of reservations particularly in respect of paragraph 41 (see the response to question 3) and of the examples in Appendix B.

76. Expressed simply as a principle that derecognition is not permitted where the originator of the asset has any continuing involvement in that asset, the approach seems very similar to that underlying the derecognition principle in UK FRS 5. Derecognition occurs only when all significant risks and rewards relating to the asset have been transferred to another party and there is no mechanism by which the transferor retains an ability to access benefits arising from, or an exposure to the risks, of the asset involved. Where this is not the case there is continuing involvement. However, the model proposed by the IASB diverges from that used in the UK as on closer examination it still contains elements of the control model that causes the friction with continuing involvement determined from a risk and rewards perspective. For example, the references in paragraphs 37 and 38 to the reacquisition of control of contractual rights or cash flows.

77. Furthermore, the IASB's proposed approach has overlaid the basic principle with rules based on legal form. This we fear will lead to the development of significant abuse driven by structures designed to achieve off or on balance sheet treatment that will exploit such rules.

78. We do not believe that the proposed approach has sufficient support to replace the present derecognition approach in the immediate future. However, we consider that the continuing involvement approach is worthy of further research to determine whether it can be improved to make it more relevant, reliable and easier to understand. That the new proposals have to be supported by extensive guidance in the appendix indicates the complexity and thus the need for rigorous field-testing and substantial consultation.

79. The example in Appendix B, paragraphs B18 et seq (sale of a financial asset with a retained call option) appears to allow the balance sheet of the transferor to be inflated by an arbitrary amount, based on the price at which the call option may be exercised, which is in excess of the asset's fair value. In our view, the pledged AFS security in the transferor company should be stated at fair value at the date of the transfer, not at the call option price. If this example is retained, it is not difficult to imagine options being granted over assets that have artificially high strike prices merely to ensure the upward revision of the transferor's carrying amount.

80. Nor do we support the proposed treatment by the transferee in the same example as shown in paragraph B20. The proposed treatment is inconsistent with the principles for recognition of a financial asset in paragraph 27 of the standard.

81. We appreciate that whatever the ultimate decision on the appropriate approach to derecognition that it will require illustrations of the approach to common transactions. We therefore welcome the examples in Appendix A. However, we express some caution as to the lack of precision in the wording of some of the examples. In particular:

a. paragraph A9(b) prohibits derecognition if the assets that are subject to continuing involvement are "substantially the same" as those transferred. We consider that this term should be suitably restricted to ensure that its interpretation is not open to abuse.

b. paragraph A9(e) defines a 'wash sale' (a 'bed and breakfast' transaction) as one that takes place "shortly after" the initial transfer. Again the term encourages liberal interpretations.

c. paragraph A9(p) states that an interest rate swap between the transferor and transferee does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset. The example should nonetheless recognise that where the transferred asset is the sole asset of the transferee and it has no other resources then irrespective of whether there is a contractual agreement that payments under the swap are not conditional, in substance they are and derecognition should not be allowed.

Qiii ***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?*

82. No. As a fix for the conflict between IAS 39's derecognition rules and SIC 12's principles on consolidation of special purpose entities the proposals are unsustainable and dangerous. While it is clear from the Basis for Conclusions that the IASB intends the fix to apply to special purpose entities used in typical securitisation structures, this does not flow through to the standard. The application of paragraphs 41 and 42 are unrestricted and thus can be interpreted as having a wider application, for example, to asset-backed securities in an operating entity. This would circumvent the notion of continuing involvement and over-ride IAS 32's rules on offsetting. As a consequence, many entities would produce financial statements that show no assets or liabilities.

83. Derecognition should be based on the substance of the transaction. The same principles of derecognition should apply to the entity as a whole, irrespective of the structure of the transaction or the nature of the counterparty. If the proposals are followed it essentially permits the offsetting of assets and liabilities in circumstances that do not meet the criteria in IAS 32.

84. If no significant change is made to the proposals, further guidance is essential to minimise confusion about the types of transaction that are covered as the present proposals lack clarity and are thus likely to lead to a number of conflicting interpretations.

85. Pass-through type arrangements, such as typical securitisation structures using special purpose entities, would benefit from the proposals such as these. However, the requirements of paragraph 41 are unlikely to be met by many securitisation structures because of its restrictive conditions, particularly conditions (a) and (c).

86. In a typical securitisation structure assets are transferred to a special purpose entity ('SPE') and the originator (or transferor) often has a continuing involvement by way of provisions that ensure any surpluses in the SPE are for its ultimate benefit. Consequently the term 'transferor' used in the conditions to paragraph 41 would appear to be referring to the SPE since it generally does not have any continuing interest in the assets (as they are generally passed back to the originator). Given this type of structure condition (a), which states that 'the transferor does not have an obligation to pay amounts to the transferee unless it collects equivalent amounts from the transferred assets or portion thereof that qualifies for derecognition…' appears to be restrictive since the SPE will have assets other than the transferred assets such as cash, sundry debtors, prepayments and contingent assets (for example, a liquidity facility and often various forms of credit enhancement) that can be for the ultimate benefit of the

transferee. If condition (a) is only applicable to the transferred assets, and not any other assets of the SPE, it would appear that the condition is not met in typical securitisation structures and derecognition is not possible.

87. Condition (c) would also appear to rule out derecognition in typical securitisation structures because cash flows from transferred assets might be remitted to the transferee without material delay in respect of interest but not necessarily in respect of capital. Cash in the SPE is often used to purchase more assets rather than being remitted back to the transferee and additional interest earned by the SPE, for example in respect of cash deposits, often ultimately is for the benefit of the originator and not the transferee.

88. As a result of applying the conditions currently set out in paragraph 41 most assets transferred in respect of typical pass-through securitisation structures will not qualify for derecognition. Consideration should be given to amending the conditions to meet the objective of allowing derecognition.

Qiv ***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?*

89. We support this amendment as we agree with the justifications set out in paragraph C58 of the Basis for Conclusions.

90. However, we suggest that the IASB should give further consideration to some of the implications.

a. An entity fair valuing its own debt will include the effect of changes in its own credit risk in its profit and loss account.
b. The irrevocable designation of a financial instrument as one to be fair valued (or not) at initial recognition can be overcome by wash through transactions, despite the provisions of paragraph A9(e).
c. Allowing the selection of <u>any</u> financial asset or liability seemingly contradicts the general application of accounting policies to particular classes of assets or liabilities.

91. In respect of the issue of own credit risk, the proposals do not recognise that movements in an issuer's own credit risk are essentially equity interests. They expose the holder to the issuer's net asset position. Consequently, we question whether it is appropriate to measure these at fair value when equity interests are not carried at fair value. At this time when the debate on full fair value accounting is inconclusive, we prefer that, in general, liabilities should be valued exclusive of the issuer's own credit risk. Only where an entity has issued debt securities that have similar credit risk characteristics to the assets backing them and which it classifies as held for trading should an entity then be permitted to fair value the debt securities inclusive of its own credit risk and take the changes in fair value to the profit and loss account.

92. If the IASB continues with its proposed approach, we recommend that there should be additional disclosure requirements in IAS 32 that draw out the impact of including changes in the fair value of own credit risk on own debt (or other financial instruments) in the profit and loss account. In this respect, the disclosure requirements of new paragraph 77B of IAS 32 relating to the methodology used to determine fair value in the absence of market prices needs to be strengthened.

93. In addition, there should a requirement for an entity to explain its rationale for selecting the option to designate particular assets and liabilities as "held for trading" that would not normally qualify for inclusion in that category. This would ensure that there is sufficient information to compare the financial statements of different entities.

94. We recommend that the IASB reviews the situation experienced by issuers of exchangeable bonds who are not allowed to designate the embedded written options as a hedge of the physical security, even when there is a mandatory exchange feature. The proposed ability to designate any financial liability as "held for trading" at inception does not resolve this problem. Consequently, issuers of such bonds continue to face volatility of their profit and loss account that does not reflect the true economics of the hedged position.

Qv ***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?*

95. We agree with the general thrust of paragraphs 95 to 100D. However, we have some reservations on specific matters.

a. We do not agree with the deletion of the material in paragraph 98 relating to the need to reflect the current circumstances of the entity in determining fair value. This is particularly relevant where the value of the asset is likely to be affected by a decision to dispose of the asset in the immediate future and thus this consideration should be incorporated into the valuation methodology.

b. It is unclear as to the intentions in removing the guidance in paragraph 100 relating to large holdings and illiquid markets. The implication of the deletion and the retention of paragraph 99 and IGC 100-1 is that the IASB wishes to remove any possibility of recognising illiquidity discounts in the valuation of large holdings of securities and, indeed, any other discount such as for administration and maintenance of the portfolio (essentially a discount for future transaction costs).

   This matter needs to be addressed urgently as such a prohibition in IAS differs from the way in which US GAAP is applied, and accepted, in practice (not necessarily as FAS 133 is written). This causes considerable friction for IAS-adopters that are also SEC foreign registrants.

c. With regard to no active market valuation techniques, different banks employ different valuation models. As a result, the same instrument may be ascribed different values in practice. As there is no prohibition on switching models, we perceive there is scope for abuse. We suggest that entities should be required to explain why they have adopted a different model should they change models one year to another.

d. It is unclear from the proposed text as to whether adjustments to the product of a valuation model are permitted or, as with adjustments to valuations based on observable prices, they are to be prohibited.

Clarity is required, as most financial institutions make adjustments to reflect the suspected shortcomings in their valuation processes. These recognise that there are elements of many risk positions that are difficult to identify, difficult to model with precision or require parameters that are not readily observable. It is probably the case that one institution or another will make valuation adjustments for each of the characteristics that result in valuation variability, but different institutions are unlikely to make the same adjustments. In many cases, these valuation adjustments reflect a degree of prudence in the valuation process. Many financial institutions take the view that, if there is uncertainty, they would rather risk undervaluing rather than overvaluing an asset instrument (or vice versa for a liability).

96. There are two areas related to fair value measurement where we believe additional guidance is required.

a. Paragraph 66 states that the cost of an asset or liability is the fair value of the consideration. However, there may be instances where the reference price is not the fair value, for example as between related parties. We believe that the standard should clarify that fair values should be applied and provide guidance on how to do so.

b. Paragraph 67 has been amended to include guidance about the measurement of a non-interest bearing asset that is carried at cost. This paragraph should also contain similar guidance for non-interest bearing liabilities that are carried at cost.

Qvi ***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?*

97. We agree in principle that an asset 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. Thus making a general provision against a pool of assets. However, we are not convinced that applying the methodology is entirely robust: it may lead to lower provisions than at present and may in effect lead to providing for future losses. The IASB should review the text of the proposed standard.

98. We note also that the proposed standard continues an anomaly in the treatment of asset debt securities designated as available for sale. Such assets are held at fair value and cannot be adjusted further. However, an originated loan held at amortised cost can be further included within a group of assets collectively evaluated for impairment. We suggest that fair-valued assets should be capable of being treated in the same way.

99. In general, we believe that the requirements are too complex and that most corporates and many banks will not be in a position to carry out their provisioning in the way proposed in paragraphs 113A to 113D, as they do not possess the sophisticated models and necessary databases of historical default data. Even though the approach to provisioning has similarities with that proposed under the New Basel Capital Accord, we understand that banks do not envisage building such databases. We suggest that implementation of the new provisioning methodology should be linked more closely to implementation of the provisioning aspects of the New Basel Capital Accord, which is expected to be finalised by the end of 2003.

100. In paragraph 113C, the proposed standard calls for entities to use 'peer group experience' in the absence of entity-specific experience. This is an unsatisfactory solution, as there is no guarantee of comparability.

Qvii 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?*

101. No. We support reversing impairments that are no longer required. We do not see a reason why impairments of available-for-sale securities should not be reversed when other International Accounting Standards require reversal of the impairments of other assets once the circumstances that caused the impairment no longer prevail. Relevant references are: IAS 2.31, IAS 8.27 (new paragraph), IAS 16.37 and IAS 38.76.

102. We foresee problems in determining whether impairment has occurred. Paragraph 110A refers to a 'significant and prolonged' decline in the fair value of an equity investment. It would be helpful if the IASB were to provide guidance on what it means this to be in practice. In the absence of a view expressed by the IASB, there will be confusion and an inability to challenge situations where entities avoid recognising an impairment. Equally there will be countervailing views as to whether US practice, such as a 20 per cent decline

for a period of more than six months, should prevail. Whatever guidance the IASB provides it should take the form of principles rather than rules.

Qviii ***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?*

103. No. The proposed treatment:

a. will incur undue costs for companies in making the accounting changes resulting from the change in status of the hedge;

b. create confusion and increase the likelihood of error, particularly if the entity designates the hedge as a cash flow hedge of the foreign currency risk of a forecasted transaction which once that transaction becomes a firm commitment would have to redesignated as a fair value hedge; and

c. does not conform with FAS 138.

104. The case for the change in treatment has not been made. We suggest that if a change were to be made it should only be in order to achieve full convergence with US GAAP on this issue. FAS 138 recognises that a hedge of the foreign currency risk associated with a firm commitment can also be designated as the hedge of a cash flow exposure and accounted for accordingly.

Qix ***'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?*

105. No. We consider that this is a case where pragmatism should prevail over theoretical purity. We recognise that conceptually cost should not be affected by the method of financing. However, it is easier and more helpful to carry the effects of currency hedges as part of the cost of the underlying asset on acquisition. Fewer errors arise because there is no need to track gains and losses for recycling purposes.

Qx ***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 (ie that prior derecognition transactions should not be grandfathered)?*

106. No. In principle we agree that changes to accounting policy should be made retrospectively, unless it will be impracticable to apply. Paragraph 171B does not recognise that a retrospective approach will require a reconsideration of all previous sales. It is unlikely that entities will have retained sufficient

information of the transaction details, particularly those that have retreated into the depths of time.

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?

107. Yes. For the reason given above, grandfathering must be permitted.

DETAILED COMMENTS - IAS 39

Hedge accounting

Assuming perfect hedge effectiveness – paragraph 147

108. The IASB has stated that one of the aims of the amendments to IAS 39 was to eliminate differences between the standard and the comparable US standards. A particular omission in applying this aim lies in not repealing IGC 147-1. The wording of paragraph 147 is identical to that found in FAS 133. We understand that if the principal terms of the hedging instrument and of the hedging instrument and of the entire hedged asset or liability or hedged forecast transaction are the same, the entity can assume perfect hedge effectiveness without further effectiveness testing.

109. However, IGC 147-1 has interpreted the same words to mean that continuous testing for hedge effectiveness should be carried out by an entity. This is time consuming and an unnecessary burden. The IASB should take the opportunity to align practice with that adopted in the US.

Hedge accounting for Held-to-maturity instruments – paragraph 127

110. Hedging of interest rate risk is not permitted by IAS 39 (paragraph 127 and IGC 127-1) for the stated reason that the holder of the instrument is insensitive to changes in interest rates as it will be held to maturity. Such a rationale is understandable were risk exposures limited to fair value changes; by holding it to maturity the holder is focused on realising the instrument's face value and is unconcerned about the changes in fair value due to changes in interest rates in the intervening period.

111. However, IASs 32 and 39 define risk exposure in terms of cash flow risk as well as fair value risk. Consequently, we do not understand the rationale for prohibiting the use of cash flow hedges for held-to-maturity instruments. Nowhere else does the standard prescribe risk reduction in terms of one type of exposure. We recommend that the requirements are reconsidered.

Designation of groups of items as hedged items - paragraphs 132 and 133

112. We support the pragmatic approach adopted by IGCs 121-1, 121-2 and 134-1-b to management of interest rate risk on a net basis and the practical difficulties of central treasury management. However, paragraphs 132 and 133 apparently prohibit the strategies promoted by the IGCs. In view of the IASB's aim to simplify the standard, we recommend that the standard is amended to incorporate the principles behind these IGC Q&As.

Interests in subsidiaries, joint ventures and associates – paragraph 1(a)

113. We recommend that the revised standard should make clear that the exemption from IAS 39 for "interests in" subsidiaries, joint ventures and associates includes derivative interests in these entities and also derivatives relating to the

acquisition of additional interests in such entities. Furthermore, it should be clarified as to whether the term includes monetary items considered to form part of an investment in a foreign operation (paragraph 13 of the exposure draft of the proposed revised IAS 21) and whether loans to/from a parent to a joint venture or associate are sufficiently similar to be encompassed as an "interest in" such entities.

Financial guarantee contracts - paragraph 1(f)

114. We agree that a financial guarantee contract meets the definition of a liability (paragraph C16 of the Basis for Conclusions) but find the proposed treatment confusing. It is not clear why a financial guarantee contract should fall within IAS 39 at inception and immediately thereafter be dealt with under IAS 37. There are significant consequences if the proposed treatment is followed because the two standards use different measurement bases. For example, the financial guarantee would at inception be measured at fair value but it may fail the "more likely than not" test under IAS 37 on subsequent reassessment with a consequential gain recognised in the profit and loss account. We recommend that all the relevant requirements should be contained in one standard.

115. The increasing use of credit derivatives means that there is a substantial amount of confusion between a financial guarantee contract and credit default derivatives. The proposed expansion of paragraph 1(f) does not adequately encompass the full guidance in IGC 1-1, 1-2, 1-5a and 1-5b and leaves unanswered questions. We recommend that the ICG guidance should be incorporated into Appendix A – Application Guidance of the new standard.

Contingent consideration in a business combination - paragraph 1(g)

116. The exemption should refer clearly to the fact that the exemption is only applicable to the purchaser in a business combination who will account for contingent consideration in accordance with IAS 22. From the seller's perspective, contingent consideration receivable should fall within the scope of IAS 39.

Contracts to buy and sell a non-financial instrument

117. We do not agree with the proposed expansion of the scope of IGC 14-2 beyond the strict confines of commodity trading activities. We can understand that the intended expansion may be intended as an anti-abuse mechanism since it would capture those situations where an entity never intends to use the asset in its business or production processes but merely takes delivery and then makes an immediate on-sale to defeat the standard's requirement to treat the contract as a derivative. However, the proposals are too widely drawn and will cause significant complexity and confusion to many normal trading situations.

118. If an anti-abuse mechanism is needed, it should be more sensitive to normal conditions and not require unnecessarily burdensome documentation and designation requirements.

Definition of effective interest rate method – paragraph 10

119. This definition does not provide necessary guidance on how to determine the term (maturity period) of an instrument that has embedded put or call options (or both) which are deemed to be closely related to the host contract. This is important in determining the period over which transaction costs are amortised as well as the period of amortisation of the imputed discount arising on the separation of the equity component in a compound instrument.

120. The amendments to the definition in the fifth line is unhelpful in arriving at the correct substance of an instrument because by replacing the reference to "expected" cash flows with the term "contractual" cash flows this means that, other than in limited circumstances, it effectively prohibits the recognition of an earlier maturity date if one of the options is likely to be exercised.

121. The standard should specify that the term of the instrument should be the earliest date on which the holder or issuer can exercise an embedded put or call option that has not been separated from the underlying host contract. To prevent abuse through the inclusion of artificial options to extend the term of the instrument (with a concurrent adjustment to market rates of interest), the standard should require that the term of the instrument should not include the period of the extension if there is a genuine commercial possibility that the period will not be extended. In addition, the paragraph should define a "market-based repricing".

122. In the absence of a reliable basis of assessing the term of an instrument that has closely related embedded options, more schemes can be expected that will exploit this loophole and lead to situations where the true short-term nature of the borrowing is set aside and the true finance cost for each period is understated as the amortisation has to be spread over the longer period in the contract.

Embedded derivatives - paragraph 23

123. Where an embedded derivative in an asset available for sale is separated, the separate values may not equal the total value of the instrument. In such cases, the derivative should be valued first with the residual going to the host. This should be made explicit in the standard.

Servicing assets and liabilities – paragraph 43

124. We recognise the need to address such assets and liabilities if a fair value is readily available. However, in many parts of the world the market in such services is immature and therefore it will not be possible to apply the principles in this paragraph consistently.

Interest income after impairment – paragraph 115

125. We do not agree with the proposal that the unwinding of the discount in the impairment provision should be classified as interest income. This effectively

would be requiring banks to recognise income on non-performing loans. The quantum of interest income is an important measure of performance for many financial institutions and to include the unwinding of the discount as interest would lead to serious distortions. The unwinding of the discount should be picked up in the movement in bad debt (loan loss) provision.

Inaccurate cross-references

126. Paragraph 27 cross-refers to paragraph 30, which is to be deleted.

127. Paragraph 164 cross-refers to paragraph 103, which is not applicable.

APPENDIX A: INSURANCE CONTRACT LIABILITIES AND INSURANCE CONTRACT RELATED EMBEDDED DERIVATIVES

MAJOR MATTERS

A1. We have serious reservations about the practicality of applying the current IAS 32 and 39 requirements to those insurance and re-insurance contracts brought into the scope of the standards, and embedded derivatives in all insurance contracts, as required by paragraph 1(c) of IAS 32.

A2. Under IAS 32, liabilities for insurance contracts that 'principally involve the transfer of financial risk' are to be measured applying the principles described in the IAS. The measurement alternatives are some form of amortised or fair value. IAS 32 and 39 contain virtually no guidance on how the scope and measurement requirements are to be interpreted and the current position is to leave insurers, particularly life assurers, with no practical way of proceeding which will ensure any degree of consistency of interpretation.

A3. This position is untenable and urgent remedial action by IASB will be needed if the current requirements are to be capable of implementation for the 2005 deadline, by which time EU listed insurers are obliged to apply IAS to their financial statements.

A4. In the absence of an IAS for insurance contracts being in place, the IASB has already made some initial progress in considering the arrangements for the 'interim solution' that will apply for the period between 2005 and the implementation of such a standard. We would urge that this interim solution fully consider the practical arrangements that will need to be in place for insurance contracts and insurance contract related embedded derivatives that are currently within the scope of IAS 32 and 39.

A5. These considerations must include detailed guidance on the requirements of IAS 32 and 39 for these items. The issues that this detailed guidance will need to address are extremely complex and have many common features of the issues that have already been considered as part of the Draft Statement of Principles for the now delayed insurance standard.

A6. It had originally been hoped that the insurance standard would have been developed to a sufficiently advanced position that the guidance required for the insurance standard would have been helpful to assisting with developing an appropriate level of guidance for the implementation of IAS 32 and 39.

A7. In the absence of resolution of the issues identified as part of the insurance standard project, guidance in respect of the IAS 32 and 39 requirements will need to be developed to a sufficient degree of rigour as reflects the very high level of complexity.

A8. Inter alia, the IAS 32 and 39 guidance will need to have been fully exposed for comment to as wide an audience as possible of preparers, users, and auditors of financial statements. Furthermore the detailed guidance will need to have been thoroughly field-tested by insurance companies in sufficient time for it to have been fine-tuned. Companies that are to be required to meet the 2005 deadline will need to have sufficient time to establish appropriate systems, prepare and publish prior year comparative results to the market.

A9. In addition to these complications we have concerns that any guidance prepared in the context of IAS32 and 39 compliance should share a consistent approach with the features of the (as yet) not fully defined and tested standard for insurance contracts. The guidance will also need to address the option of applying an amortised approach to the measurement of liabilities for insurance contracts that are within the scope of IAS 32 and 39.

A10. Full resolution of these issues in the timescales required will require a considerable amount of resource application by IASB staff. To our knowledge the staff that have previously developed the DSOP work in separate streams from the financial instruments project.

A11. Given the esoteric nature of these insurance related issues we consider it impractical for those currently involved with the development of IAS 32 and 39 to be able to develop the required guidance and field-testing. We strongly advocate the full involvement of those staff within IASB who have the expertise in this area and that the resolution of these issues be considered as part of an integrated package for the interim solution for all insurance contracts.

A12. A possible way forward that some may suggest would be to exclude from the scope of the standards those contracts with significant transfer of insurance risk. However, even in these circumstances IASB would still need to provide thorough guidance that has been field tested well in advance of the deadlines for companies' set up procedures related to publication of restated comparatives.

A13. Such guidance would initially need to resolve issues that have previously been identified in the context of the development of the DSOP as to how 'significant' should be interpreted. Once defined the measurement of fair or amortised value could only be addressed by satisfactory resolution of all related issues.

A14. These issues would include determination of the appropriate cash flows to be included in the calculation, appropriate discount rates, allowances for risk and uncertainty, treatment of renewal premiums and acquisition costs, and many other items that have been considered in developing the DSOP but as yet not fully resolved.

A15. These issues are fundamental to the values ascribed to liabilities for such contracts and also highly complex. Given the length of time that it has taken to develop the DSOP and that the issues that remain are the most difficult to resolve it will be difficult to achieve all requirements of the guidance and field-testing that is needed in the necessary timescales.

A16. We advocate that the IASB should develop, and expose for public consultation, guidance in this area as soon as is practicable. In our opinion, this guidance, which will have a fundamental impact on the results of insurers, particularly life assurers, should be developed and field-tested in as collegiate a manner as possible with the major insurers and professional accounting bodies, including the ICAEW.

A17. In addition to these complications it would seem that related performance reporting issues have yet to be addressed by IASB. Since IAS32 and 39 permit alternative measurement and performance reporting statement treatments for investments, and alternative measurement options for liabilities of insurance contracts that are within the scope of the two standards, there must be a concern that investor confidence in the financial statements of insurers will be significantly reduced.

DETAILED POINTS

A18. As explained above, we have very considerable concerns regarding the application of IAS 32 and 39 to insurance contract liabilities and insurance contract related derivatives. A comprehensive list of issues would be extremely extensive. However, to illustrate the complications involved we ask that the IASB consider the following.

Scope - insurance contracts

A19. The current definition of those contracts brought within the scope of the standards is only very generally drawn but by the use of the words ‘principally transfer financial risk’ is not narrowly drawn and potentially includes a significant proportion by current liability measurement of UK insurers’ contracts.

A20. UK insurers have liabilities under a wide range of types of products. The degree of finance risk transfer within many of them will be more than incidental but not the overriding objective. A very considerable number of types of contracts may or may not, depending upon interpretation, fall with the definition of ‘principally transferring financial risk’. In reality the distinction is arbitrary.

A21. The problem can be illustrated by considering with-profit and annuity contracts. Depending upon the precise nature of the contracts a convincing case can be made in either direction as to whether they fall within the scope of IAS 32 and 39.

A22. For example, to draw an analogy with insurers filing US GAAP results, conventional with-profit contracts are classified as FAS60 products whilst unitised with-profit contracts which are very similar are classified under FAS97 as ‘investment products’. Similarly certain types of UK annuity will be classified as FAS60 whereas traditional fixed annuity business in the USA is classified as FAS 97.

A23. In reality, since US GAAP has been developed with US products in mind, categorisation may hinge on somewhat arbitrary distinctions. It is important that the IAS32 and 39 scope issues are addressed by IASB with ‘real world’ examples having been fully considered.

A24. Furthermore, in developing guidance on these issues, the IASB needs to consider that the income statement effects of the distinction between those deemed within the scope of IAS 32 and 39 and those to be covered by the interim solution project may be profoundly different. This is very unlikely to be helpful to users of financial statements.

A25. We note also that the definitions of insurance contracts brought within the scope of IAS 32 and 39 and the definition of an insurance contract in the DSOP are not consistent. At least in principle it will be possible for a contract to both 'transfer significant insurance risk' (DSOP) and 'principally transfer financial risk' (IAS32). If the DSOP definition is contained in the final insurance contract standard it will be possible for some contracts to be classified as either insurance contracts or financial instruments with as yet uncertain consequences for measurement of liabilities.

A26. Given the very sizeable impact that these distinctions may have, we would emphasise the need for the performance reporting implications to be fully considered so that the overall impact, and its desirability to be properly considered. It would be inadequate to merely adopt a 'tick the box' approach to the definitions issue by considering these scope issues within the narrow confines of which measurement approach is used for determining the carrying value of liabilities. Wider issues of practicality and consistency of measurement and impact on performance reporting also need to be given full consideration.

A27. If there is insufficient time to fully address these issues we consider that many commentators, both from within the industry and accounting and actuarial bodies, will consider it more appropriate to restrict temporarily the scope of the standards in so far as they apply to insurance contracts and embedded derivatives so that the overall intellectual integrity and usefulness of the financial statements is not compromised.

Scope - embedded derivatives within insurance contracts

A28. These derivatives are required to be valued in accordance with IAS 32 and 39. As for insurance contracts there is considerable ambiguity as to the precise scope of application and, again, depending upon interpretation likely to lead to very different results being reported for contracts that are similar.

A29. Where embedded derivatives are deemed to be not closely related to the host contract, but those host contracts are not within the scope of IAS 32 and 39, companies will be required to value one part of the contract applying the measurement principles of IAS 32 and 39, but the remainder of the contract under whatever is decided as part of the interim solution being progressed by IASB.

A30. The calculations necessary to comply with this requirement, particularly bearing in mind the probable need for stochastic modelling for the embedded derivative element, the need to consider the aggregate liability for overall sense, and the different cohorts and types of products will give rise to very considerable practical difficulties. Unless guidance in this area can be quickly developed it will be impractical for insurers to apply the requirements of IAS 32 and 39 as they currently stand.

A31. We note also that in previous discussions on these issues, in the context of the insurance standard, the IASB has expressed a preference for not bifurcating the value of embedded derivatives from other components of an insurance contract. To require this as part of an interim solution ahead of the hoped for 2007 implementation of an insurance standard would seem to be contrary to IASB's previously stated intentions.

Measurement

A32. Liabilities of insurance contracts that are deemed to be financial instruments are required under IAS 32 and 39 to be valued at either fair value or using amortisation principles. Neither of the two methods in the context of insurance liabilities, or the fair value measurement approach for embedded derivatives contained in insurance contracts is articulated in any depth in IAS 32 and IAS 39.

A33. If the IASB wishes to continue with the current scope it will need to provide detailed guidance, which has been fully opened to public consultation and field tested as to the measurement methodologies to be applied. This guidance should extend beyond theoretical considerations and include consideration of particular types of products, for example different types of with-profit, annuity, linked and other types of contracts that are generically common (to the extent covered by the scope of IAS32 and 39).

A34. The requirements of IAS 32 and 39 will apply to listed European insurers for 2005. However, many of these companies own operations outside the European Union. Accordingly, to avoid confusion, the guidance notes should cover all major product types outside the EU.

A35. In this regard, inter alia, the following topics for each major product type will require detailed consideration

(i) Premium receipts and future payments from and to policyholders and acquisition costs

A36. The extent to which renewal premiums should be recognised in the valuation of liabilities and the deferral (or not) of acquisition costs is critical to the reported profit profile of insurance contracts. The level to which future renewal premiums should be included requires an exposition of the differences between contracts where renewals have differing levels of contractual entitlement, and policyholder entitlements or obligations. The automatic assertion that all renewal premiums should not be taken into account on supposed grounds of comparability with other industries is inappropriate if the overriding objective of the IASB accounting model is a fair value approach. If other industries' accounting was required to be on a fair value approach then renewal contributions would undoubtedly be taken into account.

A37. Similarly, the IASB position on deferral of acquisition costs needs to be articulated against the background of the accounting of the other industries and the fair value and amortisation options in IAS 32 and 39.

A38. Guidance on the level of future payments to policyholders will need to take full account of the discretionary nature of terminal bonuses for with-profit contracts, policyholder benefits for paid up or surrendered policies and other such complications.

(ii) Policyholder taxes

A39. In the UK, under the current taxation regime, with-profit funds are taxed on a hybrid basis with the tax borne by the fund representing a mixture of policyholder and shareholder taxes. Policyholder liabilities do not therefore correspond to the usual model that applies for a trading operation of expenses being charged gross of tax with appropriate tax relief being received by the company.

A40. On the contrary, bonuses for with-profit business are declared from the post-tax surplus available for distribution. Accordingly, alteration of liabilities included in financial statements to anticipate future bonuses will necessitate consideration of associated deferred tax provisions.

A41. Similarly, in the UK, liabilities due to linked business policyholders are determined net of tax borne by the policyholder in respect of taxes on the fund in respect of investment income, realised gains, and deferred tax on unrealised appreciation. To the extent that fair valuation of linked contracts anticipates future premiums, future management fees, surrender charges the related tax effects may also be altered.

(iii) Participating contracts, in particular with-profit products

A42. Future investment returns on assets matching liabilities are an integral part of the assessment of the fair value of liabilities of participating products. The methodology for determining liabilities for such contracts needs to take full account of all of their key features to ensure the aggregate accounting answer reflects an economic reality that is both sensible and explainable to users of financial statements.

A43. These features will include consideration of future premiums, future investment returns, related volatility, discount rates, acquisition expenses, asset shares, bonus glide path, and other significant features.

(iv) With-profit funds

A44. In the UK with-profit funds are in many instances operated on the so called 90/10 principle which is enshrined in the Articles of Association of the company concerned. Under this principle all surpluses arising in the fund that are declared by the Appointed Actuary as distributable surplus are allocated in the ratio of 90% policyholders, 10% shareholders.

A45. In the current UK modified statutory basis reporting the balance sheet surplus of assets over liabilities are held within the Fund for Future Appropriations (FFA)pending, as the name implies, appropriation on declaration of future surpluses for distribution. This fund is available for all purposes of the fund and is not attributable to particular classes of policyholder by type of with-profit product, cohort or generation of policyholder.

A46. When IAS 32 and 39 and the interim solution are implemented for the 2005 deadline a decision will need to be made as to the treatment of the excess of the value of IAS basis assets over liabilities. This excess will not be capable of being attributed to either IAS 32 style contracts or other with-profit contracts accounted for under the interim solution for other insurance contracts.

A47. The alternative accounting treatments for this reserve that are most practicable are either:

(a) That an IAS equivalent of the FFA will be permitted. This reflects the formal legal position that the fund has yet to be attributed between policyholders and shareholders and that it is neither shareholder equity or policyholder liability. If this approach is adopted then the FFA treatment would need to be accommodated within the IAS framework; or

(b) The IAS basis reserve is allocated as being, for accounting purposes, 90% attributable to policyholders of the fund in general and 10% to shareholders. The policyholder allocation would be recorded as a liability. This treatment is applied for US GAAP purposes and is designated as a liability for 'Undistributed Policyholder Allocations'. In this case either IAS 32 and 39, or the interim solution guidance, or both need to address this issue.

A48. Furthermore, it should be noted that the residual balance represents a post-tax excess. For performance reporting purposes in the income statement an acceptable grossing-up methodology to derive sensible pre-tax results will be required.

A49. These issues are illustrative of the complexity of the requirements to fair value policyholder liabilities under IAS32 and 39 and an as yet unknown solution for insurance contracts not classified as financial instruments. Many of these have been explored in the development of the DSOP. However, the DSOP has not been field tested and it would be prudent for the IASB timetable to anticipate that significant second order issues will emerge on developing and testing guidance.

Performance reporting

A50. We note that based on the current requirements there are multiple potential income statement effects depending on how the components of insurance contract liabilities are measured.

A51. Embedded Derivative contract liabilities will be measured on either a fair value basis (as yet to be determined) or, if closely related to the host contract on a basis under the interim solution (again as yet to be determined).

A52. Other insurance contract liabilities will be reported on either a fair value basis (as yet to be determined), an amortised basis (as yet to be determined) or, if not within the scope of IAS 32 and 39, within the requirements of the IASB interim solution.

A53. Taken together with the option to use amortised cost, available for sale, or trading bases of income statement reporting there are likely to be very considerable differences of reported earnings for insurance contracts and backing assets for essentially similar products and backing investment portfolios.

A54. There appears to have been no detailed consideration by IASB of these issues. Given the variety of potential performance reporting models for value movements on assets backing liabilities and solvency capital, and alternative bases of measuring liabilities, we would urge that the IASB fully address these concerns as part of the interim solution.

A55. Based on current requirements there is a high risk of a loss of investor confidence in the financial statements of insurers due to the lack of comparability, both between insurers' financial statements, and within insurers' financial statements for investments and contract liabilities. Whilst it could be argued that this position currently pertains due to different world wide reporting conventions it would be highly unsatisfactory for the solution to be applied in 2005 to be even more opaque and less understandable to readers of financial statements.