CL 131

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Dear Sir or Madam

EXPOSURE DRAFT OF REVISED IAS 32: DISCLOSURE AND PRESENTATION AND REVISED IAS 39: FINANCAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

We welcome the opportunity to comment upon the proposed amendments to IAS 32 and IAS 39. We apologise for the late submission of these comments; this was caused by absence through illness.

The adoption of International Financial Reporting Standards in 2005 by listed companies currently using other accounting standards represents a great undertaking which will require a significant amount of time and effort to be dedicated to it. IAS 39 alone is a complex standard which will necessitate a great effort in understanding its implications for the BP group, in establishing documentation and in ensuring that our systems can adequately account for the myriad transactions that our centrally-managed treasury function generates.

Hedging activities

In general, we agree with the initiative to formalise the principles for hedge accounting but must take issue with the current proposals where genuine risk management activities might not meet the requirements of the standard. This may result in an asymmetry in the accounting for the hedging instrument and underlying exposure that does not fairly present the economic substance of the transactions.

In addition to responding to the Board's questions on the main changes to IAS 39, we would like to describe briefly BP's risk management activities and related issues that will arise with the implementation of this standard (in its current form).

BP operates a centralised treasury model for the funding and financial risk management of the Group. Many groups operate similar treasuries to take advantage of the benefits of centralisation that include:

- Netting of internal financial exposures thereby reducing external transaction costs;
- Better pricing for external transactions; and
- Centralisation of financial expertise and risk management skills.

BP Finance undertakes risk management activities using financial derivatives in two major areas:

- The interest rate risk management of the external debt book; and
- The foreign exchange risk management of the Group's cash flows.

The external debt book consists of a relatively large number of individual pieces of debt. The book is risk-managed as a portfolio in accordance with a target range for the fixed/floating ratio.

The Group's exposure to the effects of foreign exchange rates on short-term cash flows is managed with reference to the Group's functional currency. Cash flow exposures are aggregated centrally and the net exposures are hedged externally.

The provisions of the proposed standard that disallow or restrict the netting of hedged items, the aggregation of individual assets or liabilities (hedged items) and the designation of internal derivative transactions as hedging instruments (on consolidation) will adversely affect the accounting for the genuine risk management activities explained above. We believe a far simpler statement that focuses on the key principles of clear designation and documentation of hedging relationships and their effectiveness would achieve the desired purpose while better reflecting the economic purpose of the hedging activity.

Derecognition

The basing of the derecognition of financial assets and liabilities on the new concept of continuing involvement is a principle which has merit. We believe however that it is too early for us to be able to conclude on whether this concept is workable in practice. We would like therefore to see further testing to take place in order to confirm its suitability as a concept which can properly replace current practice, such as the "risk and reward" approach of UK GAAP.

Transition provisions

Finally, we believe that the time allowed for the implementation of IAS 39 is inadequate. As a US registrant, BP will be required to produce two years' comparatives for the income statement, making 1 January 2003 the date of transition. As the standard is still being finalised and will require significant changes to risk management and documentation procedures currently in place, we do not believe sufficient time is available for a proper implementation. We would suggest that in order to allow sufficient time for transition to be prepared for a similar approach be adopted as that of the USA in the case of FAS 133. Mandatory adoption could be as at January 1, 2005 on a prospective basis with no restatement of previous years required.

SUMMARY OF MAIN CHANGES (IAS 32)

Q1. Probabilities of different manners of settlement (paragraphs 19, 22 and 22A)

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

A1. We agree with the underlying principle that if the issuer does not have an unconditional right to avoid settlement of the obligation in cash or other financial asset then the instrument should be classified as a financial liability. The change to paragraph 19 “without regard to probabilities” seems to add nothing to the requirements, and it might be preferable to use the last sentence of paragraph 22A (“Such a financial instrument is a financial liability of the issuer [if] the issuer does not have an unconditional right to avoid settlement of the obligation in cash or other financial assets) in place of this additional phrase.

Q2. Separation of liability and equity elements (paragraphs 28 and 29).

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

A2. Yes, this appears consistent with the definition of an equity instrument.

Q3. Classification of derivatives that relate to an entity's own shares (paragraphs 29C and 29G).

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

A3. There is a requirement here to establish clearly the conceptual basis for treating certain derivative financial instruments as equity. The guidance given appears to be a series of rules without an obvious set of principles behind it. For example, the derivative described in paragraph 29C as an equity instrument seems to satisfy the definition of a financial liability rather than equity, as there is “a contractual obligation to exchange financial instruments…under conditions that are potentially unfavourable”.

Q4. Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard.

Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards).

A4. It would be useful to combine the two standards into one, if only because this would help ensure that the two are fully consistent and eliminate some of the cross-referencing which hinders easy comprehension of what are fairly complex standards. This would however be a major undertaking and result in a voluminous standard, and we do not believe that it should be regarded as a priority at present.

SUMMARY OF MAIN CHANGES (IAS 39)

Q1. Scope: loan commitments (paragraph 1(i)).

Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?

A1. Yes, this is appropriate.

Q2. Derecognition: continuing involvement approach (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?

A2. Although the IASB's "continuing involvement" approach to derecognition does appear to have merit we believe that it is premature to introduce it without further field testing. In addition, the approach should be tested for application to the wider definition of assets and liabilities, not restricted to just financial instruments. Only if the approach is satisfactory in this wider context should it be adopted, as it is not acceptable to have recognition/derecognition criteria for financial assets and liabilities different from those of other assets and liabilities.

As an alternative, we would propose the adoption of the UK ASB's "risks and rewards" approach, which has been successfully applied in the UK for a number of years. The real tests of whether an item should be recognised or derecognised are the questions of who will benefit or suffer from changes in the item's value and what is the commercial purpose of the transaction. Answers to these questions generally make it clear whether the entity should retain an asset or liability.

Further points

In our opinion, the wording of paragraph 39 is not sufficiently clear. The first example B1 is helpful to some extent, but does not deal with the case of an asset being sold with a contractual arrangement providing for the transferor either to receive an additional payment or to repay some of the consideration. This may be illustrated in an example similar to B1, but where the transferor will indemnify the transferee for the first 20% of any fall in value of the asset and the transferee will reimburse to the transferor the first 20% of any increase in value. Our understanding is that the transferor would retain 100% of the asset on its balance sheet, as this is "the amount of the asset on which increases in value are returned to the transferor" and is, of course, greater than the maximum amount of consideration which could be repaid. Similarly, where there is contractual provision for only increases in value to be returned to the transferor (and no provision for losses to be made good), then the item would not qualify for derecognition. If this is the Board's intention then it should be clarified in the wording.

Such provisions might be considered to be contingent adjustments to selling price and accounted for if and when they arise, with the disposal of the asset itself being recognised immediately.

In our opinion, the concept of the servicing asset or liability is not adequately explained in the draft standard or in the basis for conclusions. The servicing liability appears to be akin to a provision for an onerous contract, but the justification for the creation of a servicing asset is not convincing. A similar service contract for an asset in which there had been no previous involvement would not be recognised as an asset, and it seems to be inappropriate to create differing accounting models for the same economic event. In addition, the creation of the servicing asset is dependent on the fee's being more than adequate to compensate for the service. This begs the question of what adequate means. If adequate compensation means that the fee exactly covers the cost of providing the service without giving any profit, then the servicing asset must represent the future profits from the service. The propriety of recognising such revenue is debatable.

Q3. Derecognition: pass-through arrangements (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?

A3. Yes, we agree that assets transferred with an arrangement for the transferor to collect and forward cash to the transferee should be eligible for derecognition. The question of the consolidation or non-consolidation of special purpose entities is not dealt with specifically in this proposed standard and the introduction of this concept in question 3 is confusing rather than helpful.

Q4. Measurement: fair value designation (paragraph 10).

Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?

A4. We would agree with this in general. However, an exception should be made for the entity's own borrowings as this would potentially allow an entity with a falling credit rating to boost its profit or loss account unduly.

Q5. Fair value measurement considerations (paragraphs 95-100D).

Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95-100D of the Exposure Draft? Additional guidance is included in paragraphs A32-A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?

A5. Yes, we agree with these requirements and have no further suggestions.

Q6. Collective evaluation of impairment (paragraphs 112 and 113A-113D).

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?

A6. We agree with the principle of a portfolio approach to assessing whether financial assets have been impaired on a probability basis using historical data. However, we believe that most entities other than banks and similar financial institutions will be more concerned with short-term financial assets rather than the longer-lived assets that are the prime object of paragraphs 112 and 113. It may be more appropriate therefore to state the general principles here and relegate the detail to an appendix.

Q7. Impairment of investments in available-for-sale financial assets (paragraphs 117-119).

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

A7. No, it is not clear why impairment losses on available-for-sale securities should not be reversed when losses may be reversed on other categories of financial assets. There should be one principle of reversal or prohibition of reversal which applies to all assets. The basis for conclusion argues the difficulty of objectively determining when impairment losses have been recovered, but this is difficult to accept. If it is possible to determine that impairment has occurred it should be equally possible to determine that the factors causing the impairment are no longer present and it is logical to reverse the impairment loss.

Q8. Hedges of firm commitments (paragraphs 137 and 140).

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

A8. No, we do not agree. The accounting treatment for the hedged item (the unrecognised firm commitment) should determine the accounting treatment for the hedging instrument. In this case, the hedged item is unrecognised and consequently, the fair value of the hedge instrument should be recognised in accordance with the accounting requirements for cash flow hedges.

The IASB's proposal results in the anomaly of recognising a firm commitment if it is hedged, but not recognising exactly the same commitment if it is not hedged. Furthermore, while the nature of the hedging item accounted for is comparatively easy to comprehend, the item accounted for in respect of the firm commitment is probably meaningless, particularly when identical unhedged commitments remain unrecognised.

We believe it is preferable to maintain the currently widespread practice of deferring the gain or loss generated by the hedging instrument until the hedged item occurs. This produces the same effects as the IASB's proposed treatment without creating the anomalous treatments of unhedged firm commitments referred to above.

Similarly, we believe that cashflow hedges, to the extent that they are effective, should be treated in the same way. The ineffective portion of the hedge should be recognised in profit or loss.

Q9. 'Basis adjustments' (paragraph 160).

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

A9. No. The removal of the hedge gain or loss from equity when the hedged transaction occurs and inclusion in the value of the resulting asset or liability (i.e. basis adjustment), most accurately presents the economic consequences of hedging. Further, to recycle, period-by-period, the gain or loss from equity adds practical complications to the accounting without any additional benefit. The proposed approach necessitates potentially substantial additional monitoring and accounting effort on the part of the preparer of accounts compared with the simplicity of the basis adjustment approach.

Q10. Prior derecognition transactions (paragraph 171B).

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

A10. On the assumption that complete re-analysis of past transactions is likely to be an onerous task, we believe it would be appropriate to allow grandfathering in this context in the same way that it is proposed to allow it for prior business combinations in the approach to the first-time application of IFRS's.

Yours faithfully

G D HODGKISS