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Dear Mr Ebling

ASB FINANCIAL REPORTING EXPOSURE DRAFT 30 FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION RECOGNITION AND MEASUREMENT

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

The Committee is concerned about aspects of the ASB's proposed process of convergence in the UK and would refer the ASB to the detailed comments on these concerns made in its response to FRED 23 to 29. However, we believe that the Board should act quickly in order to minimise uncertainty and to give users as much warning as possible of what they need to do. While the Committee appreciates that a fundamental review has not been requested, we wish to point out that we disagree with the adoption of a rules based approach in preference to a principles based approach.

Response to Detailed Questions FRED 30

Our responses to the specific questions in the Exposure Draft are set out below.

(i) *Do you agree with the proposal to view the requirements in IASs 32 and 39as a single package that should be implemented in the UK at a single point in time?*

Yes. We believe that it is not desirable to make an artificial split between Disclosure and Presentation and Recognition and Measurement. We further believe that additional guidance is necessary to clarify the status and levels of authority of the IAS 39 Q&As and appendices.

(ii) *Do you agree that the best possible approach to implementing international requirements in this area in the UK is to implement, at a single point in time, some parts of the IASs in mandatory form, some in non mandatory form and some not at all, and at the same time to withdraw FRSs 4 and 13 (and related UIYF abstracts) and to keep in place most parts of FRS 5?*

We disagree. We consider that all UK entities (subject to exemptions for smaller companies) should adopt all IASs, including the revised IASs 32 and 39, which are applicable in the year of transition to IAS in preference to piecemeal adoption.

(iii) *Do you agree that the new IAS 39 approach to recognition and derecognition should not be implemented in the UK until the direction of international convergence on this subject becomes clearer and when a further consultation document will be issued?*

We believe that any change to the basis of recognition and derecognition should only be introduced as part of the changeover to International Accounting Standards in 2005.

(iv) *a) Do you agree that prior to 2005, companies should be required to adopt IAS 39's measurement requirements only if they have adopted the fair value accounting rules that will be set out in companies' legislation?*

We disagree. We do not believe that any of the LAS 39 provisions should be adopted earlier than 2005.

b)Do you agree that the recycling requirements of 145 39 should not be implemented in the UK pending completion of the project on reporting financial performance and do you agree with the alternative treatment proposed in the E4osure Draft?

We agree that the recycling requirements should not be implemented in the UK. On the assumption that the alternative treatment is that proposed in paragraph 103(b), we believe that by deleting the reference to impairment losses in that paragraph and the corresponding changes in paragraphs 117 to 119, impairment losses on available-for-sale assets would never in any circumstances be recognised in the profit and loss account.

(v) *a) Do you agree with the proposal to follow IAS39's hedge accounting requirements for measurement?*

We disagree. As noted above we do not believe that any of the LAS 39 provisions should be introduced earlier than 2005.

b)Do you agree with the approach being proposed in place of recycling?

We believe that in the absence of recycling it is probably the only way that the economic impact of undertaking a cash flow hedge can be achieved. However we believe that it should be noted that the treatment for a "forecast" transaction that subsequently results in an asset or liability is different from the way in which a "firm commitment" transaction is treated. Although both result in an asset or liability that do not meet the definitions of an asset or liability under the ASB's Statement of Principles or the IASB Framework, the way in which the asset or liability arises is different. For a "forecast" transaction, the asset or liability is the gain or loss on the hedging instrument which has been deferred. For a "firm commitment", the gains or losses on both the hedged item and the hedging instrument are reflected in the profit and loss account, and the "dubious" asset or liability is the gain or loss on the hedged item. In our view it does not make sense to have different treatments, particularly as a "forecast" transaction will at some stage become a "firm commitment" transaction.

(vi) a) Do you agree with the proposal that from 2005, listed entities that do. not prepare consolidated financial statements and unlisted entities will not be required to adopt IAS 39's measurement and hedge accounting provisions unless they choose to adopt the fair value accounting rules set out in the Companies Act 1985 and similarly that listed entities that prepare consolidated financial statements will not be required to adopt IAS 39's measurement and hedge accounting provisions in their individual financial statements unless they adopt the fair value accounting rules in those financial statements.

We disagree. We believe that all of the recognition, measurement and hedging requirements of IAS 39 should apply to all UK companies other than those under the FRSSE or its post 2005 international equivalent.

b)Do you agree with the proposal that FRS 13's disclosure requirements should be revised on 1 January 2004 and the new requirements applied to all listed entities, all other entities that have publicly-traded securities and all banks thereby removing the exemption for listed insurance companies?

We believe that since the exemption for insurance companies will disappear in 2005, this question only arises as a transitional issue if the standard is applied from 2004 and as noted above, we do not believe that that any changes should be made before 2005.

c) Do you agree with the proposal to retain an exemption similar to that in PBS 13 which permits that entities preparing FRS 13-compliant consolidated financial statements do not need to apply the disclosure requirements in their individual financial statements?

We agree with this approach although we have been unable to find this exemption in the Exposure Draft.

Other Observations

We noted a number of areas where cross-referencing was made to paragraphs that had been deleted. While this may just be a drafting issue, we believe that it should be resolved prior to implementation, as the problem will otherwise cause a significant amount of confusion. We also consider that a detailed exercise should be carried out to check that the logic of the Exposure Draft flows properly, that misleading cross references are corrected or eliminated as necessary and that deletions have been made only where appropriate.

Responses to detailed questions - IAS 32

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

(i) *Do you agree that the clas4fication 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 4fferent manners of settlement?*

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

(ii) *Do you agree that the options in 145 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?*

We agree.

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

We agree.

(iv) *Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments?*

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

Other observations

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

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

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

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

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

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

Responses to detailed questions - IAS 39

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

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

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

(ii) *Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS39?*

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

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

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

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

We agree.

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

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

(vi) *Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 1 13A-1 13D?*

We agree.

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

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

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

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

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

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

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

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

Other observations

Our additional comments on LAS 39 are set out below.

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

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

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

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

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

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

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

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

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

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

Yours sincerely

Richard Anderson

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