Grupo Ferrovial, S.A.
Príncipe de Vergara, 135
28002 Madrid

Tel.: 91 586 25 00
Fax: 91 586 26 77
E-Mail : mail@ferrovial.es

ferrovial

IASB
30 Cannon Street
London 6XH – Reino Unido

Madrid, 14th September 2009

Dear Sirs,

We welcome the opportunity to comment on the proposals set out in the Exposure Draft on "Financial Instruments: Classification and Measurement".

Although we support the steps taken by the IASB to simplify the reporting of financial instruments, we are concerned as the solution proposed by the IASB leads to entities reporting at fair value many instruments which should not be so classified from the point of view of decision useful information and will continue to produce misleading volatility in companies' equity.

As explained in the detailed comment paper attached, we firmly believe that amortized cost provides more decision-useful information for a financial asset or financial liability that are "managed on a contractual yield basis" as defined in the ED and that the "basic loan features" requirement introduces a distortion in the classification between amortized cost and fair value.

This is more relevant in the case of debt and other financial liabilities or assets related to that debt, of industrial companies other than financial institutions which normally use those instruments to finance their producing activities. From our point of view, this type of assets and liabilities should be measured in any case at amortized cost regardless of whether they comply or not with the "basic loan features" requirement.

An example of this situation is a certain type of derivatives that are contracted separately but are linked to a financing contract with the sole purpose of adjusting the conditions of the financing, like a Interest Rate Swap that is linked to a variable rate loan that turns the loan into a fixed rate loan, or a Index Linked Swap that is linked to a variable rate loan that turns the loan into a real fixed rate+inflation loan. These derivatives, according to the IASB proposal (paragraph B5 appendix B), should be measured at fair value because they do not have "basic loan features", although they are "managed on a contractual yield basis" as they are managed on the basis of the contractual cash flows that are generated when held or issued in order to adjust the contractual cash flows of the linked loan.

The obligation to measure these derivatives at fair value introduces high volatility in the Equity of the companies, and it does not contribute to representing the true and fair view of their financial position as they are not held for trading, but to maturity linked to the loan in order to adjust the interest cash-flows of the loan. Additionally the application of fair value measurement generates absolutely different treatments for economically equivalent transactions, depending on how the transaction is structured,

Grupo Ferrovial, S.A. Inscrita en el Registro Mercantil de Madrid 1ª de la Hoja núm. 40.204, Folio 212 del Tomo 5.076 de General 4.227 de la Sección 3ª del Libro de Sociedades. C.I.F. núm. A-28606556

ferrovial

although the impact on cash is the same: 1) if the transaction is structured as a sum of a principal transaction with a derivative (variable loan + IRS) fair value is applied 2) If the transaction is a single transaction (fixed rate loan) amortized cost is applied. We think this is the sort of inconsistency that makes information about financial instruments difficult for users to understand

Bearing in mind the reasons mentioned above, we propose that the model should be reformulated to make the "business model" the key criterion to separate between fair value and amortized cost. In accordance with this approach the classification criterion would be straightforward:

- If financial instruments are managed as held for trading fair value should be applied.

- If financial instruments are managed on the basis of the contractual cash flows that are generated when held or issued amortized cost should be applied.

In the paper attached you can find other examples of distortions introduced due to the requirement and definition of "basic loan features" and our comments on other issues of the Exposure Draft. We would be happy to have the opportunity to meet you in order to discuss all these questions in greater detail.

Yours sincerely,

Jesús Herranz Lumbreras
Group Financial Controller

Detailed comments to the Exposure Draft (ED) of Proposed Amendments to IAS 39 Classification and Measurement

RESPONSES TO SPECIFIC QUESTIONS

CLASSIFICATION APPROACH

Question 1—Does amortized cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

We firmly believe that amortized cost provides more decision-useful information for a financial asset or financial liability that is "managed on a contractual yield basis" as defined in the ED. We understand that the "basic loan features" requirement introduces a distortion in the "business model approach" as it excludes from amortized cost some types of assets or liabilities in which amortized cost would provide more decision useful information than fair value. So the main change we propose is that the model should be reformulated to make the "business model" (managed on a contractual yield basis) the key criterion to determine whether an instrument should be measured at fair value or amortized cost.

This is more significant in the case of debt and other financial instruments related to that debt, of industrial companies other than financial institutions which normally use that debt to finance their producing activities. From our point of view this type of assets and liabilities should be measured in any case at amortized cost.

This is the case of some types of derivatives that are contracted separately (they are not embedded derivatives) but are linked to a financing contract with the sole purpose of adjusting the conditions of the financing, like a Interest Rate Swap that is linked to a variable rate loan that turns the loan into a fixed rate loan, or a Index Linked Swap that is linked to a variable rate loan that turns the loan into a real fixed rate+inflation loan.

These derivatives, according to the IASB proposal (paragraph B5 appendix B), should be measured at fair value because they do not have "basic loan features", although they are "managed on a contractual yield basis" as they are managed on the basis of the contractual cash flows that are generated when held or issued in order to adjust the contractual cash flows of the linked loan.

The obligation to measure these derivatives at fair value introduces high volatility in the Equity of the companies, and it does not contribute to representing the true and fair view of their financial position as they are not held for trading, but to maturity linked to the loan in order to adjust the interest cash-flows of the loan.

Additionally the application of fair value measurement generates absolutely different treatments for economically equivalent transactions, depending on how the transaction is structured, although the impact on cash is the same: 1) if the transaction is structured as a sum of a principal transaction with a derivative (variable loan + IRS) fair value is applied 2) If the transaction is a single transaction (fixed rate loan) amortized cost is applied.

A similar situation can arise in the case of a purchase of a commodity contract for own use with a variable price linked to a derivative, which turns the variable price purchase contract into a fixed price one. If the transaction is structured as a sum of a principal

transaction with a derivative (variable price purchase contract + derivative), fair value is applied; 2) If the transaction is a single transaction (fixed rate loan) or (fixed price purchase contract) amortized cost is applied.

Also, it appears to us that amortized cost could be a better measurement basis for equity securities where these are held for long-term strategic purposes or because of performance (e.g. high yield, so income- rather than capital gain-oriented) as this would also better reflect expected cash flows

In accordance with all the reasons mentioned above, we propose that the model should be reformulated to make the "business model" the key criterion to separate between fair value and amortized cost

Question 2—Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a contractual yield basis'? If not, why? What additional guidance would you propose and why?

(a) Basic loan features

As explained above, we understand that the "basic loan features" should not be considered as a requirement to apply amortized cost. This is a key issue in order to support that amortized cost is being used in all circumstances where it is more relevant than fair value.

In the event that the decision of the IASB finally is to continue with the "basic loan features" requirement, we understand that the ED's guidance on whether an instrument has "basic loan features" is far too restrictive. So in that case and as an alternative solution, we would propose introducing some changes in the guidance in order to avoid some of the distortions mentioned in q1. The changes proposed are:

- We understand that uncertain or contingent changes in the timing and amount of payments of principal and interest should not be excluded from the definition. We cannot see why a contingent variability of principal or interest rate or timing of cash flows should disqualify the instrument from being accounted for at amortized cost if the conditions that principal should be repaid in full and interest serviced are met. Applying the market interest rate or including a liquidity risk factor in the valuation of the instrument at fair value would not provide a better estimate of future cash flows to or from the entity if the instrument is being managed on a "contractual yield basis".

- Similarly we do not see any logical reason why trenches in securitisations (other than those which grant the holder only a residual interest) would be excluded from the definition of basic loan features where the issuer remains obligated to pay principal and interest (that incorporates a higher risk premium) and if cash flows to be received are subject to a reliably measurable credit risk.

- At present structured liabilities and convertible bonds are generally bifurcated, with the embedded derivative measured at fair value and the host at amortised cost. The ED, however, plans to prohibit bifurcation and to require the hybrid to be classified by considering it as a whole. As the embedded derivative would generally mean that the instrument as a whole does not have basic loan features, the liabilities would be measured at fair value, which may mean measuring such instruments at amounts that reflect changes in own credit risk.

- More thought is urgently needed on the specific nature of financial liabilities, in particular long-term debt used to finance operations. For example, most treasury functions manage long-term debt on a contractual yield basis in the context of financing the entity, even in circumstances where debt contains embedded derivatives or other "non-basic" features. Hence, the interaction between being managed on a contractual yield basis and the definition of basic loan features needs to be thought over for liabilities that serve such a funding purpose, to ensure that the information generated is meaningful and properly reflects the economics. This might be done, for example, by extending what is meant by a basic loan feature specifically for long term debt issued by an entity or by adapting the bifurcation rules for financial liabilities (see Q.4(a) below).

- Related to financial liabilities and as an alternative solution to the derivatives issue mentioned in q 1, we would propose considering that some types of derivatives meet the requirement of "basic loan features" when:

  - They have been contracted in order to adjust the financing terms of a loan or the price of a purchase/sale contract of a non financial item, being the final result, from the point of view of the cash flows, the same as a loan measured at "amortized cost" or as a purchase/sale contract for internal usage purpose.

  - The company has a clear intention and a real possibility of holding the derivative until maturity.

  - The have not been contracted for speculative purposes.

(b)Managed on a contractual yield basis

As explained in question 1 we understand that the "business model" approach should be the key criterion for deciding whether amortized cost or fair value should be applied.

Bearing this in mind, we think that it would be easier for users to understand if we establish a definition of business model criteria, distinguishing two type of business model:

- When assets or liabilities are managed as held for trading or for speculative purposes, fair value should be applied.

- When they are managed on the basis of the contractual cash flows that are generated when held or issued amortized cost should be applied.

We are not comfortable with the notion that loans and other financial assets that are purchased at a discount reflecting incurred credit losses could not be considered as being managed on a contractual yield basis. Since an entity's business model is a matter of fact that can be observed, this appears to us a quite unnecessary restriction, for such assets purchased at a discount are not necessarily held for trading.

Question 3—Do you believe that other conditions would be more appropriate to identify which financial asset or financial liabilities should be measured at amortised cost?

If so,

(a) **What alternative conditions would you propose? Why are those conditions more appropriate?**
(b) **If additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in information that is more decision-useful than measurement at fair value?**
(c) **If financial assets or financial liabilities that the exposure draft would measure at amortised cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?**

See our comments in questions 1 and 2.

EMBEDDED DERIVATIVES

Question 4(a)—Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal, explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

We understand that all the questions related to the complexity of embedded derivatives would be resolved applying the "business model approach" in accordance with our proposal in q1 and q2, as this type of hybrid contract would be measured at amortized cost or at fair value depending on whether they are managed on a cash-flow or on a trading basis.

In any case if the IASB continue with their proposal, the elimination of the bifurcation of hybrid financial instruments between embedded derivatives and financial hosts would be a backward step and potentially give very misleading information on expected future cash flows. It should not be undertaken. It would contradict the basic classification principle and would, as a result, significantly reduce the benefits expected from the application of that principle. As stated by the IASB, amortized cost best reflects future cash flows that are expected to arise from instruments having basic loan features and being managed on a contractual yield basis: it will often be the case with many hybrid assets and liabilities that the host, generally making up the larger part of the overall value of the hybrid, unequivocally fulfils the amortized cost criteria.

Also, as we have already pointed out in our concerns under Q.2, many types of convertible debt (for example, those with equity features that do not meet the definition of equity) would under the proposals have to be measured *in their entirety* at fair value through profit and loss. In other words, the entity would no longer have the ability to separately account for the embedded derivative and the funding component. This would result in entities including in profit and loss changes in fair value, including changes relating to own credit risk, of instruments primarily used to finance the entity. We do not believe that this would give decision-useful information. Furthermore, the proposals mean that contracts could be measured differently depending on whether

they are standalone contracts or part of a hybrid contract (i.e. have derivatives embedded in them). We think this is the sort of inconsistency that makes information about financial instruments difficult for users to understand. There needs to be a simple principle that is consistently applied. For that reason, we think, if IASB continues with its model, it should retain bifurcation but should explore the possibility of bifurcating on a basis that is consistent with the basic classification model.

It also seems that e.g. maturity extension options and interest indexed to inflation could result in similar unhelpful reporting of instruments where amortised cost would give a far better reflection of the expected future cash flows than fair value.

Question 4(b)—Do you agree with the proposed approach regarding the application of the proposed classification approach to contractually subordinated interests (e.g. tranches)? If not, what approach would you propose for such contractually subordinated interests. How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision-usefulness of information about contractually subordinated interests?

We do not agree at all with the proposed application of the classification proposed to contractually subordinated interests. Most trenches in securitisations provide the holder with rights to receive payments of principal and interest that remain subject to reliably measurable credit risk. The holder of subordinated trenches receives higher interest flows for, in effect, providing credit protection to other trenches. However, we do agree that trenches that give their holder only a residual interest should not be regarded as fulfilling the basic loan features criterion. Neither do we agree with measuring loans purchased at a discount at fair value in all circumstances. Such loans still involve payments of principal and interest, the difference between the purchase price and the fair value being in no way different in economic substance from an upfront fee.

RECLASSIFICATION

Question 5—Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications?

We disagree with prohibiting reclassification. Although we agree that an entity's business model is unlikely to change and that assets can generally be easily identified as being managed in one line of business or another, circumstances may arise when an entity's activity may be stopped because of, for example, significant changes in market conditions. The last two years have shown that such circumstances are possible. The hasty changes which the Board had to make in October 2008 are clear evidence that a standard dealing with classification and measurement of financial instruments has to allow for reclassification: when the criteria for a classification are no longer met, a reclassification should be made.

FAIR VALUE OPTION

Question 6—Do you agree that entities should be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?

We agree with allowing a fair value option to eliminate or significantly reduce an accounting mismatch, as many business models involve asset/liability management and accounting requirements should not obscure the economics of such activities by requiring inconsistent reporting of the same economic phenomena.

Question 7—Should the fair value option be allowed under any other conditions? If so, under what other conditions should it be allowed and why?

If the application of fair value it is not restricted, as we are proposing in this letter, we understand that the IASB should allow the application of the fair value option to some types of non financial assets in order to avoid an accounting mismatch when those assets are being financed with a liability that according to the standards has to be measured at fair value.

This is a key issue for corporations other than financial institutions, as normally they do not have accounting mismatches between financial assets and financial liabilities, but between a non financial asset and a financial liability. We think this is another sort of inconsistency that makes information about financial instruments difficult for users to understand.

INVESTMENTS IN EQUITY INSTRUMENTS THAT DO NOT HAVE A QUOTED MARKET PRICE AND WHOSE FAIR VALUE CANNOT BE RELIABLY MEASURED

Question 8—Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value?

As explained in question 1, it appears to us that amortized cost could be a better measurement basis for equity securities where these are held for long-term strategic purposes or because of performance (e.g. high yield, so income- rather than capital gain-oriented) as this would also better reflect expected cash flows

In any case, if the final decision of IASB is to continue applying fair value to this type of assets, we understand that the cost exemption for unquoted equity investments that cannot be measured reliably at fair value should be maintained. It prevents the reporting of unreliable increases in value of equity investments. Where conditions for reliable measurement of fair value are not met, impairment of equity investments reported at cost should be required on as reasonable a basis as possible. Estimates necessary to perform impairment tests do not need the same level of reliability as those required to measure at fair value: estimates are needed only in cases where indicators of impairment exist, and specific disclosures would help users to understand the uncertainty involved.

Where a reasonably reliable threshold cannot be reached, we believe that such fair-value "information" cannot be relevant for users. The Board should maintain the exemption, while emphasising more strongly if necessary that whenever the fair value of equity investments *can* be determined reliably, those investments *must* be measured at fair value.

Question 9—Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? In such circumstances, what impairment test would you require and why?

As indicated under Q.8, we believe that the cost exemption for unquoted equity investments that cannot be measured reliably at fair value should be maintained. We believe that this exemption avoids reporting unreliable increases in value of equity investments. We believe that while conditions for reliable measurement of fair value are not met, impairment of equity investments reported at cost should be required on as reasonable a basis as possible. Estimates necessary to perform impairment tests do not need the same level of reliability as those required to measure at fair value.

INVESTMENTS IN EQUITY INSTRUMENTS THAT ARE MEASURED AT FAIR VALUE THROUGH OTHER COMPREHENSIVE INCOME

Question 10—Do you believe that improved financial reporting results when fair value changes for particular investments in equity instruments are presented in other comprehensive income? If not, why?

As explained above we understand that it would be better to apply amortized cost for equity securities where these are held for long-term strategic purposes or because of performance (e.g. high yield, so income- rather than capital gain-oriented) as this would also better reflect expected cash flows.

If fair value is applied, we understand that it would be better to maintain the present available for sale treatment unless the shares are held for trading reasons. In any case, we understand that reporting dividend income (a real cash flow which analysts are interested in seeing in income) in "Other comprehensive income" is unacceptable. We also oppose the decision to eliminate recycling in the event of the sale of the shares.

Question 11—Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value of any investment in equity instruments (other than those that are held for trading), if it elects to do so only at initial recognition? If not:

- **What principle do you propose to identify those for which presentation in other comprehensive income is appropriate?**
- **Should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet that principle?**

Please see our response to Q.10.

EFFECTIVE DATE AND TRANSITION

Question 12—Do you agree with the additional disclosure requirements proposed for entities that adopt the proposed IFRS early? If not, what would you propose instead and why?

These proposals seem in order (on the assumption that all of the Board's other proposals were implemented.)

Question 13—Do you agree with the proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

We do not have comments on this issue.

AN ALTERNATIVE APPROACH

Question 14—Do you believe that this alternative approach (including disaggregated presentation of fair value changes for each period) provides more-decision useful information than measuring those financial assets at amortised cost? If so, why?

We are convinced that the alternative would ***not*** provide more decision-useful information to users. As explained under Q.1, we think there are many circumstances where amortised cost gives them better information and where fair value is quite irrelevant (even if more up-to-date.) Further, if the Board were to follow this path, it must realise that this would further intensify the trend for the focus of preparer-user communication to shift away from the financial statements and towards non-GAAP information in management commentary where there is greater freedom to concentrate on meaningful, decision-useful information to which both preparer and user can relate.

Question 15—Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

We do not agree, for the reasons given in the answer to Q.14.