EFRAG
European Financial Reporting Advisory Group

21 September 2009

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sir/Madam

Re: Exposure Draft Financial Instruments: Classification and Measurement

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft *Financial Instruments: Classification and Measurement* ('the ED'). This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issues.

The IASB is carrying out a project to improve IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). This is a multi-phase project, and the first phase involves a review of IAS 39's existing classification and measurement requirements for financial instruments. The ED is part of that first phase of work. It proposes that all financial assets and financial liabilities should be allocated to one of two categories: those that are measured at fair value and those that are carried at amortised cost. It sets out criteria to be used to achieve this allocation. It also proposes various limited exceptions to this approach (for example, a fair value option and a presentation choice for equity investments).

EFRAG's detailed comments are set out in the appendices to this letter but to summarise:

- While we understand the IASB's decision to split the IAS 39 replacement project into phases, a phased approach has some consequences that we think the IASB needs to bear in mind in the later phases of its work. As a result, we urge the IASB to carefully consider ways of minimising the negative effects of such an approach on constituents (including foreseeing reconsideration of accounting choices by entities upon implementation of a subsequent phase of the IAS 39 replacement project as well as taking into account the circumstances of insurance entities awaiting the completion of the IFRS 4 *Insurance Contracts* replacement project.)

- We agree that a mixed measurement model should be retained.

- We agree that the existing classification model should be simplified and that instruments should be allocated to categories in a way that will enable useful information to be presented.

- We agree with the proposals that the classification of financial instruments should be based on whether the cash flows on an instrument have a close relation to the amount advanced under the instrument. However, we have some important concerns about how that principle is translated by the standard into detailed tests. As a result, we suggest that the classification model proposed is amended so that it can be characterised as being based on whether instruments are managed on a contractual yield basis, with an exception so that instruments that do not have the appropriate characteristics, currently described as 'basic loan features' in the ED, are measured at fair value. Furthermore, we believe that the tests to distinguish between the measurement categories should be clarified by making them more principles based.

- We do not support the proposals in the ED:

    - on the treatment of embedded derivatives. Instead we think that for the time being entities should be allowed to apply the existing IAS 39 requirements on the bifurcation of hybrid instruments;

    - prohibiting reclassification of instruments from one category to another. In our view a classification system is most transparent if, when an instrument that previously met the criteria for a particular classification no longer does so, reclassification is required;

    - to omit the reliability exemption from the requirement to measure all equity investments (and all derivatives on such investments) at fair value. We believe that there are cases where the costs of determining the reliable fair value of unquoted securities would exceed the benefits of the resulting information; and

    - to require an entity choosing not to account for an equity investment at fair value through profit or loss to present the total return on the instrument in OCI and to prohibit the recycling from OCI to profit or loss of any part of that total return. Instead, as a pragmatic solution for the time being—until the fundamental financial statement presentation issues underlying these proposals have been addressed—we recommend the IASB grant entities an instrument-by-instrument option to apply the existing available-for-sale model to equity investments, except that we would also urge the IASB to consider simplifying the impairment recognition model for financial instruments (including reconsideration of the prohibition on reversal of impairment on available-for-sale equity securities).

We understand that the FASB is currently working on its set of proposals for reporting for financial instruments and that those proposals are likely to be significantly different from the proposals in this ED. We urge the IASB to encourage FASB to converge around a classification and measurement model along the lines set out in the IASB's ED.

If you wish to discuss our comments further, please do not hesitate to contact Svetlana Boysen, Kristy Robinson or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1
EFRAG's general comments on the proposals in the ED

1 In appendix 2 we have set out our responses to the questions asked. However, because we have found it difficult to express our views clearly within the confines of those questions, we thought it would be useful to make a few general comments first. That is the purpose of this appendix.

2 The views we express in this appendix can be summarised as follows:

- We agree that a mixed measurement model should be retained.
- We agree that the existing classification model should be simplified so that there are fewer categories and that there is a better rationale for allocating financial instruments between those categories to enable useful information to be reported.
- Although we have some detailed concerns about both the business model test and the characteristics of the instrument test, we think that, broadly speaking, the ED is heading in the right direction in proposing that only instruments that satisfy both a 'business model' and 'characteristics of the instrument' test should be measured at amortised cost.
- We suggest that the classification model proposed is amended by giving greater emphasis to the business model test. We think this should be done by characterising the classification model as being based on whether instruments are managed on a contractual yield basis, with an exception so that instruments that do not have the appropriate characteristics, currently described as 'basic loan features' in the ED, are measured at fair value.
- While we understand the IASB's decision to split the IAS 39 replacement project into phases, this phased approach has some consequences that we think the IASB needs to bear in mind in the later phases of its work. For example, it will be difficult for preparers to make definitive decisions on some of the accounting choices these proposals allow without knowing what the 'overall package' will be. For that reason we think it will be very important that the IASB allows entities to reconsider some of the choices made while implementing these proposals. For similar reasons, we think it is essential that either insurers can implement this standard and the IFRS 4 replacement standard at the same time or that it is possible for insurers to reconsider the accounting choices they have made in implementing the earlier of this standard and the IFRS 4 replacement standard when implementing the later of the two.
- We understand that the FASB is currently working on its own proposals for reporting for financial instruments and that those proposals are likely to be significantly different from the proposals in this ED. We urge the IASB to encourage FASB to converge around a classification and measurement model along the lines set out in the IASB's ED.

3 The IASB explains in the ED that many of its constituents have told it that the number of categories of financial instruments in IAS 39 creates unnecessary complexity in the reporting of financial instruments. We agree that fewer categories and a better rationale for those categories could improve the usefulness of the information provided and also make IAS 39 easier to apply.

4 The existing IAS 39 measurement model is a mixed measurement model. The IASB considered the possibility of introducing a single measurement category for all financial assets and financial liabilities but concluded, as paragraph BC13 explains, “that measuring all financial assets and financial liabilities at fair value is not the most appropriate approach to improving the financial reporting for financial instruments.” It is therefore proposing that a mixed measurement model be retained. We agree with this decision and reasoning.

5 The ED proposes to introduce a clear rationale for distinguishing between the two categories of instruments.

(a) The IASB believes that amortised cost can provide useful information only if the cash flows on the instrument have a close relation to the amount advanced under the instrument and the instrument is managed on the basis of the contractual cash flows generated. Accordingly, the ED proposes that only instruments that have so-called basic loan features and are managed on a contractual yield basis in accordance with the business model shall be carried at amortised cost. (For short-hand we will sometimes refer to this as being ‘the characteristics of the instrument’ or ‘basic loan features’ test and ‘the business model’ test although they are really two components of one test.)

(b) The IASB believes that, in the case of other instruments, amortised cost would not produce useful information, since the cash flows are likely to represent some other feature (ie leverage or a derivative) or will not represent the use to which the entity is putting the instrument. Accordingly, the ED proposes that such instruments should be measured at fair value.

6 We think the IASB is thinking along the right lines, because we agree that some instruments are best measured at amortised cost and some at fair value, and that the best test is what is useful for users. The key issue though is whether the ED’s proposals draw the line between amortised cost and fair value in the right place.

The business model test (ie whether an instrument is managed on a contractual yield basis)

7 Some commentators are suggesting that the ED in effect treats the characteristics of the instrument as the primary test and the business model test as the secondary test, and that the approach would be better were this reversed so that the business model test was the primary test. In fact, the order of the tests itself has no effect on the accounting result. However, we do think it would be preferable if greater emphasis were given to the business model test. Indeed, we think it would be an improvement if the classification model was characterised as being based on whether instruments are managed on a contractual yield basis, with an exception so that instruments managed on a contractual yield basis that do not have certain characteristics are measured at fair value. There are three main reasons why we think this would be an improvement.

(a) We think that giving greater emphasis to the business model test in this way will help the IASB to draw the most appropriate line between amortised cost and fair value by better identifying those financial assets or financial liabilities for which amortised cost provides useful information. That is because, by identifying the types of instruments that are generally managed on amortised cost basis as a starting point, the IASB may be able to understand better whether its current characteristics of the instrument test (ie the basic loan features test) should be nuanced to move the boundary between amortised cost and fair value slightly.

(b) We think such an emphasis would make the approach easier to understand.

(c) We think that such an emphasis would also reflect how the tests will be applied in practice in most cases. First, the business model test will be applied to identify which instruments might qualify as amortised cost instruments, then the characteristics of the instrument test will be applied to those instruments to narrow down the number that are allocated to the amortised cost category. We think requirements are generally easier to understand if they reflect the way they will usually be implemented.

8 We have raised some detailed issues later in this letter about aspects of the business model test (see some of our comments in response to questions 2 and 3 for example). We think it might be necessary to define more clearly the test in order to create a principle that better addresses the concerns raised in this letter. Nevertheless, our view is that, broadly speaking, the business model test described in the ED is heading along the right lines.

The characteristics of the instrument test (ie whether an instrument has basic loan features)

9 Similarly, we have raised some specific concerns about the basic loan features test in our response to questions 2 and 3. We think that getting the principle behind the characteristics of the instrument/basic loan features test 'right' is probably the key to ensuring that financial instruments are appropriately classified. The issues identified so far could require some changes to the test as described in the ED—to enable certain additional instruments to be measured at amortised cost—but again we think that, broadly speaking, it is also heading along the right lines.

The 'phased approach' and relationship of these proposals to the IASB's other work

10 While we understand the IASB's decision to split the IAS 39 replacement project into phases, this phased approach has some consequences and we think it is important that the IASB bears these in mind in the later phases of its work. In particular:

(a) it is difficult to assess the proposed classification and measurement proposals in isolation from the other aspects of the IAS 39 replacement project—impairment recognition and hedge accounting—as well as some of the other active IASB projects that have a significant bearing on the information that will be provided on financial instruments, such as the insurance contracts project and the project on financial statement presentation. As a result, proposals that seem acceptable now might become less acceptable in the context of the later proposals, and vice versa.

(b) we suspect that preparers will be reluctant to make definitive decisions on some of the accounting choices these proposals allow without knowing what the 'overall package' will be. For that reason we think it will be very important that the IASB allows entities to reconsider some of the choices made while implementing these proposals (for example, the presentation choice for equity instruments or application of the fair value option).

11 We also think it is important that special consideration is given to the insurance industry, which will be faced with implementing two standards that will have a fundamental effect on their financial statements (the standard developed from this ED and the replacement standard for IFRS 4 *Insurance Contracts*). In our view the

IASB needs to ensure either that insurers can implement two standards at the same time or that it is possible for insurers to reconsider the accounting choices they have made in implementing the earlier of the two standards when implementing the later of the two.

Global convergence of accounting standards

12 We note that on 15 July 2009 FASB agreed to propose that all financial instruments will be presented on the balance sheet at fair value with changes in value recognised in net income (ie profit or loss) or other comprehensive income (OCI). It also agreed to propose that there should be an optional exception for own debt in certain circumstances, which could instead be measured at amortised cost. These proposals when finalised will be issued by the FASB in an ED.

13 Given the IASB's intention to issue a final Classification and Measurement standard in 2009, there seems to be insufficient time for the two boards to analyse the two sets of proposals in the light of the comments received and agree on a converged approach. That is unfortunate, because achieving convergence in reporting financial instruments is in our view desirable—though not regardless of the cost. However, despite the disparity in timing, we urge the IASB to continue to work with the FASB. We support a mixed measurement model for financial instruments and we understand that this view is also broadly held amongst European constituents. We therefore urge the IASB to promote this view in its future discussions with the FASB.

Appendix 2
EFRAG's response to the questions asked in the ED

CLASSIFICATION APPROACH

Question 1—Does amortised 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?

Summary of EFRAG's view:

- We agree that amortised cost provides decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis, both as described in the ED.
- However, we believe that amortised cost would provide decision-useful information in some other circumstances as well. That is because we do not agree in all respects with how the business model or characteristics of the instrument tests are described in the ED.

1 Paragraph BC17 explains that the IASB believes that "amortised cost can provide useful information only when the instrument produces predictable returns based on its contractual terms and is managed on the basis of the contractual cash flows generated if it is held rather than sold or transferred. Accordingly, a financial asset or financial liability would be measured at amortised cost if two conditions are met:

   (d) the instrument has only basic loan features; and

   (e) the instrument is managed on a contractual yield basis."

2 We agree with the IASB that in such circumstances amortised cost will provide useful information for users. However, we think that amortised cost would provide decision-useful information in some other circumstances as well. In other words, we think the dividing line between amortised cost and fair value needs to be moved a little so that certain instruments that would under the ED's proposals be measured at fair value can be measured at amortised cost. We have therefore concluded that we do not agree in all respects with the managed on a contractual yield basis test and the basic loan features test as they are described in the ED. This is discussed further in our responses to Questions 2-4 below.

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?

Summary of EFRAG's view:

- We have a number of concerns about how the ED describes the basic loan features test, relating both to its clarity and to the way it proposes the test should be applied. We think the test should be described in a more principle-based way, and that that description should include a reference to financial instruments without leverage, where the term leverage includes credit.
- We also have some concerns with some of the detail of the ED's description of the managed on a contractual yield test. Again we think the description is not as clear as it might be. We also question how the ED proposes the test is applied in certain

circumstances. As a result, we think the test might be better described in terms of whether instruments are managed on *an expected* yield basis, rather than on a contractual yield basis.

- We have concerns about the implications of the proposals for financial liabilities.
    - The proposals seem likely to mean that many more financial liabilities will be measured at fair value through profit and loss, meaning that changes in own credit risk will have a much greater impact on the financial statements. This concerns us.
    - We think further consideration should be given to the treatment of long-term debt that is used by entities to finance operations.

Basic Loan Features

3 The ED describes the idea behind the notion "basic loan features" in the following terms: an instrument has basic loan features if its contractual cash flows represent principal and interest on that principal and the interest is consideration for the time value of money and the credit risk of the issuer of the instrument. However, we have concerns about the way this notion has been articulated in the ED because we think it is not always clear how the notion should be applied and in other cases we disagree with how the ED proposes the notion should be applied.

A lack of clarity

4 We think it is not clear how the basic loan features test is to be interpreted in relation to trade receivables and payables, and other balances that are not generally viewed as contractual cash flows representing interest and principal.

5 We also do not think it is clear how the payment of fees (upfront or over the life of the instrument) or incentive payments should impact the assessment of basic loan features. These are contractual features that are not interest as defined (i.e. consideration for the time value of money or credit risk of the borrower as set out in paragraph B1). They are however contractual features that give rise to cash flows.

6 In order to address these concerns about lack of clarity, we think the IASB should:

(a) include a principles-based definition about what characteristics of the instrument should be considered when determining whether an instrument that is managed on a contractual yield basis is eligible to be measured at amortised cost;

(b) include in that principle a reference to financial instruments without leverage; and

(c) make it clear that that reference to 'leverage' includes credit leverage. In particular, the principle-based description should make it clear that the amount of credit risk relative to that of the issuer and, in the case of tranched instruments, of the principal underlying investments is a relevant factor.

We also think such redrafting might result in the characteristics of the instrument test being labelled as something other than the 'basic loan features' test.

Disagree with how the ED applies the notion

7 In our response to Question 4, we highlight two areas in which we have concerns about how the ED is proposing to apply the 'basic loan features' test. They involve tranched debt and certain hybrid instruments.

Instrument is managed on a contractual yield basis

8 In Appendix 1 we discussed the classification and measurement model proposed in general terms and said that we believe that, broadly speaking, the business model test described in the ED is heading along the right lines. However, we have some concerns about the detail and, as with the 'characteristics of the instrument' test, we think the test is not as clearly articulated as it could be and in some cases is not being correctly applied.

A lack of clarity

9 In the paragraphs below we highlight areas where we believe the application of the current business model test is not clear.

<u>At what level should the test be applied?</u>

10 The ED explains that whether financial instruments are managed on a contractual yield basis does not depend on management's intentions for an individual instrument; rather it depends on how management actually manages the instruments. The guidance in the ED on the one hand refers to business units and at the same time talks about "how management manages instruments". As a result, it is not clear at which level the ED intends the condition "managed on a contractual yield basis" to be applied. Does it have to be based on business units or should it be applied more narrowly than that, say on a portfolio basis? For example:

(a) Consider the example of an entity that does not separate its trading business from its banking business—and as a result comprises only one business unit—but does nevertheless hold some portfolios of instruments for trading purposes and some others for yield purposes. Therefore, if the test is to be applied at the business unit level, we think it would mean measuring all portfolios—those that are held for trading and those that are held for yield purposes—at fair value, but we do not know whether that is the intention.

(b) Consider the example of an entity that has a separate trading business unit and within that business unit has instruments that it never intends to trade. (An example of this could be a portfolio of liabilities that are funding the trading book. Another example is the practice that some financial institutions have been following of classifying certain instruments as held for trading even though they were not—and in some cases could not be—traded.) Would these instruments be required to be measured at fair value?

<u>Selling some or all of an instrument that is managed (entirely or in part) on a contractual yield basis</u>

11 We agree with the ED's proposal that the condition 'managed on a contractual yield basis' should not be subject to 'tainting provisions'. Appropriate disclosures highlighting the amounts of instruments sold, the effect on profit or loss and the reason for selling the instruments that were being managed on a contractual yield basis until they were sold should provide decision-useful information to users about such sales.

12 However, we do not think it is clear how the proposals should be applied if management, while holding a portfolio of instruments for yield, tries to maximise the yield by, say, selling some instruments in the portfolio and acquiring others with a higher yield. Also, what if an entity actively manages the interest rate element of an instrument through hedging strategies? What if for risk purposes the management of the company evaluates instruments on a fair value basis while for operational purposes holds the same instruments for their yield? Or, if an entity matches durations of the assets and liabilities in asset/liability managed portfolios rather than orienting itself for holding instruments in such portfolios until maturity, would the 'managed on a contractual yield basis' still be met? We think part of the issue here is that many institutions manage the risks arising from instruments, rather than the instruments themselves, yet the ED is proposing that an instrument-based test should be applied.

<u>Transfers of financial instruments</u>

13 We do not think it is clear how instruments used as collateral in a repo transaction or how factored receivables are to be accounted for under the proposals. Paragraph BC33 states that "sales or transfers of financial instruments with basic loan features before maturity would not change the business model of an entity, as long as such transactions were consistent with managing the collection or payment of contractual cash flows rather than realising changes in fair values". The fact that a sale or transfer has to involve "realising changes in fair values" presumably means that the sale or transfer of financial assets as collateral through many repo and factoring transactions would not be treated as sales or transfers for the purpose of paragraph BC33. It would be helpful to clarify this.

14 It would also be helpful more generally to consider the interaction of the proposals developed in the project on derecognition and the requirements on classification of financial instruments more generally.

Disagree with how the ED applies the notion

15 In the paragraphs below we highlight areas where we disagree with how the ED is proposing to apply the business model test.

<u>Instruments acquired at a discount that reflects incurred credit losses</u>

16 Paragraph B13(b) states that an example of a financial asset that is not managed on a contractual yield basis is a financial asset that is acquired at a discount that reflects incurred credit losses. This would mean that, for example, impaired loans sold under new rules adopted by Governments to help resolve the recent financial crisis would be required to be measured at fair value. We question whether this treatment is appropriate (because we believe that measuring certain of these instruments at amortised cost can produce decision-useful information). We also wonder whether the treatment is consistent with the thinking underlying the expected loss model that the IASB is working on in another part of the IAS 39 replacement project. In our view, although it could perhaps be argued that a literal interpretation of the words in the ED would lead to the conclusion that such assets are not managed on a contractual yield basis, we think either that interpretation or the wording itself is wrong because measuring such assets on an amortised cost basis would result in useful information.

17 We also have concerns about the reasoning given in the ED for the proposals in this area.

(a) We think the reasoning is confused. On the one hand, paragraph B13 of the ED says such loans are an example of instruments that do not meet the condition of being managed on a contractual yield basis in the corresponding application guidance. However, paragraph BC29 of the Basis for Conclusions states that such instruments do not have basic loan features.

(b) Furthermore, paragraph BC29 explains that such instruments do not have basic loan features by saying "An investor acquiring an instrument at such a discount believes that the actual losses will be less than the losses that are reflected in the purchase price. Thus, that instrument creates exposure to significant variability in actual cash flows and such variability is not interest."

(i) We think that what "the investor believes" is not a characteristic of the instrument, and therefore has nothing to do with whether the instrument has basic loan features.

(ii) In our view what "the investor believes" seems to be more an attempt to capture the business model. If that is the case, when the investor does believe that "the actual losses will be less than the losses that are reflected in the purchase price" paragraph B13 is right to say that such loans are not managed on a contractual yield basis—so the requirements in the ED seem to be in line with this reasoning rather than explanations in the Basis for Conclusions. However, we do not think it is appropriate to presume that investors acquiring instruments at discounts that reflect credit losses always believe that the actual losses will be less than the losses that are reflected in the purchase price.

(iii) In any case we find paragraph BC29's explanation confusing. Generally, an entity issuing even a 'normal' loan would have different expectations as to the actual cash flows compared to the contractual cash flows due to a risk of default. We are not convinced that there is a difference of substance between such instruments and instruments acquired at a discount reflecting incurred credit losses that justifies the use of different measurement bases.

18 We think that, while in some situations instruments acquired at a discount that reflects incurred credit losses may well be managed on a basis other than contractual yield, it is not correct to assume that this will be always the case. Therefore we believe that the standard should not prescribe how such instruments should be categorised.

19 Based on the above concerns, we note in this context that the G20 recommendations talk of the need to improve the standards for the valuation of financial instruments *based on investors' holding horizons*. (emphasis added) It could be argued that holding an instrument for the longer-term implies holding it in order to obtain a return from the cash flows generated by the instrument rather than by disposing of the instrument. The IASB is proposing to operationalise this by applying a managing for contractual yield test, but we wonder whether the business model principle would be more effectively articulated by focusing on whether instruments are managed on *an expected* yield basis, rather than a *contractual* yield basis. We believe that such an approach would deal more appropriately with purchases of loans at a discount reflecting impairment and also appears to sit more

comfortably with an expected loss model (which by definition accepts that one generally does not receive all the contractual cash flows).

Application of the tests to financial liabilities

20 We have particular concerns about the way the characteristics of the instrument and business model tests as described in the ED would apply to financial liabilities.

Own credit risk

21 Under existing IAS 39 structured liabilities and similar instruments are generally bifurcated, with the embedded derivative measured at fair value and the host at amortised cost. Under the proposals in the ED, bifurcation is not permitted; so the instrument will need to be classified by considering it as a whole. As the embedded derivative would generally mean the instrument as a whole does not have basic loan features, the liabilities would be measured at fair value through profit and loss. On the basis of the IASB's current thinking on fair value measurement, that would mean measuring such instruments at amounts that reflect changes in own credit risk.

22 We recognise that this is an area on which the IASB is doing further work—hence the recent IASB discussion paper *Credit Risk in Liability Measurement*—but the proposals in this ED make that other further work all the more important and relevant because the result of the ED's proposals seems likely to be many more financial liabilities being measured at fair value; in other words, own credit risk having a much greater impact on the numbers in the primary financial statements than hitherto.

Long-term debt that finances the reporting entity

23 We think further consideration should be given to the specific nature of financial liabilities, in particular long term debt that is used by entities to finance operations. For example, we think it is arguable that most treasury functions would 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. We therefore consider that the interaction between being managed on a contractual yield basis and the definition of basic loan features needs to be re-evaluated for liabilities that serve a funding purpose. This could be achieved in a number of ways, including perhaps:

(a) extending what is meant by a basic loan feature specifically for long term debt issued by an entity;

(b) making the business model (i.e. financial liabilities used for long-term funding) the sole test for liability classification purposes. We recognise that this may require the development of additional criteria; or

(c) addressing the bifurcation rules for financial liabilities (see our response to Question 4(a)).

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?**

Summary of EFRAG's view:

- We broadly agree with the classification model proposed and that the business model and the characteristics of the instrument tests are appropriate conditions for determining which financial asset or financial liabilities should be measured at amortised cost.
- However, as we explain in our responses to Questions 2 and 4, we have some detailed—but nevertheless important—concerns about both the business model test and the basic loan features test described and with the application guidance provided.

24 As we explained in Appendix 1, we broadly agree with the classification and measurement model proposed in the ED. In particular, although we have some detailed concerns about both the business model test and the characteristics of the instrument test, we think that, broadly speaking, the ED is heading in the right direction in proposing that only instruments that are both managed on a contractual yield basis and have basic loan features should be measured at amortised cost.

25 In our response to Question 2, we highlight areas where we believe the current proposed descriptions of, and related guidance on, basic loan features and managed on a contractual yield basis need clarification or amendment. In our responses to Questions 4(a) and 4(b) below, we highlight two other areas of concern: the treatment of host contracts in which derivatives are embedded; and the treatment of tranched securities.

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.

Summary of EFRAG's view:

- Although we think the existing embedded derivatives requirements are in need of improvement (including simplification), we do not support the proposals in the ED on the subject.
- We therefore suggest that the existing requirements on embedded derivatives and bifurcation in IAS 39 are retained for the time being and the subject is revisited as future developments in hedge accounting, impairment, the treatment of credit risk in liability measurement and accounting for insurance contracts are finalised.
- A consequence of this is that we believe it should be possible under the new standard to apply the fair value option to hybrids with financial hosts for which bifurcation of an embedded derivative is otherwise required.

26 We share the concerns about the existing embedded derivatives requirements mentioned in the ED and therefore agree that it is appropriate to consider whether some sort of bifurcation requirements are really needed and, if they are needed, what form they should take.

27 However, we believe that the ED's proposal to eliminate bifurcation and require hybrid instruments to be assessed together for classification purposes has some major drawbacks. To give some examples:

(a) Under the proposals in the ED, many types of structured liabilities will be required to be measured in their entirety at fair value through profit and loss, because the structuring involves an embedded derivative. In other words, the entity would no longer have the ability to separately account for the embedded derivative and the funding component. This will result in entities including in profit and loss changes in fair value, including changes relating to own credit risk, of instruments used primarily to finance the entity. We do not believe that would be appropriate.

(b) We are concerned that it will be difficult to apply this principle beyond those situations that are addressed in the application guidance. For example, it is not clear to us whether a host financial instrument with an embedded guarantee has basic loan features. We think it is similarly unclear how to treat maturity extension options and interest indexed to inflation (both of which are addressed under the existing embedded derivative rules).

(c) We think the proposals will result in inconsistent application of the principles underlying the proposed classification model, because it will mean that an instrument will be measured at fair value when it is a host contract with a derivative embedded in it and at amortised cost otherwise. We think the financial statements would be much more useful if the principles underlying the proposed classification model were consistently applied.

28 We are also concerned about the implications of the IASB making a decision on bifurcation of embedded derivatives at this point in time when future developments arising from current IASB projects will directly impact on an assessment of the IASB's proposals. In particular, we think that to assess properly whether the IASB's proposals to eliminate bifurcation of hedge accounting are appropriate it is necessary to know what the future developments in hedge accounting, impairment and the treatment of credit risk in liability measurement will be. For insurers, the requirements of the revised IFRS 4 will also be relevant.

29 For these reasons we do not support the proposals in the ED on the treatment of embedded derivatives. Furthermore, rather than encouraging the IASB to develop an alternative approach, our view is that the IASB should retain the existing bifurcation model as set out in IAS 39 until such time as the impact of the abovementioned developments on the classification and measurement of hybrid instruments is known.

30 However, we also think that those entities that believe it is simpler and at least as useful to measure the whole hybrid instrument at fair value should be able to do so. To achieve this, we think that the circumstances in which an entity is able to use the fair value option need to be extended from those proposed in the ED to include hybrid instruments that have financial hosts with embedded derivatives that require bifurcation.

Question 4(b)—Do you agree with the proposed approach regarding the application of the proposed classification approach to contractually subordinated interests (eg 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?

Summary of EFRAG's view:

- EFRAG does not support the proposals as currently drafted.
  - Although we agree that some subordinated tranches would not exhibit basic loan features, we think it is an oversimplification to suggest that it is useful only to measure the most senior tranche at amortised cost.
  - Furthermore, we think under the approach proposed some senior tranches of certain structures will be measured at amortised cost even though amortised cost would not provide useful information.
- We would suggest that the IASB develop a principle-based description of the characteristics of the instrument test that incorporates appropriate references to leverage (and in particular credit leverage) so that entities are able to apply a substance based approach to subordinated tranches. Although we prefer the IASB not to require entities to 'look-through' securitisation vehicles to classify tranche investments, we recognise that it might still be necessary in some circumstances in order to represent faithfully the substance of the instrument.

31 We note that under the existing IAS 39 investments in waterfall structures would qualify for amortised cost measurement if markets for such instruments are inactive and such investments as a result qualify for the loans and receivables category or if the entity can demonstrate that it holds such instruments until maturity. However, any embedded derivatives that are not closely related to the host that are

determined on a look through basis are separated and measured at fair value through profit or loss; although IAS 39 also allows the entire instrument to be carried at fair value through profit or loss.

32 The proposals in the ED do not use either market activity or ability to hold instruments until maturity as a factor to distinguish between those instruments that qualify for amortised cost measurement and those that qualify for fair value measurement. Furthermore, the intention seems to be that entities should not 'look through' structured entities. The proposals are in effect that the instruments that are to be carried at amortised cost are those whose cash flows have a close relation to the amount advanced under the instrument. The ED concludes that subordinated tranches in waterfall structures do not have that close relationship (ie they do not have basic loan features).

33 We understand why the IASB has found it difficult to view instruments whose value depends on the performance of other instruments as instruments with basic loan features. We also accept that cash flows under such instruments in many cases may be very different from the amount advanced under the instrument (because the waterfall structures usually change the payments that arise from such instruments).

34 Nevertheless, we think the IASB's proposal of affording basic loan feature status to only the most senior debt in the waterfall (the most senior tranche) is an over simplification of a difficult issue. Our reasoning is as follows.

(a) Firstly, difficulties may arise in distinguishing subordination of investors due to waterfall structures from ranking of creditors in an entity.

(b) Furthermore we think it is relevant that many investments in these vehicles are held on a long-term basis and have cash flows that can be managed on a contractual yield basis (i.e. cash flows similar to the financial assets held by the vehicle).

(c) We think it is also relevant that often a number of the subordinated tranches will have a lower credit risk than the underlying instruments; in other words, that a key effect of the structuring is to reduce the volatility of cash flows from instruments that themselves have basic loan features. On the other hand, we also think that significant structuring opportunities are possible under the proposed approach by using special purpose vehicles to create instruments with basic loan features when the underlying instruments do not have such features.

35 We see this as a significant issue that needs to be resolved if we are to have a satisfactory classification and measurement model. Furthermore, we think ideally a solution should be found that does not involve looking through a securitisation vehicle to the underlying investments, because we think such approaches involve more complexity for both preparers and users. On the other hand, we accept that it might not be possible to develop a sufficiently robust approach without looking through to the underlying investments.

36 In our response to Question 2 we stated that we think a principles-based definition about what characteristics should be considered when determining whether an instrument is eligible to be measured at amortised cost should include a reference to financial instruments without leverage, including credit leverage. We think that incorporating an appropriate definition of credit leverage into the definition of 'basic loan features' may enable entities to apply a substance based approach to subordinated tranches. Based on the facts and circumstances of each particular

structure it could be determined whether the credit leverage in a subordinated tranche is sufficient to preclude it from having ‘basic loan features’. We appreciate that in some circumstances looking-through a securitisation vehicle might be the only way to determine and represent faithfully the substance of an investment. Such “looking-through” in effect applies ‘the basic loan features’ test at the level of the underlying instruments held by the securitisation vehicle.

FAIR VALUE OPTION

Question 5—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?

Summary of EFRAG’s view:

- EFRAG supports the proposal to retain the fair value option to mitigate an accounting mismatch. However, because we are proposing that IAS 39’s existing requirements on the bifurcation of hybrid instruments should be retained for the time being, we would also wish to see the option available in circumstances in which bifurcation would otherwise be required.
- We think there is a strong case for reconsidering the prohibitions in existing IFRS (and retained in the ED) on reclassifications out of the fair value option and exercising the fair value option subsequent to initial recognition. However, rather than tackle these issues as part of this phase of the IAS 39 replacement project, we suggest the prohibitions are retained for the time being and reconsidered as part of the hedge accounting project.

In what circumstances should the fair value option be available?

37 EFRAG agrees that the fair value option should be retained when its use would eliminate an accounting mismatch. We agree also with the examples given in paragraph B17 of circumstances in which an accounting mismatch might arise. We are aware that the fair value option has been used a lot by certain types of entity to eliminate or minimise accounting mismatches that would otherwise arise (for example, we know that mortgage institutions in certain jurisdictions rely heavily on paragraph B17(c)(ii) to ensure that the matches they achieve economically do not result in accounting mismatches) and it is essential for these entities to continue having this possibility in the future.

38 However, as we are arguing elsewhere in this letter (see our responses to Questions 4 and 6) for the retention for the time being of the existing IAS 39 requirements on the bifurcation of hybrid instruments, we believe that the fair value option also needs to be retained in circumstances in which bifurcation would otherwise be required.

Should reclassifications out of the fair value option be prohibited and should the option be available only on initial recognition?

39 Under existing IAS 39, if the fair value option is to be exercised, it needs to be exercised on initial recognition and cannot be revoked (in other words, reclassification of instruments designated as at fair value through profit or loss is not permitted). Over the last few years there have been a number of calls for the IASB to change its requirements so that reclassifications out of the fair value option were possible. Some have also questioned whether it is appropriate that the option

should be available only on initial recognition. The ED nevertheless proposes no changes to this aspect of the option.

40 However, it is feasible that, because of changed circumstances, either an accounting mismatch would no longer arise if the option was not exercised or that exercising the option would not eliminate or significantly reduce an accounting mismatch. Similarly, it might be that there was not an accounting mismatch on initial recognition or using the option would not have eliminated or significantly reduced an accounting mismatch; but circumstances have since changed. For example, as an alternative to hedge accounting some entities elected to use the fair value option for highly rated financial instruments so as to offset the change in fair value of interest rate derivatives. During the credit crisis, some of those entities found that unexpected changes in fair value of those highly rated assets were arising (predominantly from a lack of liquidity) and that, because those changes were not offset, they were resulting in significant earnings volatility. If the lack of liquidity had existed at initial recognition electing the fair value option would have produced as much of an accounting mismatch as it offset. Bearing all this in mind, we think there is a strong case for reconsidering the prohibitions in existing IFRS (and retained in the ED) on reclassifications out of the fair value option and on exercising the fair value option subsequent to initial recognition.

41 That said, we think that the fair value option is one of the aspects of the proposals that is difficult to assess without knowing the outcome of the other phases of the IAS 39 replacement project and in particular the outcome of the hedge accounting phase. The objective of hedge accounting is to present faithfully the hedging activities undertaken and it is generally accepted that this involves eliminating or reducing accounting mismatches to reflect that economic matches achieved through the hedging activities. As the fair value option is another way of eliminating or reducing accounting mismatches to reflect that economic matches achieved, entities tend not to take decisions about the use of the fair value option and the use of hedge accounting in isolation from each other. Bearing that in mind, the new hedge accounting requirements will have an effect on how entities will wish to use the fair value option. This in turn would influence the assessment of whether and in which circumstances it might be appropriate to allow or require reclassifications out of the fair value option and/or to allow designations after initial recognition.

42 Therefore, although we think it is imperative that the existing prohibitions are reconsidered, we also think that reconsideration can be deferred until the hedge accounting phase of the project and that until then they can remain in place. Such an approach will also avoid the risk of changing the requirements twice in a short period of time.

Question 6—Should the fair value option be allowed under any other conditions? If so, under what other conditions should it be allowed and why?

Summary of EFRAG view: • Based on EFRAG's response to Question 4(a)—where we supported the continued bifurcation of hybrid instruments for the time being—we think the application of the fair value option should be extended to apply to hybrid instruments that have financial hosts and that contain one or more embedded derivatives that require bifurcation.

43 Earlier in this letter we explained that we do not agree with the ED's proposed treatment of embedded derivatives. We suggested that for the time being the existing requirements on bifurcation of hybrid contracts should be retained. We are

also of the view that entities that wish to measure the whole hybrid contract at fair value should be able to do so. EFRAG considers that the most operational way to achieve this is to continue to make the fair value option applicable to hybrid instruments that have a financial host and contain at least one embedded derivative that requires bifurcation.

RECLASSIFICATION

Question 7—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?

Summary of EFRAG's view:

- We do not support the proposed prohibition on reclassification. In our view the classification system will be at its simplest and most transparent if an instrument is required to be reclassified if it no longer meets the criteria for its current classification.

44 The ED proposes that reclassifications between the amortised cost and fair value categories should not be permitted. The ED argues that this proposal improves comparability and eliminates the need for complex reclassification requirements.

45 EFRAG agrees neither with the proposal nor with the reasoning behind it. In our view, although there will never be a need to reclassify an instrument because of the characteristics of the instrument part of the test, there could be a change in the business model that would mean that instruments that were previously being managed on a contractual yield basis are no longer being managed on that basis or vice versa.

46 We would expect that an entity's business model would change only rarely. However, we believe it <u>can</u> change. In fact over the last couple of years a number of financial institutions (or business units within those institutions) have changed their business model. For example, some of the businesses that sold mortgages to securitisation vehicles now have a very different business model. Requiring reclassification in such cases will ensure that the only items that are currently measured at amortised cost are those that currently meet the criteria for the amortised cost category.

47 We recognise that users have had difficulties with the reclassifications made as a result of the October 2008 amendment to IAS 39, partly because of a perceived lack of transparency but also because of the additional complexity it creates. Indeed, we have heard users argue that the classification system will always be imperfect, and prohibiting reclassification helps to impose discipline on how the instruments are classified. However, we think this is too pessimistic. In our view, a significant part of the complexity and lack of transparency that users believe is created by reclassifications is in fact created by the complexities of the existing classification system, and the quality of some of the disclosures provided in support of the reclassifications that have been made. In our view, simplifying that system—which is what the ED is proposing to do—will significantly reduce the complexities that surround reclassifications, and will make it easier for disclosures to be designed that will address any transparency concerns that would otherwise exist in a comprehensive manner.

48 Turning now to the reasoning given in the ED for proposing to prohibit reclassifications:

(a) We do not agree that prohibiting reclassification will enhance comparability. Instead, what it means is that two entities that have the same business model and are managing a financial instrument in exactly the same way might be measuring it in fundamentally different ways because one acquired the instrument before a change of business model and one afterwards. Comparability requires that like things look alike and unlike things look differently.

(b) We do not agree that it necessarily follows that, if reclassification is to be allowed, there need to be complex requirements to police reclassification. In our view, if the classification system being used is based on good principles, the requirements and guidance that apply to classifications on initial recognition should be sufficient for reclassifications too—with the addition of some disclosure requirements. It is important in this context to emphasise that reclassifications are expected to be rare and can occur only when there has been a change in the way a business is managed, not merely in the way an individual financial instrument is managed or used.

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?

Summary of EFRAG view:

- We do not support the proposal to omit from the new standard the exemption in existing IAS 39 from measuring at fair value unquoted equity instruments whose fair value cannot be reliably measured (and derivatives on those equity instruments). We believe that the existing exemption should be retained.

49 We think it is very difficult to make any general statements about the measurement at fair value of equity investments that do not have a quoted market price in an active market because the facts and circumstances will vary from case-to-case. As a result, in some cases it will be possible to estimate a reliable fair value at a cost that is exceeded by the benefits to be derived from using a fair value measure, and in some cases it will not. (Partly that will depend on an entity's individual abilities to estimate fair value.) We are therefore not comfortable with the proposal that the revised standard should omit the exemption in existing IAS 39 from measuring at fair value unquoted equity instruments whose fair value cannot be reliably measured (and derivatives on those equity instruments). In our view the proposal will result in the much greater use of fair value numbers that are highly judgemental and extremely difficult to verify effectively. We are not as sure as the IASB that this is what users want.

50 It seems to us that an effect of the proposal might be that some equities will be carried at cost unless and until there is evidence that fair value (or the impaired value) is different. Although this could perhaps be an acceptable approach, we are not sure such a measure should be described as fair value.

51 We have two final comments. Firstly, whatever model the IASB adopts for equity investments, it will need to consider how to deal with embedded derivatives in an

equity investment host. That is important because, under the proposals in the ED it would appear possible that gains and losses on a derivative embedded in an equity investment could be reported in OCI and never recycled. We are not certain that is the intention.

52 Secondly, we are concerned that some seem to view this 'exemption from fair value' as some sort of 'amortised cost option'. Yet it is not an option; it is an exemption that must be applied when circumstances dictate, and cannot be applied in other circumstances by choice. If a fair value that previously could not be reliably determined becomes reliable (for example because the entity has listed its shares under an Initial Public Offering), the exemption is no longer applicable. We would support any efforts the IASB could make to reinforce this message.

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?

Summary of EFRAG view:

- We think there could be circumstances in which, if entities are forced to measure equity investments on an ongoing basis at fair value when there are very significant reliability issues involved in estimating those fair values, there may be no improvement in decision-usefulness.
- We do not believe however that it necessarily follows that something other than fair value would need to be used in the impairment test, because we believe the benefits might differ when an impairment is involved.

53 As we said in responding to the previous question, it is difficult to make any general statements on this issue because the facts and circumstances will vary from case-to-case. However, we think there could well be circumstances in which, if entities are forced to try to estimate fair value when there are very significant reliability issues, there may be no improvement in decision-usefulness. There could well be other circumstances in which it would result in improved decision-usefulness but the benefits of that would not outweigh the costs of providing the information.

54 It seems to us that the second part of the question assumes that, if the benefits of improved decision-usefulness do not outweigh the costs of providing this information, something other than fair value would need to be used in the impairment test. We do not think that is necessarily the case; the benefits might differ when an impairment is involved.

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?

Summary of EFRAG's view:

- We agree that more useful information can sometimes be provided by presenting some or all of the total return on equity investments in OCI, rather than in profit or loss.

- EFRAG supports the proposal that the standard should not be prescriptive as to which equity investments should be accounted for in some other way than at fair value through profit or loss; rather there should be an instrument-by-instrument option.
- We do not support the proposal that IAS 39 should be amended now to require that, if an equity investment is not to be accounted for at fair value through profit or loss, the total return on the equity investment (dividends, impairments and other value changes) should be recognised in OCI and no elements shall be recycled to profit or loss.
- In our view, until the fundamental presentation issues relating to performance reporting are addressed, the existing available-for-sale approach to presentation and recycling should be retained for equity investments. At the same time, we believe the impairment requirements that currently apply to available-for-sale equity investments should be simplified, and this should include reconsidering the prohibition on reversal of impairment losses through profit or loss for such items.

Allowing entities to recognise the return on an equity investment in OCI with no recycling

55 Some equity instruments are purchased for strategic purposes (ie they are not held with the primary objective of realising a profit from increases in the value of the instrument and dividends) and, where that is the case, we agree it can be helpful to present some or all of the return on such investments outside of profit and loss (ie in OCI).

56 We also think there is merit in presenting all elements of the total return on an equity investment (ie dividends, impairments and other value changes) in a single place because they can be closely related to each other.

57 However, we also recognise that such proposals raise issues that go far beyond financial instrument reporting. In particular, they raise issues about the role of the OCI and recycling in reporting performance that the recent Discussion Paper *Financial Statement Presentation* did not address because they are difficult to resolve quickly. For example:

(a) There is no principle that currently underlies the requirements in IFRS as to which items are presented in profit or loss and which in OCI. As such, it is not possible to state categorically whether all or any of the components of the total return on equity investments are items that should be presented in OCI.

(b) Similarly, there is no principle that currently underlies the requirements in IFRS as to if and when gains and losses presented in OCI are recycled (or reclassified) to profit or loss. As such, it is again not possible to state categorically whether it is appropriate that none of the components of the total return on equity investments will be recycled from OCI (if that is where they have been presented).

58 Bearing this in mind, we think that it is unrealistic to expect this ED to resolve these deep underlying issues. In our view, all that can reasonably be expected is that the revised standard should include a broadly satisfactory pragmatic short-term solution to the issues involved, pending resolution of the underlying issues. In view of this, EFRAG:

(a) supports the proposal that the standard should not be prescriptive as to which equity investments should be accounted for in some other way than fair value through profit or loss; rather, there should be an instrument-by-instrument option to account for equity investments differently;

(b) recommends that, as an interim measure, that 'other way' of accounting for equity investments should be to account for them in accordance with the existing available-for-sale model. In other words, dividends would be recognised immediately in profit or loss, impairments would also be recognised in profit or loss, and other value changes would be recognised in OCI and recycled to profit or loss on derecognition. However, as discussed in greater detail below, although we are in effect arguing for keeping the status quo on this aspect of financial instruments reporting, we nevertheless believe it is important that the IASB reconsider now certain aspects of the existing impairment test that applies to equity investments classified as available-for-sale.

Impairment of equity investments under the available-for-sale model

The prohibition on reversals

59 Under the existing impairment requirements for equity investments classified as available-for-sale, impairment losses are accounted for by reclassifying the amount involved from OCI to profit or loss. However, reversals of such impairments are prohibited. We believe that, if the existing available-for-sale model is to be carried forward into the new standard as an interim measure for equity investments, consideration needs to be given to omitting this prohibition.

60 While we understand that prohibiting the reversal of impairments of equity securities was a pragmatic solution to difficulties in distinguishing reversals of impairment from other increases in fair value (as explained in paragraph BC130 of IAS 39), we believe that this solution has significant drawbacks. At a conceptual level in the context of the IFRS impairment model, it is difficult to understand why the reversal of impairment on equity securities should be prohibited. Moreover, in practice anecdotal evidence suggests that, given the subjectivity involved in determining what constitutes impairment, the prohibition is causing entities to delay recognition of impairment losses for as long as possible, which may potentially be misleading for investors.

Improving the impairment test

61 We also believe that, if the existing available-for-sale model is to be carried forward as an interim measure for equity investments, consideration needs to be given to simplifying the existing test of when an impairment loss should be recognised. Indeed, eliminating the prohibition on reversing impairment losses would in any case probably require a change to the requirements that stipulate when entities should recognise an impairment loss.

62 We think the IASB should consider introducing a so called "lower of cost or market" approach in which all changes in fair value below cost are recognised as impairments and as a consequence all reversals of impairments would be recorded through profit or loss. Such an approach has the advantage of simplicity, and it would also eliminate concerns about the subjectivity involved in determining what constitutes an impairment or a reversal of impairment. We note that the IASB considered but rejected such an approach when revising IAS 39 in 2003 because it felt that it would "significantly change the notion of 'available-for-sale' in practice".

Given that under the current project the IASB is in any case eliminating the notion of 'available-for-sale', that argument should no longer prevent this pragmatic solution from being adopted until the long-term issues can be fully debated.

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:

(a) What principle do you propose to identify those for which presentation in other comprehensive income is appropriate?

(b) 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?

Summary of EFRAG view:

- EFRAG believes it is appropriate to make the presentation choice available for all equity investments at the current time, and therefore agrees with the proposal.
- We support the ED's proposal to require a once-and-for-all decision to be taken about presentation on initial recognition.

63 EFRAG believes that the ED is right to make the presentation choice available for all equity investments at the current time, rather than developing a principle and/or making the choice available just for certain types of equity. Perhaps this is an area where, as practice evolves, the option can be narrowed.

64 However, as stated above, in order to make this choice applicable to all equity instruments, the requirement that all elements of the total return should be recognised in OCI and no elements can be recycled needs to be reconsidered. EFRAG proposes in its response to Question 10 above that the the existing available-for-sale approach should be retained, albeit with some changes to the impairment model.

65 The proposal in the ED is that the choice of presentation is to be made on initial recognition, and thereafter is irrevocable (in other words, reclassification from the 'fair value through OCI' category to the 'fair value through profit or loss' category or vice versa is not possible). We support this proposal. Unlike the criteria for determining whether a financial instrument is "managed on a contractual yield basis"—which is based on facts and circumstances that exist at a point of time—an election to present fair value gains or losses on an equity investment through OCI is a purely optional election. We do not consider that it would be appropriate to base a reclassification solely on a change in management intent and therefore support the ED's proposal to require a once-and-for-all decision to be taken on initial recognition.

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?

Summary of EFRAG view:

- EFRAG agrees that the proposed disclosures are useful and should be provided by those transitioning to the new standard early. However, we think they are still useful disclosures even if the reporting entity is not an early adopter, so we would require them to be provided by all entities on transitioning to the new standard.

66 The proposals in this ED will, if implemented, involve some fundamental changes to financial instrument reporting. It is important therefore that they should be implemented in a way that causes minimum disruption for users. Requiring retrospective application of the new requirements will help here, but additional disclosures will still be necessary to help users to understand the changes that are being made and the effects that they have had and are likely to have in the future. For that reason, we support the proposal that additional disclosures are needed.

67 However, the ED proposes that those disclosures should be provided only by those entities that early adopt. We assume the reason for this is to ensure comparability between those entities that have early adopted and those that have not. Although we think this objective is worthy, we also think the disclosures have value in their own right and should in fact be required on transition, regardless of whether that is on the effective date or prior to it. We also think that requiring the disclosures on any transition date has the advantage of alleviating a potential concern that the disclosures could be seen as an additional burden for early adopters.

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

Summary of EFRAG's view:

- A longer lead time together with a possibility to adopt the standard before its effective date could distort comparability between entities for quite some time. Nevertheless, we believe it is an acceptable compromise under the circumstances and we support the effective date as proposed by the IASB.

- If an entity chooses to implement the classification and measurement phase early, it should be able to reconsider the way it has implemented that phase on implementation of the impairment phase and on implementation of the hedge accounting phase. In addition, the IASB will need to consider the circumstances in which insurance companies will find themselves, having to take their IAS 39 classification decisions without knowing what the revised, comprehensive version of IFRS 4 *Insurance Contracts* will require.

- Even though we appreciate that practical difficulties may arise in application of the final standard on the classification and measurement of financial instruments, our preferred option would be the retrospective application for the new classification and measurement model as proposed in the ED. In line with EFRAG's general position, adoption of amendments or new standards should not distort the comparability of financial information through time because we believe that it is very important for users to be able to compare the financial statements of an entity between successive years.

Effective date

68 We understand that some entities will want to implement the simpler, improved classification and measurement model proposed in the ED as soon as possible, whilst others will wish to wait for the impairment and hedge accounting phases—and even related projects such as insurance contracts—to be finished so that they can implement an integrated set of changes. The IASB is proposing to meet the needs of both types of entity by having an extended transition period.

69 We note that an issue with long lead times when there is also the possibility of adopting the standard before its effective date is that comparability between entities could be affected for quite some time. This is a concern. On the other hand, the classification and measurement model proposed in the ED is intended to result in improvements in the information provided to users, so an appropriate balance needs to be struck. We believe the ED is proposing an acceptable compromise under the circumstances and we support the IASB's proposals.

70 The IASB's work on the classification and measurement of financial instruments is the first phase in a three phase project to replace IAS 39. We discussed the implications of adopting a phased approach in Appendix 1 of this letter. In addition to the comments made in that appendix, we believe that it is necessary that, if an entity chooses to implement the classification and measurement phase early, it should be able to reconsider the way it has implemented that phase—in other words, it should be able to reclassify instruments and reconsider accounting choices made—on implementation of the impairment phase and on implementation of the hedge accounting phase. To not allow this would in effect be punishing an entity for choosing to implement the improved classification and measurement model as early as possible.

71 In addition, we think the IASB will need to consider the circumstances in which insurance companies will find themselves, having to take their IAS 39 classification decisions without knowing what the revised, comprehensive version of IFRS 4 *Insurance Contracts* will require. In our view it is important that insurers have the opportunity to consider the implementation of these standards as a package. This means, in our view, that:

(a) the IASB could extend the IAS 39 classification and measurement transition period for insurers up to the effective date for the new IFRS 4, or

(b) the IASB could grandfather the existing available-for-sale requirements for insurers until the effective date for the new IFRS 4, at which time the new classification and measurement requirements would also apply to such instruments; or

(c) the IASB could allow insurers the chance to reclassify their financial instruments on implementation of the new IFRS 4.

An advantage of option (b) is that insurers would be able to change the way they account for their assets and the way they account for their liabilities at the same time. However, bearing in mind that the new IFRS 4 still seems some way off, option (c) might be preferable.

72 At a more detailed level, we understand that the transitional provisions (see paragraphs 24-26 of the ED) give a possibility for this [draft] IFRS to be applied initially at any time during a reporting period. Our preference would be that the initial application date would be the first date of an annual reporting period: giving a free choice as to the initial application date could lead to manipulation with entities "shopping" for the best date, in terms of financial impact, within a particular period. However, if the reason for allowing the flexibility in choosing the initial application date was in order to enable entities to implement the new standard in 2009 financial statements, a possibility could be to limit that flexibility to 2009 financial statements.

Retrospective application

73 As a matter of general policy, EFRAG much prefers new or amended standards to be applied on a retrospective basis because we think it is very important for users to be able to compare the financial performance of an entity over time. We understand that applying the proposals in the ED will be a significant undertaking for many organisations, in particular financial institutions, and that whether the standard is to be applied retrospectively, prospectively, or somewhere in between could make a significant difference to when entities will implement it. Nevertheless, our preferred option would be the retrospective application proposed in the ED.

AN ALTERNATIVE APPROACH

Question 14—Do you believe that this alternative approach provides more-decision useful information than measuring those financial assets at amortised cost, specifically: (a) In the statement of financial position? (b) In the statement of comprehensive income? If so, why?

Summary of EFRAG's view:
• We do not believe that the alternative approach provides more-decision useful information than the approach proposed in the ED. In our view the amortised cost category under the alternative approach would be too narrow.

74 As explained above, the main differences between the alternative approach and the approach proposed in the ED are that the alternative approach involves a narrower amortised cost category and a different presentation of the fair value gains and losses arising on the instruments (with as cost-based gains and losses being presented in profit and loss and the remaining gains and losses in OCI).

(a) We do not support the narrowing of the amortised cost category in this way. In our view there are a wider range of financial assets for which amortised cost provides useful information than just loans and receivables that have basic loan features and are managed on a contractual yield basis. We note furthermore that the principle behind adding an additional classification test relating to loans and receivables is not clear and has not been articulated by the Board. In addition, we are uncertain how the alternative approach applies to financial liabilities.

(b) We agree that users find it useful for cost-based gains and losses to be presented separately from other gains and losses.

(i) However, presenting the cost-based gains and losses in profit or loss and other gains and losses in OCI (with no recycling) is only one way—and not necessarily the best way—of achieving that separate presentation.

(ii) The presentation proposed would require entities to carry out incurred loss impairment tests on financial assets measured at fair value. We are not sure whether it is intended that impairment tests would be carried out on all financial assets—including those that are being actively traded—or just some financial assets (for example, those that would be measured at amortised cost under the approach proposed in the ED).

- We doubt that much useful information is provided by carrying out incurred loss impairment tests of financial assets that are, for example, being actively traded.

- We agree that applying an incurred loss impairment model to other financial assets measured at fair value is probably preferable to the existing approach in IAS 39, but we find it difficult to judge whether it is better than the approach proposed in the ED.

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?

Summary of EFRAG's view:

- We do not believe that either of the possible variants of the alternative approach provides more decision-useful information than the approach proposed in the ED.

- In particular, we are not in favour of the introduction of a full fair value measurement model for financial instruments at this time, even if it is restricted only to the statement of financial position.

75 Under the first variant, instruments would be measured for statement of financial position purposes in the same way as under the alternative approach discussed in our response to Question 14. As we explained in responding to Question 14, we believe the alternative approach's amortised cost category is too narrow.

76 The second variant would in effect require a full fair value statement of financial position, but with only some of the resulting gains and losses presented in profit or loss. As we made clear earlier in this letter, EFRAG supports the use of a mixed measurement system for reporting financial instruments.