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Mr Stig Enevoldsen
European Financial Reporting Advisory Group
13-14 Avenue des Arts
B-1210 Brussels
Belgium

11 November 2009

Dear Mr Enevoldsen,

Invitation to Comment: Draft Endorsement Advice on IFRS 9 Financial Instruments – Classification and Measurement

We appreciate the opportunity to comment on EFRAG's draft endorsement advice on IFRS 9 *'Financial Instruments'*.

Following consultation with members of the PricewaterhouseCoopers network of firms in Europe, this response summarises the views of member firms who commented on this draft advice. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Support for EFRAG's positive endorsement advice

We attach for information our comment letter issued to the IASB in September on its previous Exposure Draft on *'Financial Instruments - Classification and Measurement'*.

Having reviewed the IASB's latest near-final draft of IFRS 9, and compared it with the comments in our earlier letter, our view is that the changes made by the IASB to the proposals deal substantially with the significant issues that we raised.

Accordingly, we support EFRAG's overall conclusion in its draft advice that EFRAG should recommend endorsement of IFRS 9 so that it is available for use in the European Union.

We would be happy to discuss our views further with you. If you have any questions regarding this letter, please contact Richard Keys (+44 20 7212 4555) or Pauline Wallace (+44 20 7804 1293).

Yours faithfully,

PricewaterhouseCoopers LLP

cc Mr Jorgen Holmquist, European Commission

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ANNEX

PwC Response to IASB on its Exposure Draft on Classification and Measurement

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

14 September 2009

Dear Sir

Exposure Draft Financial Instruments: Classification and Measurement

We are responding to your invitation to comment on the above Exposure Draft on behalf of PricewaterhouseCoopers.

Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms who commented on this exposure draft. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We recognise the significant efforts that the Board is making to respond promptly to current economic events and the requests of the Financial Stability Forum and, in particular, to ensure that reporting entities are given the opportunity to apply the new principles of classification and measurement for 2009 financial reports. As a general rule, we do not support a phased approach to the development of accounting standards as this creates uncertainty for preparers and risks confusion for users. However we understand that this has been an inevitable result of the perceived urgency of the issue. We therefore welcome the opportunity to comment on Board's proposals on the first phase of this important topic.

We are disappointed to note that the urgency of the project has meant that the Board has been unable to work to the same timetable as the FASB on this topic. The recent crisis has illustrated the importance of ensuring convergence in reporting exposure to financial risk. We were therefore pleased that the Boards held joint roundtables to discuss their proposals before the end of the consultation period. Accounting for financial instruments is an important area of accounting with far reaching consequences and dynamics. We will continue to monitor developments in this debate globally and we will consider any new information that may emerge. We encourage the IASB to do the same. In particular we urge the Boards to engage in continuing dialogue with each other and with constituents and to work together to develop a single model of classification and measurement as the basis for a high quality single converged standard for financial instrument accounting.

The application of a mixed measurement model

As indicated in our comment letter dated 5 September 2008 in response to the Discussion Paper on Reducing Complexity in Reporting Financial Instruments, we support the continued application of a mixed measurement model for financial instruments but recognise the need for the removal of excessive complexity from the current model. Accounting standards should be based on principles

rather than rules and result in clear and transparent financial statements that faithfully represent the economic consequences of transactions and set results in the context of the entity's business model. We therefore welcome the Board's proposal that accounting should reflect, at least to some extent, the different objectives for originating, acquiring, issuing or holding financial instruments. We also support the proposal that the model should be simplified to require, in essence, two measurement models for financial instruments: fair value and amortised cost.

In our view, the business model employed by a reporting entity should be the primary factor in determining how best to report the amount, timing and uncertainty of cash flows for financial instruments. The strategy behind entering into a financial instrument should affect its classification and ultimately its accounting and reporting. In other words, the accounting for financial instruments should primarily reflect the way the business is run and managed and not be pre-determined solely by contractual characteristics. We therefore support the notion that amortised cost is an appropriate measurement attribute for financial instruments that are held predominantly for the collection or payment of the contractual or expected cash flows rather than to sell or settle with a third party. On the other hand, we believe that fair value is the most appropriate reporting basis for instruments which are held with a view to realisation through sale.

We recognise, however, that there are some financial instruments that, by their nature, are unsuited to an amortised cost model because they contain features that do not compensate the holder solely for the time value of money or credit risk. It is unlikely that such instruments can be managed solely on the basis of cash flows. Consequently we support the inclusion of a secondary criterion, based on the characteristics of the instrument, for determining its classification. As indicated in our detailed responses in the Appendix, however, we believe that the principle set out in the exposure draft needs some modification to be suitable for this purpose.

In addition to the comments made above, we address some more detailed concerns about the Board's proposals in the attached appendix. In particular, we believe that it is essential that the criteria relating to the business model and basic loan features are clearly defined as a principle to ensure that they can be consistently applied in practice. Furthermore, we do not agree with the proposals to require fair value treatment to all financial assets acquired at a discount or to all tranches of debt issued by structured vehicles below the most senior tranche. As discussed in more detail in the appendix, we believe that a more precise articulation of the principles for classification will ensure that these instruments will be classified and accounted for appropriately.

Reclassification

In view of our support for the business model as the primary factor behind the classification of financial instruments, we do not support the prohibition on any subsequent reclassification. In fact, we believe that this is inconsistent with the use of the entity's business model as a criterion for classification, even where the characteristics of the instrument carry equal weight. We assume that this prohibition is intended to be an anti-abuse provision but do not agree that this is either necessary or appropriate in a principles-based standard.

As indicated in paragraph BC32 of the Basis for Conclusions on the Exposure Draft, an entity's business model is not a voluntary designation but rather a matter of fact that can be observed from the way that an entity is managed. Consequently, a change in the way in which a portfolio is managed will equally be a matter of fact and should be reflected by a prospective reclassification of affected instruments into the appropriate category at the time of the change. Such reclassifications should be both from amortised cost to fair value and vice versa, as appropriate, and should be mandatory where the business model changes.

We do not expect the business model to change frequently but, where it does, any such changes should be reflected in the accounting. Furthermore where reclassifications are required there should be full and transparent disclosures to ensure that users have a clear understanding of how,

and why, the business model of the entity has changed and the impact that this has had on the financial statements. Prospective application of changes in the business model as well as robust disclosures should alleviate any concerns over abusive reclassifications.

Equity investments

We recognise that equity investments lack contractually determinable cash flows and are held for appreciation in value realised either through discretionary dividends or an ultimate sale and hence that amortised cost is not an appropriate measure. We therefore support the proposal that these should be measured at fair value in the balance sheet. Nonetheless, as indicated in our response to the Discussion Paper on Reducing Complexity in Reporting Financial instruments, we believe that the current use of the available for sale category for equities allows for a better reflection of the business model for holding equity investments as a long term strategy than requiring income statement recognition of the movements in fair value.

The proposal in the exposure draft for a voluntary election to present in other comprehensive income all fair value changes, including dividends, on selected equity investments with no subsequent recycling achieves the objective of allowing such volatility to be excluded from the income statement. However by concluding that recycling of realised gains and losses is inappropriate, it pre-empts the debate around the purpose of the other comprehensive income statement that rightly belongs in the financial statement presentation project. Furthermore, the prohibition on the recognition of dividends on such investments in the income statement results in an accounting mismatch between dividend income and funding cost that is important for an understanding of the business model of long term investors in equities such as insurance companies. Consequently, we recommend that any decision to eliminate the available for sale category for equity investments is deferred until the financial statement presentation project has been fully debated and the role of the other comprehensive income statement has been established.

The retention of the available for sale category for equity investments means that it is not possible to eliminate one related source of complexity – impairment. We believe that much of the difficulty associated with determining the timing of impairment of such instruments could be eliminated if subsequent reversal of impairment losses were permitted. Consequently we recommend that all fair value movements below cost, including subsequent recoveries in value, should be recognised in the income statement once the impairment event (a significant or prolonged decline below cost) has occurred.

As far as the Board's proposal is concerned, we note that the decision not to allow any recycling through the income statement has the effect of excluding dividend income from net income. This is counter-intuitive since the payment of dividends is not contractual and is outside the control of the investor. As stated above, it can also result in an accounting mismatch between dividend income and the associated funding cost that may impair an investor's understanding of the financial performance of the entity. If the Board decides to proceed with this model, we would encourage them to address this issue, although care would need to be taken to ensure that the recognition of dividends in the income statement does not extend to returns of capital. However, in view of the additional complexity any such amendment would introduce, coupled with the difficulty of defining the circumstances when the optional treatment is appropriate and the risk of pre-empting the wider debate around the performance reporting model, we do not support the Board's proposal.

Financial liabilities

As indicated above, we support, in general terms, an approach which classifies financial instruments based primarily on the business model but also taking into account the characteristics of the instrument. We recognise, however, that this model, if not modified, would result in an increased use of fair value through the income statement for structured financial liabilities and in a

consequential increase in the impact of movements in an entity's own credit risk on the income statement. We acknowledge the concerns expressed in the recent report of the Financial Crisis Advisory Group which recommended that "the Boards should reconsider the appropriateness of an entity's recognition of gains or losses as a result of fair value changes in the entity's own debt because of decreases or increases, respectively, in its creditworthiness". This debate has only just begun with the recent publication of the staff paper for comment.

The proposed treatment will also create income statement volatility for some long-term funding structures. In many cases non-financial entities issue structured debt for funding purposes where there is market appetite for such instruments making it easier to raise funds in this form. Such entities will usually hedge the resulting exposures to simulate the issuance of a 'vanilla' debt instrument. We do not consider that the income statement volatility created by the proposal for such instruments provides decision-useful information in these circumstances. However, any alternative model is inextricably linked with the ability to achieve hedge accounting which will not be addressed until the third phase of this project.

Finally we note that the Board is still deliberating on its proposals to amend the classification of debt and equity. This project may result in a change in classification for equity components of compound instruments which will then need to be accounted for in accordance with this standard.

In the light of the above we urge the Board to retain existing guidance for financial liabilities and to reconsider their proposals once the debates around movements in own credit, hedge accounting and the classification of debt and equity have been resolved.

Fair value option

The right to carry any financial asset or liability at fair value is important to many entities, particularly in the financial services sector, and therefore we continue to support an unrestricted fair value option. We note that the requirement to designate a financial asset or liability at inception and the prohibition on subsequent reclassification, which we support, impose stringent conditions on the selection of the option which reduces incentives for abuse.

We recognise, however, that an unrestricted fair value option has been opposed by many in the past and that it may not be practical to introduce it now. Therefore, if the Board decides to proceed with a restricted fair value option, we agree that, as a minimum these restrictions should not prevent an entity from applying the fair value option where there is an accounting mismatch. In general, we support the prohibition on subsequent reclassification of financial instruments under the fair value option but we believe that there should be some flexibility where an accounting mismatch is created or removed by a change in the accounting policy relating to the matching asset or liability. In such circumstances, a reporting entity should be allowed to apply, or cease to apply, the fair value option to existing assets and liabilities. This is particularly important since both hedge accounting and the treatment of insurance contract liabilities are currently under review by the Board and may result in future changes.

Transition

We note that one of the key objectives of the Board in publishing these proposals separately from its proposals to amend the impairment and hedging requirements of IAS 39 is to permit early adoption in 2009. Consequently we believe that it is important to ensure that the transition requirements are practical to adopt within a very short timescale. In particular, we believe that full retrospective application and the restatement of comparatives are likely to prove prohibitive for early adopters. We therefore recommend that reporting entities adopting the standard early are not required to restate comparatives.

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Our responses to the specific questions in the exposure draft are attached in the Appendix to this letter. If you have any questions on the content of this letter, please do not hesitate to contact Richard Keys, PwC Global Chief Accountant (+44 20 7212 4555), or Pauline Wallace (+44 20 7804 1293).

Yours faithfully

PricewaterhouseCoopers LLP