EFRAG

European Financial Reporting Advisory Group

October 18, 2002

Sir David Tweedie
Chairman IASB
30 Cannon Street
London EC4M 6XH
UK

Dear David,

Re: Proposed amendments to IAS 32 and 39 Financial Instruments

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft of proposed amendments to IAS 32 Financial Instruments: Disclosure and Presentation and IAS 39 Financial Instruments: Recognition and Measurement. 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 IFRS on the issues.

We support the objectives of the proposed amendments to improve the existing requirements in IAS 32 and 39. However, in general, we believe that IAS 39 remains a complex and controversial rule-based standard requiring further changes, in addition to the amendments currently proposed. Appendix 1 sets out our comments on the IASB proposals together with some suggestions for change. In Appendix 2 we set out our answers to the questions named in the draft standard together with comments on other issues which we believe require consideration.

If you would like further clarification of the points raised in this letter Paul Rutteman or myself would be happy to discuss these further with you.

Yours sincerely

Johan van Helleman
EFRAG, Chairman

EFRAG COMMENTS ON THE EXPOSURE DRAFT AMENDMENTS TO IAS 32 AND 39

1. Introduction

1.1. We are pleased that IASB has reviewed IAS 32 and IAS 39 for possible amendment. There is a need for a clear statement setting out the accounting for financial instruments. These have always been controversial standards and remain so even after the amendments proposed. As such we believe there is a need for a more fundamental review. In the meanwhile it is important that amendments be made to correct the deficiencies in the standard that have been brought to light.

1.2. Whilst we support certain of the amendments we have concerns about the following aspects of the proposed standard:

i. Hedge accounting – too much rule driven
ii. Long term investment contracts – the absence of guidance
iii. The derecognition approach – the continuing involvement approach is attractive in some aspects but still flawed
iv. Loan provisioning – the underlying principles are unclear and apparently conflicting.

2. Hedge accounting

2.1. Hedge accounting has proved to be one of the most contentious areas of IAS 39. Whilst IASB has addressed some of the difficulties in its current amendment project we believe further consideration needs to be given to this area. Our concerns are centred on the rules based approach and the distortion of cost based items in the balance sheet when hedged with a derivative that must be accounted for at fair value (when using a fair value hedge).

2.2. We believe that a positive strength of IAS standards is that they are principle based standards but the hedging requirements of IAS 39 are obviously rule based and we invite IASB to consider whether improvements cannot be made in that regard.

2.3. In banking in particular, most assets and liabilities outside the trading book are accounted for on a cost basis but interest rate swaps are extensively used to manage interest rate risk. Where the hedging transaction is classified as a fair value hedge any change in interest rates will result in a change in value of the swap and an equal adjustment has to be made to the asset or liability that is hedged. That asset category can no longer be said to be carried at cost or, in the case of a hedged liability, the liability no longer represents an amount payable. Such a distortion can confuse users of financial statements unless explained in some detail.

2.4. Banks typically centralise their management of interest rate risk in special departments whose role is to determine the bank's net exposure to fixed/variable interest rate mismatch for different time periods. They then enter into derivative contracts, usually interest rate swaps, to exchange the existing contractual future interest cash flows for different ones thereby eliminating the mismatch or limiting it to levels determined by management.

When using cash flow hedges there is no need to make any basis adjustment to assets or liabilities carried at cost. Since the hedging operations are designed to swap future interest cash flows it should make no difference whether the swap is from fixed to floating interest rate or vice versa. However where the hedged item is a fixed interest rate asset or liability the swap has to be designated as a fair value hedge that is accounted for differently from a cash flow hedge. It is understandable that banks find the current hedging requirements of IAS 39 arbitrary and unrealistic. It would seem more logical to treat all such hedge transactions in the same way – as cash flow hedges. We invite IASB to reconsider the need for a distinction in the case of hedges of the above kind because we believe this lies at the root of many of the objections currently voiced to the IAS 39 hedging requirements.

2.5. Since hedge accounting in IAS 39 is complex and based on somewhat arbitrary rules we would welcome any simplification that can be made by basing the accounting on clear and justifiable principles and by reducing the number of restrictions that cannot be justified by those principles.

2.6. The key and overriding principle should be that for hedge accounting to be used the hedging relationship must be “clearly defined, measurable and actually effective”. That principle is already set out in paragraph 22 of the introduction to the existing standard.

2.7. However, in our view, some of the detailed rules go beyond this principle for reasons that are not obvious. In particular we believe further consideration should be given to:

i. Permitting the hedging of interest rate risk in held-to-maturity financial instruments
ii. Permitting instruments other than derivatives to be used to hedge any item or position – not just a currency position.

We believe that normal interest rate risk management of the balance between fixed and variable interest rate exposures should be allowed to apply. For example, it is common for a bank to acquire a portfolio of loans which it then intends to hold to maturity. These loans are not originated loans and are therefore classified as held to maturity assets carried at amortised cost. It appears logical, therefore, to permit the hedging of interest rate risk in held-to-maturity instruments also.

We recognise that in other than currency hedges the hedging instrument would most often be a derivative but the rule preventing any other instruments from being used as hedges appears to be both arbitrary and unnecessary. The justification for the restriction is given in paragraph 122 as being the different basis for measuring derivatives and non – derivatives and we question whether that is appropriate and sufficient justification.

2.8. The Implementation Guidance Committee has published extensive guidance on hedge accounting. We believe it would be useful to include in the standard itself some of the more important explanations currently in the Guidance Notes (e.g. hedging of risk components).

2.9. We are concerned also that the detailed requirements of IAS 39 make the normal management of interest rate risk by banks and large corporates unduly difficult and sometimes impossible. We have in mind particularly:

i. The relationship of the hedge to specific individual items or positions rather than a net position
ii. The prohibition of internal hedging.

2.10. Typically a bank's risk management department collects together exposure from branches and subsidiaries on a daily basis and, by use of derivatives, offsets the interest rate or currency risk on a net position. Large numbers of transactions are involved and risks are dealt with using a component approach such that portfolio hedging is used for managing separately interest rate risk and currency risk. However, IAS 39 requires that hedges involving basis adjustment for example are related to single instruments and this becomes extremely difficult when large numbers of individual transactions are aggregated. The guidance notes set out how individual transactions can be used as a surrogate for a net position to be hedged. Whilst in theory the effectiveness of the hedge can best be demonstrated in relation to individual transactions the reality is that the risk management systems of the bank are not geared to selecting individual transactions for this purpose. Generally a bank will use risk models to keep track of its risk exposure. We urge IASB to reconsider whether it would be possible to permit portfolio hedging to be used without the cumbersome monitoring of effectiveness against the surrogate individual transactions – provided, of course, that there are other ways of demonstrating the effectiveness of the hedge. Similarly we ask IASB to consider whether any basis adjustment could be dealt with by means of an overall adjustment to the portfolio rather than to individual items.

2.11. Paragraph 126 B of IAS 39 indicates that only derivatives that involve an external party can be designated as hedging instruments. There are conflicting considerations on the question of Internal Hedging. In practice many financial organisations have internal arrangements to 'hedge' positions through a Treasury Department which may or may not offset those externally. We urge IASB to reconsider the need for external offset for all such transactions. If internal hedging is to be permitted, the circumstances in which it is to apply would have to be closely defined.

2.12. In the spirit of simplification we draw attention to the "short cut method" set out in the US standard (SFAS 133 paragraph 68 of Appendix A – Implementation Guidance) that expressly provides that an interest rate swap that exactly matches the terms (maturity, size, currency, underlying) of a hedged interest-bearing instrument is assumed to represent a perfect hedge and therefore no further effectiveness testing is needed. Paragraph 147 of IAS 39 recognises that such a hedge is likely to be effective but it would be helpful to clarify that the effects should be as described in SFAS 133.

3. Long term investment contracts

3.1. Definition of Insurance Contracts

The distinction between insurance contracts and contracts accounted for under IAS 39 involves defining insurance contracts. This raises a number of questions.

3.1.1 The Draft Statement of Principles (DSOP) in relation to insurance contracts sets out the arguments for basing a standard on insurance contracts although it is noticeable that in most countries the standards tend to relate to the industry. We prefer the DSOP approach, because it supports the principle that similar contracts should be accounted for in the same way – whether written by an insurance company or any other financial institution. However, there are significant differences between the definition of an insurance contract in IAS 32 and the DSOP.

3.1.2 IAS 32 paragraph 3 defines an insurance contract as "a contract that exposes the insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period, including death (in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others and business interruption". Further it states that "the provisions of this Standard apply when a financial instrument takes the form of an insurance contract but principally involves the transfer of financial risk".

3.1.3. The main reason for our concern about the current definition in IAS 32 is that it suggests that the provisions of IAS 32 apply when a financial instrument takes the form of an insurance contract but principally involves the transfer of financial risk and indicates examples as being some types of financial reinsurance and guaranteed investment contracts issued by insurance and other entities.
The concern is that where insurance contracts involve a savings element and an insurance element the borderline between an insurance contract (to be dealt with outside IAS 32 and 39) and an investment contract (covered by IAS 32 and 39) is unclear. IAS 32 may be taken to mean that unless a contract is principally an insurance contract it will be principally a contract involving the transfer of financial risk. In practice, of course, many insurance contracts are principally savings products but with significant insurance risk. We believe such contracts should be dealt with by the insurance standard.

3.1.4. We regard the definition of insurance contracts included in the DSOP as an improvement to that currently included in IAS 32 and recommend applying the more up to date DSOP definition in IAS 32.
However, we believe that the DSOP definition needs clarification. Paragraph 1.44 of principle 1.3 of the DSOP classifies a contract as an insurance contract, "if and only if, there is a reasonable possibility that an event affecting the policyholder or other beneficiary will cause a significant change in the present value of the insurer's net cash flows arising from that contract". Guidance is needed as to how the terms "reasonable possibility" and "significant change" should be interpreted to distinguish insurance contracts from other contracts.

3.1.5. For reasons of consistency we suggest that the amended definition should then be used throughout all standards where a reference to insurance contracts is made. For example IAS 37 paragraph 1 (c) and paragraph 4 scopes out reserves, contingent liabilities and assets arising in insurance enterprises from contracts with policyholders; the dividing line under IAS 37 should not be inconsistent with the definition of the DSOP when applied in IAS 32.

3.2. Accounting for contracts which fall under IAS 32 and 39

3.2.1 In practice many contracts written by insurance companies are in substance savings or investment management contracts which would have to be accounted for under IAS 39. However, there are features of these contracts that make it difficult to ensure consistency of accounting treatment in the absence of further guidance within the standards. These features also apply to contracts that do qualify for treatment under the proposed insurance contracts standard. Two particular features that give rise to difficulties are renewal options and profit participation contracts.

We acknowledge that these features are not exclusive to contracts written by insurance companies and we regard it as important that such contracts be accounted for in the same way regardless of whether they are written by an insurer, a bank, or any other financial institution.

3.2.2. Contracts marketed by insurance companies are often written in the form of savings plans (e.g. pensions policies) with annual premiums to be paid by the policyholder. The contract period is often unspecified or permits varying maturity dates. One feature of such contracts is an option for the policyholder to renew or cancel the contract after a certain period.

(For further elaborations on contracts containing renewal options we refer to the DSOP principle 4.2. paragraphs 4.50 to 4.71.)

Accounting for contracts containing renewal options is an issue on which guidance is needed because there are very different earning profiles depending on whether they can be assumed to happen (based on actuarial experience) or must be ignored. However the same issues arise whether the contracts are classified as savings contracts or insurance contracts so there must be consistency in treatment of renewal options between IAS 39 and the future Insurance Contracts standard. It may be that IASB cannot give that guidance until Phase II of the Insurance Contract standard is completed but in that case this would involve granting exemption from IAS 39 in respect of contracts containing renewal options.

3.2.3. Many profit participation contracts will not qualify as insurance contracts and therefore fall under IAS 39, but IAS 39 does not address the accounting for contracts with performance-linking features. Further guidance will be needed to deal with these. Once again a consistent treatment of such contracts will be needed between those accounted for under IAS 39 and performance linked insurance contracts to be accounted for under the future standard on Insurance Contracts.

3.2.4. One feature of profit participation contracts is that policyholders share in the profits arising from a designated fund of investments but the policy terms are such that management has certain discretion as to how much is to be allocated to shareholders. In years of high return a proportion of profits is set aside to a Fund for Future Appropriation (“FFA”). In years of poor returns management may decide to allocate part of that fund to the current policyholders so that returns to policyholders over time are smoothed although the payments may be made to different generations of policyholders.

Under the European Company law the FFA is classified as a liability but it is doubtful whether at any time it meets the definition of an obligation under IFRS. Guidance is therefore needed as to whether it should be classified as a liability or be shown in equity prior to appropriation.

3.2.5. Another problem in bringing certain types of insurance business within the scope of IAS 32 and 39 is embedded derivatives. These exist, for example, in contracts that include a guaranteed minimum repayment to the policyholder. Under the amended IAS 39 such derivatives have to be separated from the host contract and accounted for separately if three conditions are met (paragraph 23). In practice there are a number of problems in applying the conditions, because in many cases it is difficult to isolate the embedded derivative from the host contract (e.g. guaranteed minimum payments). Embedded derivatives should therefore not be unbundled from insurance contracts pending a comprehensive proposal from IASB for the interim solution.

3.2.6. We believe it is important not only to deal with these issues but to provide timely guidance. It is not clear when this guidance will be given and it may be that this can be dealt with only when Phase II of the insurance contract standard is completed. If that is the intention of IASB, a clear statement is needed that until such time these contracts are not required to be treated as falling within IAS 39. If, however, IASB does not intend to give a temporary exemption, clear guidance on how to account for renewal contracts, profit participation contracts and long-term contracts in general is urgently needed because European insurance companies will need to modify their present accounting systems to meet the 2005 timetable. Currently their accounting does not distinguish between contracts falling within IAS 39 and these falling outside it because, other than the absence of insurance risk in pure savings contracts, the two kinds of contracts are very similar. Guidance on accounting for those contracts within IAS 39 should be consistent with the ultimate requirements for accounting for insurance contracts with similar characteristics under Phase II of the insurance contracts project. If this cannot be provided in the short term, IASB should consider granting a temporary exemption from IAS 39 for such long term contracts and including them in Phase I of the insurance contracts project.

4. Derecognition

4.1. As explained in our response to Q2 and Q3 set out in Appendix 2 to this paper we do not believe the continuing involvement approach is sufficiently developed to be included in a final standard without further amendment and without further strenuous field testing. We have identified situations where we consider full disposal has taken place but an asset cannot be derecognised because a market value call option exists (or even an above market value call option!). This would imply that any asset that is sold where the contract includes a clause giving the vendor "a right of first refusal" if the buyer resells, cannot be derecognised by the vendor.

4.2. Whilst we acknowledge that there are problems both with a control based approach and a risk and rewards approach we believe the continuing involvement approach is too blunt a response. It needs to be tempered by reference to substance over form which may involve a proper analysis of risks and rewards.

5. Loan provisions

5.1. We do not agree with the methodology set out in paragraph 113C. The effective interest rate approach is different from the way loan provisioning is managed in practice. Implementation of this method for provisioning would go beyond the existing data sources companies – particularly banks – have in use. Furthermore it is different from the existing guidance written by the SEC Staff (Accounting Bulletin 102 'Selected Loan Loss Allowance Methodology and Documentation Issues').
Our further concerns are that this is a substantial change which takes into account future events. We believe further field testing is necessary before application of such a new methodology is required. (The examples given in B32 – 36 are clear but demonstrate the difficulty in applying the method to a large loan book).

5.2. We acknowledge that there are different interpretations as how to apply the new methodology. We believe that the approach is to base general provisions on the position and conditions extant at the time the provision is to be made. However, a number of commentators believe that the proposed standard takes a forward looking approach that takes into account future expectations – sometimes called "dynamic provisioning". We are concerned on the great subjectivity in interpreting the requirements for these principles which could result in profit smoothing. We do not support dynamic provisioning because it makes assumptions about future performance of loans unrelated to present economic circumstances. The proposed standard's requirements should be clarified in this respect.

Amendments to IAS 32

Q1. *Probabilities of different manners of settlement (paragraphs 19, 22, and 22A). Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).*

Response

We do not support the proposed change to paragraph 19 in the form suggested because we consider it confusing. The important message is that the classification of an instrument is made on the basis of an assessment of its substance when it is first recognised as set out in the original paragraph 19. The additional wording "and without regard to probabilities of the manners of settlement" (second issue) reduces the focus on the issue of substance in paragraph 19. Paragraph 20 (virtually unchanged) deals with the second issue separately and effectively so there is no need to complicate paragraph 19 by introducing this issue prematurely.

Paragraph 22 makes it clear that a preferred share that does not establish a contractual obligation explicitly may nevertheless do so indirectly through its terms and conditions. The original example suggested that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. By deleting the example IASB seems to be signalling that it is working to a much narrower understanding of "substance" than we believe is appropriate. Whilst we accept that economic compulsion will not always create a liability (e.g. the need to maintain facilities in good repair), the example deleted illustrated rather well the importance of determining the substance of a series of related, contrived transactions.

The new example in paragraph 22A is helpful also but, in our view, should make clear that the classification would be different if the settlement depended on the outcome of uncertain future events that were so unlikely to happen that the substance is that the condition is artificial and unrealistic (e.g. if payment would only be made if the FTSE Index were to increase by 200% in one month).

Q2. *Separation of liability and equity elements (paragraphs 28 and 29). Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?*

Response

We recognise that compound instruments are complex and that splitting them into elements is therefore acceptable. We agree that any asset and liability elements should be separated and measured first and then the residual assigned to the equity element. We also agree that the other option for measuring the elements be eliminated.

The amended paragraph 17 states that “a financial instrument classified as an equity instrument by a subsidiary is eliminated on consolidation when held by the parent, or presented by the parent in the equity section of the consolidated balance sheet as a minority interest separate from the equity of the parent.” This statement can be taken to suggest that an equity instrument of a subsidiary can be “automatically” considered as an equity instrument at the consolidated level. That could lead to inappropriate equity classification at the consolidated level of certain financial instruments guaranteed by another group company and classified as equity at the subsidiary level. We are aware of various schemes which use such structures to classify what is in substance debt as equity and believe it would be helpful to clarify that, on consolidation, the subsidiary’s “equity” would be classified as debt in those circumstances.

Q3. *Classification of derivatives that relate to an entity’s own shares (paragraphs 29C –29G). Do you agree with the guidance proposed about the classification of derivatives that relate to an entity’s own shares?*

Response

We agree with the guidance proposed in paragraphs 29C-29G on the classification of derivatives that relate to an entity’s own shares.

Q4. *Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard. Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)*

Response

EFRAG has no particularly strong feelings on the integration of IAS 32 and 39 but we do see the benefit of setting out in one comprehensive standard the recognition, measurement, presentation and disclosure requirements for Financial Instruments. Such a standard will inevitably be voluminous.

Other comment

Classification of financial instruments

The last sentence of paragraph 19 states that the classification of a financial instrument continues at each subsequent reporting date until the financial instrument is derecognised, except as provided in paragraph 29F. We believe that other cases than that described in paragraph 29F can warrant a reclassification (e.g. a preferred share with a put option that expires at a certain point in time). We therefore recommend the Board to amend paragraph 19 or 29F so that the standard requires reconsideration of the classification of a financial instrument when its substance has changed.

Amendments to IAS 39

Q1. *Scope: loan commitments (paragraph 1(i)). Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?*

Response

We concur with this simplification of the accounting requirements for both holders and issuers of loan commitments for the reasons explained in paragraphs C10-C15 of the Basis for Conclusions. We recommend the Board to consider the inclusion in the standard of a principle under which changes in fair value of derivatives that can only be settled gross by delivery of the underlying item are accounted for in the same way as the accounting that will be required for the underlying. Such a principle can replace the current piecemeal exemptions in paragraph 1 (i) and paragraph 14.

Q2. *Derecognition: continuing involvement approach (paragraphs 35-57). Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?*

Response

Whilst the continuing involvement approach has a number of attractive features we consider the measurement aspects as described in the Exposure Draft to be fundamentally flawed. We support the dissenting view of the two Board members in that the proposed continuing involvement approach results in recognizing assets and liabilities that do not meet the definitions of those elements in the Framework. We find the proposed continuing involvement approach too blunt in that it requires continuing recognition of assets that are in substance disposed of (e.g. a transaction whereby the transferor has an option to repurchase the assets at fair value or at an unrealistically high price).; ignoring the substance over form principle. The Basis for Conclusions states that the proposed approach does not address all conceptual arguments that may be raised against the derecognition requirements, which the Board will continue to consider. It is further indicated that the Board will look more broadly at the derecognition of all assets and liabilities, rather than just at financial assets and liabilities. Due to the conceptual issues of the proposed continuing involvement approach as well as its temporary character, we do not support the proposed amendments. We believe that the SIC 12 Consolidation – Special Purpose Entities guidance should be considered by the Board in further developing the derecognition issue.

Q3. *Derecognition: pass-through arrangements (paragraph 41). Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?*

Response

We agree that the conditions set out in paragraph 41 qualify an asset for derecognition. In paragraph 41 we recommend the Board either to delete the words "(a 'pass-through arrangement')" or to define the term clearly since in effect they define a term which is not used again and the term is understood to mean different things. We understand from paragraph 42 that the definition of "pass-through" has been broadened to include special purpose entities which are in substance not agents. We do not agree that such an SPE is a "pass-through" vehicle that would meet the criteria as proposed. This applies especially to situations where various classes of instruments are issued and most of the holders of securities issued by the SPE do not take risks other than those of lenders. In such a case cash flows are not passing through the vehicle, but the vehicle has positions and the beneficial interest holders have rights on the return from the investments to a varying degree. Those rights do not represent a proportionate share in the assets of the entity.

Q4. *Measurement: fair value designation (paragraph 10). Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?*

Response

We regard the proposed amendment to allow entities to irrevocably designate any financial instrument at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss as a very important change which we welcome in so far as it simplifies the application of IAS 39 and facilitates the use of natural hedges. However, the standard does not indicate how to treat the entity's own risk when calculating the fair value of its financial liabilities. Situations whereby an entity would recognise a gain, simply because its credit rating deteriorates, should be avoided. We recommend the Board to amend the standard in this respect.

Q5. *Fair value measurement considerations (paragraphs 95-100D). Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95–100D of the Exposure Draft? Additional guidance is included in paragraphs A32–A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?*

Response

We welcome the expanded guidance but recommend the Board to further develop the requirements in paragraph 99 regarding the fair value measurement considerations for a portfolio of financial instruments. These fair value considerations should include guidance on block discounts (liquidity effect) or premiums (control stake effect).

Q6. *Collective evaluation of impairment (paragraphs 112 and 113A–113D). Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A-113D?*

Response

Yes, we agree with the proposed amendment to include loans or other financial assets measured at amortised cost, which are individually assessed for impairment and found not to be impaired, in a group of similar financial assets that are assessed for impairment on a portfolio basis. We also agree that, in the light of the law of large numbers, impairment may be probable in a group of assets, but not yet probable in assessing any individual asset in that group. However, we do not agree that the proposed amendment for measuring such impairment in paragraph 113C should be implemented without further discussion. We believe that the proposed methodology goes further than current practices in anticipating non-payment by the debtor and therefore needs to be field tested before it replaces such practices. Further, we have the following additional comments regarding the impairment requirements:

- The final paragraph 115 should include guidance for interest income recognition on groups of financial assets after impairment recognition.
- Para 1 d and f scope out receivables from leasing contracts as well as financial guarantee contracts. Consequently, the collective evaluation of impairment does not apply. We believe there is no good reason to exclude these financial instruments from the impairment guidance in paragraph 109-119.

Q7. *Impairment of investments in available-for-sale financial assets (paragraphs 117–119). Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?*

Response

We do not support the proposed amendment since we fail to see any substantial difference between this and the situations explained in IAS 2 paragraph 31 (reversal of any write-down of inventories), IAS 8 new paragraph 27 (recognition of the effect of a change in accounting estimate in profit or loss), IAS 16 paragraph 37 (Property, plant and equipment: the reversal of a revaluation decrease of the same asset previously recognised as an expense shall be recognised as income) and IAS 38 paragraph 76 (Intangible assets : a revaluation increase should be recognised as income to the extent it reverses a revaluation decrease of the same asset which was previously recognised as an expense) all of which require a consistent treatment of reversals through income when the initial revaluation decrease was previously recognised as an expense.
Further, we recommend the Board to consider the inclusion of guidance in the standard concerning the determination of impairment for available-for-sale financial assets.

Q8. *Hedges of firm commitments (paragraphs 137 and 140). Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?*

Response

We do not agree with the proposed amendment and believe that it is preferable that the accounting for a hedging instrument should follow the accounting for the hedged item and not vice versa. In appendix 1 we have indicated our difficulties with the current hedge accounting rules.

Q9. *'Basis adjustments' (paragraph 160). Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?*

Response

We do not support the proposal to revise the rule in IAS 39 that the gain or loss on a hedge should be removed from equity at the time the hedged transaction gives rise to an asset or liability and should be included in the measurement of the asset or liability. The former treatment was significantly simpler both to record and present. The proposed treatment, to recycle the gain or loss out of equity, period by period, in line with depreciation on the asset or other recognition in profit or loss of the consumption of the asset or reduction of the liability is cumbersome and would make the effects of the hedge much harder to understand. We also find it difficult to see how different carrying amounts for two different transactions – one hedged and one not hedged – impair comparability, as stated in paragraph C103. The economic difference justifies the different treatment. It also provides better information for the investor to see the success (or failure) of a hedge directly connected to the hedged item. The IASB has taken its position using the principle that a gain or loss does not form part of an asset or liability. We can understand that, until the hedged item is recognised, a gain or loss on the hedging instrument should be recognised in equity, since it is not itself a liability or asset. However, once the hedged item is recognised, we see no merit in insisting that re-cycling out of equity should take place little by little over the life of the item rather in one amount on recognition of the hedged item, which is the moment when preparers will wish to comment on it and users expect to see it. The problem is that hedge accounting, by definition, suspends the normal rules of recognition and/or measurement. If, to promote convergence, a choice needs to be made between abandoning the basis adjustment approach or retaining it, we believe that the basis adjustment approach needs to be retained: the US GAAP alternative is considered too complex and the proposed amendment would not result in a better standard.

Q10. *Prior derecognition transactions (paragraph 171B). Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (ie that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?*

Response

We agree that there should be no grandfathering.

Other comments

1. *Scope*

Electricity has the unique characteristic that it cannot be stored in significant quantities. As a result, contracts to buy electricity may permit the buyer some flexibility in determining when to take electricity and in what quantity or may permit entering into offsetting contracts to avoid power imbalances that would endanger the electricity system as a whole. These contracts are entered into in the normal course of business and not for trading or hedging purposes. We believe it is currently not clear how such contracts should be accounted for under IAS 39 and therefore request the Board to clarify this matter.

2. *Presentation of interest income and fair value changes*

Interest income from available-for-sale and held for trading financial instruments should be included in interest income within the income statement, and not as part of the changes in fair values. We recommend the Board to consider such a presentation in the upcoming Performance Reporting project.

3. Definition of effective interest rate

We noted that "effective interest rate" is defined in paragraph 61 of IAS 32 with a reference to IAS 39 paragraph 10. For clarity reasons, we recommend the Board to include the definition of IAS 39 paragraph 10 in paragraph 5 of IAS 32 and to delete the definition in paragraph 61 of IAS 32 accordingly.