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

14 September 2009

Dear Sir or Madam,

Re: EXPOSURE DRAFT (ED) OF PROPOSED AMENDMENTS TO IAS 39 *CLASSIFICATION AND MEASUREMENT*

BUSINESSEUROPE very much welcomes that the Board is taking steps to simplify the reporting of financial instruments and is pleased that it has chosen to follow the thrust of our response to its Discussion Paper on Reducing Complexity in Reporting of Financial Instruments by retaining a mixed measurement model, which should in principle enable entities to present information in the most decision-useful form best aligned to expected future cash flows.

We are, however, very concerned that the approach to classification between amortised cost and fair value is not even-handed but would, through its many restrictions and narrow definitions, lead to entities reporting at fair value through P&L many instruments which should not be so classified from this viewpoint of decision-useful information. A classification schema based on the entity's business model as the key criterion would, by more faithfully reflecting expected future cash flows, produce more decision-useful and understandable information for capital providers and other users.

As the "Economist" began its recent article on the ED, "Rewriting laws in a hurry is never a great idea". Since the revised standard is intended to be in force for the long term, we strongly urge the Board to take the time to reconsider its proposals in the light of comments received from capital market participants to ensure that it will in the end deliver to the capital markets the information which meets their needs and is indeed the most decision-useful, even if this means not being able to offer a full revision by the end of 2009. A narrow-scope pragmatic amendment in respect of impairment (including permission of reversals of impairments on equity securities) by this date – even if only stop-gap – with subsequent reconsideration as part of the overall revision over a further few months, and then taking properly into account the input received in the due

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process, would in our opinion render far better service to the capital markets in the long term.

Having been supporters of the convergence process – for a global set of standards – we are extremely disappointed in the FASB's recent actions on financial instruments, which seems to fly in the face of convergence efforts and indeed would create new divergences. Our support for convergence has always been "but not at simply any price", and we believe that the FASB's approach would in no way be in the interests of the capital markets. We hope that the IASB will not allow itself to be distracted by the actions of a single national standard-setter from achieving a "single set of ... standards to help participants in the world's capital markets ... make economic decisions."

We would also like to mention our perception that, apart from a couple of remarks about receivables, the ED's focus is almost exclusively on matters affecting first and foremost financial institutions. While this is in many ways understandable, we hope that the Board will finesse its final revision in such a way as to ensure that industrial and commercial entities are not unreasonably burdened with an unfair application of fair value and with requirements which are not appropriate to their circumstances. (Experience with IFRS 7, Financial Instruments: Disclosure, has unfortunately been rather negative in this respect.)

A further general comment we would like to register relates to the practical linkage of this ED with other work being done by the Board, e.g. on impairment and hedge accounting and on financial statement presentation. Staggered adoption could well be a very messy business, for instance when classification decisions are taken which subsequently turn out to be inappropriate in the light of subsequent changes on hedging. Entities must be allowed to reconsider some of the accounting choices made while implementing these proposals (for example, the presentation choice for equity instruments or application of the fair value option) when implementing later phases of the replacement project. Such difficulties would of course be substantially reduced if the Board limited 2009 work to stop-gap work on impairment and took more time over classification and measurement.

In the appendix we respond to the specific questions raised in the ED, emphasising areas where we think the approach suggested could be practically improved, above all to ensure the maximum usefulness of the information produced in a more even-handed manner. Our key points are:

- To emphasise alignment of classification with expected future cash flows the business model criterion should made the key determinant and be more clearly defined as being "a matter of fact" (avoiding the impression of a free choice.)

- The proposed approaches on long-term financial liabilities, on derivatives linked to long-term financial liabilities,on tranches and on hybrids where the host would qualify as amortised cost under both criteria need to be rethought: they would lead to distortions of information, away from expected cash flows, in many cases.

- The blanket prohibition of reclassifications would be inappropriate.
- The cost exemption for unquoted equities where the reliability criterion is not met should remain.
- For the time being existing presentation requirements for equity investments not held for trading should be maintained (dividends and impairment losses in P&L, changes in value in OCI, recycling of gains and losses upon derecognition.)
- Existing impairment requirements need indeed to be revised: above all, the incomprehensible prohibition on reversal of impairment losses on equity securities should be eliminated.
- We are strongly opposed to any change in the entity's own credit risk being reflected in the measurement of liabilities.

Yours sincerely,

Jérôme P. Chauvin
Director
Legal Affairs Department
Internal Market Department

APPENDIX

RESPONSES TO SPECIFIC QUESTIONS

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?

We firmly believe that amortised cost provides decision-useful information for a financial asset or financial liability and is more relevant than a measurement at fair value in circumstances where the entity's business model is such that amortised cost better portrays the future expected cash flows of such an instrument. This will generally be the case where the instrument is managed on a contractual yield basis and where it has basic loan features. But there will be many cases which do not meet these two rather restrictive criteria but where amortised cost better reflects expected future cash flows than fair value in terms of the instrument's expected deployment within the framework of the entity's business model.

The ED does not question the relevance of fair value for all financial instruments that do not qualify as having basic loan features. The Board is currently consulting on whether own credit risk should be reflected in the valuation of liabilities. If the definition of fair value as proposed in the current ED on Fair Value Measurement - including own credit risk - is carried over into a standard, we would be strongly opposed to financial liabilities (including quoted debt instruments) or any other liability being measured at fair value as so defined.

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

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?

We are of the opinion that the approach should be reformulated to make the "business model" criterion the key determinant. This would emphasise alignment of classification with expected future cash flows. It must be appreciated that any other criteria imposed which lead to the classification and measurement of instruments such that expected future cash flows are not appropriately reflected – perhaps out of anti-abuse considerations – would make the information given to users less decision-useful and less understandable.

(a) Basic loan features

The ED's guidance on whether an instrument has "basic loan features" is far too restrictive to support the application of a robust principle and ensure that amortised cost is being used in all circumstances where it is more relevant than fair value, i.e. circumstances in which it better depicts expected future cash flows. The following remarks highlight further concerns which we would have if the Board nevertheless continued to pursue basic loan features as a classification criterion.

The notion of "basic loan features" is supposed to encompass contractual terms that give rise to cash flows that are payments of principal and interest and that are subject to credit risk. However, uncertain or contingent changes in the timing and amount of payments of principal and interest should not be excluded from the definition. We cannot see why a contingent variability of principal or interest rate or timing of cash flows should disqualify the instrument from being accounted for at amortised cost if the conditions that principal should be repaid in full and interest serviced are met. Applying the market interest rate or including a liquidity risk factor in the valuation of the instrument at fair value would not provide a better estimate of future cash flows to or from the entity if the instrument is being managed on a "contractual yield basis".

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

In the context of "basic loan features" we would have significant concerns on the impact of the criterion for financial liabilities:

- Own credit risk

  At present structured liabilities and convertible bonds are generally bifurcated, with the embedded derivative measured at fair value and the host at amortised cost. The ED, however, plans to prohibit bifurcation and to require the hybrid to be classified by considering it as a whole. As the embedded derivative would generally mean that the instrument as a whole does not have basic loan features, the liabilities would be measured at fair value, which may mean measuring such instruments at amounts that reflect changes in own credit risk. In our response to the DP on Credit Risk in Liability Measurement, we have explained our objections to inclusion of changes in own credit risk, and the present ED makes the matter all the more crucial since, as explained above, it is probable that many more financial liabilities would be measured at fair value.

- <u>Long-term debt financing the entity</u>

  More thought would be urgently needed on the specific nature of financial liabilities, in particular long-term debt used to finance operations. For example, most treasury functions manage long-term debt on a contractual yield basis in the context of financing the entity, even in circumstances where debt contains embedded derivatives or other "non-basic" features. Hence, the interaction between being managed on a contractual yield basis and the definition of basic loan features would need to be thought over for liabilities that serve such a funding purpose, to ensure that the information generated is meaningful and properly reflects the economics. This might be done, for example, by extending what is meant by a basic loan feature specifically for long term debt issued by an entity or by adapting the bifurcation rules for financial liabilities (see Q.4(a) below). In such circumstances, however, our strong preference would be to retain the present two categories for financial liabilities until such time as performance reporting and the P&L/OCI distinction have been further developed.

- <u>Derivatives linked to long term financing the entity</u>

  We think that more decision-useful information would be provided for users if certain derivatives which currently have to be measured at fair value were carried at cost, such as where a variable-to-fixed IRS combined with a variable-rate borrowing results in the same cash flows as a plain-vanilla fixed-rate loan. The obligation to measure these derivatives at fair value introduces high volatility into equity of the companies concerned, and it does not contribute to represent a true and fair view of the companies as the instruments are not held for trading but are held to maturity linked to the loan in order to adjust the interest cash-flows of the loan. Additionally the application of fair value measurement generates quite different treatments for economically equivalent transactions, depending on how the transaction is structured, although the impact on cash is the same. We think this is the sort of inconsistency that makes information about financial instruments difficult for users to understand

Finally, referring back to a general point made in our covering letter on the focus on financial institutions, it seems a little myopic that the criterion is worded entirely in terms of "loans" – obviously very relevant for such entities. Scarcely any explicit mention at all is made of the common-or-garden receivables and payables which often form a very significant portion of industrial and commercial entities' financial assets and liabilities. We assume – though it is not stated – that these would meet the criterion even if they were not "financial" in this restricted sense. The same remark similarly applies to e.g. own debt instruments and certain types of preference shares.

(b)Managed on a contractual yield basis

As mentioned above, we believe that the business model should be the key criterion. This could in our opinion usefully be more clearly defined, as being “a matter of fact” (avoiding the false impression of a free choice.) If “managed on a contractual yield basis” were introduced as a classification criterion, we would not be comfortable that loans and other financial assets that are purchased at a discount reflecting incurred credit losses could not be considered as being managed on a contractual yield basis. Since an entity's business model is a matter of fact that can be observed, this appears to us a quite unnecessary restriction, for such assets purchased at a discount are not necessarily held for trading. Also, it would mean that impaired loans sold under new rules adopted by various governments to help resolve the credit crisis would have to be measured at fair value – not really appropriately, in our view, as an amortised cost approach would be a more meaningful reflection of expected cash flows.

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?**

We firmly believe that the business model should be the key classification criterion for all instruments. Unless that is the case, users would be no better off in understanding the financial instruments information than they are today. Hence, more financial instruments should be carried at amortised cost than the ED proposes. We refer to some examples under Q.2 above and Q.4(b) below. Also, unquoted equity investments whose fair value cannot be reliably measured should remain accounted for at cost (see Q.8 and Q.9 below.)

EMBEDDED DERIVATIVES

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

We agree that the present IAS 39 rules on hybrid instruments and bifurcation are very complex and sometimes difficult to operationalise. However, the elimination of the bifurcation of hybrid financial instruments between embedded derivatives and financial hosts would be a retrograde step and potentially give very misleading information on expected future cash flows. It should not be undertaken. It would often contradict our preferred classification principle (where host and embedded derivative fit with different parts of the business model) and would, as a result, significantly reduce the benefits expected from the application of that principle. As already stated, amortised cost should be applied where it best reflects future cash flows that are expected to arise from instruments: it would often be the case with many hybrid assets and liabilities that the host, generally making up the larger part of the overall value of the hybrid, would unequivocally fulfil even the amortised cost criteria proposed in the ED.

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

We do not believe that this would give decision-useful information. Furthermore, the proposals mean that contracts could be measured differently depending on whether they are standalone contracts or part of a hybrid contract (ie have derivatives embedded in them). We think this is the sort of inconsistency that makes information about financial instruments difficult for users to understand. There needs to be a simple principle that is consistently applied. For that reason, we think the IASB should retain bifurcation but should explore the possibility of bifurcating on a basis that is consistent with the basic classification model; in other words, it should explore the possibility of the bifurcation of embedded derivatives requirements being based on the entity's business model.

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

It should also be mentioned that, for industrial and commercial entities at least, substantial practical problems arise from embedded FX derivatives in non-financial

hosts, e.g. where a supply contract is denominated in an "abnormal" currency. While the theory here is probably right, the significant practical problems of identifying, tracking and accounting for such derivatives could be appreciably alleviated and complexity reduced with a rather less dogmatic approach in the standard – an approach which could also be taken on some of the other practical difficulties identified as being experienced with embedded derivatives.

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?

We do not agree at all with the proposed application of the classification proposed to contractually subordinated interests. Most tranches in securitisations provide the holder with rights to receive payments of principal and interest that remain subject to reliably measurable credit risk. The holder of subordinated tranches receives higher interest flows for in effect providing credit protection to other tranches. However, we do agree that tranches that give their holder only a residual interest should not be regarded as fulfilling the basic loan features criterion.

It should be said that application of the final standard will be all the more robust, and uncertainty in practice reduced, if the judgement necessary in handling such situations as the above is exercised in the context of principle-based guidance and not on a detailed set of rules specifying when and where instruments have basic loan features.

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?

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

We would, however, point out the effects of the absence of balance here, in the case of non financial institutions,as there is no corresponding amortised cost option where non-financial assets have to be measured at cost while related liabilities managed jointly with the assets might be forced into fair value measurement by the proposed

classification approach. This is a further reason to be most circumspect in applying fair value measurement to liabilities.

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?

There does not seem to be any need for a fair value option under other circumstances in the case of financial instruments(though this may need review once hedging requirements are developed – see our covering-letter comment on practical linkages to other work.) The fair value option is an exception to the principle-based approach to classification and measurement that the Board is proposing, and exceptions should be allowed only if absolutely necessary.

Notwithstanding the above, we understand that the IASB should consider to apply the fair value option to some type of non financial assets in order to avoid the accounting mismatch mentioned in last parargraph of question 5

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?

We disagree with prohibiting reclassification. Although we agree that an entity's business model is unlikely to change and that assets can generally be easily identified as being managed in one line of business or another, circumstances may arise when an entity's activity may be stopped because of, for example, significant changes in market conditions. The last two years have shown that such circumstances are possible. The changes which the Board had to make in October 2008 are clear evidence that a standard dealing with classification and measurement of financial instruments has to allow for reclassification: when the criteria for a classification are no longer met, a reclassification should be made. (In Lord Keynes's word, "When the facts change, I change my mind. What do you do?") Robust principle-based guidance should not be undermined by arbitrary rules. In our opinion the financial reporting requirements on reclassification already defined by the Board, together with adequate disclosures, are appropriate for such cases and should be maintained.

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?

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

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

Moreover, as pointed out under Q.1, we believe that there are equity securities which are, in terms of the entity's business model, held for long-term strategic purposes or because of performance (e.g. dividend yield) where amortised cost would better reflect expected future cash flows.

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

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

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

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

As indicated in Q.8 above, we agree that certain equity investments need to be treated differently from others to best reflect the entity's business model. However, as far as the ED's proposed fair value approach is concerned, the Board has unfortunately not yet worked out a principle to define which changes in value should be shown in P&L and which in OCI. Pending the definition of such a principle, we see little point in substituting one arbitrarily determined approach with another arbitrarily determined approach and would recommend maintaining the present available-for-sale accounting (dividend income, impairments and gains/losses on disposal in P&L, other value changes in OCI until derecognised.) In particular, reporting dividend income – a real cash flow which analysts are interested in seeing in income – in OCI as proposed is unacceptable.

At the same time, we would prefer, if two presentation possibilities remain, that the choice between the two is not left as an arbitrary choice but requires an indication being given to users of the basis for the presentation chosen.

We strongly oppose the Board's tentative decision to eliminate recycling and require dividends to be reported in OCI if changes in value of the related instruments have to be presented in OCI. Until such time as the Board resolves the issue of performance reporting and the P&L/OCI distinction, we would recommend it to stick with the current AFS accounting approach if such a separate OCI category of equity investments is retained: it should rather just to revise the existing impairment rules for available for sale assets for greater consistency in application and drop the incomprehensible prohibition on reversal of impairment losses on equity securities.

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

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

Please see our response to Q.10 which also covers much of this question. On the matter of the "principle" for determining whether equity instruments should be

accounted through P&L or OCI, we repeat that the first step is for the Board to determine a *general* principle for what goes into P&L and what into OCI.

In BUSINESSEUROPE's view the entity's business model must play a key role here if the financial statements are to represent economic reality as faithfully as possible. In the meantime, entities should state the criteria they apply for the differentiation. As with reclassification between amortised cost and fair value through P&L, we believe it obvious that, in order to continue to represent economic reality as faithfully as possible, reclassification between fair value through P&L and fair value through OCI must be permitted where these criteria are no longer met.

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?

We do not understand why disclosures should be provided only by *early* adopters. It would be useful information in all cases, we would have thought. Also, we think that users would find most useful a reconciliation, on adoption, of prior closing balances and revised opening balances with clear explanations of changes. On the other hand, disclosures of restated prior-year information would generally be of no practical value to users, even if it is available – which, in many cases, it will not be.

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

We would like to make four general points:

- Several of the items to be applied retrospectively appear to us to call for hindsight.
- We hope that the Board is not making the (false) assumption that, just because statistical disclosure is made of the fair value of financial instruments not measured at fair value, such information is robust enough to serve as a basis for the measurement in the main financial statements of instruments which would now have to be so measured.
- As mentioned in our covering letter, there will need to be some continuing adaptations as other work on financial instruments is completed, e.g. hedging. Defining the transition requirements will be nailing jelly to a wall.
- The impracticality and cost of parallel-running systems based on two classification and measurement systems cannot be emphasized enough.

AN ALTERNATIVE APPROACH

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

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

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

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