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CL 30

14 October 2002

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

Dear Sir David,

**Exposure Draft - Proposed Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement**

Deloitte Touche Tohmatsu is pleased to comment on the International Accounting Standards Board's (IASB's) Exposure Draft of Proposed, *Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement* (the Exposure Draft). Our objective in developing this letter is to provide constructive feedback to assist the IASB in developing standards of the highest possible quality.

Overall, we believe that adopting the amendments proposed in the Exposure Draft would make the standards clearer and easier to consistently implement. The amendments also would increase the quality of financial reporting for financial instruments under International Financial Reporting Standards (IFRS). We recognize that the Exposure Draft is not intended to reflect conclusions the Board might reach in full reconsideration of the accounting for financial instruments—that is, IAS 32 and IAS 39, as amended, will continue to be viewed as an interim solution to financial instruments accounting until such time as the Board can identify and evaluate other comprehensive alternatives for recognition and derecognition of financial instruments. The ideal approach not only would result in convergence with other standards setters, but would also focus on reducing the complexity of accounting in this area. We also note that as the use of fair values in accounting standards increases, there is an increasing need for the Board to develop more complete guidance on how to develop appropriate estimates of fair values.

Nonetheless, our review of the Exposure Draft identified a number of significant issues that we believe should be addressed by the IASB before the document(s) is (are) finalized. In some cases, we were able to identify potential alternative solutions for the Board's consideration. Where relevant, those are included in our comments. This letter presents our comments in the following areas:

Appendix I—General Comments on Scope. We believe it is very important for the scopes of IAS 32 and IAS 39 to be the same. There may be some areas in which a lack of clear delineation of what is considered within or outside the scope may cause confusion or raise questions.

Appendix II—Comments on IAS 32, *Financial Instruments: Disclosure and Presentation*. We provide our responses to the questions posed in the Invitation to Comment and suggest an alternative approach to determining classification of derivatives on an entity's own shares. We also provide specific comments on the following parts of the Exposure Draft: summary of main changes, scope, definitions, liability-equity presentation, classification of compound instruments, transactions in an entity's own equity instruments, offsetting, disclosures, and the appendices.

Appendix III—Comments on IAS 39, *Financial Instruments: Recognition and Measurement*. We provide our responses to the questions posed in the Invitation to Comment and suggest an alternative approach to the accounting for assets and liabilities associated with the failure of an asset transfer to qualify for derecognition. We also provide specific comments on the following topics in the Exposure Draft: financial guarantees, derecognition, impairment, recognition of gains and losses related to hedging activities, embedded derivatives, and various other items.

We thank you for the opportunity to provide our comments. If you have any questions concerning our comments, please contact Ken Wild in London at +44 (20) 74382511.

Sincerely,

Deloitte Touche Tohmatsu



DELOITTE TOUCHE TOHMATSU

## APPENDIX I—GENERAL COMMENTS ON SCOPE

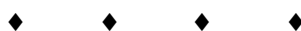
We believe it is very important for the scopes of IAS 32 and IAS 39 to be the same. We believe that the Board has striven to achieve this; however, there are some areas in which a lack of clear delineation of what is considered within or outside the scope may cause confusion or raise questions.

For example, IAS 39 permits nonderivative financial liabilities to be accounted for as trading items or at amortized cost. Presumably that guidance would apply equally to certain equity-settled derivatives classified as financial liabilities under paragraph 29F of IAS 32; to financial liability components of compound instruments; to the puttable rights to residual interests in net assets of entities such as mutual funds, partnerships, and puttable common stock; and to other items classified as liabilities, including some constructive obligations identified under paragraph 22A of IAS 32. That is likely to be clear if the two documents are merged, however, if the Board issues the documents separately, it might be useful to indicate in IAS 39 that derivatives and financial liabilities identified under the guidance in IAS 32 are within the scope of IAS 39, even if they do not otherwise meet the definition of a financial liability, which technically does not include equity-settled items, for example. (We believe that while the proposed approach under which certain equity-settled obligations are classified as liabilities is not fully consistent with the current conceptual framework, it provides a reasonable interim solution. As a longer-term effort, it would be useful for the Board to work on refining the conceptual framework distinction between liabilities and equity. Convergence among the liaison standard setters on the definitions of the elements would be an important objective to meet in that effort as well. See our comment below on IAS 32, paragraph 5).

We also are concerned about the scope of the two standards with regard to the description of nonfinancial derivatives (e.g., commodity contracts). The words should be consistent across both documents and should provide a delineation that can be consistently and straightforwardly applied. We provide more specific comments and suggestions below.

Finally, we believe it is important for the Board to ensure the mutual exclusivity of the scopes of IAS 32 and 39 vis-à-vis any future IASB standard on share-based payments. We believe that share-based payments covered under a future share-based payment IFRS should be specifically scoped out of IAS 32 and IAS 39. To do so requires that the Board clarify the delineation between items that are accounted for as financial instruments and those that are accounted for as share-based payments. We believe that the distinction between equity instruments exchanged for goods and services versus those exchanged for financial instruments is a start. However, it may be possible to conclude that liabilities arising under share-based payment contracts are “financial liabilities.” If so, how would those financial liabilities be distinguished from other financial liabilities that are to be accounted for under IAS 39? Conversely, would it be possible for an entity to conclude that it is in the scope of the share-based payment IFRS instead of IAS 39 for an equity-settled obligation?

We believe that those scope issues can be resolved by providing clearer words consistent across both standards.



## **APPENDIX II—COMMENTS ON IAS 32**

The following sections provide responses to the questions posed in the invitation to comment in IAS 32 and additional comments on that standard.

### **A. Responses to Invitation to Comment**

#### **Question 1—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).*

We agree that financial instruments should be classified based on their substance; however, we believe that the new wording in paragraph 19 is confusing and results in a de-emphasis on that main principle. The classification should be based on the substance of the financial instrument based on all of its terms—both explicit and implicit. The added wording only refers to the assessment of probabilities for manner of settlement. The manner of settlement is merely one of the terms that should be assessed in determining classification of a financial instrument.

Further, we believe it is difficult to determine “substance” without assessing probability in some manner, and it is not clear to us whether the combined amendments proposed in paragraph 19, paragraph 22, and paragraph 22A are intended to achieve the same objective. Paragraph 19 suggests eliminating probability assessment for the purposes of classifying an obligation as a liability or as equity. In contrast, the guidance in paragraph 22 is not necessarily related to a distinction between liabilities and equity, but rather to the assessment of whether or not an obligation exists. Similarly, application of the guidance in paragraph 22A results in ignoring the probability that an uncertain future event may or may not occur, which is not related to the manner of settlement. We support the elimination of probability assessment for classification purposes. However, we are concerned about a lack of guidance for determining whether an entity has an obligation in circumstances in which the “substance of the contractual arrangement” results in a constructive obligation. We elaborate those views below.

#### ***Probability Assessment for Classification as Liabilities or Equity***

The Exposure Draft proposes to eliminate probability assessment in determining classification of an obligation as a liability or as equity. We support that approach because we believe that other terms of a contract, such as whether the issuer has explicit discretion over the manner of settlement, must be considered even if it appears probable at the inception of a contract that a particular manner of settlement will occur. For example, if the holder has a choice as to cash or share settlement, the issuer does not have discretion to avoid settlement in cash, even if it is

probable that the holder will require shares. Thus, such an obligation meets the definition of a liability and should be classified as one.

Nonetheless, we believe that the elimination of probability assessments for classification purposes results in a need for other guidance for determining liability or equity classification (for derivatives and nonderivative obligations) in circumstances in which an obligation requires a manner of settlement that the entity is neither in a position to provide nor has control over whether it will be able to do so in the future. An example would be one in which the obligation allows the issuer the choice to settle in a fixed number of shares or in cash equivalent to the value of the fixed number of shares, but the issuer has neither a sufficient number of shares authorized for issue to settle the obligation nor the unilateral power to issue additional shares.

***Probability Assessment in Determining whether the Substance of the Contractual Arrangement Results in a Constructive Obligation***

Although the example of preferred stock with an accelerating dividend has been eliminated from paragraph 22, that paragraph still states that a preferred share that does not establish a contractual obligation explicitly may do so indirectly by its terms—that is, the entity may have a constructive obligation. We believe in order to conclude that an obligation exists outside the explicit terms of the contract there must be some explicit or implicit assessment of the probability that a payout of cash or other assets by the entity is unavoidable. We believe that the example in paragraph 22 provides a useful illustration in that regard and suggest the Board consider keeping it. Whether or not the Board concludes that the example in paragraph 22 should be eliminated, it would be helpful if the Board provided general guidance to assist entities in understanding under what circumstances the terms and conditions of a contract indirectly establish an obligation.

If such guidance is not provided in IAS 32, it appears that IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, may apply for determining whether a constructive obligation exists for financial instruments that are not carried at fair value.<sup>1</sup> It might, therefore, be useful to refer to IAS 37 in paragraph 22 and clarify whether the need to identify constructive obligations is limited to preferred share contracts (as paragraph 22 seems to imply) or applies to all types of financial instruments that might contain implicit obligations. In any case, we believe that paragraph A21 may result in confusion for entities attempting to assess whether a preferred share implicitly creates a liability because it illustrates what conditions should not be considered. We believe it would be useful for the Board to also indicate in that paragraph what factors an entity should consider in determining whether an obligation has been established.

**Question 2—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?*

<sup>1</sup> It is not clear how to determine whether a particular financial obligation is within or outside the scope of IAS 37 because one would need to determine first whether an obligation existed that must be classified as a liability *before* designating that liability to be carried at fair value.

We generally support the approach in the Exposure Draft and agree that the amount to be recognized in equity should be the residual after measurement of any asset and liability elements. The approach in the Exposure Draft treats the separated components as if they were freestanding components with similar characteristics (an “as if freestanding” approach). An as-if-freestanding approach is an accounting convention that helps overcome the problems associated with accounting for combinations of components that, if issued freestanding, would have measurement attributes that differ.<sup>2</sup>

The as-if-freestanding approach has the merit of reflecting appropriately each of the components of an instrument within the balance sheet according to their nature. There are drawbacks to that approach, however. In particular, although compound financial instruments that have liability and equity components would be split for accounting purposes, in reality (with a few exceptions) the components will remain interdependent and will behave as such from an economic standpoint over the lives of the various components. For callable convertible debt, for example, the call option (which will be subsumed in the liability component measurement under the Board’s proposal) will relate to (and will derive value from) both the debt and the equity components. Further, the value of both the debt and the conversion option will be influenced by changes in interest rates. As a result, there is no “pure” equity component—it is predominantly equity but not purely equity.<sup>3</sup>

Although we support the Board’s approach and believe it is an appropriate pragmatic solution for accounting for compound instruments, we note that the reality of the interdependence of the components of compound instruments may have implications for hedge accounting. Consider, for example, a 10-year, fixed-rate debt instrument issued with a conversion option exercisable after 5 years. It would be difficult for an entity to hedge the fair value exposure to interest rate changes and qualify for hedge accounting beyond the first 5 years since the life of the debt is unknown and is dependent on the exercise of the conversion option. That observation suggests that the Board may want to clarify the application of hedge accounting guidance in those circumstances.

Whatever the Board’s final conclusion on how to account for the components of convertible debt, an important objective for purposes of fair presentation and comparability is to ensure that the amount reported as interest on the debt component is the real interest. Under today’s accounting, if the entire instrument is classified as a liability, the option premium received by the issuer for the equity conversion option generally is netted against interest expense, obscuring the true interest rate paid by the issuer. We believe it is important for the financial statements to reflect the appropriate amount of interest expense related to the debt component. Specific guidance for that purpose would assist financial statement preparers in meeting that objective.

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<sup>2</sup> IAS 39 includes a similar approach to accounting for embedded derivatives, as does the FASB under its Statement No. 133, *Accounting for Derivatives and for Hedging Activities*.

<sup>3</sup> This observation, viewed in tandem with guidance for distinguishing liabilities and equity in paragraph 29G of the Exposure Draft (which states that “a derivative contract whose fair value fluctuates . . . in response to changes in response to . . . variables other than the value of an entity’s own equity instruments . . . is not an equity instrument of the entity . . .”), may lead to a conclusion that, in fact, the conversion option would not be an equity item, but, rather a derivative asset or liability. See our later comments on paragraphs 29C and 29G in Question 3.

**Question 3—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?*

While we generally agree that, pending a full review of the distinction between liabilities and equity, certain obligations settled in an entity’s own shares should be classified as liabilities, we disagree with aspects of the Board’s proposed model for classification when multiple settlement alternatives exist. Below, we propose an alternative model, which we believe is better and simpler to apply. In addition, we have two significant comments with respect to the guidance in paragraphs 29C and 29G. First, we believe there are some inconsistencies in that guidance that will cause confusion in their application and second, we believe that the same guidance should be broadly applicable to classification of all obligations (nonderivative as well as derivative) for which an entity may settle in its own shares. Those comments are elaborated below.

***Proposed Alternative Classification Model***

Paragraphs 29E and 29F provide guidance for classification and accounting for derivatives on an entity’s own shares when the contract has more than one settlement alternative. The guidance is difficult of follow and seems to be contradictory to the underlying principle in paragraph 29C. Paragraph 29C states that a derivative should be classified in equity if and only if the contract will be settled by an exchange of a fixed number of an entity’s equity instruments for a fixed monetary amount of cash or other financial assets. That paragraph is indifferent as to whether the entity is to receive or to deliver the fixed number of equity instruments.

When multiple settlement alternatives exist and the entity has control over how the instrument will be settled, it is presumed that the entity will settle net (i.e., the contract is a derivative) unless the entity meets the conditions in paragraph 29E. The conditions in paragraph 29E seem to be intended to lead to the presumption that it will meet the requirement in paragraph 29C—that is, that the issuer will settle gross and the derivative is an equity instrument. However, classification as liability or as equity when multiple settlement alternatives exist is further premised on whether the entity or the holder will have to deliver the underlying equity instruments—which appears to be a direct contradiction of the principle in paragraph 29C.

An exception to derivative accounting (as opposed to nonderivative liability accounting) for derivatives that provide multiple settlement alternatives is also provided by the last sentence under paragraph 29F. In particular, when the holder has control over how the instrument will be settled and physical settlement is an alternative, it is presumed that the holder will require physical settlement. This also seem contradictory to the general principle in paragraph 29C, since it is the existence of the net settlement alternative that invokes the application of the guidance in paragraph 29E in the first place.

We propose that the Board simplify its model by modifying the circumstances in which a derivative on an entity’s own shares can be classified as a liability to be only those in which the issuer meets the conditions in paragraph 29E and would be required to pay cash if the derivative was physically settled. That is, we suggest eliminating the possibility for liability (rather than derivative) treatment if the contract provides for multiple settlement alternatives and the holder has control over how the derivative will be settled. We believe that approach is more consistent

with the underlying principles that distinguish derivative and nonderivative liabilities generally. We provide a flowchart illustrating the application of the proposed approach as Attachment A to this letter. We also include, as a basis for comparison, a flowchart illustrating the approach in the Exposure Draft. That is provided as Attachment B.

If the Board chooses to adopt the approach in the Exposure Draft as the final standard, we believe the guidance under the Board's approach could be explained more clearly, including providing examples and explanations.

Notwithstanding our proposed alternative approach for determining accounting for derivatives on an entity's own shares, we have provided comments on the Board's model below and in other parts of this letter because we believe that aspects of the Board's approach need clarification and refinement.

### ***Inconsistent Guidance***

Paragraph 29C states that equity classification is appropriate for a derivative "... if and only if the contract will be settled by the exchange of a fixed number of an entity's own equity instruments (other than derivatives) for a fixed monetary amount of cash or other financial assets." The Board uses that guidance as a basis for separating a compound instrument under the with-and-without approach. We believe that the Board intended that, if the terms of a convertible debt instrument with a face value of 100 permitted the holder to convert the debt into 50 shares, the conversion option would be classified in equity because the face value is fixed, as is the number of shares. We support an approach under which obligations that require an entity to settle gross with a fixed number of shares for a fixed monetary amount are not considered liabilities.

However, applying the guidance in paragraph 29G would lead to a different conclusion because 29G states that "a derivative contract whose fair value fluctuates in part or in full in response to changes in one or more underlying variables other than the value of an entity's own equity instruments ... is not an equity instrument of the entity ... ." As noted above under Question 2, there is interdependence between the debt component and the conversion option in convertible debt. That being the case, the *fair value* of the conversion option would fluctuate in part in response to changes in an underlying variable (interest rates) other than the value of the entity's own equity instruments. In fact, we believe that for many compound instruments that contain nondetachable options, there will be interdependency between the equity instrument and another variable that, under paragraph 29G, would result in the entire instrument being classified as a liability because the fair values of the components will be indexed to more than one variable. The same would be true for certain freestanding option components.<sup>4</sup>

We believe that paragraph 29C and paragraph 29G represent two different approaches to distinguishing liability and equity components. If the Board intends the guidance in paragraph 29G to prevail, the only equity-settled obligations that would potentially be classified as equity would be freestanding forward contracts to sell equity shares. However, if such contracts contained contingent features that essentially tied the fair value of the contract to an index other than the entity's own shares, they would not be classified in equity. One example would be a

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<sup>4</sup> If the entire instrument were classified as a liability, it would seem to be subject to the embedded derivative guidance in IAS 39.



forward contract that requires delivery of 50 shares for \$100 if the price of oil reaches \$35 per barrel.

### ***Broaden Guidance***

We support the Board's decision to provide specific guidance to assist financial statement preparers in determining classification of derivatives based on an entity's own equity instruments. This guidance has been lacking from international standards, and those types of derivatives create opportunities for accounting arbitrage in the absence of clear guidance for their classification. We believe that similar guidance should be provided for equity-settled obligations generally, and that guidance should be consistent with the liability-equity distinction used for derivatives (whichever the Board decides based on our above comments). Paragraph 22C of the Exposure Draft deals with the classification of an obligation that may be settled in an entity's own shares. We suggest that the Board include in that paragraph broader guidance on determining when an equity-settled nonderivative obligation is equity versus a liability based on paragraph 22C versus when it is an equity-settled derivative that should be classified based on paragraphs 29C – 29G.<sup>5</sup> It also would be helpful in understanding the Board's approach if the standard provided guidance for determining classification for nonderivative equity-settled obligations when alternative settlements exist, including when two settlement alternatives exist for different settlement amounts. For example, an obligation might require the issuer either pay \$100 or issue 75 shares in six months at the counterparty's choice. We suggest that the Board add to the guidance provided in paragraph 22C to ensure that the accounting for various combinations of (1) derivative and nonderivative obligations and (2) share and non-share settlement alternatives is clear.

### **Question 4—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 IAS32 and IAS39 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.)*

Yes! We support the integration of the two documents into a single document. Any entity subject to one of the documents would, by definition, be subject to the other. We believe that integrating the two documents will assist in a better understanding of how they interrelate and would facilitate their application. For example, some definitions appear only in one document or the other but are necessary to understanding both (such as the definition of a derivative). Integrating the two documents will overcome those issues, as well as assist the Board in identifying issues that may have perhaps been overlooked because they relate to both liability-equity distinction and recognition and measurement (for example, there is no guidance on the subsequent accounting—including recognition of interest expense or accounting for conversion or other extinguishment—for convertible debt).

While we support integration of the two documents, we believe a key objective in doing so is to ensure that the rather complex principles and guidance are presented in a way that enhances their

<sup>5</sup> If paragraph 22C is intended to provide the same liability-equity distinction for nonderivatives as is provided in paragraphs 29C – 29G for derivatives, the same issue identified in the previous section about potential inconsistencies arises for nonderivatives as arises for derivatives.

understandability and consistent application. We believe it would be of great benefit to constituents for the Board to integrate the documents in a manner that meets that objective. For example, the Board should consider such approaches as the following:

- For certain items that within the scope of IAS 39, only part of the guidance in the standard applies. In addition, some aspects of the guidance are not to be applied in certain circumstances. For example, IAS 39 would only apply to the initial recognition of financial guarantees, and options arising from a failure to qualify for derecognition would not be accounted for as derivatives. To minimize confusion about which section of the standard is or is not applicable to an instrument covered by the scope, we suggest that the Board include in an appendix a table that provides an overview of the application of each section of the revised standard to various types of financial instruments and other similar instruments.
- The use flow charts can assist in distinguishing between and determining the appropriate accounting for liabilities versus equity, derivatives versus nonderivatives, derivatives in general, derivatives based on an entity's own shares, and qualification for hedge accounting.

The Board might consider those and other approaches to integrating the two documents in a way that enhances their understandability and application.

## **B. Additional Comments on the Proposed Amendments to IAS 32**

The following comments relate to specific paragraphs or sections of the Exposure Draft related to IAS 32 that were not covered under our response to the questions above. To the extent possible, they are presented in the order in which they arise in the text of the Exposure Draft.

### ***1. Summary of Main Changes***

Page 10—In the discussion of classification of derivatives based on an entity's own shares, the summary uses the term "indexed to." That term also is used in IAS 39. The guidance in the standard section of IAS 32 generally does not use that term; rather it describes the relationship between shares and monetary amount (e.g., paragraphs 22C, 29C, and 29G). We believe that the Board should avoid use of the term "indexed to" since its meaning is not clear and could differ depending on interpretation. Or, if the term is to be used, we suggest it be specifically defined.

Page 12, second bullet under the section on disclosures—We generally support the proposed disclosures and agree that the difference between the carrying amount and the settlement amount of nonderivative financial liabilities that are carried at fair value should be disclosed. However, we are concerned about the presentation of fair value gains and losses due to changes in an entity's own credit quality within the equity section of the balance sheet prior to settlement of a nonderivative liability. For example, if an entity chooses to carry at fair value its nonderivative liability (irrevocably and at inception as will be permitted under the amendments), subsequent declines in the entity's credit quality will appear as fair value gains in profit or loss. Those gains do not represent increases in shareholder value or positive performance by the entity and, thus, are not appropriately represented as retained "earnings." Accordingly, we recommend that the Board consider that those items be closed to a separate account in equity until the liability is settled or otherwise extinguished.

Page 13, first sub-bullet—We found the clause "...the amount of which is determined based on an index or other item that has the potential to increase or decrease ..." in this bullet confusing.

We believe that under IAS 32, all instruments puttable for cash or another financial asset meet the definition of a financial liability under IAS 32. We suggest explaining how it differentiates one obligation from another.

Page 13, second sub-bullet—We agree that liabilities related to repayment of a proportionate share of net asset value should be presented with an appropriate caption (such as those described) as long as all of the net assets are available to the unit holders. That is, we would constrain the use of the special caption to those circumstances in which (1) the entity has no permanent equity and (2) the liability thus described is for the lowest tranche of available net assets.

## **2. Scope**

Paragraph 4A and 4B—We understand that the Board intends for these paragraphs to scope in certain contracts to buy or sell nonfinancial items, such as commodity contracts, under both IAS 32 and IAS 39. We found the words somewhat unclear. For example, for what purpose would an entity obtain a nonfinancial item that could not be described as for “expected purchase, sale, or usage requirements?” Further, although literal reading of paragraph 4A would result in a conclusion that an item purchased for expected sale would be excluded from the scope, the example in paragraph 4B (which is intended to illustrate an item that would be in the scope) is of a sale of the item acquired.

In order to avoid possible confusion or the perception of inconsistent guidance within these two paragraphs, we suggest an alternative approach to determining which nonfinancial contracts are within the scope along the lines of the following:

Contracts to buy or sell nonfinancial items shall be accounted for under this Standard as derivative financial instruments unless the entity:

- (a) has an unconditional right and ability to receive or deliver the nonfinancial item;
- (b) has an established practice of settling such contracts by receiving or delivering the nonfinancial item; and
- (c) intends to settle the contract by receipt or delivery of the nonfinancial item.

## **3. Definitions**

Paragraph 5, definition of a financial liability—IAS 32 changes what is considered a financial liability under IFRS, however, the definition in paragraph 5 does not reflect important changes including the recognition as financial liabilities of certain equity-settled obligations that, technically, do not meet the definition of a financial liability. (As noted in paragraph A7, the notion of potentially unfavourable terms is not a consideration under current concepts related to equity, since an entity’s own stock is not its asset and anything received for stock is an increase in net assets.)

As noted earlier, we support an interim approach under which certain equity-settled obligations are accounted for as liabilities, pending the Board’s full review of this issue. However, we believe that the Board should consider the implications for the conceptual definitions of liabilities and equity and whether, if the current proposals are adopted, the definition of a financial liability in IAS 32 should be modified to include derivatives whose value changes

based on something other than the fair value of the issuer's equity shares. (See also related comments on paragraph 22D below.)

Paragraph 6—Consistent with earlier comments, we suggest that the Board refer to the guidance in IAS 37 on constructive obligations as an example of how to identify a contractual obligation that may not be in writing.

Paragraph 10—The word “generally” was added to the last sentence of this paragraph. We believe that there are no circumstances in which the underlying is transferred on inception. “Underlying” as used in the definition of a derivative in IAS 39 refers to the price or index to which the contract is indexed. Perhaps this term is being used differently in the two standards?

Paragraph 14—The words in this paragraph should be made consistent with whatever the final words are in paragraphs 4A and 4B. They also should be consistent with the reference to the same items in IAS 39, which uses the term “contracts” instead of “commitments.”

Paragraph 17—We think the decision to classify minority interest in the equity section of the consolidated balance sheet that is proposed under the IASB's Improvements project raises questions about how to apply the proposed guidance on classification of equity-settled derivatives, even though paragraph 17 indicates that minority interest is not a financial liability or equity instrument of the parent. In particular, it is not clear how to account for gains and losses on a derivative contract issued by the parent company that is based on its subsidiary's shares, such as a fixed price forward contract written by the parent to deliver to an unrelated entity 20 percent of its wholly-owned subsidiary's shares. Equity classification of minority interest might suggest that gain or loss should not be recognised on deemed disposals and deemed acquisitions of subsidiary shares (at least as long as the parent maintains control). However, paragraph 17 implies that subsidiary shares are not equity of the parent. We suggest that the Board provide guidance for those types of contracts or explicitly scope them out of the standard pending decisions about acquisition and disposal of interests in subsidiaries in Phase 2 of the IASB's Business Combinations project.

#### ***4. Presentation—Liabilities and Equity***

Paragraph 19—See our response to Question 1 above.

Paragraph 20—The words in the first sentence of this paragraph should be reviewed in light of the guidance developed for distinguishing between liabilities and equity. That is, it is not clear that the notion of the “critical feature” (that is, an obligation to deliver cash or other financial assets or exchange financial instruments on potentially unfavourable terms) still applies because it is not clear that some equity-settled items that will be classified as liabilities under the standard meet the definition of a financial liability.

Paragraph 22—See our response to Question 1 above.

Paragraph 22A and 22B—We believe that the principles underlying the distinction between liability and equity classification should be the same for all obligations, whether or not they are derivatives. Thus, we suggest that the Board take steps to ensure that guidance provided paragraphs 22 – 22D, which is to be applied to obligations broadly, and the guidance provided for derivative obligations in paragraphs 29C – 29G are not inconsistent with each other. That would be facilitated if those paragraphs were equally comprehensive in terms of their scope of guidance (e.g., deal to a similar extent and in the same way with issuer and holder choice of

settlement). If, however, the Board intends a distinction between approaches based on whether an obligation is a derivative or nonderivative, we suggest that the Board explain its reasoning.

Paragraph 22B—As a result of the Board’s decision to require that puttable instruments (such as interest in mutual funds, puttable common stock, and so forth) be accounted for as liabilities it would be helpful for the Board to clarify whether those liabilities can be designated as trading and carried at fair value under IAS 39. In addition, the Board might reference the interaction of the guidance in this paragraph with the guidance on paragraph 29F for items such as puttable common stock (which contains an embedded derivative). In particular, the Board should make clear that what is recognized as a liability is the financing component of the instrument, not the equity component.

Paragraph 22D—Although the Exposure Draft results in certain equity-settled items being accounted for as liabilities, the statements that are made in this paragraph (as well as in paragraphs 29F, B22, and the explanation of examples in Appendix A) represent assertions by the Board that certain items are or are not representative of residual interests or that do or do not meet the definition of equity. By using such statements as “. . .the counterparty does not hold a residual interest in the entity,” and “. . .those equity instruments cease to meet the definition of equity instruments,” when describing obligations that require settlement in an entity’s own shares, the implication is that the Board has debated and decided on changes to the definitions of liabilities and equity at a fundamental conceptual level. We do not believe that is the case. The distinctions made in this proposed amendment are made as a convenience rather than being conceptual definitions of liabilities and equity that inherently result in a distinction between obligations settled in a fixed number of equity shares and those that are settled with a variable number of equity shares. In addition, paragraph 22B requires items that do have the characteristics of residual interests to be treated as liabilities. We would recommend that such assertions be eliminated or qualified with words such as “For purposes of applying this standard . . .”

## ***5. Classification of Compound Instruments by the Issuer***

Paragraph 25—The first sentence of this paragraph should be revised to reflect the fact that not all conversion options in convertible debt would meet the conditions for separate classification in equity. For example, convertible debt with a conversion option that would require the issuer to issue a variable number of shares to equal a fixed amount would not have a component classified in equity.

## ***6. Transactions in an Entity’s Own Equity Instruments***

Paragraph 29F—We believe that qualification for financial liability, rather than derivative, treatment under the standard should be further limited to circumstances in which an entity has enough shares authorized and outstanding to buy back under the contract. That is, an entity should not be permitted to write options, for example, on its own stock in excess of the number of shares authorized and outstanding and avoid derivative treatment unless it has the unilateral power to issue additional shares in settlement.

## **7. *Offsetting of a Financial Asset and a Financial Liability***

Paragraphs 33 – 41—These paragraphs provide guidance for offsetting a financial asset and liability, but do not address when and whether offsetting of related items in the income statement would be appropriate. We suggest that the Board provide such guidance or refer to the guidance in paragraphs 33 – 37 of IAS 1.

Paragraph 36—It is not clear what unusual circumstances would provide for three-way netting, and whether the “agreement” between the three parties that is referred to in this paragraph must be documented, for example, as part of the contract or could be evidenced in some other manner. We suggest that the Board clarify this guidance with an example.

Paragraph 41—This paragraph requires that both criteria in paragraph 33 be met to qualify for offsetting under a master-netting arrangement. We observe that there is a difference between IAS 39 and U.S. GAAP in this area. The difference relates the ability under U.S. GAAP to offset multiple derivative contracts under a master netting arrangement whether or not the entity intends to settle all contracts net. We encourage the Boards to consider which alternative is the higher quality solution and to converge on this issue.

## **8. *Disclosure***

Paragraph 43—Paragraph 43 contains information about various types of risks but does not specify disclosure of the items it describes. The information contained in this paragraph might be more useful if it was presented under the relevant disclosure requirements in the standard. For example, the definition of market interest rate risk and cash flow interest rate risk might be helpful as part of the discussion in paragraph 57.

Paragraphs 46A and 46B—We believe that the disclosures in IAS 32 related to risk management are helpful to financial statement users. However, we believe that information about an entity’s risk management policies and objectives also should be included in MD&A type disclosures. We note that the IASB has a project on its research agenda to potentially require MD&A type disclosures and suggest that the Board include this issue in the scope of that project.

## **9. *Appendix A***

Paragraphs A13 and A17—We recommend that the words in these paragraphs conform to final words developed by the Board for both IAS 32 and IAS 39 that effectively and clearly describe which of these nonfinancial contracts are to be accounted for as derivatives and which are not. Although we support that distinction, we do not believe that the current words in IAS 32 or IAS 39 adequately differentiate. In addition to referencing paragraph 4A in the last sentences, these paragraphs could also describe that it is those commodity contracts that are used essentially for trading and capturing short-term profits that are to be accounted for as derivatives.

Paragraph A23(a)—This paragraph indicates that an entity should assume that the debt component of convertible debt will be outstanding to maturity for purposes of initial measurement and subsequent amortization of any differential between allocated proceeds and the maturity amount. That approach raises questions about whether the entire time to maturity is also the appropriate amortization period given the existence of the conversion option. We suggest that the Board provide guidance illustrating the calculation of discount or premium and selection of the appropriate amortization period for convertible debt in either IAS 32 or IAS 39.

Further, there is no guidance in either of the proposed standards on the accounting when a convertible instrument is converted before maturity. Questions may arise, for example, on how the consideration given in exchange for the debt should be allocated to the components or how the gain or loss on the liability component should be determined. We suggest that the Board provide guidance in those areas in one of the standards.

Paragraph A23(b)—We suggest that the word “increase” in the penultimate sentence be replaced with the word “change” since derivative values may fluctuate up or down. In addition, we believe that the last sentence of this paragraph should be deleted. Debt and preferred stock instruments issued with beneficial (in-the-money) conversion options are not uncommon.<sup>6</sup>

Paragraphs A36 and A41—These paragraphs communicate similar notions, however, paragraph A36 uses the term “generally” in the first line, whereas paragraph 41 does not.

Paragraph A41—The word “written” in the last line of this paragraph should be “purchased.”

## ***10. Appendix B***

Paragraph B10—This description of the Board’s proposal seems to differ from the application of the standard described in paragraph 29 – 29F. It appears, however, to be consistent with 29G.

Paragraph B21 – B26—Once the Board clarifies its basis for a liability-equity distinction by reconciling the seeming inconsistencies between paragraphs 22C, 29C and 29G, the words in this paragraph should be updated. Also, this section of the basis uses the term “indexed to.” Please refer to our earlier comments about the use of that term.

Paragraph B25—The explanation of the Board’s conclusions in this paragraph does much to clarify the approach described in paragraph 29D – 29G. (Although we note that it is not consistent with the guidance on paragraph 29E.) If the Board decides to keep the approach in those paragraphs, perhaps the Board should consider replacing words in the standard section with the words in this paragraph.

Paragraph B27—The table in this paragraph indicates that a forward to buy that requires gross physical settlement would be classified as a liability, whereas a purchased call option also requiring gross physical settlement would be classified as equity. What would be the accounting for a deep-in-the-money purchased call option for which it is determined that the terms of the contract constructively obligate the entity to exercise the call? The guidance in paragraph 22 would seem to indicate that an assessment of the substance results in liability classification.

## ***11. Other***

We notice that a number of terms are used interchangeably within the standard to refer to different types of equity instruments. For example, “common shares” is used interchangeably with “ordinary shares,” and “preferred shares” and “preferred stock” are used interchangeably with “preference shares.” We suggest that the Board define the terms (with reference to the alternative terms) but use “ordinary shares” and “preference shares” within the document.



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<sup>6</sup> Refer, for example, to EITF Issue No. 98-5, “Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios.”

## **APPENDIX III—COMMENTS ON IAS 39**

The following sections provide responses to the questions posed in the invitation to comment in IAS 39 and additional comments on the proposed amendments to that standard.

### **A. Responses to the Invitation to Comment**

#### **Question 1—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?*

We note that the scope exception is narrower than this question implies, since it is not available to issuers of loan commitments with a past practice of selling loan assets shortly after origination. Further, an issuer would apply the guidance in IAS 37 to loan commitments that are outside the scope. No specific guidance is provided for holders of loan commitments. That approach to the accounting for loan commitments results in the same types of loan commitments being accounted for differently depending on whether the entity designates them as held for trading or has a past practice of selling the underlying loan shortly after origination.

We believe that all loan commitments should be within the scope of IAS 39 for both the holder's and issuer's initial recognition and measurement without regard to an entity's practice or intent, similar to the approach taken by the Board for financial guarantees. We also believe they should be excluded from the definition of a derivative, provided they are to be settled by executing a loan within a normal period of time necessary to complete the underwriting of the loan. Thus, rather than excluding loan commitments from the scope, we suggest that the Board include them, requiring that they be recognized at fair value and appropriately classified as if they were nonderivatives.

We recognize that under our proposal, the Board would need to address the subsequent accounting for loan commitments, as is the case with financial guarantees (see our comments below under "Financial Guarantees"). For example, in order to facilitate the subsequent accounting for fees and costs associated with loan commitments designated as other than trading by the issuer, the Board might refer to appropriate guidance in IAS 18, IAS 37, or other IFRS.<sup>7</sup> However, if the subsequent accounting for loan commitments is intended to be under another IFRS (such as IAS 37 or IAS 18), the Board would need to provide additional guidance to indicate how the guidance in those standards interacts with the guidance in IAS 39, since those standards may have different recognition criteria and measurement objectives. The issue of guidance on subsequent measurement is highlighted later in this letter in the context of our comments on the treatment of financial guarantees under IAS 39.

#### **Question 2—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?*

<sup>7</sup> We note that the guidance provided in the appendix in IAS 18 to distinguish between different types financial service fees might be useful in the application of IAS 39. We suggest that the Board consider including that type of guidance in IAS 39 or make a direct reference in IAS 39 to that guidance.



We support the continuing involvement approach to derecognition in the Exposure Draft as useful interim solution because we believe it will improve the operationality of the standard until such time as the issues surrounding the risk-and-rewards-based and control-based approaches are resolved and a superior solution can be agreed. We suggest that the Board address some application issues that we identify later in this comment letter in the section on “Derecognition.”

In particular, we note that the approach in the Exposure Draft to the accounting for assets and liabilities associated with the failure of an asset transfer to qualify for derecognition results in the adjustment of the asset’s carrying value based on an option’s strike price. We believe that approach in essence creates a synthetic instrument that could not be replicated in the market. We believe that the asset (or portion of the asset) associated with the failed sale should continue to be accounted for as if it were not transferred (which is result that would occur if the accounting premise is take to its logical conclusion). Because of the “failed sale” circumstances, there is a relationship between the asset and the liability and, therefore, subsequent gains and losses both could be accounted for on the same basis. Finally to the extent that there are puts and calls that result in a failed sale, they should be associated with the liability. We illustrate the application of that approach and contrast it with the accounting proposed in the Exposure Draft later in this letter in the section on “Derecognition.”

**Question 3—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?*

We generally support the approach in paragraph 41 and believe its appropriate application should result in appropriate derecognition based on the rights and obligations embedded in the particular arrangement. However, we believe some aspects of the approach need to be clarified. Our comments are provided below in the section on “Derecognition.”

**Question 4—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?*

We agree with the provision in the Exposure Draft that permits an entity to designate any financial instrument to be accounted for at fair value with changes in value recognized in profit or loss. We believe that this approach is better than a similar alternative permitted under IAS 39 currently, which allows entities to choose to recognize gains and losses on available-for-sale financial assets in net profit or loss. By allowing the option to recognize fair value gains and losses for both assets and liabilities in profit or loss under the proposed amendment, the Board’s proposal improves an entity’s ability to take advantage of natural hedges without having to bear the costs of documentation and tracking effectiveness, among other things. We recognize that the Board’s proposal is not consistent with its policy to reduce alternatives within standards, although it is consistent with the Board’s direction of increasing the use of fair values for financial instruments.

Nonetheless we believe it is important for the Board to carefully evaluate the interaction of this proposal with other aspects of IAS 39’s guidance and with the change in the distinction between

liabilities and equity proposed in the Exposure Draft for IAS 32, which expands the types of financial instruments that will be considered financial liabilities for purposes of applying IAS 39.

We observe that the accounting for assets and liabilities associated with the failure of an asset transfer to qualify for derecognition are not accounted for at fair value under the approach in the Exposure Draft. If the Board maintains that approach, we suggest it clarify that those items are excluded from fair value designation. We also believe that the asset (or portion thereof) that has not been derecognized should be accounted for based on its original classification, which may or may not be at fair value with changes in fair value recognized in profit or loss (see our comments below on “Derecognition”).

We also suggest that the Board clarify whether the calculation fair value of an issuer’s liability should take into account its own credit risk. The answer is implicitly yes, since an entity should use a current bid price (which would take into account the credit rating of the issuer) if available; however, we were not aware of whether the Board intended this issue to be resolved without further debate. If not, that debate will need to be undertaken in the future if and when a full fair value accounting model for all financial instruments is developed. If an entity’s credit risk is to be taken into account in measuring the fair value of the entity’s own nonderivative liabilities, we are concerned about the presentation of fair value gains and losses due to changes in an entity’s own credit quality within the equity section of the balance sheet prior to settlement of a nonderivative liability. For example, gains due to a deterioration in credit quality do not represent increases in shareholder value or positive performance by the entity and, thus, are not appropriately represented as retained “earnings”(see our comments on IAS 32 “Additional Comments, Page 12, second bullet under the section on disclosures”).

Finally, we note that the proposal to permit any financial instrument to be carried at fair value, coupled with the ongoing difficulties associated with fair value measurement, will increase pressures on the Board to move forward in its efforts to improve the guidance and standards related to fair value measurement. (See our comments below in response to Question 5.)

**Question 5—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?*

While we understand that it is the Board’s intent to move toward greater use of fair value measurement for financial instruments, we recognize that practical issues can arise in implementing that approach. In particular, we believe that preparers will have difficulties when little or no information is available for a particular financial instrument and the instrument does not have contractually specified cash flows. Fair value is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction. The only circumstance in which fair value can be readily observable is in an active market where knowledgeable parties are actively setting a price through actual transactions. In the absence of an active market, estimates of what amount two parties may be willing to exchange an asset is not always information that can be determined with minimal cost or effort, if at all. The only reliable information readily known by the reporting entity in those situations may be the cost of the investment.

We observe that there is a difference between IAS 39 and U.S. GAAP in this area. The difference relates to the exceptions under U.S. GAAP from fair value measurement for debt and equity securities that do not have readily determinable fair values and for derivatives on equity instruments that require delivery of, for example, an equity security (or other asset) that is not “readily convertible to cash” (e.g., marketable). In contrast, under the amendments in IAS 39, holdings in private companies whereby the reporting entity does not have significant influence or control would be subject to fair value. It may be difficult for the entity to gain access to the necessary information to estimate fair value and then properly analyse that information without substantial effort. When one considers that the information is to be reflected in the financial statements as frequently as quarterly, it may be difficult to justify the costs associated with obtaining that information. We encourage the Boards to consider which alternative is the higher quality solution and to converge on this issue.

The guidance in paragraph 102 is only applicable to equity instruments and derivatives on those instruments. Certain derivatives and non-marketable equity instruments are the types of financial instruments likely to be most difficult to measure at fair value due to a lack of information. However, there may be other items whose fair value cannot be estimated within a narrow range because of a lack of observable market information or significant uncertainty, such as non-collateralised (or under-collateralised) debt instruments of issuers experiencing significant credit difficulties, residual interests subject to substantial credit and prepayment risks, financial instruments that have more than one underlying with the payoff on one being dependent on the other, credit guarantees, or combinations of those items.

Again, we encourage the Board to move forward in its efforts to improve the guidance and standards related to fair value measurement. The proposed guidance on fair value in the Exposure Draft improves the guidance on determining fair value by emphasizing the consideration of market-based assumptions and evidence for estimating amounts. We support the inclusion of this additional guidance. We observe that paragraph 102 limits the use of fair value for equity instruments without a quoted market price when variability in estimates is wide. We suggest that the Board clarify that this approach does not create another classification (i.e., items accounted for at cost) that provides an exception to fair value measurement. Rather we suggest that the Board emphasize that should fair value for the items subsequently become reliable, the item should be measured at fair value. For example, an active market may develop for private equity securities that are made available to the public capital markets.

We observe that the Exposure Draft’s references to fair value are often followed by parenthetical references to present value. We would be concerned about readers inferring that the terms fair value and present value are interchangeable. One example is in paragraph 159(a)(ii). Since fair value is a measurement attribute and present value is a measurement technique, we do not view the two as equivalent unless the objective of the present value calculation is fair value. In those circumstances where the two terms are presented together, we suggest that the Board select one or the other term as appropriate, or indicate that the objective of the present value calculation is to achieve a fair value consistent with the guidance in paragraphs 95 – 102 of the Standard.

**Question 6—Collective evaluation of impairment (paragraphs 112 and 113A—13D)**

*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?*

Yes, we agree with the approach in the Exposure Draft. We believe that the methodology for calculating an impairment loss ensures that no loss would be recognized at the date the loan is originated or acquired, which is an appropriate result. We identified some potential application issues that might be avoided with additional guidance. Those are discussed below.

**Question 7—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?*

We do not agree with the Board's proposal that impairment losses for investments in debt and equity instruments that are classified as available-for-sale should not be reversed to the statement of profit or loss. That approach would lead to adoption of different accounting treatments for identical financial instruments bearing the same level of risk, according to their classification (originated loans and debt instruments held to maturity vs. available for sale debt instruments). In addition, the approach is not consistent with the current requirements of other IASB standards, in particular IAS 36, dealing with impairment. We believe that entities should be required to reverse impairment losses through profit or loss. We understand that the Board might have arrived at this conclusion because it is perceived to be consistent with U.S. GAAP; however, we do not believe that the Board has been able to adequately assess whether such an approach improves the quality of financial reporting—especially since it creates an internal inconsistency within IFRS when taken as a whole.

We recognize the possibility for cherry-picking may arise if the Board changes its position and permits reversal of impairment losses on available-for-sale securities. However, we believe that can be mitigated if the Board provides more guidance on the circumstances in which it is appropriate to recognise and to reverse an impairment loss.

**Question 8—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?*

We support this change to the accounting for a hedge of an unrecognised firm commitment. However, we believe that the Board should consider allowing an entity to account for a foreign currency hedge of a firm commitment either as a cash flow hedge or as a fair value hedge consistent with U.S. GAAP. In that circumstance, the value of the firm commitment is affected by changes in value of both the foreign currency and the price of the underlying item to be delivered. Please also see our response to Question 9.

**Question 9— '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 recognized 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?*

We agree with the conclusion to eliminate basis adjustment. However, we believe the Board needs to clarify the accounting for the fair value hedge of the foreign currency exposure of a firm

commitment to acquire an asset. We observe that an approach that views the firm commitment as part of the fair value of the asset to be acquired essentially results in basis adjustment.

We also encourage the Board to consider providing guidance or examples to clarify the appropriate accounting for the transferred amount from the hedging gains and losses in equity related to the forecast transaction (i.e., the effective portion of the hedge) to the income statement as part of the measurement of revenue or cost of sales. Clarification may also be needed in IAS 18 (on revenue) and IAS 2 (on inventory and cost of sales).

**Question 10—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?*

We believe that entities should be required to restate their financial statements for items that were derecognized but would not have been derecognized under IAS 39 as amended. However, we believe it is important to acknowledge the practical issues that entities may face in restating, for example, securitisation structures for which the accounting would change under the IAS 39 proposals. We suggest the Board provide examples and supplemental guidance to assist entities with implementation of the transition provisions.

**B. Additional Comments on the Proposed Amendments to IAS 39**

The following comments relate to specific paragraphs or sections of the Exposure Draft related to IAS 39 that were not covered under our response to the questions above. The following areas are covered topically: the accounting for financial guarantees, derecognition, impairment, recognition of gains and losses related to hedging activities, and embedded derivatives. Following those topics, we provide general and editorial comments (in the order in which they arise in the text of the Exposure Draft) on other parts of the Exposure Draft.

**1. Financial Guarantees**

We support the Board's proposal to initially recognize and measure financial guarantee contracts in accordance with IAS 39 (discussed on page 127, second bullet and paragraph 1(f)). However, we believe that it would be useful for the Board to clarify the subsequent accounting for those financial guarantees. We believe the standard needs to clearly state that initial recognition and measurement under IAS 39 is required for both holders and issuers of financial guarantees. Further, as noted in our response to Question 1 on loan commitments, we believe that by scoping these items into the standard, a number of implementation questions arise with respect to the subsequent accounting, which often is contained in other standards that have different recognition criteria and measurement objectives. Some questions might include, for example, when and how is the initial amount recognized adjusted—is the initial “premium” amortized to income over the life of the contract? Is it deferred and not remeasured but embedded in the loan as an adjustment to yield? When and how does IAS 37 apply? The following paragraphs illustrate some of those issues in terms of financial guarantees.

We believe that the interrelationship of IAS 39 and IAS 37 raises some implementation questions when their respective recognition and measurement requirements are applied to the guarantee. Under paragraph 1(f) of the Exposure Draft, financial guarantee contracts would be initially recognized and measured under IAS 39. Subsequent measurement would be calculated using guidance in IAS 37, specifically paragraphs 36 – 39. We observe that the measurement guidance in paragraphs 36 – 39 of IAS 37 is not consistent with the fair value measurement guidance provided in IAS 39. For example, under IAS 39, an entity would be required to estimate fair value using quoted market prices, recent market transactions, or a valuation technique using “estimates and assumptions that are consistent with available information about the estimates and assumptions that market participants would use in setting a price for the financial instrument” (paragraph 100C). In contrast, an entity would develop its “best estimate” under IAS 37 using “. . . the judgement of management of the enterprise, supplemented by experiences of similar transactions and, in some cases, reports from independent experts.” We suggest that the Board provide guidance on how to determine the fair value of financial guarantees on initial recognition and indicate whether there is a presumption that the fair value of the financial guarantee contract is equal to the present value of the premiums to be received.

A secondary aspect of the same issue is that IAS 39 refers only to the guidance in paragraphs 36 – 39 of IAS 37 and does not provide guidance on when an entity should recognize a change in value of a guarantee. The recognition guidance in IAS 39 and that in IAS 37 differ. Under IAS 39 an entity would recognize a financial guarantee when it becomes a party to the contract. Under IAS 37, an amount would be recognized as a provision for the guarantee when an outflow of economic benefits is probable (i.e., more likely than not). IAS 37 further requires reversal of a provision if it is no longer probable that economic benefits will be required to settle the obligation. Without additional or clarifying guidance, it seems that an entity could recognize a financial guarantee at fair value at inception and immediately reverse (derecognize) it because an outflow is not probable.<sup>8</sup> We suggest that the IASB consider providing guidance to clarify the subsequent accounting for financial guarantees, including guidance on how amounts initially recognized are adjusted and how revenue would be recognized by the writer of the guarantee.

We also note the FASB recently issued an Exposure Draft, *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees and Indebtedness of Others*, which requires that nonderivative guarantees be recognized at inception and initially measured at fair value, with subsequent measurement under other appropriate U.S. standards. We believe that the approach to accounting for guarantees proposed by the FASB is similar to that proposed by the IASB.<sup>9</sup> We encourage the Boards to monitor developments on each other’s projects and to arrive at a converged solution if possible.

## 2. Derecognition

We are supportive of the Board’s continuing involvement approach to derecognition as an interim measure to improve the operability of the standard until a better solution can be

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<sup>8</sup> In dealing with similar issues in its Exposure Draft on guarantees, the FASB concluded that the amount to be recognized at initial recognition would be the greater of the guarantee’s fair value or the amount that would be estimated as probable under FASB Statement No. 5, *Accounting for Contingencies* (roughly equivalent in scope to IAS 37). However, the FASB did not address subsequent accounting for financial guarantees.

<sup>9</sup> Although the approaches appear similar, the subsequent accounting (e.g., measurement) for guarantees under IAS 37 may differ from subsequent accounting under U.S. GAAP.

developed. We have some comments on its application and some suggestions to improve the guidance as discussed below.

*Scope of guidance.* We believe that it would be appropriate to extend the derecognition provisions to an entity's interest in an associate that has continuing involvement in transferred assets. The guidance in paragraph 37(b)(ii) indicates that the derecognition guidance applies to a consolidated entity, but is not clear whether it also applies to an entity's interest in an associate if, for example, the entity sold an asset to the associate that otherwise would meet the requirements for derecognition. Does the entity have continuing involvement to the extent of the reporting entity's interest in the associate?

The standard also does not provide guidance on the derecognition of interests in subsidiaries, associates, and joint ventures. For example, what is the appropriate accounting if an entity sells a 20 percent minority interest of a 100 percent owned subsidiary to a third party and simultaneously enters into, with that same counterparty, a call option to buy back the 20 percent subsidiary shares at a fixed price at a future date, and the minority interest holder has a put option to sell the 20 percent back to the parent under the same terms. We are unsure whether these options would create a failed sale or should be treated as derivatives and, in this case, follow the accounting treatment that will be ultimately decided by the Board (refer to IFRIC agenda on derivatives on interests in subsidiaries, associates and joint ventures).

*Pass-Through Arrangements.* Although we believe that there is a need for guidance to describe the circumstances in which certain types of structures—pass-through arrangements—qualify for derecognition, the guidance provided in paragraphs 41 and 42 must be clarified. In particular, we are concerned that (1) application of the guidance in paragraph 41(a) – (c), as presently worded, will disallow derecognition of all or a portion of assets for an entity operating as a pass-through arrangement and (2) the guidance in SIC-12 may result in a circumstance in which a transferor meets the derecognition conditions under a pass-through arrangement but ultimately must consolidate an SPE that holds the assets for the benefit of investors.

It is not clear from the words in paragraph 41 whether the term transferor is intended to apply to the originator of the assets or to, for example, a special purpose entity (SPE). That makes it difficult to analyze transactions within the guidance provided in that paragraph. Nonetheless, when analysed from the perspective of the SPE as the transferor, application of 41(a) – (c) may disqualify assets from derecognition for some arrangements that typically are viewed as pass-throughs.

One simple example is that of an SPE that issues beneficial interests to investors that are backed by short-term credit card receivables. In some types of arrangements, investors may receive long-term beneficial interests that entitle them to a series of fixed payments at predetermined dates. However, the receipt of cash flows from the transferred assets during the period may not be equivalent to the amount the SPE is obligated to pay to investors. When excess cash flows arise, there may be a delay between receipt and payout of cash flows, during which time, the SPE may invest in short-term, highly liquid investments (which is currently permitted under IGC 35-2) and thus, benefit from those cash flows. Alternatively, the SPE may be required to acquire additional receivables to fund the beneficial interests. This type of arrangement would seem to fail to meet all three of the conditions described in paragraph 41. We are not clear if the Board intended those consequences for certain types of structures that are currently viewed by many as pass-through arrangements.

Other common terms of pass-through type arrangements that would not seem to meet 41(a) include specific protection mechanisms (excess spread, reserve fund, liquidity arrangements, credit enhancement facilities, and so forth) which are set out to protect the investors from related risks (and thus create an obligation for the SPE to pay amounts to the investors even if the transferred assets that qualify for derecognition do not pay out). Similarly, the SPE might enter into derivative transactions (e.g. swaps) to convert cash received to a basis consistent with the SPE's liabilities; thus investors will not necessarily be paid directly from the amounts collected from the financial assets. Paragraph 41(b) prohibits the selling/pledging of the transferred assets to qualify for the pass-through arrangement. In order to protect investors, SPE are often contractually allowed to sell specific (impaired) assets. In our opinion, that criterion would significantly limit the derecognition of assets in a large number of transactions, such as in the case of managed CDO structures. Finally, paragraph 41(c) would seem to prohibit derecognition for common securitisation transactions that have characteristics of revolving structures. Thus, we recommend that the Board re-evaluate and clarify what the intended application and results should be for guidance on pass-through arrangements.

In addition to those concerns, we also note that in cases where assets are not fully derecognised from the balance sheet of the transferor (because of a credit guarantee issued or of retained interests) and the transferee is an SPE that must be consolidated under SIC 12, there remain uncertainties about the consequences of the securitisation transaction on the financial statements of the transferor. This is particularly true in cases where the SPE recognises a loan to the transferor up to the amount of the 'failed sale' instead of the transferred assets.

We believe that it would be valuable to provide a more complete example of the accounting treatment of a securitisation transaction involving both a transferee, an SPE, and investors rather than the example presented in paragraphs B4-B17, which only encompasses the accounting treatment on the level of the SPE and does not show the potential impacts on the balance sheet of the transferor.

*Servicing.* Although the initial recognition for servicing assets and liabilities is explained in the Exposure Draft, we believe that more guidance on defining what is meant by "adequate compensation for the servicing" in paragraph 48(b) would be helpful. We suggest that guidance indicate that the amount of the servicing asset recognized when allocating proceeds is limited to the amount of servicing fees expected to be more than adequate compensation for servicing (see paragraph 43 of the standard). It may not be clear as written because the example provided in paragraphs B4 – B17 does not differentiate between adequate and excess servicing.

Further, the subsequent accounting for servicing assets and liabilities is not specifically addressed. Although the Board acknowledges that they are not financial instruments, perhaps additional guidance or reference to another standard (such as IAS 38) is needed to clarify the subsequent accounting.

*Transfers that do not qualify for derecognition.* Paragraph 52 indicates that an entity should "recognize a financial liability for the portion of the transferred asset that does not qualify for recognition." We believe it would be more accurate to say that a liability is recognized for a portion of the proceeds received for the transferred asset that does not qualify for derecognition. The suggestion we are making is not consistent with the examples used to illustrate the application of these provisions in Appendix A (A8(a)) and Appendix B (B20(b)). In those examples, the amount recognized as a liability is equal to the option exercise price less its time



value, which bears no relationship to either the proceeds received or the fair value of the asset. Part of the difficulty is that similar words are used to describe what is a failed sale (paragraph 52) and what is derecognition of a portion of a transferred asset (paragraph 47). It is not clear how to distinguish the two, and the guidance views items retained and items that do not qualify for derecognition differently. As discussed more fully below, we believe that paragraph 52 should be changed to measure the liability at an amount equal to the proportion of the proceeds received that is associated with the portion of the asset transferred that failed to qualify for derecognition. For example, if the fair value of the portion of the asset that failed to qualify for derecognition was equal to 20 percent of the fair value of the asset transferred, then the liability should be recognized at an amount equal to 20 percent of the proceeds received.

Similarly, the example provided in paragraph A8(a) is confusing. Can a conclusion be reached about the values assigned to various items without knowing the amount of the proceeds? What would be the conclusion in this example if the option only related to, say, 30 percent of the carrying value of the asset and that portion was worth 50 percent of the fair value of the entire asset?

Paragraphs 53 – 55 (and the example in paragraph A8(a)) describe the accounting for a transfer that does not qualify for derecognition and take an approach that reclassifies the transferred asset and recognizes a liability for a borrowing. Under that approach, an option to reacquire the transferred asset affects the accounting for the asset. We believe that if a transferred asset does not qualify for derecognition, the accounting for that asset should be the same as it would be if the asset was not transferred—consistent with the accounting conclusion that it effectively was not transferred. Instead, the liability that results from a “failed sale” should be accounted for as if it were debt indexed to the underlying asset. That approach is contrasted to the Exposure Draft approach and illustrated below.

Suppose Entity A transferred to Entity B its share of Company X with a call option allowing A to repurchase the share at a later date. Entity A received 75 proceeds, and the call option, which is exercisable in 1 year, has a strike price of 95. The stock has a fair value of 80 and the option’s time value is 5. Given the call option, the transfer does not qualify for derecognition. Thus, under the Exposure Draft, Entity A does not derecognize the share but reclassifies it as a pledged available-for-sale security and increases its carrying value to 95. Entity A also recognizes a liability for  $95 - 5 = 90$  (the call option would not be accounted for as a derivative). Under paragraph 53, since Entity A’s exposure to changes in fair value of the asset is perceived to be limited, no decreases in value of the share would be recognized, and only changes in fair value above 95 would be recognized, even though it is designated as available for sale. That approach essentially treats the asset as if it were derecognized and the option as providing Entity A with the right to participate in a particular tranche of cash flows associated with the stock; those cash flows above 95. However, in our review of that approach and the examples in the appendix we observe that (1) none of the items involved in the transfer are carried at their fair values, (2) the transferee’s accounting does not mirror the transferor’s accounting (3) there would be interesting effects on the transferor’s balance sheet if the call option is way out of the money—for example, if the strike price was, say, \$500. We do not believe that the option’s strike price is a relevant measure of the asset in any case.

We believe that a better approach would be to treat the transferred asset as if it was not transferred and, instead, reflect the relationship between the asset and the call option in the accounting for the liability. We propose this alternative because we believe it provides a better

representation of the economics underlying the transaction when the accounting is taken to its logical conclusion—the asset’s carrying value is the same as it would be absent the transfer, and the liability is a debt instrument recognized at proceeds at initial recognition. Neither value is dependent on the strike price of the option, and the liability would be analogised to indexed debt (that is indexed to the fair value of the asset). We believe that this approach is further supported by the economic effects of the put or call option associated with the failed sale. The effect of the transferor’s exercising a call option in the failed sale circumstance is essentially to settle the liability. Similarly, the effect of the transferee’s exercise of the put option is to require settlement of the liability. In neither case is the value of the asset anything other than its fair value. We have difficulty understanding what the measurement of the asset represents under the approach in the Exposure Draft because it changes the asset’s carrying amount to an amount unrelated to either its fair value or its original carrying amount. We believe the objective of our proposed approach would be for the net of the asset and the liability amounts to equal the residual (retained portion) carried at an amount appropriate and consistent with its classification.

We acknowledge that, under our proposal, the Board would need to develop further guidance for subsequent accounting, including whether the difference between the proceeds received and the strike price of the option should be amortised, the extent to which gains and losses on the asset are reflected in the carrying amount of the liability, and whether subsequent gains and losses on both the asset and the liability associated with the failure of an asset transfer to qualify for derecognition should be accounted for on the same basis (that is, if the asset (or portion of the asset) that does not qualify for derecognition is accounted for as trading, gains and losses on the liability would be also accounted for in profit or loss, or if the asset is accounted for as available for sale, the gains and losses on the liability likewise would be accounted for in equity). However, that is the same level of detailed guidance that the Board has developed under its current derecognition proposals.

Using the same example as above, Entity A would keep the available for sale classification and measurement (that is, 80) for the transferred security and account for it accordingly. A liability would be established for the amount of cash Entity A received, that is for 75. When the value of the stock is greater than 95 (the option is in-the-money), changes in value of the stock above that price would be reflected in carrying value of the liability. Recognition of fair value changes in the asset is not limited (as it would be under paragraph 54), and any option is appropriately associated with the liability and not the asset. Under that approach, the numbers in the examples in Appendix B would differ (e.g., paragraph B20, B21, and B22).

*Paragraph A9(i).* This paragraph indicates that derecognition of an asset is precluded for assets subject to fair value puts and calls. We agree that that conclusion is consistent with the continuing involvement approach in the Exposure Draft. We note that under the guidance in paragraph A8, the borrowing related to an asset that does not qualify for derecognition because of a call option should be measured at the option exercise price less the option’s time value, and the carrying amount of the asset is to be adjusted to the higher of the asset’s fair value or the option exercise price. We believe that it would be helpful for the Board to provide an example of how the cash flows associated with the asset in the intervening period from inception to exercise date would be accounted for. For example, it would be helpful to illustrate how the cash flows associated with the asset in years 1 – 5 be accounted for if the option was not exercisable until year 5.

*Application of Paragraph 89B.* Paragraph 89B of the Exposure Draft states that designation as held for trading occurs at initial recognition. We believe an entity might interpret that guidance to include the ability to designate as held for trading a liability recognized pursuant to a transfer of a financial asset that does not qualify for derecognition. The Board might want to clarify that in the guidance for applying paragraph 89B.

*Other Comments on Derecognition.* It is unclear how the concept of ‘continuing involvement’ will be reflected in the accounting entries, depending on the nature of the ‘continuing involvement’. Thus, we believe it is necessary to give more detailed examples of what would be the correct accounting treatment according to different scenarios, including illustrating a transfer with a deferred payment, a transfer with the constitution of a cash collateral, a transfer with a limited credit guarantee, and a transfer of a portion of a portfolio with the remaining portion pledged as collateral. The example given in paragraphs B1-B3, illustrating the sale of a financial asset with a credit guarantee, is too simplistic.

### **3. Impairment**

We support the proposed approach to impairment evaluation of assets carried at amortized cost. The comments that follow relate to areas in which we saw opportunities to clarify or improve the guidance.

In the general guidance for impairment, paragraph 111 says that cash flows relating to short-term receivables generally are not discounted. That statement might imply to some that the Board does not believe it is appropriate to discount short-term items or that entities are precluded from discounting those items if they so chose. We suggest that the Board consider being silent on this issue by dropping this sentence in paragraph 111.

Paragraph 112 indicates that “an entity . . . includes the asset in a group of financial assets with similar credit risk characteristics that are collectively assessed for impairment.” We cannot tell if this is a requirement either (1) to group assets for impairment or (2) to include an asset (that individually was not deemed impaired) in a group if assets are grouped for impairment, or whether this guidance is intended to permit both or a choice between (1) and (2). We suggest that the words used in this paragraph might be interpreted in different ways and thus, we believe the Board should clarify the intent of this guidance to avoid confusion. We also suggest the Board provide guidance on what is meant by “similar credit risk.”

We agree with the guidance in paragraph 113C, which indicates that an entity incorporates historical loss experience into its estimates of expected cash flows. We believe that historical prepayment experience also should be incorporated for assessing impairment. As a consequence, we suggest that paragraphs 113C and 10 (definition of the effective interest rate) be modified to make clear reference to prepayment experience.

We suggest referring in paragraph 113D to the example in paragraph B35 to assist readers in understanding both the initial calculation of effective rate and the subsequent accounting for interest and other changes in value for assets evaluated collectively for impairment.

Paragraph 115 uses the phrase “rate of interest used to discount the future cash flows for the purpose of measuring the recoverable amount.” Based on our reading of the guidance, we believe that is the same as the original effective interest rate referred to in paragraph 111 and determined under paragraph 113D, but it sounds like a different rate is required. If the two are the same we

suggest that the same words be used or a reference be made to where in the standard guidance is provided for calculation of the appropriate rate. Also, we were unsure about whether the guidance in paragraph 115 also was applicable for the recognition of interest income after impairment of available-for-sale financial assets.

The example in paragraphs B32 - B36 is a good base example to illustrate the mechanics of the impairment guidance for a group of financial assets. We recommend that the Board also provide a more complex example illustrating application of the guidance when assets within the group are sufficiently homogeneous for grouping but have different interest rates and maturities. Those types of groupings are likely to be more common than a group of assets with identical characteristics. Further, we believe that illustration of calculation of the appropriate discount rate when the population of items in the group changes (for example, new assets are added to the group) would clarify the intent of the Board's approach.

#### ***4. Recognition of Gains and Losses related to Hedging Activities***

*Macro-hedging.* We support the Board's conclusion not to provide exceptions to the general hedge accounting guidance for macro hedging strategies. We believe that the standard provides sufficient flexibility in terms of designating hedging instruments entirely, in proportion, or in combination and permitting any item to be classified as trading to allow entities to effectively meet the same objectives as those met through a macro-hedging strategy. At the same time, an entity is not encumbered by the need to designate, document, and test for effectiveness each particular item within a portfolio to achieve its objectives. The guidance and discussion in paragraph 133 is helpful in conveying that point.

*Gains and losses on hedging instruments and hedged items.* We support the guidance in paragraph 103 for accounting for gains and losses on financial assets and financial liabilities based on their classification. The comments that follow relate primarily to gain and loss recognition associated with hedging activities.

With respect to cash flow hedges using nonderivative hedging instruments, we suggest that the Board clarify that any portion of ineffectiveness related to changes in foreign exchange rates should be recognized in profit or loss, regardless of the classification of the hedged item.

Paragraph 164(b)(ii) discusses the accounting for a hedge of a net investment in a foreign operation and refers to the "disposal" of a foreign operation. We note that IAS 21 clarifies that disposal may include partial disposal. To assist readers in applying the standard, we suggest that this paragraph either be followed with guidance similar to that presented in paragraph 38 of IAS 21 (1993) or refer the paragraphs 37 and 38 of IAS 21 (1993).

Although the example provided in paragraph B38 is helpful, it would be enhanced if it illustrated a case in which there is hedge ineffectiveness. We suggest that the Board provide such an example for a fair value hedge.

#### ***5. Embedded Derivatives***

We encourage the Board to articulate the principle(s) underlying "closely related" rather than to convey the notion only through examples. We recognize that the approach to providing guidance on embedded derivatives is similar to the existing liaison standard setter approaches (in particular, the U.S. approach). However, the example-based approach makes it difficult to apply

the guidance with confidence to circumstances that are not illustrated in the standard. Instead, the Board might, for example, consider whether contracts should be considered to be derivatives or to have embedded derivatives to the extent that the fair value of the total contract is determined based in whole or in part on a variable other than the price or index that determines the fair value of what must be transferred at settlement. Some possible characteristics that might be considered in developing a general principle might be such things as (1) the instrument's price risk exposure (e.g., if the instrument poses exposures to multiple price risks, it is a hybrid instrument), (2) whether price changes associated with the instrument move in tandem with market price changes associated with the same risks (e.g., if the terms of the instrument cause the settlement amount to be subject to variability, terms that expose the holder to variations that differ from market variations associated with the same risks should be separately accounted for), and (3) the way the instrument can be settled (e.g., if the item can be settled for an amount other than its face amount, there is a derivative). Those suggestions are some of the possibilities. There may be other characteristics that would be useful in developing a general principle or principles to be applied in determining whether an embedded derivative should be separately accounted for.

Paragraph 22 provides guidance on identification of derivative components of hybrid financial instruments. We suggest that the Board state in this paragraph that a hybrid instrument may contain more than one embedded derivative—guidance on that circumstance otherwise is not provided until the appendix.

In addition, the reader's understanding of the interaction of the embedded derivative provisions with the liability – equity guidance in IAS 32 would be facilitated if this paragraph also stated that a liability component of a compound financial instrument that is separated from its related equity component also may be a host instrument and contain an embedded derivative.

We were initially confused by the parenthetical references in paragraph A1 to “either an asset or a liability” following the words “equity instrument”—when is an item classified as an equity instrument either an asset or a liability? If this is from the holder's perspective, that should be made clear. If the guidance in this paragraph is from the issuer's perspective, do the words need to be modified based on the Board's decision in IAS 32 that certain puttable or redeemable residual interests in the net assets of an entity are to be classified as financial liabilities?

Finally, we observe that there is a difference between IAS 39 and U.S. GAAP in terms of a scope exclusion for certain contracts not traded on an exchange, such as those based on internal indicators such as specified sales volume or service revenues. We encourage the Board to work with the FASB to identify which approach provides a higher quality solution and agree to eliminate that difference.

## ***6. General and Editorial Comments***

### **a. Scope**

Paragraph 1(b)—If a lease receivable is a financial asset, we believe it should be subject to all the provisions of IAS 39, not just those related to derecognition.

Paragraph 1(c)—We agree that employer's rights and obligations for employee benefits accounted for under IAS 19 should be excluded from the scope of IAS 39. We suggest that the Board consider, however, whether the guidance on determination of fair value provided in IAS 39 is appropriate for inclusion in IAS 19 as guidance for determining the fair value of plan assets

(paragraphs 102 – 104 of IAS 19). In any case, the fair value guidance in the two documents should not be inconsistent or capable of being interpreted inconsistently.

Paragraph 2—If IAS 39 does not apply to the items identified in paragraph 2 (contracts based on climatic, geological or other physical variables), it would be helpful if the Board referred to the appropriate guidance to be applied, since there does not seem to be an international accounting standard that explicitly addresses these items. If no existing guidance is appropriate, we encourage the Board to add a project to its agenda to address those issues.

Paragraphs 6 – 7—See our earlier comments on paragraphs 4A and 4B of IAS 32. We suggest an alternative approach to determining which nonfinancial contracts are within the scope of IAS 32 and IAS 39 along the lines of the following:

Contracts to buy or sell nonfinancial items shall be accounted for under this Standard as derivative financial instruments unless the entity:

- (a) has an unconditional right and ability to receive or deliver the nonfinancial item;
- (b) has an established practice of settling such contracts by receiving or delivering the nonfinancial item; and
- (c) intends to settle the contract by receipt or delivery of the nonfinancial item.

## **b. Definitions**

Subparagraph (a), definition of a derivative—We believe that the word “fair” is missing between the words “its” and “value” in the first line.

Trading—The phrase “. . . is acquired or incurred principally for the purpose of . . . repurchasing” in the definition of trading seems to be a contradiction in terms.

Effective Interest Method—We suggest that the Board provide guidance on, and an example illustrating, a revision to the effective yield calculation. For example, how would one account for a change in the effective yield on a portfolio of assets due to a change in prepayment assumptions?

Another question that can arise in application of the effective interest method is what maturity date to use when calculating the effective yield on a financial instrument that has a written put option component. The Board might consider whether there are circumstances in which exercise of the option should be presumed. Further, it is not clear to us whether, if a put option or other embedded derivative is required to be separately accounted for under the embedded derivatives guidance, there is any implication for determining the effective yield for the host. The Board might consider providing guidance to address those types of issues as well.

Hedging Instrument—We suggest inserting the word “designated” before the word “nonderivative” in both instances in the first sentence of this definition. We also believe that the Board should add “and only the risk of changes in foreign currency exchange rates” to the end of the last sentence in this definition.

Paragraph 14—Please see our earlier comments on IAS 32 paragraphs 4A and 4B and IAS 39, paragraphs 6 and 7. The words used in this paragraph should conform to any changes the Board decides to make.

Paragraph 16—Here and elsewhere, references to paragraphs 30 – 34 should be changed to paragraph 57A.

Paragraph 18A—This paragraph introduces the notion that there is a distinction between financial instruments held for trading and other financial instruments carried at fair value. We believe that if a distinction is intended, then that should be explicit in the standard and presented as a requirement to segregate trading items from other fair value items.

### **c. Derecognition**

Paragraphs 38 and 39—Providing examples (or referring to later examples if applicable) to illustrate the meaning and context of these paragraphs would be helpful.

Paragraph 43—This paragraph refers to paragraph 47. We suggest that it also refer to paragraph 49, which clarifies the distinction between servicing assets and servicing liabilities.

Paragraphs 65A – 65C—The guidance provided on derecognition (extinguishment) of a liability covers the straightforward circumstance of a liability that is accounted for as a single component. We recommend that the Board also describe or illustrate the accounting for settlement (prior to maturity) when a liability component is a host contract to a separately accounted for embedded derivative and when the liability is part of a compound instrument with a separately accounted for equity component.

### **d. Subsequent Measurement of Financial Assets**

Paragraph 69(c)—This paragraph introduces the phrase “linked to” whereas IAS 32 uses “based on.” Please also see our earlier comments on the use of the term “indexed to.” We encourage the Board to evaluate the three terms and choose the single best term for describing the notion of derivative value changes to be used throughout both IAS 32 and IAS 39.

### **e. Held-to-Maturity Investments**

Paragraph 83(b)—We note that this paragraph establishes an arbitrary bright line that is different from similar guidance in the United States, which is set at 85 rather than 90 percent. We suggest that if such bright lines are to be drawn the Board should consider converging with the U.S. unless there is a significant reason to depart.

Paragraph 86—We believe the reference to 83 should be instead to 83(c).

### **f. Hedging**

Paragraph 103A—We believe the reference to paragraph 73 should be replaced with paragraph 75.

Paragraph 106—The reference to paragraph 30 should be replaced with a reference to paragraph 57 and Appendix A.

Paragraphs 126C and 126D—It could be read that paragraph 126D is inconsistent with or contradicts paragraph 126C. We suggest that the following phrase be added to the beginning of paragraph 126D: “Notwithstanding the guidance in paragraph 126C, a proportion of the entire hedging instrument . . .”.

Paragraph 153(b) — Is the last sentence necessary? If so, should it also refer to items otherwise measured at amortized cost?

Paragraphs 156(a) and 163(a)(ii) — The parenthetical guidance refers to the circumstance in which an entity rolls over or replaces the hedging instrument and states that it is not regarded as an expiration or termination of the hedge. Even if it were regarded as an expiration or termination, wouldn't the accounting result be the same? If so, it is not clear why special guidance for rollovers and replacements necessary. Alternatively, the Board could clarify that there is no difference in the accounting.

Paragraph 157 — Would this paragraph be better positioned as a follow on to paragraph 153?

#### **g. Appendix A**

Paragraph A3 — We propose that the Board modify the words of this paragraph to read as follows: “However, if a hybrid instrument has more than one embedded derivative feature and each relates to different risk exposures that are readily separable and independent of each other those features are treated as separate embedded derivatives.”

Paragraph A8(d) — We are unclear what is meant by the last sentence and would suggest an example to clarify.

Paragraph A13 — We have difficulty distinguishing trade date accounting from the recognition of executory contracts. Trade date accounting effectively recognizes an equally unperformed executory contract on a gross (rather than net) basis. We do not believe that is an appropriate accounting methodology and the Board should reconsider this guidance.

Paragraph A25 — We suggest including guidance in this paragraph addressing the circumstance in which market information is not available and the best evidence of fair value is the fair value of the whole less the proceeds received.

Paragraph A25 — The term residual interest is used in this paragraph (and elsewhere in discussions of derecognition) in a different way than it has been in other sections of this document and in IAS 32. In other instances, the term residual interest has referred to items classified in equity (or that would be classified in equity but for some redemption requirements). We suggest dropping the word “residual” and just using “retained interests” whenever appropriate under derecognition guidance, or redefining the term “equity instrument” in IAS 32.

#### **h. Appendix B**

Throughout this appendix, the formatting of various examples is inconsistent. In some cases, items that are intended to be credits are aligned with debits (e.g., paragraph B14) and the margins vary from example to example. We suggest that the Board crosscheck the formatting of the examples prior to publication of a final standard.

Paragraph B16 — We suggest replacing the word “for” in the last part of the sentence with the words “to determine” so that the end of the sentence would read “. . . would have to be evaluated to determine whether and to what extent . . .”

Paragraph B43 — In the first sentence, we suggest that the wording be revised as follows: “If instead the fair value of the swap increases . . .” In addition, we suggest replacing the words “present value” with the words “estimated fair value” in the second sentence in this paragraph.



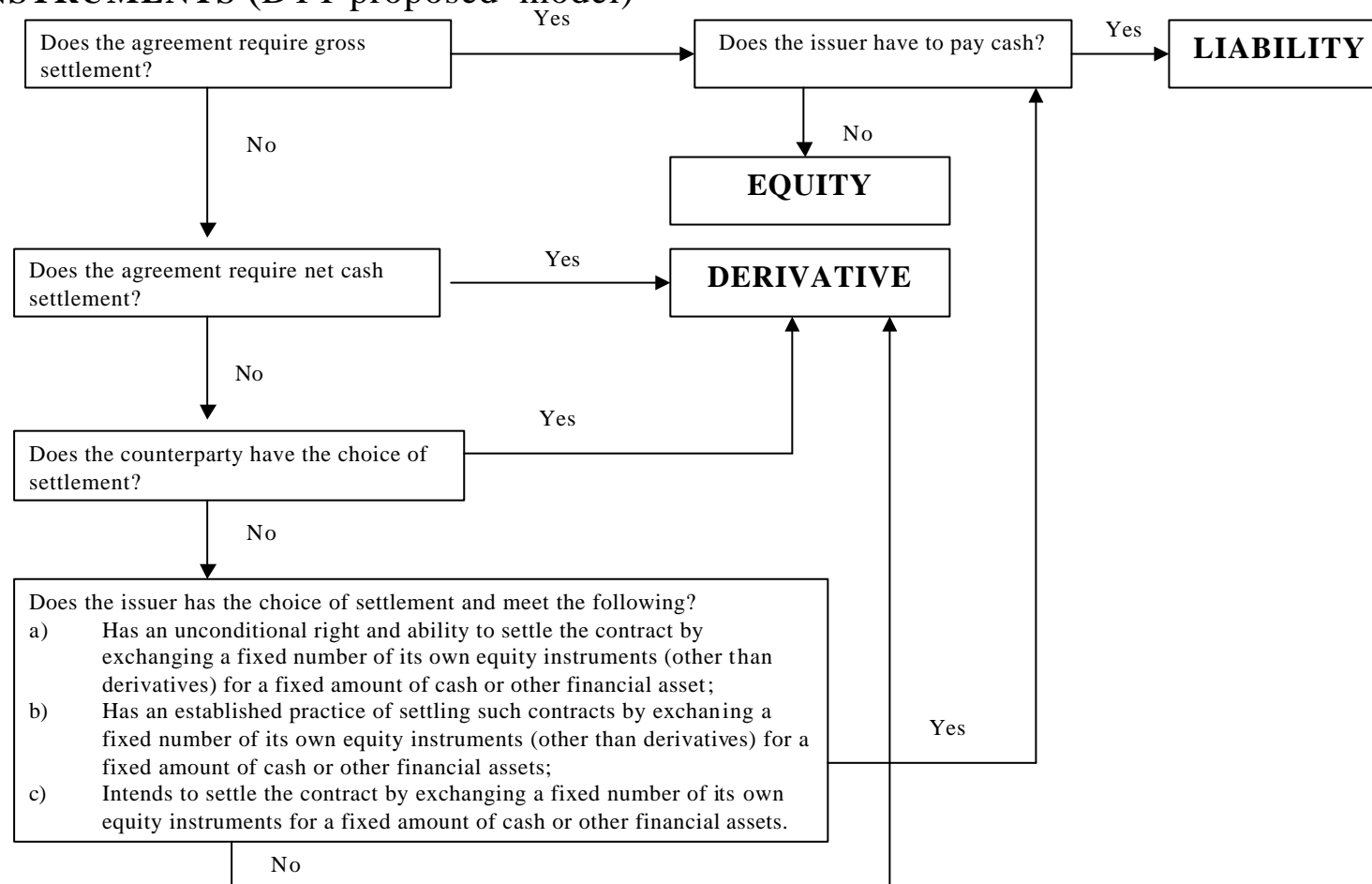
**i. Other**

C26 makes reference to "(cf IAS 29...)". It may not be clear to all what "cf" means. We suggest that the Board instead use "compare," "consult," or "refer to" or other wording as appropriate.

The standard includes a preface that indicates that Appendix D includes alternative views. Perhaps it should be made clear that these alternative views are not alternative treatments and are not acceptable under the accounting standards.



# ATTACHMENT A: CLASSIFICATION OF DERIVATIVE ON OWN EQUITY INSTRUMENTS (DTT proposed model)



**ATTACHEMENT B: CLASSIFICATION OF DERIVATIVE ON OWN EQUITY INSTRUMENTS**  
Exposure Draft proposal

