The Corporate Reporting Users' Forum

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Replacement of IAS39: Phase I: Classification and Measurement

Dear Ms Lloyd

The Corporate Reporting Users' Forum (CRUF) welcomes the opportunity to respond to the Exposure Draft (ED) on Financial Instruments: Classification and Measurement.

Financial Instruments is a subject area where users currently face challenges in obtaining relevant measures of value and are often at a disadvantage as to whether adjustments are required in their analysis of reported information. Further, in our discussions it became obvious that different users can have different informational needs. It is also an area where the debate between those advocating "full fair value" and those willing to accept a pragmatic "mixed model" is made particularly obvious. This ED does not set out to resolve that particular debate but instead seeks to achieve pragmatic improvements by simplifying the approach to classifying and measuring financial instruments. Like the Board, CRUF members have a spectrum of views regarding the merits of fair value as a measurement approach in this context but we welcome the focus evidenced in this ED on practical improvements to IFRS. However, members note that it is difficult to evaluate the overall effect of this ED without knowing how the accounting for financial instruments will be affected by the second and third phase of the project (impairments and hedging).

The CRUF finds itself largely in debate about several of the questions posed in this ED. Some are broadly in favor of using fair values for financial instruments while others generally favor the IASB approach over the FASB's. However there was a general consensus regarding the information we as investors need collectively and the problems we currently face. Based on the assumption that the IASB will go forward with the current proposal, we would like to see the following in addition to the responses to the questions in the subsequent pages.

The CRUF would like to get a better sense of:

- How the Board's proposed criteria would apply in practice to certain instruments.
- Whether improved disclosure about financial instruments could be provided generally, and particularly in the case of the following elements of the proposal:
  - The use of the fair value option.
  - The economic characteristics of hybrid instruments that are no longer bifurcated.
- Whether a business model approach could be developed to provide a reliable basis for determining when financial instruments with basic loan characteristics might genuinely be said to be managed on a cash flow yield (harvesting) basis.
- Should reclassification be permitted, what will be offered as a solution to manage and monitor reclassifications and mitigate abuse? One suggestion would be to tie reclassifications to an evidenced change in the business model and to make them mandatory in the event of such an occurrence.

Many constituents of the CRUF have expressed significant misgivings about the proposed effective date along with permitted early adoption - companies can adopt from 2009 financial years but the final measures of the adopted ED are not mandatory until 2012. We believe this could cause problems for investors and users alike due to a long period of reduced comparability. In addition, we believe users will bear the risks of hastily implementing the measures in an early adoption scenario. We would urge the Board not to follow through with allowing early adoption based on a primary concern that early adoption by a few would make comparisons impossible and in addition, investors and users alike would not be allowed time to consider the next two EDs on impairment and hedging prior to implementation of this ED.

Additionally, many CRUF members commented that they would prefer to see the IASB and the FASB work towards one converged standard, preferably implemented on the same timetable. As currently written, the two Boards' proposals would create a considerable lack of comparability and would pose a significant challenge to analysts and investors in financial institutions.

It is also worth re-emphasizing our desire to see financial reporting kept separate from the information needs of regulators and related discussions about regulatory capital. We do not believe that the needs of investors will be well served by determining financial reporting outputs based upon a perceived need to prevent pro-cyclical feedback loops developing in the banking system. Rather, it is our view that the twin aims of capital market stability and economic growth are best served by clear disclosure, honest reporting by preparers, and an independent, pragmatic, evidence-based approach by accounting standard setters.

We are also cognizant of the fact that these proposals will not just affect banks and other financial institutions, but will also affect non-financial companies who use financial instruments to raise finance and for hedging purposes. Our comments in this letter reflect this broader perspective.

The following are composition of thoughts and comments in response to the ED questions amongst CRUF participants in Germany, the UK and the US. The associated paragraphs of the ED are given in parenthesis at each heading.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF came together in 2005 as a discussion forum to help its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters such as the IASB and FASB.

CRUF participants come from all around the world, including individuals from both buy- and sell-side institutions, and from both equity and fixed income markets.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. It does not seek to achieve consensus views, though at times some or all of its participants will agree to make joint representations to standard setters or to the media. It would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative.

We sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum (www.CRUF.com) and not as representatives of our respective organizations. The views expressed are those of individual CRUF participants and do not necessarily reflect the views of the respective organizations where we are employed.

The participants in the Forum that have specifically endorsed this response are listed below.

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Section I - Classification (paragraphs 3 – 5)

We recognize the importance of this series of questions, since the overall direction of the project depends on the answers. Thus we appreciate the importance of receiving feedback on these issues to inform the Board's decision-making process. However, the CRUF membership is itself divided on this topic. While CRUF members feel that amortized cost provides some useful information in certain circumstances, members differ in their opinion on whether amortized cost amortized cost amounts should be the sole measurement displayed on the balance sheet in these circumstances, and what criteria should be required to qualify for an amortized cost classification. Thus we have tried to present a balanced view that faithfully represents the diversity of opinion within the CRUF membership.

On a higher level, we again believe that this touches on larger issues that we have highlighted in other comment letters. Investors, lenders and other users still struggle to differentiate between items with differing natures. For example, differentiating between nonrecurring items, whether gains or losses, that should receive a multiple of 1 in an earnings-based valuation versus recurring items that would receive a higher multiple. While such a judgment is by its nature subjective, we often lack even the information on which to base a judgment. Items such as impairments, other changes in value and realized gains and losses are viewed very differently than fixed interest flows. Perhaps what is needed is greater disaggregation and disclosure, and issues of classification and measurement would not be as contentious as they are today. Please refer to our comment letter on the Financial Statement Presentation project for more detailed comments on this theme.

Question 1
Does amortized cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

The simple answer to this question is sometimes "yes", but that does not preclude the fact that information about the instrument's fair value might sometimes also be useful. The more important question is "how does one decide, in practice as opposed to theory, when the decision-usefulness of fair value over-rides the decision-usefulness of amortized cost?" (or vice versa).

From a philosophical perspective it is important to emphasize that most CRUF members do not believe that eliminating fair value accounting or disclosure results in better financial reporting. Most would not be in favor of losing the fair value disclosures that we already have under current GAAP. However, this view was not universal.

CRUF members who support requiring an approach based on amortized cost for some financial instruments believe the approach advocated in this Exposure Draft ("ED") is an acceptable compromise between the need to reduce complexity in terms of financial reporting standards and the need to facilitate the provision of meaningful information about complex businesses operating in a complex world. These members agree with the Board's analysis that the amortized cost approach may reduce complexity and provide information that is more relevant to users in relation to these instruments than would be the case if a current fair value approach was applied to them. These members disagree with the Alternative View expressed by Mr Leisenring. While they acknowledge the reduction in complexity that would be achieved by adopting a full fair value approach, they do not believe it would result in an improvement in financial reporting. They believe the over-use of fair value accounting would inhibit communication between management and the providers of capital..

These members make the following arguments:

- Businesses are not managed on a full fair value basis in the vast majority of cases and they believe that financial reporting should reflect this complexity.

- Most corporations do not, and cannot, manage their debt on a fair value basis. Fair value changes with respect to a company's own debt may in fact pose little relevancy to investors when assessing future cash outflows especially in a legal obligation context.

- In many situations businesses are holding and managing financial instruments because of their expected cash flows and the crucial information for investors is the extent to which these cash flows expose the business to increased risk or help to mitigate it. Fair value measurement does not provide a full picture of these cash flow matching aspects whereas an amortized cost approach can provide greater insight when accompanied by adequate disclosure.

Other members support incorporating greater fair value into the Board's proposed standard. These members believe that fair value provides a more relevant and current indication of value than amortized cost. They acknowledge that unrealized gains and losses can have different implications for entities with different business models (for example, businesses that engage in short-term trading versus businesses that manage assets over longer time periods), but argue that fair value still provides relevant information, albeit for different reasons, and would hope that the accounting standard ultimately adopted would provide, rather than conceal, this information.

If the question ultimately becomes whether to provide fair value amounts solely in the footnote disclosures, these members would generally prefer to see the fair value amounts reflected in the primary financial statements, and have some interest in the alternative view discussed in Section

VIII, as well as the approach proposed by the FASB which would provide both amortized cost and fair value amounts on the face of the balance sheet, for certain instruments.

For financial sector companies, investors tend to focus on different information during market expansions than during periods of market turmoil. For example, during the recent boom times in the financial industry, many of these companies were valued based on earnings or other income-based metrics. However, during the recent financial crisis, we have observed many investors valuing banks based on tangible book values, often adjusting the value of loan portfolios held at amortized cost in their analysis to reflect their expectations about future credit losses that have not yet been reflected in the allowance for loan losses. These investors also tend to focus on whether these banks have ample access to liquidity to continue as going concerns. Given this it is clear that full disclosure is as important as the particular valuation approach applied to the financial instruments in question. It will not be possible for this ED to satisfy the philosophical arguments of all users but improved disclosures and clearer reporting of value changes would enable investors to better analyze businesses at all points in the economic cycle.

These members are not convinced that fair value accounting by itself is necessarily pro-cyclical. Rather, they believe that the combination of fair value accounting and regulatory capital requirements, particularly in the U.S., have resulted in the perception that fair value accounting can force banks into insolvency. However, they would point out that banking regulators have a narrower objective that is focused on solvency and prudential regulation, as opposed to an investor or a lender. To the extent that regulators do not believe unrealized losses or impairments impact the solvency of an institution, we would advocate them adjusting their measures of capitalization rather than changing the accounting.

Further, they are not convinced that greater use of amortized cost information, or the concealing of fair value information, would be less pro-cyclical. They would argue that in the absence of current information about the value of distressed financial assets, investors might be forced to assume the worst and potentially go too far in discounting their estimates of value. They worry that failing to provide the market with information about current fair values would decrease transparency and force market participants to charge a greater premium for bearing risk.

Finally, some CRUF members do not believe fair value is relevant for entities that manage assets on a long-term basis, and believe that for these entities, the only information that is relevant is information that provides management's best estimate of the company's financial condition as a going concern. They believe that measuring assets on a fair value basis in these conditions introduces temporary market contractions and expansions and distorts an analyst's or investor's ability to evaluate management's own estimates of current performance and capability to manage through into the future. They argue that during an expansion, any market-based fair value measure would have simply overstated (temporarily) earnings and asset valuations and understated liability valuations and vice-versa during a contraction.

Question 2
Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a contractual yield basis'? If not, why? What additional guidance would you propose and why?

Some CRUF members believe the ED is too restrictive and would prefer a model that bases classification only on how an asset is managed, and for what purpose i.e. a business model focus. These CRUF members feel the requirement that instruments have basic loan features is too restrictive and is at odds with the criteria that would allow AC accounting for instruments managed on a contractual yield basis.

Other CRUF members support both criteria, but question the application of the criteria as described in the application guidance. These members believe AC accounting should be allowed for subordinated tranches of debt-like instruments where the loss priority is predetermined (as described in Application Guidance paragraph B7 & B8). These members also believe that financial assets acquired at a discount that reflects incurred credit losses should qualify for amortized cost accounting under the proposed criteria. These members are not convinced by the arguments put forward in the Basis for Conclusions paragraphs BC27 and BC29 in respect of these two issues. These members make the following arguments:

- Purchased impaired loans – Some businesses buy impaired loans with a view to managing them to redemption (i.e. benefiting from the contractual cash flows as opposed to changes in their market value). In these situations, we feel that amortized cost accounting would faithfully represent the economics of the management decision. As an alternative, we would consider changing the criteria to "managed on a contractual cash-flow basis" rather than "contractual yield", as we feel this is a clearer explanation.

- Subordination - We acknowledge this is a complex area, but do not find the exposure draft's arguments regarding subordinated tranches clear or convincing. We feel that subordination on its own should not preclude amortized cost accounting. It is also unclear how an issuer would have to account for the tranches issued by an SPV that it was consolidating - would it have to fair value lower tranches?

Other members support the two criteria set out in the proposal, but have concerns about the operational aspects and the lack of application guidance to certain instruments. Several of these concerns include but are not limited to the following:

- Index-linked debt & foreign currency issues – We are concerned that the exposure draft is not clear on the consequences of the proposals in relation to instruments such as index-linked debt (i.e. linked to inflation, or to a commodity such as gold), and also situations where a bond is issued in a "foreign" currency (e.g. a company with US dollars as its functional currency borrowing in Euros). It is unclear whether such instruments would be eligible for amortized cost accounting both from the issuer's and the holder's perspective.

- While not directly responsive to question two, further confusion results from using a "managed on a contractual yield" basis definition for certain industries, such as private equity. Investors in Private Equity must record their investments at fair value. If the underlying investee fund is required under IFRS to record loan assets at amortized cost because they are deemed "managed on a contractual yield basis", the resultant reporting to the investor becomes less helpful than fair value. The same problem occurs when the underlying fund is required to consolidate investments rather than report on a fair value basis. In such circumstances, IFRS compliant reporting by the underlying Fund becomes unusable for the needs of the Investor. Insurance companies and other who invest in Private Equity will not get relevant financial information given the current model.

Question 3
Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortized cost? If so,

(a) what alternative conditions would you propose? Why are those conditions more appropriate?

See our comments in Question 2 above for more details on specific recommendations by certain members.

Some members believe developing a business model criteria and making it the primary test for using AC might provide greater clarity to preparers in terms of when this approach was appropriate, and greater comfort to users that the choice was based on genuine economics and a desire to best communicate those to users rather than less noble reasons.

See our comments at the end of the letter for more on this.

(b) if additional financial assets or financial liabilities would be measured at AC using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at AC result in information that is more decision-useful than measurement at fair value?

Some CRUF members believe that certain of an entity's own liabilities, such as long-term debt and deposits should be included in the amortized cost category.

As a general principal most members disagree with including an entity's own credit in measurements of their own debt. In their view, entities should only recognize gains in the event that they repurchase or retire their own debt at a discount to the amortized cost amount. Including an entity's own credit in the measure of its debt allows for the generation of fictitious gains that distort the entity's underlying risk profile. We discuss the fair value option further in Section III below.

Some CRUF members had concerns about the classification of purchased credit-impaired loans, subordinated debt securities, index-linked debt and debt denominated in a currency other than the functional currency. See our comments in Question 2 above for more detail on these concerns.

(c) if financial assets or financial liabilities that the exposure draft would measure at amortized cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?

We would not favor introducing a third measurement approach. As a pragmatic solution we believe that the amortized cost category should be permitted.

Section II - Embedded Derivatives (paragraphs 6 – 8)

Question 4

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

The current view is that existing standards are "rules-based and complex" – whether one refers to US GAAP or IFRS. Effectively, under the new standard, if IAS 39 is applicable, and a host contract and its embedded derivative do not exhibit basic loan features, then the entire instrument would be fair valued. The simplification achieved by this approach is appealing (i.e. less need for rules and less need for related exceptions), but it is difficult to understand the full ramifications of such a change without having a clearer understanding of the situations when a host contract would qualify for amortized cost treatment and when it would not.

As noted above, many of us would not favor a situation where the host contract was fair valued in such a way that a reduction in the entity's own creditworthiness resulted in gains arising on the host contract.

It is also not clear to what extent these proposals might result in a lack of consistent application resulting in the same instrument being accounted for differently by different holders (particularly issuers), nor the extent to which economically identical transactions might be accounted for differently if they were constructed in a different legal form.

We support the proposal that bifurcation of instruments with one component having basic loan features should be allowed so that the loan feature component is treated consistently (at amortized cost) with similar non-hybrid instruments.

We also agree that loan features such as caps, collars and floors should not prevent a loan from being measured at amortized cost (nor should be treated as separable derivatives) provided adequate disclosure is given about the terms and their effect on the expected cash flows and risks to the business.

Measuring everything else at fair value in essence could allow the embedded derivatives to be adequately and uniformly treated in all other circumstances. We note that embedded derivatives will still need to be identified and measured separately (at fair value) if they are contained in non-financial contracts (e.g. FX derivatives in long-term supply contracts).

One area the CRUF would encourage the Board to explore further is in the treatment of inflation linked debt. As mentioned in our response to Question 3, it is not clear, presently, in the ED how inflation-linked debt would be accounted for under these proposals.

In summary, the suggestion has a pleasing simplicity about it but we are concerned that achieving this simple result may result in greater complexity when it comes to interpreting the resulting information, and even in some situations, counter-intuitive results which would be unhelpful.

(b) Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (i.e. tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision-usefulness of information about contractually subordinated interests?

The ED concludes that underlying tranches of a structured investment provide credit protection for higher tranches. As we state as part of the response to Question 2, we are not convinced by the Board's arguments against treating tranches as loans measured at amortized cost.

While acknowledging this particular topic is highly complex, the CRUF believes the arguments regarding tranches are neither clear nor convincing. The ED does not succeed, in our view, in identifying an underlying principle for the Board's viewpoint. It is a function of whether a user or issuer is behind the investment. We believe there is general agreement that subordination on its own should not automatically push an instrument into the fair value category (a point that BC26 seems to acknowledge but then does not apply to tranches). The ED is unclear regarding how an issuer would have to account for the tranches issued by an SPV that it was consolidating - would it have to fair value lower tranches? The argument for lower tranches providing "credit protection" to higher tranches (BC27) should not be accepted on the basis that subordination is different than providing protection.

It would seem better to apply the tests proposed for the amortized cost category to these instruments as to all others and see whether they qualified or not, rather than introducing a blanket ban.

Section III - Fair value option (paragraph 9)

Question 5
Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?

The CRUF agrees that entities should continue to be permitted to utilize the fair value option if such designation eliminates or significantly reduces an accounting mis-match. However we are concerned that the optionality provided by the current standard can and has reduced comparability between and within reporting entities. Linking the use of this option to the business model might help to limit this optionality and ensure its appropriate use.

Additionally, the requirement under the ED (paragraph B19) that specifically forbids firms from fair valuing only a component (e.g. benchmark interest rate) of a liability can also reduce comparability and relevance, when the accounting for the corresponding asset or liability being 'matched' is not subject to the influence of identical components.

Disclosures should be improved so that it is easier to see why a company has selected the fair value option and what accounting mismatch has been prevented as a result. In particular it would be helpful to know what the corresponding asset or liability was that the fair value option was designed to match.

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

We would encourage the IASB to require adequate disclosure for firms electing the fair value option for assets or liabilities that would otherwise be carried at amortized cost, beyond those currently required under IFRS 7. Such disclosures should include amortized cost of the asset or liability for which the fair value option was elected, the rationale for electing the fair value option, as well as quantitative disclosure regarding the contribution of various factors to the divergence of fair value and amortized cost for such assets/liabilities (e.g., benchmark interest rate fluctuation, issuer non-performance risk, etc.).

Questions 5 and 6 would seem to pose whether there remains any appetite for a full fair value option still and we believe the answer is yes. Accordingly our responses to both questions (subject to the recommendations and concerns stated) would support the further notion that there is still a need in the investor community for optionality for full fair value and up to this point, that choice would lie specifically in instruments that exhibit loan like features and thus should be measured at amortized cost.

Section IV - Reclassification (paragraph 10)

Question 7
Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

We generally are not in favor of such "blanket" bans. If a business model changes then it would appear to be beneficial for users of financial statements for the firm to acknowledge this in the accounts and change the accounting accordingly – provided full disclosures and explanations are provided so that comparability and transparency is maintained. We could see situations where a business no longer managed a portfolio on a fair value basis and so wanted to show it thereafter at amortized cost (i.e. frozen fair value at the point of transfer). We would, however, require tight controls and can envision difficulty achieving this. It may be that after further investigation it becomes clear that a "blanket" ban might be the only solution that avoided undue complexity and opportunities to manipulate earnings (which some CRUF members believe to be the case). We would like to see that work done before drawing such a conclusion.

That being said, some of us favor a clearer definition of the "business model" and criteria for establishing when a company can argue that it has changed and thus justify a change in accounting approach since this could provide the basis for a "reclassification if the business model changes" exemption.

One way to avoid the potential for "pick and mix" accounting would be to make reclassification mandatory rather than optional in the event that a change in the business model required a company to adopt a different management approach to a particular portfolio or instrument.

The Corporate Reporting Users' Forum

Section V - Investment in equity instruments that do not have a quoted market price and whose fair value cannot be reliably measured.

Question 8

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

Existing IAS 39 guidance allows instruments whose fair value cannot be reliably measured, to be measured at cost. The ED requires all equities (and related derivatives) to be measured at fair value. Support for the Boards decision here can lead to greater convergence with US GAAP and greater logical consistency. Fair value as a concept, taking into account the Board's Fair Value ED, can always be determined (though with various levels of reliability). Illiquid assets, for example, can be and are measured at fair value. We see evidence of this with the application of the IPEV (International Private Equity and Venture Capital) Valuation Guidelines in the Private Equity, Venture capital and Business Development space. .

There is a general recommendation that having more granular disclosures about financial instruments would be helpful, including identifying par values so that users could identify situations where fair values or impaired amortized costs diverged significantly from par. This would also provide greater usability and comparability for users and thus greater decision usefulness.

Question 9

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

We cannot comment specifically on the costs of producing particular measurements but we would question whether the costs involved in producing a fair value estimate are any greater than those involved in undertaking an impairment review.

Section VI - Investments in equity instruments that are measured at fair value through other comprehensive income (paragraph 21 – 22).

Question 10
Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

The ED proposes an instrument by instrument presentation choice: gains and losses through the P&L or in OCI, with no recycling through the P&L. Based on BC68, we believe the reason for the choice is due to the notion that some instruments are purchased for strategic reasons although the option is not qualified in any way in the ED.

However, we are concerned by the implicit ban on recycling. The CRUF expresses a broad spectrum of opinions clearly indicating division on the general issue of recycling and we do not believe this ED is an appropriate place to introduce such a fundamental change.

In relation to equity instruments we cannot see the advantage of reporting dividends received within OCI instead of within the P&L. Similarly many users are concerned that when a financial instrument is derecognized (e.g. sold, for example) failure to recognize the gain and loss in the P&L likely obfuscates actual results.

Some CRUF members believe it might be better to allow OCI treatment for unrealized gains and losses, while requiring realized gains and losses to flow through the P&L. However, these members acknowledge that such an approach retains the complexity of the current available-for-sale category, and it may be that clearer disclosures would alleviate the need to see particular entries in the financial statements.

Obviously these proposals will be influenced by the outcome of the Performance Reporting project and we would refer the Board to our letter in response to its proposals, particularly with reference to the future of OCI and the desire amongst many CRUF members for an operating earnings subtotal.

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

(a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?

The majority of CRUF members were not in favor of the current proposed treatment of investments in equity instruments measured at fair value through other comprehensive income. Since one of the main criticisms of the current IAS 39 regime is the use of hard rules (including the "tainting provisions") it seems odd to propose new "irrevocable" elections in this ED. Some members believed that if a clearer concept of the business model criteria could be developed (with a robust associated disclosure regime) it would be possible to include strategic equity investments in such an approach, and thereby allow for future changes to the business strategy (including the possibility that a stake was no longer held for strategic purposes and thus should no longer be accounted for in that way).

Some members did not believe it is helpful that as proposed this irrevocable option applies to individual investment. Justifying this choice in the context of the business model would seem to provide a more principled basis for such treatment.

Furthermore, these members are not convinced that allowing a choice as to OCI or P&L with no recycling achieves better decision-useful information – particularly in situations where the business model is to make money from selling equity holdings after significant periods (i.e. Private Equity).

Using a business model approach might also avoid some of the more peculiar consequences of this proposed option. As an example a private equity fund might invest in both the debt and equity of private companies. Under the current proposals the debt instruments could be shown at amortized cost if they qualified as having basic loan features and were deemed to be managed on a contractual yield basis, but would otherwise be at fair value with changes through the P&L. The equity stake however could not be at cost (amortized or otherwise) but would have to be shown at fair value; the fair value changes would either go through the P&L or OCI depending on the investor's choice.

So the treatment of the debt security is based on factual tests, whereas the treatment of the equity security is prescribed; but the P&L impact of the debt security is prescribed whereas the P&L impact of the equity security is based on an unrestricted choice.

If a business model approach was applied to equity securities as well it is unlikely that a private equity investor would be able to argue for the OCI treatment whereas a company holding a stake in a key supplier or customer might be able to.

This approach has the potential to result in better information for users since it would clearly distinguish between the raison d'etre of different businesses and alert users to the different potential motives behind holding equity investments.

(b) should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

Entities should present changes in fair value in OCI only in the periods in which the investments in equity instruments meet the proposed identification principle in question (a) above. Our response in question (a) and the illustration provided provide our reasons for support.

Section VII - Effective date and transition (paragraphs 23 – 33)

Question 12

Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

As previously mentioned, the majority of members opposed the proposed early adoption criteria. However, any additional disclosure that is deemed helpful for investors to understand the economics of the business and the transactions is useful in our view. That being said, we would welcome where applicable both the amortized cost values and the fair values on the face of the financial statements or in the footnotes.

To further help investors, we recommend preparers put together tables for instruments which show the following:

- cost at inception (issuance/investment)
- fair value at inception (if different from cost)
- fair value in current reporting period and previous reporting period
- changes in fair value from previous reporting period
- cumulative changes in fair value since inception (issuance/investment)
- disposals since the previous reporting period
- approach behind fair value measure (market, income approach, transaction approach etc)
- classification
- par or principal amount (if applicable)

As noted earlier some members would like to see more work done regarding a business model approach such that the business model formed the basis for the financial reporting approach used and thus was a core accounting policy. Under such an approach, any change to the business model would then require significant extra disclosures to explain the transition and the resulting changes to measurement and disclosure.

We would also like more information on how classification judgments have been made and what instruments are classified in each category, together with information on any reclassifications that have taken place in the period (with reasons).

Finally it is important to note that we do not just want these disclosures to be required for companies adopting the proposals early. Better disclosures should be required of all companies in this regard.

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

We agree with the related proposed transition guidance and that the proposals should be applied retrospectively.

Section VIII - An alternative approach

Question 14
Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortized cost, specifically:

(a) in the statement of financial position?

As previously mentioned, there were a variety of views among CRUF members. Some members preferred the IASB's proposed approach, while others preferred one or more of the alternatives. However, we would note that the discussion of the alternative approaches in the ED was brief and several points were unclear. For example, it is unclear whether the split between earnings and OCI would apply to all instruments that do not qualify for the amortized cost bucket or whether the split would only apply to those instruments with basic loan features that are managed on a contractual yield basis. The proposal seems to indicate the former, while the project summary on the IASB website seems to indicate the latter. Based upon our reviews of the FASB's proposals to date, the alternative approaches are more similar to the FASB's proposal than the conclusions reached in the ED. If the ultimate goal is to achieve a converged standard, one of the alternative approaches could represent a viable compromise. Variant 3 is the closest to the FASB's proposal and is favored by some CRUF members for that reason.

(b) in the statement of comprehensive income? If so, why?

Some members point out that disaggregating impairments from other changes in fair value might be helpful for users. If gains and losses are presented in OCI, then the usefulness of this approach might be enhanced by including OCI on the face of the income statement. We would note there is a need for users to be able to distinguish between items that are nonrecurring (and should only have a multiple of one) and those items that should be awarded a higher multiple based on their underlying and recurring nature. Here there is a logical connection in emphasizing the importance of the Board's Performance Reporting Project and our earlier recommendations via our letter submitted in May 2009.

Under Variant 1 it seems that many unrealized gains and losses will never impact earnings since there will be no recycling of gains or losses recorded in OCI. Some would prefer to see realized gains and losses reflected in earnings under such an approach. As noted in our answer to Question 10, we do not believe that this ED is an appropriate way to introduce a ban on recycling.

Question 15

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

In general, the CRUF found the descriptions regarding the Variants to be somewhat confusing and unclear on some points. Some members did not feel that any of the Variants provided "more" decision-useful information and so would prefer a solution based on the main proposals in the ED.

However, some CRUF members were attracted to Variant 2 because it shows all gains and losses in earnings and provides a straightforward approach which they feel would reduce complexity (and breaking out impairments separately in earnings would allow users to make adjustments if they wished).

Similarly, some CRUF members are attracted to Variant 3 because it is the closest to the FASB's proposal and could represent a viable compromise to reach a converged standard. Variant 3 would also result in the balance sheet showing all financial instruments at fair value which some CRUF members believe gives a clearer and more current view of the company's financial health.

Another point to consider is Variant 3 could also be enhanced by also displaying the cost amounts as well as the fair values, similar to the FASB's proposal either in the financial statements or in the footnotes. The counterargument is that would increase complexity.

Business Model Criteria– A Possible Way Forward

As noted in our response to this ED, some believe that the concept of a business model criteria would be worth pursuing further and might provide a principled framework for resolving some of the issues highlighted by financial instruments accounting, as well as broader issues which we discussed in our response the Financial Statement Presentation discussion paper earlier this year.

Our thinking in this area is far from finalized but we set out some of the core concepts below in the hope that it will further the debate.

1. The business model criteria is based upon the idea that businesses are created for a strategic purpose – they have a raison d'etre which determines how they set about making a profit, the systems they use to manage their business processes, how employees are incentivized, and the risks that equity investors can expect to be exposed to, and the means by which they hope to earn rewards for taking these risks.

2. Management intentions relate to the tactics employed by the business in order to succeed in a competitive market place and so may change, sometimes frequently, and often in response to changes in the external environment. In contrast the business model will not change that often. When it does there will be clear evidence of major change across all aspects of that part of the business and there will be an associated investment of either retained reserves or new capital to achieve this change (perhaps accompanied by the withdrawal by some investors of their capital).

3. Financial reporting should facilitate communication between the business and its investors in the context of its pursuance of this business model. Investors generally categorize businesses by sector and it is likely that businesses within a sector will have broadly similar business models. Given this, investors' requirements for financial information about these businesses and the uses to which that information is subsequently put in terms of analysis and valuation, are likely to have strong common themes. Financial reporting should respond to these themes.

4. As a policy choice the measurement approach applied to assets and liabilities, and the way in which operating performance and cash flows during a period are reporting should be determined in the context of the business model rather than exclusively by the specific accounting item, but sufficient disclosures should be provided to facilitate proper

communication between preparers and the users of the accounts, and to enable users to take alternative views (including challenging management) when appropriate.

5. In the infrequent situations that a business changes its business model in respect of a particular business unit or the whole business, extensive disclosures should be provided explaining the rationale for the change and the consequences in financial reporting terms so that users can identify how things would have been reported without the change.

6. As a policy choice changing a business model should have mandatory financial reporting effects rather than optional ones.