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14 September 2009

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

Email: CommentLetters@iasb.org

Dear Sir/Madam

SAICA SUBMISSION ON EXPOSURE DRAFT *FINANCIAL INSTRUMENTS: CLASSIFICATION AND MEASUREMENT*

In response to your request for comments on the IASB's exposure draft, *Financial Instruments: Classification and Measurement*, attached is the comment letter prepared by The South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but also secretariat for the Accounting Practices Board (APB), the official standard-setting body in South Africa. The SAICA comment letter results from deliberations of the Accounting Practices Committee (APC), which is the technical advisory body to the APB.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director – Accounting

cc: Moses Kgosana (Chairman of the Accounting Practices Board)
Prof Alex Watson (Chairman of the Accounting Practices Committee)

Integritas, 7 Zulberg Close, Bruma Lake, 2198 POSTAL ADDRESS PO Box 59875, Kengray, 2100, Johannesburg
TEL +27 11 621 6600 FAX +27 11 621 3321 CALL CENTRE 08610 SAICA (72422) EMAIL saica@saica.co.za WEB saica.co.za | accountancysa.org.za

SAICA SUBMISSION ON EXPOSURE DRAFT ON *FINANCIAL INSTRUMENTS: CLASSIFICATION AND MEASUREMENT*

GENERAL COMMENTS

We are in general agreement with the principles contained in this Exposure Draft on the classification and measurement of financial instruments. We note that the Board's objective is to issue a new document that is more principle-based and less complex than the current requirements of IAS 39 – *Financial Instruments: Recognition and Measurement* (IAS 39). Whilst we agree that this objective has largely been met with this Exposure Draft, we have highlighted below instances where this objective may not have been achieved.

Our response has taken cognisance of the fact that this Exposure Draft represents the first phase of the redrafting of the current standards on financial instruments. We would like to emphasise to the Board that some of the comments made in this comment letter may have an impact on other current and future projects on financial instruments. We urge the Board to consider these comments for those projects in order to ensure the principles are consistently applied within the final standards on financial instruments.

We have provided below our specific comments to the questions raised as well as other comments that we have noted are not directly addressed by the questions in the Exposure Draft.

SPECIFIC COMMENTS

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

Yes, we believe that the measurement of financial instruments at amortised cost does provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis.

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?

Our responses below have been divided between those on the application of whether an instrument has basic loan features and the management of such instruments on a contractual yield basis:

Basic loan features

We do not believe that the terminology that defines 'basic loan features' is sufficient and clear. We recommend that the definition of a basic loan instrument should be based on the current definition of 'Loans and receivables' contained in IAS 39 and amended as follows:

*~~**'Loans and receivables**~~ **Basic loan instruments** are non derivative financial ~~**assets**~~ **instruments** with fixed or determinable payments that ~~**are not quoted in an active market**~~ **represent both payments of principal and interest on the amount outstanding**, other than:*

> *~~(a)~~ those instruments that the entity intends to **sell** ~~**immediately or in the near term**~~ in **response to changing market conditions**, which shall be classified at ~~**s**~~ ~~**held for trading**~~ fair value , and those that the entity upon initial recognition designates as at fair value through profit or loss.~~;~~*
>
> *~~**(b) those that the entity upon initial recognition designates as available for sale; or**~~*
>
> *~~**(c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale. '**~~*

(the words that have been struck through indicate the words that should be deleted and those that are underlined represent those words that should be added).

We recommend that the guidance in B1-B8 of the application guidance in the Exposure Draft should be retained (subject to our comments below) to provide guidance on basic loan features.

We have further recommendations with respect to the following:

- Guidance on basic loan features;
- Instruments with waterfall features; and
- Inflation linked financial instruments.

Guidance on basic loan features

We recommend that B1 of the application guidance of the Exposure Draft be amended as follows: *'For the purposes of this [draft] IFRS, interest is consideration for the time value of money and the credit risk associated with the* ~~**principal**~~ *amount outstanding during a particular period of time.'* (the words that have been struck through indicate the words that should be deleted)

We believe that the proposed amendment is required in order to allow instruments that are initially recognised at a discount to its maturity amount, such as a zero coupon bond, to qualify as a basic loan instrument. This is required for instruments where interest, which is determined on the effective interest rate basis, is determined with reference to the amount outstanding rather than the principal amount.

We also believe that further clarification is required with regard to the definition of interest. In our view, interest should not only refer to the cash rate of interest (coupon), but should also extend to the effective interest rate (implied yield) of an instrument at the time that an instrument is initially recognised, i.e. it should include the impact of an instrument purchased at a premium or a discount to the par value. Whilst we acknowledge that the Board has provided an example of a zero coupon bond as a basic loan instrument, and hence that 'interest' in this case includes an instrument's yield, we believe that this concept should be more clearly defined in the proposed standard. We also note that an example of a debt instrument acquired at a discount or a premium (other than one that has incurred credit losses noted in B13(b)) has not been noted as an example, and hence question whether it is sufficiently clear, without the suggested guidance above, that such an instrument would meet the definition of a basic loan instrument or not.

We believe that it is unclear in the Exposure Draft whether the interest rate of the instrument should be one that is linked to the currency in which the instrument has been issued. We recommend that the Exposure Draft indicate clearly whether instruments whose interest rate is linked to a currency other than the currency in which the financial asset or liability is issued have basic loan features or not. In line with B1 that *'interest is consideration for the time value of money and the credit risk associated with the principal amount …',* we recommend that such instruments be permitted to meet the basic loan feature requirements noting that the requirements of IAS 21 – *The Effects of Changes in Foreign Exchange Rates* (IAS 21) will result in the recognition of any foreign currency gains and losses.

Instruments with waterfall features

Our concerns with regard to instruments with waterfall features have been addressed in our response to Question 4(b) below.

Inflation linked instruments

We believe that further guidance should be included for financial instruments whose cash flows (principal and interest) are linked to an inflation index in order to determine whether such instruments meet the definition of a basic loan feature as envisaged by the Exposure Draft. In terms of economic theory, we believe that a component of an interest rate of a financial instrument provides compensation for the underlying inflation in the economy and therefore instruments that are linked to an inflation index can be considered to display 'basic loan features'. This can be achieved by adding a further example to B3 as follows:

'(v) a return that is referenced to an inflation index'

For similar reasons to those noted above for instruments with interest rates that are linked to a different currency to the currency in which the instrument is denominated, we believe that it is necessary to provide guidance on whether the inflation index relates to the inflation in the entity's own economic environment.

We recommend that the Board should include guidance on the accounting treatment to be applied for instruments whose cash flows are linked to an inflation index. We note that the Board tentatively agreed the following improvements to the existing IAS 39 at the October 2008 Board meeting:

- *'For the effective interest method, a floating rate financial instrument is an instrument with contractual variable cash flow amounts arising from changes in market variables. The Board will not define the term market variable but may provide examples.*

- *Expectations (and changes in expectations) of future cash flows are not considered when calculating the effective interest rate for floating rate instruments.'*

This decision was not included in ED/2009/11 – *Improvements to IFRSs* issued in August 2009, and therefore we recommend that such guidance be considered for inclusion in the final standard on classification and measurement of financial instruments.

Managed on a contractual yield basis

We have provided further comments below on the management of instruments on a contractual yield basis relating to:

- "Business unit approach"; and
- Examples of instruments that are not managed on a contractual yield basis.

"Business unit approach"

We do not believe that sufficient guidance has been provided in the Exposure Draft with regard to the classification of financial instruments in terms of business units, as contained in paragraph B10 of the Exposure Draft:

'However, an entity may have several units that are managed in different ways. Therefore, classification need not be determined at the reporting entity level. For example, a bank with a broad scope of activities may have an investment banking business managed on one basis and a retail banking business managed on another basis. Instruments held in the investment banking business will most likely be managed differently from those in the retail banking business.'

We note that it may be possible for a number of instruments to be managed on a different basis within the same business unit. We are of the opinion that the accounting treatment of a financial instrument should reflect the manner in which it is managed and therefore be consistent with the business overlay model regardless of the business unit in which that instrument is located. Therefore, we believe that the classification of a financial instrument should be permitted on an instrument by instrument basis. However, whilst we acknowledge that the nature of the business unit could be used as an indicator in determining the manner in which instruments are managed, we do not believe that it should be the deciding factor.

For example, an originator of a receivable book may manage the financial asset in order to recover the principal debt and the accrued interest thereon (therefore managed on a contractual yield basis), whilst the purchaser of the same receivable book may manage it in such a way so as to recover the cash in the most efficient and effective way (managed on a fair value basis). If these transactions took place within the same business unit, we believe that management should be permitted to measure the financial assets in line with the manner in which the individual instruments are managed.

Should the business unit approach guidance be retained in the final standard, we are concerned that the example provided of a bank and its two business units, being an investment bank and a retail bank, may be subjected to an extremely strict and narrow interpretation. We recommend that B10 be amended as follows: *'For example, a bank* ***may identify two business units, being*** ~~***with a broad scope of activities may have***~~ *an investment banking business* ***that is*** *managed on one basis and a retail banking business managed on another basis. Instruments held in the investment banking business* ***may, in this instance,*** ~~***will***~~ *most likely be managed differently from those in the retail banking business.'* (the words that have been struck through indicate the words that should be deleted and those that are underlined represent those words that should be added).

Examples of instruments that are not managed on a contractual yield basis

We believe that the wording contained in B13(b) may lead to the incorrect application of the business overlay model contained in the Exposure Draft. Application guidance B13 states that:

''The following are examples of financial assets or financial liabilities that are not managed on a contractual yield basis:

(a) …

(b) a financial asset that is acquired at a discount that reflects incurred credit losses.''

We believe that if an entity acquires such a financial asset and manages it by collecting the contractual cash flows rather than on-selling the instrument, it should satisfy the requirements of managing the instrument on a contractual yield basis. This is because the future cash flows that are being managed are the contractual cash flows.

We believe that the application of B13(b) may result in several additional complexities in determining whether the discount on the acquired instrument relates to incurred credit losses or changes as a result of expectations of future credit losses. Accordingly, in order to preserve simplicity in reporting financial instruments, we believe that B13(b) should be deleted from the Exposure Draft or amended to state that even if an instrument was acquired at a discount it should not imply that the instrument cannot be managed on a contractual yield basis.

We do not believe that the application of B13(b) is consistent with the objective of the Exposure Draft, being to present relevant and decision-useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of future cash flows. Therefore, we do not believe that whether the instrument is acquired at a discount or not should determine the manner in which the instrument is managed. The manner in which an instrument is managed should be independent of the purchase price.

Question 3

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

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

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

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

Other than noted in Question 2 above, we did not identify any other conditions that would be more appropriate to identify which financial assets or liabilities should be measured at amortised cost.

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 majority of the respondents agreed with the principle that embedded derivatives contained in a hybrid contract with a financial host should not be separately accounted for. Those respondents believed that this approach would reduce the complexities contained in the current accounting requirements and provide decision useful information as it would reflect the economic substance of the transaction.

However, a minority of the respondents were of the opinion that the current requirements for embedded derivative instruments in hybrid financial instruments should be retained as this is more closely aligned with the business overlay approach proposed by the Exposure Draft. They believe that the separation of embedded derivatives does provide decision-useful information as the embedded derivative component is managed separately on a fair value basis, while the host contract is managed on an amortised cost basis (this may be the case where, for instance, different business units manage each component separately). They also noted that the inability to separate embedded derivatives may result in increased complexity and divergence from the objective of the Exposure Draft, i.e. to present relevant and decision-useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of future cash flows. This is because an entity may have a financial asset that contains an embedded derivative that it intends to hold until maturity with the intention of earning a contractual rate of interest on the loan host contract, with a fair value risk with respect to the embedded derivative. If the entire combined contract is required to be measured at fair value, this may result in additional fair value volatility being recognised in respect of the host contract. Assuming that the entity is required to measure the entire contract at fair value, with changes in fair value recognised in profit or loss, the entity may now be required to enter into other appropriate interest rate derivative in order to eliminate such fair value volatility in the statement of comprehensive income. Those respondents question whether the proposed accounting requirements would result in additional unintended fair value volatility that is contrary to the manner in which the financial instrument components are managed. They were also of the opinion that the information obtained by the separation of the embedded derivative will justify the complex accounting principles and provide decision useful information.

Those respondents also noted a concern that an immaterial reference to another variable (not meeting the basic loan feature criteria) would require the entire contract to be measured at fair value. They argued that being forced to fair value the entire contract due to an immaterial feature does not contribute to decision-useful information.

With regard to tranches that provide credit protection to other tranches (e.g. waterfall features), please refer to our response in Question 4(b) below.

(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 majority of the respondents did not agree with the proposed application of the proposed classification approach to contractually subordinated interests.

The Exposure Draft notes that, *'Any tranche that provides credit protection to other tranches in any situation does not have basic loan features.'* The Exposure Draft notes that such features exist in waterfall structures and that *'a tranche that provides credit protection to other tranches in any situation is leveraged and, therefore, does not have basic loan features.'* This would result in all issued securities, other than the most senior tranche, failing the definition of a basic loan instrument and therefore being required to be measured at fair value.

The majority of the respondents were concerned that the application of the requirements of B6-8 will result in instruments being measured at fair value, which is inconsistent with the objective of the Exposure Draft, being *'to establish principles for the classification and measurement of financial assets and financial liabilities that will present relevant and decision-useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of future cash flows.'* This will result in information being reported that may not be relevant nor provide decision-useful information. This is especially so where the entity intends on managing such instruments on a contractual yield basis.

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The majority of the respondents expressed concerns as to the application of the B6-8 to an entity's normal liabilities. We note that BC26 of the Basis of Conclusions in the Exposure Draft states that *'… the Board believes that it is reasonable to assume that commercial law does not intend to create leveraged credit exposure for general creditors such as trade creditors. Thus, the Board believes that the credit risk associated with general creditors is consistent with the notion of a basic loan feature.'* These respondents were of the opinion that the credit leveraging features exist equally between entities' general creditors and that this does not differ in comparison to those that are structured in a waterfall structure. Those that expressed this concern are not of the opinion that such general liabilities should be measured at fair value since they believe that such liabilities, where they are managed on a contractual yield basis, should continue to be measured on an amortised cost basis.

A proposal that should be considered by the Board is to require liabilities that are not issued against a specific asset (i.e. general creditors in the context of the Exposure Draft) to be regarded as not failing the basic loan feature criteria (in the absence of other features that would result in the instrument failing the basic loan feature criteria or being managed on a fair value basis).

Other concerns were raised whether the result proposed by the Board would result in relevant and decision-useful information being reported. This is illustrated by means of the following example:

Example
Assume the following two securitisation structures:

- A in which high quality corporate bonds are securitised; and
- B where a portfolio of mortgage bonds are securitised.

We assume that in both instances 3 liabilities are issued in a waterfall feature (differing levels of seniority, note 1 being the most senior note, note 2 and liability 3 being the most junior note.). If the Board's proposed guidance were to be applied, this would result in note 2 and note 3 being measured at fair value with note 1 being measured at amortised cost (unless managed on a fair value basis). The liabilities issued against the corporate bonds would be classified at fair value despite the fact that the loss expectations are minimal for the corporate bonds.

We therefore recommend that where liabilities are issued against a specific asset(s) that a further analysis is conducted to evaluate the extent of losses that are expected to arise from such assets (i.e. a look through approach to the assets should be performed). In this regard, the expected loss for the portfolio of the assets should be determined and then applied to the liabilities in determining which of the liabilities' capital may not be repaid. Only those liabilities that are expected, at the date of inception, to be affected by losses on the underlying assets would fail the basic loan feature criteria. All other liabilities would meet the basic loan feature criteria and could therefore be measured at amortised cost. This may result in more of securitisation B's liabilities being required to be accounted on a fair value basis when compared to securitisation A. We believe that the application of such an approach would balance the Exposure Draft's objective with its classification and measurement criteria. The suggested approach would also appropriately distinguish between waterfall features that have different credit expectations (e.g. the securitisation of high quality corporate bonds as opposed to mortgage loans).

We do not believe that the application of the Board's proposals for a waterfall structure in the Exposure Draft is operational for the duration of a waterfall structure's life. Assume that the senior note at inception is classified to be measured at amortised cost, with all other notes being classified to be measured at fair value. Assume further that the senior note is derecognised. The next most senior loan note will, since reclassification is prohibited, continue to be measured at fair value despite the fact that it now meets the basic loan feature criteria. This event has happened in the absence of changes in the intention of management and hence it is questioned whether the next most senior loan note should be measured on a fair value basis. Instead, had an expectation of credit losses been established at inception, then it is likely that the second most senior tranche note may have also been measured at amortised cost and hence it is less likely that such instances would arise.

A further example is a securitisation vehicle with an established waterfall feature with the most senior loan note being measured on an amortised cost basis and a new more senior loan note is issued. Since the Exposure Draft prohibits reclassification of the initial senior loan note, it is considered that the new senior loan note would be permitted to be measured at amortised cost and that two tranches would now be measured at amortised cost.

Finally, we note that the principles outlined in B6-8 should be applied equally to financial assets as they are to financial liabilities. We note that the embedded derivative requirements contained in IAS 39 have been removed in the Exposure Draft due to, amongst other reasons, the complexity of identifying such instruments. We believe that entities will be required to perform a continuous evaluation to determine whether they have instruments that fall within the principles of B6-8, and thereby result in similar complexities to that experienced in terms of identifying embedded derivative financial instruments in terms of the existing criteria of IAS 39.

In light of the above-mentioned reasons, we question whether the proposed guidance is appropriate and operational and believe that paragraphs B6-8 should be deleted from the Exposure Draft and for such instrument's subsequent measurement to rather be determined in accordance with the manner in which such instruments are managed (the business overlay model), expected loss considerations (as suggested above), a look through approach, and the general definition of what a basic loan feature is.

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?

We 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.

We emphasise that we believe that this particular aspect of the Exposure Draft will be influenced directly by the final conclusions reached by the Board on the discussion paper on *Credit Risk in Liability Measurement*.

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 are unaware of any other circumstances in which the fair value option should be allowed. This conclusion should be considered by the Board in the subsequent phases of other projects such as its discussion paper on *Credit Risk in Liability Measurement* and the subsequent proposals on hedge accounting to ensure consistency of this principle.

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 believe that the ability to reclassify financial instruments could provide relevant and decision-useful information, but are not of the opinion that permitting reclassification would contribute to the simplification of reporting financial instruments. We therefore agree with the proposal in the Exposure Draft that the reclassifications of financial instruments should be prohibited.

This principle may, however, result in entities selling and then repurchasing the same instruments to obtain a change in classification and measurement of an instrument. The Board should ensure that the principles contained in the final financial instrument standard regarding derecognition and reclassifications are aligned, to promote consistent application of the principles by the preparers of the financial statements.

Further to the above, we note that paragraph 10 of the Exposure Draft states that '*An entity shall not reclassify a financial asset or financial liability between the fair value and amortised cost categories*'. We note that the same sentence has again been repeated in B11 of the Exposure Draft and question whether this is necessary.

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?

Yes, we believe that more decision-useful information is provided about investments in equity instruments (and derivatives on those equity instruments) if such financial instruments are required to be measured at fair value.

We are of the opinion that the requirement to do an impairment test on equity instruments that are currently measured at cost does not materially differ from performing a fair value calculation as required by this Exposure Draft. We believe that the information provided would be beneficial to the users of the financial statements.

The determination of fair value is a subjective process where various assumptions are made that could vary from entity to entity. We are therefore of the opinion that the current disclosure requirements contained in IFRS 7 – *Financial Instruments: Disclosures* are sufficient to ensure that decision-useful information on such assumptions is provided to the users of the financial statements.

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 are not aware of any circumstances in which the benefits of providing improved decision-useful information would not outweigh the costs of providing such information.

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 majority of respondents believe that the presentation of the fair value changes (and dividends) for particular investments in other comprehensive income would not improve financial reporting.

The current proposals in the Exposure Draft would result in an inconsistency of principles introduced by the Board in the following four standards:

- IFRS 3 – *Business Combinations* (IFRS 3). IFRS 3 paragraph 42 requires that the existing investment in an entity be remeasured on the date that control is obtained. The result of this remeasurement should be accounted for in profit or loss.

- IAS 27 – *Consolidated and Separate Financial Statements* (IAS 27). IAS 27 paragraph 34 requires an entity to measure the remaining investment in a former subsidiary at fair value on the date it loses control. The fair value adjustment should be accounted for in profit or loss.

- IAS 28 – *Investments in Associates* (IAS 28). IAS 28 paragraph 11 requires an entity to increase or decrease the carrying amount of an entity's investment in an associate and to recognise the investor's share of the profit or loss of the investee after the date of acquisition. Such increases or decreases shall be recognised in profit or loss.

- IAS 18 – *Revenue*. IAS 18 paragraph 30 refers to recognition of revenue, including dividends, and from paragraph 88 of IAS 1 – *Presentation of Financial Statements* this revenue should be included in profit or loss.

The recognition of dividends in other comprehensive income will not reflect the actual return received from the investment. Furthermore, dividends are a form of realisation of the investment and hence, without the Exposure Draft containing detailed requirements on the manner in which gains and losses should be recycled out of other comprehensive income to profit or loss, dividend income should continue to be recognised in profit or loss.

In the instance in which the Board retains its proposals to provide entities with an irrevocable election to present in other comprehensive income changes in the fair value of particular investments in equity instruments, we recommend that the Board move its guidance in B24 of the Exposure Draft, being, *'…Amounts recognised in other comprehensive income are not subsequently transferred to profit or loss…'* into the requirements of the proposed standard.

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?

(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?

Notwithstanding our answer to Question 10 above, we are of the opinion that all the gains or losses on any investment in equity instruments should follow the initial classification of the financial asset, i.e. if the financial asset is classified to be measured at fair value through profit or loss (other comprehensive income), then all such gains and losses should be recognised in profit or loss (other comprehensive income). We therefore agree with the proposed principle that the entity is required to make an election to present fair value adjustments in other comprehensive income only if it made that election at the initial recognition of the financial asset.

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?

We agree with the additional disclosure requirements proposed by the Exposure Draft, as it will provide more decision-useful information to the users of the financial statements.

We note that paragraph 44H(c) of the proposed amendments to IFRS 7 – *Financial Instruments: Disclosures* requires the disclosure of, *'…the amount of any financial assets or financial liabilities designated as at fair value through profit or loss that have been reclassified in accordance with paragraph 9 of [draft] IFRS X, and their original measurement basis and presentation method.'*

Our understanding is that paragraph 44H(c) requires the disclosure of financial assets and liabilities that have been designated as at fair value through profit or loss that previously, under current standards, were not designated to be carried at fair value through profit or loss. We believe that paragraph 44H(c)'s reference to 'reclassified' is not appropriate since that word has specific meanings in the current IAS 39 and the Exposure Draft. We also do not believe that the reference to paragraph 9 is appropriate since that paragraph does not contain any reclassification guidance. Accordingly, we recommend that paragraph 44H(c) be amended as follows: ***'the amount of any financial assets or financial liabilities designated as at fair value through profit or loss that were previously not so designated, and their original measurement basis and presentation method.'***

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 believe that the transition requirements contained in paragraph 22 of IAS 8 – *Accounting Policies, Changes in Accounting Estimates and Errors* should be applied upon adoption of the proposed standard. This would require entities to retrospectively apply the proposed standard as if it had been applied in prior periods. This would provide decision-useful information to the users of the financial statements, as it would allow them to perform a meaningful analysis on the financial performance and financial position of the entity.

The Exposure Draft proposes that the proposed standard be adopted from the *'date of application'* and that the date of initial application *'is the date when an entity first applies the requirements of the standard.'* We understand that the 'date of application' would be the date of commencement of the financial reporting period in which the amended standard is adopted. We believe that this is unclear in the Exposure Draft, especially when reading paragraph 26, *'… at the date of initial application shall be recognised in the opening retained earnings of the reporting period of initial application if this [draft] IFRS is applied initially at the beginning of a reporting period and in profit or loss if this [draft] IFRS is applied initially during a reporting period.'* Our inability to understand is a result of, amongst other areas of the Exposure Draft, paragraph 26's reference to the application of the amended standard during a reporting period. We therefore recommend that the Board clarify what is meant by 'application date' and in particular whether the application date is the date of adoption of the standard or the date on which all classification decisions need to be determined.

A minority of the respondents were of the opinion that the retrospective application of the standard may not in all instances provide both relevant and decision-useful information, especially since the comparative reported results would provide a means of comparison for all future reported results. In that regard those respondents noted the following concerns:

- The classification of financial instruments is to be determined on the date of initial application and will be applied retrospectively. This would imply that the comparative reported financial statements will report results on the basis of the entity having always applied that classification. Those respondents were of the opinion that the classification is to be determined at the date of application prospectively and not retrospectively.

- The Board has proposed that the amendments be available for adoption for financial years after publication of the proposed standard. Those respondents believe that to require retrospective application of the proposed amendment may create an obstacle to adopt the amendments early. Accordingly, they believe that in order to promote the early adoption of the proposed amendments, the amendments should only be required to be prospectively applied.

- As noted below in our other comments, the Exposure Draft is silent regarding the accounting treatment for financial instruments that existed at the start of the comparative period, but have been derecognised prior to the date of initial application of the Exposure Draft. In the event that entities have a free choice regarding the manner in which such instruments should be accounted for, the comparative financial statements may not provide relevant and decision-useful information, especially where it provides a basis against which the financial statements for future years will be compared.

- Those respondents acknowledged the need for relief in applying the transition requirements of the Exposure Draft in the areas of impairment (paragraph 30) and unquoted equity instruments (paragraph 31). It is noted that that relief is necessary due to the absence of available information to affect the necessary changes at the required time. Those respondents believe that requiring retrospective application and the transitional relief may undermine the relevance and decision usefulness of the comparative financial statements.

In light of the comments raised above, those respondents recommend that the amendments be required to be applied prospectively with disclosures to be provided on a similar basis to that required in terms of IFRS 1 – *First-time Adoption of International Financial Reporting Standards* (IFRS 1), paragraph 36A.

Question 14

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

(a) *in the statement of financial position?*

(b) *in the statement of comprehensive income?*

If so, why?

We do not believe that the alternative approach provides more decision-useful information than measuring those financial assets at amortised cost.

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Question 15

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

We do not believe that any of the variants of the alternative approach provides more decision-useful information than that contained in the approach proposed in the Exposure Draft.

OTHER COMMENTS

In addition to the above-mentioned specific comments, we have the following additional general comments:

1. Concern was expressed by some respondents regarding those financial assets that could be measured at amortised cost. While the stated purpose is to simplify reporting, the proposed changes may not always achieve that objective. The present standard refers to 'loans and receivables' and so the reference to just loans could be interpreted by some that receivables could not be recorded at amortised cost. This clarification is only noted later in the Exposure Draft. In addition, management of many entities may state that they do not manage their receivables on a contractual yield basis and so again, may believe receivables could not be recorded at amortised cost. This clarification is again only noted later in the Exposure Draft. Accordingly the effect of the proposed wording is not immediately clear. Consideration could therefore be given to replacing the word 'loan' with 'receivable' and making a contractual yield basis a basic receivable feature as opposed to it being in addition to a basic receivable feature.

2. B25 of the application guidance of the Exposure Draft states the following: *'IAS 21 requires any foreign exchange gains and losses on monetary assets and monetary liabilities to be recognised in profit or loss. An exception is a monetary item that is designated as a hedging instrument in either a cash flow hedge or a hedge of a net investment.'*

   We note that a third exception exists in paragraph 15 and 32 of IAS 21, whereby such gains and losses are included in a separate component of equity where settlement of the monetary item is neither planned nor likely to occur in the foreseeable future and that is, in substance, a part of the entity's investment in a foreign operation. We recommend that the Board amend B25 appropriately to reflect these requirements of IAS 21.

3. We note that the transitional requirements require many of the changes in classification be applied retrospectively. Other transitional requirements are required to be provided as at the date of initial application of the proposed amendments (refer to our responses in Question 13 above). We note further that paragraph 32 of the Exposure Draft notes that any hedge accounting relationship that is de-designated as a consequence of the classification approach in the Exposure Draft shall be accounted for as a discontinuation of hedge accounting from the date of initial application. Since the changes in classification are required to be applied retrospectively with no mention of the date of initial application, we

recommend that the same requirements be applicable to instances in which the hedging relationships are discontinued and that the paragraph be amended as follows: '*Any hedge relationship accounted for in accordance with paragraphs 85–101 of IAS 39 that is de-designated as a consequence of the classification approach in this [draft] IFRS shall be accounted for as a discontinuation of hedge accounting in accordance with paragraphs 91 and 101 of IAS 39* ***and be applied retrospectively****.* ~~***from the date of initial application.'***~~ (the words that have been struck through indicate the words that should be deleted and those that are underlined represent those words that should be added).

4. If we assume that the final standard on classification and measurement incorporates the ability of an entity to designate irrevocably an equity instrument to be measured at fair value through other comprehensive income, an unintended consequence may arise where such equity instruments are hedged by means of derivative financial instruments (such as a forward sales agreement). Such hedging activities may be entered into from time to time in order to protect the entity's net asset value as a result of decreases in equity prices. Such hedges would have been permitted to be accounted for in terms of the fair value hedge accounting requirements of IAS 39 since it was a hedge of an exposure to changes in the fair value of a recognised asset attributable to a particular risk and that could affect profit or loss. In the current IAS 39, fair value hedge accounting was possible for equity instruments that were designated as available-for-sale since the gains or losses could have affected profit or loss at the time at which it was subsequently disposed of.

   In the absence of permitting hedge accounting in such circumstances, we recommend that the definition of a fair value hedging relationship in IAS 39 be amended as follows: '*fair value hedge - a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment* <u>***and***</u> ~~***, that***~~ *is attributable to a particular risk.* ~~***and could affect profit or loss.***~~' (the words that have been struck through indicate the words that should be deleted and those that are underlined represent those words that should be added).

   We note that other consequential amendments to IAS 39 may be necessary due to the proposed changes above. The Board has proposed deleting F2.19 and F2.20 of IAS 39. In light of the above, we recommend that these two items be retained and amended appropriately in light of the amendments proposed in the Exposure Draft.

   We recommend that the above also be considered as part of the Board's proposed amendments on hedge accounting due for release in the latter part of 2009.

5. We note that there are no transitional provisions for financial assets that have been reclassified from held-for-trading in terms of the IAS 39 amendment – *Reclassification of Financial Assets* (the amendment) that was published in October 2008. In the event that an entity has reclassified financial assets in terms of the amendment and had reclassified such assets either from held-for-trading or available-for-sale to a category that is measured at amortised cost, then we believe that such entities should be required to restate the carrying values of those assets

to an amortised cost carrying value on the basis that such assets had been measured on that basis since it was either originated or acquired by the entity. We believe that this would reduce complexity since such assets would be measured at an appropriate yield and would reduce complications involving the identification of an impairment event and the discounting of future cash flows in determining the impairment loss to be recognised.

6. The transitional requirements of the Exposure Draft are required to be applied retrospectively. The hedge accounting requirements of IAS 39 may not be applied retrospectively. The inability to retrospectively designate hedging relationships may eliminate an entity's ability to designate hedging relationships to reflect the economic effects of its transactions. Assuming that the final amendment will continue to require retrospective application, then an entity will not be permitted to apply hedge accounting to those results. We recommend that the Board permit an entity to apply hedge accounting retrospectively in the first year of application of the proposed amendments and for this to be clarified as part of the Board's work on the hedge accounting amendments. This could be achieved in a manner similar to that required by IFRS 1 Implementation Guidance paragraphs 60A and 60B.

7. In terms of IAS 39 it is possible that an entity may have separated an embedded derivative from a hybrid instrument and designated that embedded derivative as a hedging instrument in terms of a cash flow hedging relationship with all changes in fair value being deferred into a component of other comprehensive income. It is unclear from the Exposure Draft whether that deferred gain or loss should continue to be deferred and reclassified into profit or loss in terms of IAS 39, paragraph 98 – 100, or if such gains and losses should be immediately reclassified into profit or loss. We recommend that the Board clarify how such amounts should be treated on transition to the standard.

8. Paragraph 20A of the proposed amendments to IFRS 7 requires disclosure of *'a reconciliation of the gain or loss recognised in the statement of comprehensive income arising from the derecognition of financial assets and financial liabilities measured at amortised cost.'* We do not believe that the nature and purpose of this disclosure requirement is sufficiently clear and recommend that the Board clarify exactly what form of reconciliation is required (i.e. from what to what and for what purpose). If the intention is to require disclosure of all gains and losses arising from the derecognition of financial assets and financial liabilities, then that should be simply stated in that manner.

9. We recommend that paragraph B27 of proposed amendments to IFRS 7 be amended as follows, *'… as at fair value through profit or loss is disclosed separately from the sensitivity of* ***<u>other comprehensive income</u>*** ***~~equity~~*** *…'* (the words that have been struck through indicate the words that should be deleted and those that are underlined represents those words that should be added).

10. We recommend that paragraph 7 of IAS 1 – *Presentation of Financial Statements* (IAS 1) be extended as follows:

    '(f) the effective portion of gains and losses on hedging instruments in a net investment hedge (see IAS 39 Financial Instruments: Recognition and Measurement.'

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