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Sir David Tweedie
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30 Cannon Street
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Dear Sir David,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, I appreciate the opportunity to comment on Exposure Draft ED/2009/7 *Financial Instruments: Classification and Measurement*. Principal authors of this comment letter were Peter Bitzyk, Julius Gaugusch, David Grünberger, Ingrid Jakob, Heiner Klein, Michael Laminger, Andreas Rauter, Ernst Schönhuber, Helmut Sorger and Roland Nessmann.

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, amortised cost provides decision-useful information for a financial asset or a financial liability that has basic loan features and is managed on a contractual yield basis.

From our point of view, however, the ED in its present form has some shortcomings:

1 It is not explained sufficiently clearly why financial instruments may only be measured at amortised cost if they have basic loan features only. From our point of view, liabilities should always be measured in terms of the expected future economic outflows, based on contractual agreements. Thus, for financial liabilities, measurement at amortised cost, applying the existing rules in IAS 39.11 in its present form for the separation of embedded derivatives, seems to be the appropriate solution. Perhaps a better Application Guidance, or a more detailed definition of those de-

rivatives – e.g., with respect to subordinating features – could be helpful. Otherwise we fear problems in connection with the issue of subordinated liabilities which are accepted as Tier 2 capital in the CRD. Such problems could affect own funds in the financial sector negatively, because of

- Reluctance on the part of the industry to issue such financial instruments, because they would be measured at fair value through profit or loss afterwards, and
- The effect of increased volatility on financial statements, which would be counter to the lessons learned from the financial crisis.

2 The question should also be asked whether financial assets should also be measured at amortised cost, and if so, which financial assets. Every change of existing rules has to pass a usefulness test as well as the cost-benefit test. This is especially the case for financial assets, which may – depending on the entities' intentions and available options – be held till maturity date. We think that statutory or supervisory changes and other changes outside management's ability to influence, e.g., changes resulting from business combinations, may pose a problem here.

3 As measurement at amortised cost is to be allowed only for financial instruments with basic loan features, we do not see the need to specify management on a contractual yield basis. On the contrary, we see a need to disclose management on a fair value basis, where for example a financial instrument is to be measured at fair value through profit and loss under the fair value option in order to reduce an accounting mismatch.

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?

1 In principle we agree, as long as a strict definition of "basic loan features" applies, which does not seem to be entirely clear. But as already mentioned in our answer to Q1 above, we see the need for

- Differentiation between financial assets and financial liabilities
- Differentiation between different types of embedded derivatives. Only for those requiring to be separated under the current IAS 39.11 should there be either separation and measurement at fair value through profit and loss – as under IAS 39 currently – or measurement of the whole financial instrument at fair value through profit or loss.

2 The stipulation that a portfolio must be managed on a contractual yield basis is

- Not necessary, as argued in our answer to Q 1 above, and/or
- Not sufficiently clear at present. In particular, the effects of a change in the management of a portfolio following a change in statutory, regulatory, tax or other reasons are not yet clear.

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?

In general, we see the primary goal of financial statements as assisting, along with information in the notes, users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty (IAS 1.9, last sentence). Thus, financial statements must also take into account management's business policies and objectives, and their reasonableness. For the precise implications of this principle for the measurement of financial instruments, please see our answers to Q1.

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.

As explained above in our answer to Q1, we do not see the purpose of the proposed change.

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

We think that every proposed change must fulfil the requirements of IAS 1.15 and be in accordance with the definitions of assets and liabilities in the Framework. Thus, as explained above in our answer to Q1, with respect to liabilities the basis of measurement must be the expected outflow of economic resources under the contractual agreement, provided the entity does not have the intent and ability to repurchase the liability.

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.

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?

The fair value option should be allowed only if fair value measurement significantly reduces accounting mismatches.

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?

In principle, we agree.

But if there is a change in statutory, regulatory or tax requirements outside the management's ability to influence, it could be misleading to retain the original classification and to adhere to the former measurement principles. The same may be true if the entity's ultimate ownership changes as a result of a business combination. In any event, changes in classification, require a proper and sound justification and must be disclosed and explained in the notes properly.

Additionally, we see a need for reclassification of financial instruments if the accounting mismatch, which originally led to exercise of the fair value option, ceases to exist.

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?

No; see our answer to Q3 above.

In particular for investments in unquoted equities that are measured at cost under existing IAS 39 provisions because their fair value can not be estimated reliably, we cannot agree with the explanation in the ED that the ability to carry out an impairment test implies the ability to estimate a fair value for the equity with sufficient reliability to allow measurement at fair value through profit or loss without deterioration of measurement principles.

Problems with the determination of correct fair value dealt with in ED/2009/5 *Fair Value Measurement* are discussed in our Comment Letter to this ED.

In our opinion, therefore, that this change in the measurement would not

a) pass the cost-benefit test, and
b) in any way add to the decision-usefulness of financial statements for users.

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?

As we do not see any improved decision-usefulness in some of the proposed changes (see answers to Q1, Q3 and Q8 above), we think that the existing measurement at cost or amortised cost based on an impairment test is more decision-useful than fair value in many cases.

In all events, any new regulation must take into account the problems of calculating a comparable and accepted fair value, especially in times of market turmoil (see also our answer to Q9).

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?

No; investments in equity instruments held for purposes other than realising gains from short-time price fluctuations (which belong to trading instruments and should be measured at fair value through profit or loss) should be measured at cost, and dividends and the relevant funding costs should be included through profit or loss.

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?

See answer to Q10 above.

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 fear that the problems of applying only parts of an amended standard before knowing all amendments of the standard could lead to misleading information.

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 see retrospective treatment as generally hard to apply with respect to the replacement of IAS 39.

In any event, until the final "new" IAS 39 is available, the scope of the necessary work can not be estimated reliably – knowing the volume of financial instruments in some industries, particularly in financial and near financial institutions, proper and well-coordinated efforts will be needed. These can only be planned when the final new IAS 39 is ready, i.e., some basic parameters for assets like unquoted equity instruments may not be available. Thus, some form of transitional rules will be necessary.

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?

No, we see the ED as a reduction in the number of categories, which is positive. What we miss, though, are some conceptual clarifications as well as an underlying general concept on which the new standard for the recognition and measurement of financial instruments is to be based. As future new impairment as well as hedge accounting rules will have a big impact on these issues, we hesitate to give an unreserved opinion about parts of a standard without being able to see the whole picture.

In particular, please note our answers to Q1, Q3, Q8, Q9 and Q10 above.

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl
Chairman