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

Berlin, 14 September 2009

Dear David,

Exposure Draft ED/2009/7 Financial Instruments: Classification and Measurement

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on the IASB Exposure Draft ED/2009/7 'Financial Instruments: Classification and Measurement' (herein referred to as 'ED'). We appreciate the opportunity to comment on the Exposure Draft.

The GASB appreciates the fundamental objective of the exposure draft to simplify the accounting of financial instruments, in particular by reducing the number of categories.

Due to the split of the entire project into three phases a comprehensive and final evaluation of the proposals relating to the first phase is not possible at this stage without knowing the outcome of the other two phases. Another obstacle is the fact that the project on 'Fair Value Measurement' is still in progress. It is difficult to assess a proposed classification approach that will determine which financial assets and liabilities should be measured at fair value when the measurement objective of fair value is not finally determined. Similar difficulties arise with other ongoing projects also interrelated to the accounting of financial instruments, such as 'Financial Statement Presentation' and 'Insurance Contracts'.

To our knowledge, a majority of IFRS preparers will probably not adopt the new classification standard for 2009 year-end financial statements for these reasons. In this respect we are raising the question whether the urgent need for a new classification and measurement model for financial instruments applicable in the short term which has been expressed by financial institutions a few months ago still exists. It is our impression that this is no more the case in the previous stringency.

In light of the recommendations made by the G20 leaders we fully understand that the IASB adheres to its announced timetable. Given the perceived change in the environment mentioned in the previous paragraph, the GASB recommends a review of the timing of the project setup with the aim of working towards a comprehensive exposure draft for the accounting of financial instruments (including impairment and hedge accounting), which would be published in 2010 in line with the current timetable and which would be mandatory for annual periods beginning on or after 1 January 2012. Furthermore, we notice that despite the fact that this project is a joint project with the FASB, the two Boards seem to have reached fundamentally different conclusions on key issues, let alone not aligned their respective project timetables. Hence, there is a high risk that the Boards will not end up with a converged standard in this important accounting area – a situation that runs counter one of the key objectives mandated by the G20 in April.

With respect to the classification approach for financial instruments we do not agree with the proposals in the ED because we believe that the classification criteria introduced, i.e. 'basic loan features' and 'managed on a contractual yield basis', are not operational (for further details please refer to our answer to questions 1 to 3 below).

The GASB is of the opinion that the classification of a financial instrument should be made depending on which measurement category represents the best estimate of the instrument's future cash flows considering its intended use. We have further elaborated this approach in our answer to questions 1 to 3 below.

Please find our detailed comments on the questions raised in the ED in the appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President

Appendix

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?

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 what you propose and why?

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 these 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?

The GASB supports the basic concept in the exposure draft retaining a mixed model for the accounting of financial instruments with the two measurement categories ‘fair value’ and ‘amortised cost’. However, as already stated in our comment letter to the Discussion Paper ‘Reducing Complexity in Reporting Financial Instruments’ we hold the view that fair value is the appropriate measurement attribute for financial instruments held for trading and for derivatives, but fair value is not relevant for measuring debt instruments held for longer-term investment purposes. For those purposes fair values do not necessarily provide information that helps to predict the most likely future cash flows as management may have no intention to sell or discharge itself of the financial instruments, but may have other plans with them that are expected to result in cash flows other than the current fair value.

We believe that the criteria ‘basic loan features’ and ‘managed on a contractual yield basis’ are not sufficiently substantiated and, therefore, will be difficult to be applied in practice. Determining whether a financial instrument has ‘basic loan features’ or not will, in our opinion, result in a huge amount of additional guidance becoming necessary, especially for complex instruments with embedded derivatives or in waterfall structures. The second criterion ‘managed on a contractual yield basis’ raises further questions with regard to its application. For example, while the business model of an entity is to collect interest and principal from financial assets held, this portfolio may be managed on multiple bases, including fair value. Also, financial liabilities are often not managed on a contractual yield basis but simply repaid on maturity, especially by non-financial institutions. In this regard we would like to point out that the proposals in the exposure draft and the application guidance on the classification criteria in particular appear to be focused on financial institutions, even though the final standard would be applicable for all IFRS preparers. Thus, the effects on non-financial institutions – the majority of IFRS preparers – are somewhat unpredictable (eg the application of the classification criteria on trade accounts receivable is not clear).

The GASB prefers an approach where the classification of a financial instrument depends on which measurement attribute represents the best estimate of its future cash flows considering the intended use of that instrument. This measurement attribute would be fair value (unless the fair value cannot be reliably determined) for

- instruments without contractual cash flows (thus basically representing the default category for equity instruments),
- derivatives, and
- all financial instruments which are intended to be sold or settled in the short term.

In all other cases, the instrument should be measured at (amortised) cost. We believe that such a classification criterion is more operational and more decision-useful.

Regarding the decision where to present fair value changes of financial instruments measured at fair value, we believe that all such changes should be presented in profit or loss if the intention is to realise these changes in the short term, whilst they should be presented in other comprehensive income (OCI) if there is no intention to sell short-term, with the exception of derivatives, for which the fair value changes should always be presented in profit or loss. Fair value changes presented in OCI would have to be recycled through profit or loss in case of impairment or reversal of impairment, the latter limited to original cost. Regarding simplified impairment rules we can envisage introducing a lower of cost or current market value test.

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.

(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?

The GASB acknowledges the intended simplification by proposing the elimination of the embedded derivative requirements for hybrid contracts with financial hosts. However, we have doubts as to whether this elimination will actually result in a reduced complexity. The current assessment whether an embedded derivative has to be bifurcated would be replaced by the assessment whether the entire hybrid instrument meets the condition ‘basic loan features’ as set out in the exposure draft. Additionally, retaining the current requirements for hybrid instruments with non-financial hosts rather results in an increased complexity. Furthermore, the proposed rules could be easily circumvented by contracting the individual components with different parties and account for them separately. Thus, substantially similar items would be reported differently.

Taking these concerns into account, we overall disagree with the proposed elimination of the embedded derivative requirements for hybrid contracts with financial hosts.

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?

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 agree with the proposal to retain the fair value option for eliminating or significantly reducing an accounting mismatch.

Against the background of our objection to eliminate the embedded derivative requirements for hybrid instruments with financial hosts, we recommend to retain the fair value option also for such hybrid instruments. Thus, complex hybrid instruments can be measured at fair value in their entirety instead of carrying out a bifurcation when the latter proves to be more complex.

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?

The GASB does not agree with the proposed prohibition of any reclassification between the amortised cost category and the fair value category. As stated above, we would prefer a classification approach for financial instruments that considers the intended use of the instruments. As these intentions may change, reclassifications are appropriate in these cases and should therefore be possible. In such cases, adequate disclosures are required that sufficiently explain the reasons for and the effects of such reclassifications to the users of financial statements. This will include corresponding disclosures in subsequent periods to make the reclassifications conducted transparent and to prevent abuse.

Apart from that, we believe that the proposed absolute prohibition of reclassifications is inconsistent with the objectives and criteria otherwise contained in the exposure draft with respect to the necessary consideration of the entity's business model. In this respect we share the concerns raised in the Alternative View para. 15 in the basis for conclusions.

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?

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?

In principal, we agree that fair value is the appropriate measurement attribute for equity instruments, which have no contractual cash flows. However, we take a different view if the fair value cannot be reliably determined.

In Germany, investments in equity instruments relate in the vast majority to limited liability companies and partnerships. As a consequence, the required continuous fair value measurement is not reliably feasible or will incur high additional costs (cost-benefit aspect).

The GASB does not agree with the IASB's conclusion that a possible increased complexity in determining the fair value of the equity instrument would be offset by eliminating the requirement to monitor it for impairment. Monitoring equity instruments for impairment mainly focuses on the existence of impairment triggers. Only in such cases where the triggers have indicated an impairment, the further impairment review procedure might result in a complexity not much different from the determination of the fair value. In all other cases the proposal will result in a higher frequency of determining the fair value.

As a result, the GASB favours retaining the 'cost exemption' and impairment requirements for unquoted equity instruments as currently included in IAS 39.

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?

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?

As mentioned in our answer on questions 1-3 in outlining our preferred approach, we believe that, conceptually speaking, fair value is the adequate measurement attribute for equity instruments (the exception being those cases where fair value cannot be determined reliably or only at costs exceeding their benefits). We believe that the decision regarding the presentation of fair value changes of equity instruments – through profit or loss or in OCI – should be made by reference to the intention how to realise fair value changes of those instruments, i.e. if the intention is to realise the fair value changes of the equity instrument in the short term, then those changes should be presented in profit or loss. If this is not the case, the fair value changes should be presented in OCI.

In contrast, the proposal in the ED to present the fair value changes of certain equity instruments in other comprehensive income is, in substance, a free choice. We disagree with that proposal. Furthermore, the requirement to present all fair value changes (including dividends) in other comprehensive income raises the question if this also relates to any other income/expense resulting from additional business relations with this entity besides the investment (such as granting a loan).

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?

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?

The proposed additional disclosures required on early adoption of the proposed IFRS are intended to ensure comparability of financial statements of entities which choose early adoption and those not. Such comparability will not be existent in subsequent periods between early adoption and mandatory application. A possible solution, requiring those additional disclosures for each period until mandatory application would be overly burdensome for early adopters. Therefore, on balance the GASB agrees with the proposed additional disclosures required on early adoption of the proposed IFRS.

We also agree with applying the proposals retrospectively and the related proposed transition guidance to avoid practical implementation difficulties.

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?

The GASB does not believe that the alternative approach represents a preferable model. The insertion of a further assessment whether financial instruments with ‘basic loan features’ that are ‘managed on a contractual yield basis’ additionally meet the definition of ‘loans and receivables’ is contrary to the target objective as it will increase complexity. The approach can be seen as a step away from a mixed model to a full fair value model. We doubt this approach will result in more decision-useful information to users of financial statements as it may rather result in a lack of understanding.

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 are not in favour of the possible variants of the alternative approach either. Please refer to our answer to the previous question.