Organismo Italiano di Contabilità – OIC
(The Italian Standard Setter)
Italy, 00187 Roma, Via Poli 29
Tel. 0039/06/6976681 fax 0039/06/69766830
e-mail: presidenza@fondazioneoic.it

EFRAG
35 Square de Meeûs
B-1000 Brussels
BELGIUM
commentletter@efrag.org

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Re: *EFRAG draft comment letter on Exposure Draft Financial Instruments: Classification and Measurement*

Dear Sir/Madam

We are pleased to provide our inputs to contribute to the finalization of the EFRAG comment letter on the IASB Exposure Draft *"Financial Instruments: Classification and Measurement"*

GENERAL COMMENTS

We appreciate the effort to reduce complexity of accounting standards for financial instruments, as recommended by G20. Therefore, we support the decision to modify the existing classification model, reducing the categories for the valuation of financial instruments to only two, fair value and amortised cost.

However, we have some general concerns about the proposals contained in the ED:

1. The decision of the IASB to separate the completion of the IAS 39 replacement project in three parts makes it difficult to judge the proposal of the ED without knowing what will be decided in the two following phases of the project. With regard to this topic, we see two alternative ways to solve the problem:

   a) accelerate the approval within year-end of the third phase of the project (hedge accounting) and defer the revision of the impairment to 2010, in order to have a complete set of rules about classification and measurement by 2009; or
   b) modify in a few specific points the existing IAS 39, as requested by a number of parties to the Board in the late autumn[1], and defer the approval of this ED to 2010, together with the two remaining phases of the project.

[1] Some of the proposed changes to the current IAS 39 include:
- Revision of impairment of available for sale items;
- Reclassification of financial instruments designated at fair value when the reasons for the adoption of fair value option no longer exist;
- Elimination or relaxation of tainting rule.

We agree with the concerns expressed in your draft comment letter at par. 98 with regard to the insurance sector. It seems appropriate for insurers to extend the transition period up to the effective date for the new IFRS 4, or alternatively to maintain the AFS requirements until the effective date for the new IFRS 4.

2. It seems that the potential pro-cyclicality due to the measurement of the financial instruments at fair value will increase with the adoption of the Exposure Draft. It would not create any advantage in terms of the usefulness of information provided by financial statements. The ED requires that instruments that do not have "basic loan features" should be measured at fair value through profit or loss. With this classification approach, the junior tranches of securitisation, hybrid instruments and bonds acquired at a discount price that reflects expected losses that previously could have been measured at amortised cost will be mandatorily measured at fair value. In all these circumstances, we do not believe that the mandatory use of fair value provides more useful information to the users of financial statements than the amortised cost in the circumstances in which such financial instruments are managed on a contractual yield basis.

3. We do not agree with the general scheme of classification proposed by the ED, as it seems that the characteristic of the instrument test is the primary test in regulating the criteria of measurement of each instrument. We would prefer a scheme completely based on the business model underlying the management of the financial instrument. Only if the nature of the financial instruments requires a different accounting, do we agree that the characteristics of the instrument can be elected to a driver for the accounting treatment. This is the case with derivative instruments.

4. We have a strong concern on the proposal of accounting models such as FVTOCI completely general criteria to distinguish which items should influence the profit or loss rather than the other comprehensive income. Following the proposal of the ED, the gains or losses arising from some equity instruments could be alternatively included in net profit or in the other comprehensive income, on the basis of a completely free choice of the entities. As a result, the distinction between net profit or comprehensive income loses meaning.

These points will find further explanation in the following paragraphs.

CLASSIFICATION APPROACH

The classification scheme proposed by the ED could be summarized in a full fair value model that accepts few exceptions in the case of certain instruments with basic loan feature and managed on contractual yield basis. The gains or losses arising from fair value measurement find place in profit and loss, with exception for equity instruments not held for trading, which can be measured at fair value to other comprehensive income. We think that this scheme should be inverted.

We would prefer that the financial instruments that are managed on a fair value basis should be measured at fair value through profit or loss, and all other instruments could be measured at amortised cost if such an accounting method were applicable to such instruments. In such a classification approach, derivates would never be measured at amortised cost.

Regarding the measurement of equity instruments, we would support two alternative solutions. The former solution is an immediate consequence of the business model approach already described. Based on such an approach, the financial instruments that are not managed on a fair value basis could be measured at amortised cost if it is applicable. Such a principle would be translated to the measurement at cost for all the equity instruments, with the requirement of disclosing the fair value for those equity instruments that are quoted in an active market. An alternative classification approach for equity instruments that are not held for trading purposes would require the fair value measurement for all those quoted in an

active market. The variations of fair value would be recognized in the OCI, except for those that arise from objective and verifiable events, that will be recycled to the P&L. In any case, for all the equity instruments that are not traded in an active market, the current cost exemption should be maintained.
The fair value option should be maintained in order to prevent accounting mismatches and to simplify the accounting of hybrid instruments.
We are convinced that a model that clearly defines what should be accounted for at FVTPL provides useful and easily understandable information to users, and permits avoiding the problem related to the definition of "basic loan features".

CLASSIFICATION APPROACH TO CONTRACTUALLY SUBORDINATED INTERESTS

We agree with your draft comment letter that this is a difficult issue to be dealt with, and in the meantime we acknowledge that the measurement approach for such instruments, especially the most junior tranches, was one of the main topics discussed last autumn during the analysis of the remediation plan for the financial crisis. The amendment of IAS 39 *Reclassification of financial assets* allowed entities to reclassify such instruments into an "amortised cost" category and it demonstrated that it would be possible to measure them at amortised cost when they are held for *non-trading* purposes and are not quoted in an active market.

Coherently with the classification approach proposed above, which is mainly based on the business model, we believe that if it is true that even the junior tranches can be measured at amortised cost, there is no reason to avoid such measurement. Therefore, in relation to your question to EFRAG's constituents at paragraph 50 of your draft comment letter, we would suggest considering the possibility in maintaining an amortised cost based measurement even for contractually subordinated financial instruments when those are not quoted in an active market and are managed on a contractual yield basis.

FAIR VALUE OPTION

The classification approach based on the business model is operational to the extent that the reclassifications are permitted at least in particular circumstances. In this context, it does not seem fair that an anti-abuse rule would restrict the application of the business model criterion, and therefore we do not support the proposal of the IASB on such a matter. We agree with your comments that a classification system should require the reclassification when the criteria for the initial classification no longer exist.
The current rules of the IAS 39 on reclassification already allow entities to reclassify financial assets from a fair value category to an amortised cost one, when the entity change its strategy on such assets. We do not understand why we should abandon this rule, and what is the information enhancement that will arise from an accounting model completely delinked to the way that entity manages such financial assets.
Having said that, we do not understand what the difference is between such a reclassification principle and the one that would stem from the fair value option when circumstances changed. It was one of the main points discussed the last autumn regarding the financial crisis and the amendment on reclassification of financial assets. We did not understand why an entity should be obliged to maintain a fair value measurement for an asset that is no longer managed on a fair value basis, even whether it designated such an asset to a fair value category in order to reduce the accounting mismatch. We do not understand it now and we do not see any significant difference between the financial instruments designated at fair value based on the fair value option and all the other financial instruments.
Therefore, regarding your question to EFRAG's constituents of paragraphs 55-58 of the draft comment letter, we would support the position of allowing entities to reclassify financial instruments designated at fair value under the fair value option, when the reasons to activate the fair value option do not exist anymore (lack of accounting mismatch reason).

INVESTMENTS IN EQUITY INSTRUMENTS THAT ARE MEASURED AT FAIR VALUE THROUGH OTHER COMPREHENSIVE INCOME

As already said above regarding the classification approach, we think that measuring equity instruments that are held for non-trading purposes at fair value to other comprehensive income has some merits. Although we acknowledge that the decision of the IASB to allow the classification at fair value to OCI without any possibility of recycling represents a pragmatic decision, we are not sure that it represents an improvement to the information given to the investors. We agree with your letter that current expectation of users is that at least something is recycled from OCI to P&L. Without recycling, there would not be reasons for maintaining the OCI section.
We support your proposal that a recycling should be permitted based on an *objective and verifiable event,* but we are not sure that such an event should be restricted only to the derecognition of the equity instruments. We are not sure that a dividend distribution could not be considered an objective and verifiable event, and we do not see critical aspects in including also the impairment notion in the boundaries of such events. We think that avoiding recycling would resolve the impairment issues but it would weaken the information of the financial statement and would reduce the comparability between entities. We suggest maintaining the recycling on the event of derecognition, dividend distribution and impairment, and in the meantime, work to enhance the current impairment rules for equity instruments. The impairment of equity instruments could be based on the valuation of its economic value that normally can be obtained with a specific valuation made by the entity management or referring to the information present in the market. In such an impairment model, the significant or prolonged test would be downgraded to a trigger event rather than a red line over which the impairment loss is automatically recognised.
Moreover, we reaffirm that it is important that the IASB defines the main aspects of the framework involved before establishing the accounting principles. It has happened in many recent projects that the IASB is developing, such as revenue recognition and the definition of control. However, in this Exposure Draft, we expected that the IASB would at least bear in mind what it means for other comprehensive income and the difference with the events recognized in P&L. It seems that this is not the case, and therefore we do not think that it is appropriate to change the rules on recycling that are currently applied to the equity instruments classified in AFS, without a clear idea of what OCI should represent.

Yours sincerely,

Angelo Casò
(Chairman)