EFRAG

European Financial Reporting Advisory Group

xx January 2009

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

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 14 January 2009

Dear Sir / Madam

Re: Exposure Draft of Proposed Amendments to IFRS 7

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft of proposed amendments to IFRS 7 *Financial Instruments: Disclosures* "Investments in Debt Instruments" (the ED). This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issues.

The ED proposes additional disclosure requirements for all investments in debt instruments (other than those classified as at fair value through profit or loss). We understand that the purpose of the proposed disclosures is to enhance comparability between investments in debt instruments held within and by different entities, by providing the information needed to adjust results on to a more consistent basis regardless of how the debts instruments are classified. The proposals will enable companies to disclose the profit or loss that would have been recorded if all financial assets (other than those categorised at fair value through profit or loss) had been measured using amortised cost (ie using an incurred cost model) or all had been measured using fair value. The ED also proposes that the disclosures shall be applied as early as annual periods ending on 15 December 2008. The ED was issued on 23 December 2008, with a 23 day comment period—much of which is a holiday period in the northern hemisphere. FASB is proposing similar changes to US GAAP.

Our detailed response is set out in the Appendix to this letter but, to summarise, our overall position regarding the proposals in this ED is that:

- we believe the IASB should not proceed with them at the pace and with the implementation timetable that is proposed—in annual periods ending on or after 15 December 2008. We do not believe the proposed disclosures are as urgently needed as that timetable implies, and in any case we believe the issues involved are complex and that more time is required for all parties—the IASB and its constituents—to

evaluate properly whether the disclosure amendments achieve the objective they purport to achieve—to enhance the comparability of reporting for financial instruments within and among entities—and do so in a way that enhances the usefulness of the information provided.

However, should the IASB decide to proceed with these amendments we recommend that they are not made mandatory for implementation in 2008 financial statements. We understand that it could be problematic for some entities to gather and analyse the information necessary to implement the proposed new disclosures in 2008 financial statements. Furthermore, backdating an effective date is problematic for jurisdictions that require legal endorsement of any changes to IFRS before they can be applied. If the IASB chose a later effective date, those entities that wish to and are able to provide the disclosures earlier could still do so.

- because of the complexity of the underlying issues and the very short comment period involved, we have not so far fully evaluated the new disclosures proposed and are therefore not in a position to comment on whether we would support them were the implementation timetable eased. However, we are inclined to the view that the IASB should undertake further analysis and consideration before bringing forward even disclosure proposals in this area.

If you wish to discuss our comments further, please do not hesitate to contact Paul Ebling or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix – general comments on the proposals in the ED

Is it appropriate to rush through these changes?

1 EFRAG recognises that, because of the current financial crisis, it might be necessary for the IASB to make some amendments to existing IFRS at very short notice. We further recognise that this might make it necessary to issue proposals for change with very short comment periods (for example 23 days) even though a holiday season might be involved and to backdate their application. However, the key word here is 'necessary'; the amendments and circumstances involved must be such that it is <u>necessary</u> to short-cut the normal due process and to backdate their application.

2 EFRAG therefore started its evaluation of the ED by considering whether the amendments proposed warranted being 'rushed through' in this way, bearing in mind market conditions currently and in the near-future. Its tentative conclusion is that they do not.

(a) We understand that a number of preparers have asked for urgent changes to be made to the way in which impairments of debt instruments classified as available-for-sale (AFS) are accounted for, and that aspects of the disclosures being proposed in the ED might be some sort of alternative to the requested changes. We also understand that a number of users have said that, although they would not support the accounting changes requested, they would it useful if the disclosures provided about impaired debt instruments classified as AFS could be enhanced urgently; and that aspects of the disclosures being proposed in the ED might satisfy that request. For those reasons we think a case could perhaps be made to move quickly on disclosures about impairments of debt instruments classified as AFS. However, the disclosures proposed are much more extensive than that.

(b) The only reason we can think of for trying to 'rush through' the changes proposed, bearing in mind they have not been requested by preparers or by users and appear designed to fill a gap that most commentators were not even aware existed is if disclosures that would meet the urgent needs of preparers and users will 'not work' unless they are placed in the context of the disclosures proposed in the ED. However, we have heard or read nothing that suggests that that is the case.

3 We understand that the purpose of the proposed disclosures is to enhance comparability between investments in debt instruments held within a single entity and also by different entities. The proposal is that this should be done by requiring disclosures that provide the information users need to adjust the numbers included in the primary financial statements to a more consistent basis. However, bearing in mind that there are some fairly fundamental issues involved, it is questionable whether it is possible to achieve this objective through what is essentially a 'minor patch' of existing IFRS; the risk is that the result will be that an illusion of greater comparability is created while in reality little has changed. As the responses to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* highlighted, it is still not clear what makes reporting financial instruments more comparable. For example, is it the use of a single measurement basis—in which case, which measurement basis would that be—or is it the use of measurement bases in ways that reflect the business model? Furthermore, does comparability require the approach adopted for assets to also be

applied when reporting financial liabilities? For these—and other reasons—it is not clear to us whether comparing only some financial assets on the basis of two measurement alternatives—fair value and amortised cost—will enhance the usefulness of reporting financial instruments greatly, if at all.

4 We are also concerned that, as with any rushed through amendment (and the recent October 2008 amendment was a good example), there is a risk of significant omissions or unintended consequences in proceeding at the pace proposed in the ED. Just as an example, this ED refers to debt instruments. However the term 'debt instruments' is not defined under IFRS and therefore there might be confusion in some instances as to which instruments are in the scope of this amendment and which are not. IAS 39 refers to non-derivative financial assets with fixed or determinable payments and fixed maturity in the definition of loans and receivables or held-to-maturity investments, but it is not clear whether these are the type of financial assets that the ED intends to cover when it refers to 'debt instruments'.

5 EFRAG's view is therefore that the proposals in the ED are not sufficiently urgent to justify abandoning the normal due process and sensible implementation regime. In our view, if the IASB believes the proposals have merit as a package, it should extend the comment period so that its constituents have the time to evaluate and comment on the proposals properly.

Backdating the effective date

6 Quite apart from our concerns about rushing through the proposed changes, we also believe that the proposal that the requirements be implemented for annual periods ending on or 15 December 2008 could result in practical difficulties.

(a) By the time the final amendment is issued, some entities will have already largely completed their annual financial reports. Issuing the amendments in late January with such an effective date would therefore require such entities to gather in a rushed way the necessary information and prepare additional disclosures.

(b) We understand that backdating the effective date the IASB assumed that no additional information to that already required by IFRS 7 needs to be gathered to provide the disclosures, but we are not convinced that that assumption is correct. However, even if new disclosures are largely based on the information already required in IFRS 7, our understanding is that for some entities it will still for various reasons (e.g. the way their information systems are designed) be burdensome to gather and analyse the information needed to meet the new requirements.

One may expect that the quality of the disclosures prepared in such a rushed manner may suffer.

Question to constituents: In paragraph (b) above we stated that it might not be correct to assume that no new information needs to be gathered to provide the additional disclosures. Do you agree? If so, could you provide examples?

7 It should also be noted that backdating the effective date of an amendment to IFRS is problematic for jurisdictions that require legal endorsement of any changes to IFRS before they can be applied.

8 For these reasons, we strongly recommend that, should the IASB decide to proceed with the disclosures, it adopts an effective date that gives entities sufficient lead time to prepare for the change with a possibility to adopt the amendments early for those entities that wish to do so and are sufficiently prepared for that.

Impairment of debt securities classified as AFS

9 Above we have argued that the proposals set out in the ED should not be rushed. In the paragraphs below we consider whether, were the the scope of the proposed new disclosures limited just to debt securities classified as AFS and treated under IAS 39 as impaired, the disclosures would be sufficiently useful to justify a short comment period and backdated implementation.

The call for changes to the accounting treatment of AFS debt securities

10 It is our understanding that that a number of preparers have expressed concerns about the fact that impairments of debt instruments classified as AFS are measured differently from impairments of debt instruments classified as loans and receivables (LAR) or held-to-maturity (HTM).[1] One of the concerns seems to be simply that the same or similar instruments are subject to different measurements of impairment depending on their classification. Another concern is that the impairment rules applying to AFS debt instruments overstate the losses incurred on such instruments, primarily because they take changes in credit spreads into account in addition to changes in expectations about future cash flows.

11 As a result, the preparers involved have been suggesting that it would be useful to disaggregate the impairment loss recognised for AFS debt instruments into:

(a) the incurred loss, determined in the same way as for debt instruments measured at amortised cost using the incurred loss model. This loss would continue to be presented in the income statement; and

(b) the remainder (ie the fair value change other than (a) above). This loss would be presented in OCI.

12 However, a number of users have told the IASB that, although they think it would be useful to understand how much of an AFS debt instrument is made up of (a) and how much of (b), they would prefer the information to be provided either via note disclosure or by separate presentation within the income statement.

13 Our understanding is that, having had an initial discussion of this issue, the IASB has concluded that, although the issues involved are worthy of further consideration, that will take time even if the IASB treats it as an urgent issue. EFRAG agrees with this assessment. It is not just that the impairment requirements in IFRS for AFS debt instruments are different from those for LAR and HTM debt instruments, there are also differences between IFRS and US GAAP and there are aspects of both the AFS requirements and the LAR/HTM requirements that would benefit from re-examination.

[1] AFS debt instruments are carried at fair value and impairment losses are measured as the difference between amortised cost and the lower fair value. LAR and HTM debt instruments are carried at amortised cost and impairment losses are measured as the difference between amortised cost and the present value of estimated future cash flows, calculated using the original effective interest rate or – for variable interest rate instruments – the current effective interest rate ('incurred loss model').

Indeed, as we pointed out in our response to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments*, the existing IAS 39 requirements for the recognition and measurement of impairment losses is one of the areas in reporting financial instruments many consider to be flawed. These are complex issues that need to be considered carefully.

14 Partly because it would take some time to consider fully the accounting issues (and partly because users said they preferred a disclosure 'solution' anyway), the IASB focused initially on disclosure.

<u>Limiting the scope of the ED's proposed disclosures just to debt securities classified as AFS and treated under IAS 39 as impaired</u>

15 Our tentative reaction to the thought that it might be useful to limit the scope of the ED's proposed disclosures just to debt securities classified as AFS and treated under IAS 39 as impaired is that, if the impairment of AFS debt securities is a complex issue that needs to be examined carefully before deciding what if any changes should be made to the existing requirements, that is the case regardless of whether the changes being contemplated are recognition, measurement, presentation or disclosure changes.

16 **Question for constituents:** We are therefore inclined to the view that the IASB should undertake further analysis and consideration before bringing forward even disclosure proposals in this area. In normal circumstances we would wish to consult informally but widely on this issue before expressing such a view even in a draft comment line but, because of the timetable involved, this has not been possible so we would welcome your views on whether there is any merit in limiting the scope of the ED's proposed disclosures just to debt securities classified as AFS and treated under IAS 39 as impaired. Our concern is that there are too many issues to be addressed to ensure that the recognition and measurement of impairments is appropriate for it to be possible to improve the quality of the information provided through disclosure. Behind this is a concern that we cannot keep adding disclosure requirements in the hope that the disclosures will be useful to someone; we should be sure the disclosures will really shed new insights or enhance the usefulness of the other information provided.

We would therefore welcome your views on whether there is any merit in limiting the scope of the ED's proposed disclosures just to debt securities classified as AFS and treated under IAS 39 as impaired.