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RE: EFRAG's draft comment letter on the IASB's Exposure Draft Financial Instruments: *Classification and Measurement*

The Committee of European Securities Regulators (CESR), through its standing committee on financial reporting (CESR-Fin), has considered EFRAG's draft comment letter on the IASB's Exposure Draft (ED) *Classification and Measurement*.

CESR thanks you for this opportunity to comment on your draft letter and is pleased to provide you with the following comments.

CESR agrees with both EFRAG - and the IASB - that in some circumstances, the application of the complex requirements in the current IAS 39 has resulted in unnecessary confusion for preparers and users of financial statements and therefore welcomes the IASB's publication. However the IASB's decision to divide its project into three phases makes it difficult in CESR's opinion to:

- make sure that all the issues identified by governments, users and regulators during the turmoil are being or will be addressed during the course of the whole project; and
- comment on the Board's proposal on classification and measurement without knowing the changes that will be made to impairment and hedge accounting in phases two and three of the project.

CESR believes that it is crucial that the IASB and the FASB work together to make sure that IFRS and US GAAP are fully converged in the area of financial instruments accounting. There is divergence at the moment between the IFRS and US GAAP in this area and CESR is concerned that this new standard, if not developed with the full cooperation of the FASB, could create yet more divergence. CESR is concerned by the Board's statement in paragraph IN11 of the ED that "the FASB has not deliberated yet on what the basic classification model for financial instruments should be". CESR agrees with the Financial Crisis Advisory Group, who emphasised the importance of "a single set of high quality, globally converged financial reporting standards that provide consistent, unbiased and relevant information".

CESR believes that it would have been preferable for the IASB to have come with a comprehensive and joint solution on financial instruments. Given the fundamental changes to financial instrument reporting expected to result from this review coupled with the difficulties in knowing how the second and third phases will develop, CESR understands that many issuers will not be in a position to adopt a new classification model for 2009 year end accounts. Therefore, CESR believes that making the changes described below (which have been previously raised with the IASB) would provide useful relief to issuers while they prepare to move to a new model:

- The thrust of the FSP approach to impairment of Available for Sale debt securities should be incorporated into IAS 39, with appropriately robust disclosure requirements in IAS 1 and IFRS 7.
- The reversal of impairment of Available for Sale equity instruments should be allowed.

Therefore, CESR believes that the approach followed by the IASB is not optimal. That said, as indicated in our comment letter to EFRAG on the IASB's DP on Reducing Complexity in Reporting Financial Instruments (ref CESR/08-658), "CESR believes that a single measurement attribute for all financial instruments such as fair value is a good goal for the future and CESR would like to support the effort of achieving such a goal. CESR does however, strongly believe that further work on fair value measurement is needed before it will be possible to reach a common understanding for this future long term goal" and therefore agrees that another measurement model should be proposed in the meantime for certain financial instruments. Therefore, CESR considers the proposed mixed measurement model (fair value / amortised costs as indicated in paragraph 3 of the ED) reasonable. CESR also supports the IASB's proposal to maintain the fair value through profit and loss option (paragraph 9 of the ED).

CESR agrees that the way financial assets (or liabilities) are managed (sometimes called *business model)* is highly relevant to determine the extent to which amortised cost provides decision-useful information to users. The IASB should consider whether to give more prominence to this criterion. CESR also believes that together with the management approach (*contractual yield basis*), the nature of the instrument (*basic loan features*) should be taken into account in deciding whether an instrument should be measured at amortised cost or not. CESR believes however that the ED could be read as indicating that criteria to measure financial instruments at amortised cost could be too restrictive For example, the ED indicates that for contractually subordinated interests, only the most senior tranche can be carried at amortised cost. This may appear as excessively restrictive. CESR therefore agrees with EFRAG that more guidance on what constitutes "a basic loan feature", what "managed on a contractual basis" means and how to apply the criteria in practice would be helpful.

The scope for the application of the amortised cost measurement attribute is also related to the treatment of embedded derivatives. CESR recognises that using the same classification approach for all financial instruments, including hybrid contracts with hosts that are within the scope of the proposed IFRS, would ensure consistency in classification (as stated in BC 46) and achieve significant simplification to the measurement model. However, CESR agrees with EFRAG that this proposal has drawbacks. CESR therefore believes that the IASB should give further consideration to whether the bifurcation of a hybrid contract with a financial host would provide users with more decision-useful information, where the different elements of the hybrid contract are managed on different bases. That would open the possibility for host contracts of some instruments with embedded derivatives to fulfill the criteria required to be measured at amortised cost. In any event, CESR considers that a clarification of the notion of derivatives would be welcomed

Paragraph B11 of the ED states that an entity shall not reclassify a financial asset (or liability) between the fair value and amortised costs categories <u>under any circumstances</u>. According to BC 57, the IASB received comments from users of financial statements that the amendment to IAS 39 allowing, under rare circumstances, the reclassification of certain financial instruments out of the fair value through profit and loss category, reduced their ability to understand the information about financial instruments and that the required disclosures had not been widely or consistently applied. CESR recognises that the disclosures relating to reclassification could have been better applied (see CESR Statement on the application of and disclosures related to the reclassification of financial instruments, ref CESR/09-575). However, bearing in mind the criteria now proposed for classifying financial instruments, CESR believes, like EFRAG, that an issuer should reclassify whenever such instruments no longer meet the relevant criteria. CESR envisages that this would only happen infrequently, in strictly limited circumstances, where changes in the way that instruments are managed can be supported by objective evidence.

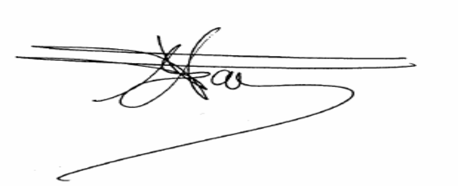
CESR is supportive of the principle that in general all equity instruments shall be measured at fair value. This said, CESR also recognises that sometimes, the fair value of an equity instrument might be difficult to assess reliably, for instance when the equity instrument is not quoted on an active market or when the market has become illiquid. CESR believes that the IASB may continue exploring the best alternative for the measurement of non listed equity instruments.

Like EFRAG, CESR agrees with the IASB's proposal to permit an entity to make an irrevocable election to present all changes in fair value of those investments in Other Comprehensive Income on initial recognition of investments in equity instruments that are not held for trading. CESR acknowledges the arguments presented to support the proposal to prohibit recycling. At the same time there could be other relevant arguments supporting a more flexible approach such as a potential negative impact of the IASB proposal on the incentives to hold equity investments. CESR believes that the IASB should further explore the issue before making a final decision. In any event, if the IASB is minded to lift the restriction on recycling, CESR believes that there would be a need for robust and very clear principles for the recognition of the impairment of instruments in that category.

CESR is concerned that the proposed delay in mandatory adoption until 2012 will cause significant issues relating to the comparability of financial statements produced over that period, even if a delay in mandatory adoption seems inevitable given the significant revisions proposed by the IASB. That said, CESR, like EFRAG, believes that the requirement to give additional disclosures should not be restricted only to those issuers who early adopt in their 2009 accounts but, should be provided by all adopters at the point of transition.

I would be happy to discuss all or any of these issues further with you.

Yours sincerely,



Fernando Restoy
Chairman of CESR-Fin

Answers to specific questions

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 not?**

CESR agrees with EFRAG that amortised cost provides decision-useful information for a financial asset or liability with basic loan features that is managed on a contractual yield basis. Although CESR believes that there are some advantages in adopting a single fair value measurement model, CESR acknowledges that there are a number of issues surrounding fair value measurement which need to be addressed before such a measurement model is feasible.

CESR believes that it is important that both the attributes and nature of the instrument (basic loan features) and the way the instrument is managed (on a contractual yield basis) are taken into account in deciding whether an instrument should be measured at amortised cost or not..

CESR believes that it is important to retain the requirement to disclose the fair value of all financial instruments not measured at fair value.

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?**

CESR supports high quality financial reporting standards that are capable of consistent application, interpretation and enforcement. With this in mind, CESR believes, as EFRAG does, that more application guidance on whether an instrument has "basic loan features" or what "managed on a contractual basis" means would be helpful when the IASB issues a final standard. In particular, further examples on the features that the IASB considers to fulfil the criterion would be welcome, to the extent that this does not conflict with the principles-based nature of the standard. In this respect CESR would welcome including the notions of "basic loan features" and "managed on a contractual yield basis" in the standard and to provide the application guidance in the Appendix.

Regarding instruments managed on a contractual yield basis, CESR supports the overall rationale behind the IASB's proposal. However, CESR would welcome additional guidance and, like EFRAG, remains unconvinced by the IASB's reasoning that assets acquired at a discount to reflect incurred losses are never managed on a contractual yield basis (see also Q4 on the cut between the two measurement categories).

3. **Do you believe that other conditions would be more appropriate to identify which financial asset 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?**

CESR believes that the proposed criteria of "basic loan features" and "managed on a contractual yield basis" are appropriate to identify which financial assets or financial liabilities should be measured at amortised cost. However, the rationale defining the cut on the two measurement categories is not always clear to us (see subordinated tranches in Q 4 b).

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, explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

CESR has some doubts about the proposal to eliminate the current requirements relating to the treatment of embedded derivatives in hybrid contracts with a financial host. On the one hand, CESR recognises that eliminating these requirements would significantly increase simplicity in accounting for financial instruments, as well as lead to greater consistency in classification. CESR welcomes the explicit inclusion of certain derivatives, such as caps, collars and floors, in the proposed application guidance for "basic loan features". In addition, CESR believes that it is still relevant to separate embedded derivatives from the host contract.

On the other hand, CESR acknowledges the drawbacks in the proposal described by EFRAG, particularly those which relate to convertible debt, and understand the argument for some form of continued bifurcation. However, CESR notes that some of these concerns may be addressed by further application guidance on "basic loan features". CESR would support optional bifurcation in cases where the host contract (after bifurcation) qualifies for amortised cost measurement.

b. Do you agree with the proposed approach regarding the application of the proposed classification approach to contractually subordinated interests (e.g. 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?

CESR notes that the requirement to measure contractually subordinated interests (other than the most senior tranche) at fair value stems from the view that such instruments do not have basic loan features, rather than from the way that they are managed. CESR acknowledges however EFRAG's view that amortised cost could provide decision-useful information for some subordinated tranches, as opposed to just the most senior tranche.CESR would therefore welcome further consideration by the IASB and its stakeholders of this issue.

CESR finds it unclear how these requirements should be interpreted as regards the following situations. If subordinated financial instruments are considered not to have basic loan features, it could be understood to imply that this would equally apply to the holder of the instrument as an asset but also to the issuer of the instrument as a liability, as the terms and conditions are the same for both parties. In addition, Basis for Conclusions 26 states that the credit risk associated with general creditors or with any secured or senior liabilities ranking above general creditors would also be consistent with the notion of a basic loan feature. CESR wonders whether this means that the credit risk associated with any junior liabilities (in relation or not to a tranche structure) ranking below general creditors would be considered not to be consistent with the notion of a basic loan feature. It would entail those instruments to be measured at fair value by both the issuer of the liability and the holder of the corresponding asset. CESR would welcome clarification from IASB.

5. **Do you agree that entities should 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?**

Overall, CESR agrees with the proposal to retain the fair value option to mitigate accounting mismatches. However, the extent to which such an option will be used will be affected by the IASB's proposals on hedge accounting, expected in December 2009. This is just one example of the difficulties that will be faced by issuers in applying parts of this new standard before the full picture of the changes proposed by the IASB to financial instrument accounting becomes clear.

6. **Should the fair value option be allowed under any other conditions? If so, under what other conditions should it be allowed and why?**

CESR does not see the need for allowing a fair value option under other conditions. The requirement that instruments not managed on a contractual yield basis should be measured at fair value should be sufficient to ensure that other instruments are measured at fair value, where an amortised cost measurement basis would not be appropriate.

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?**

Although CESR notes that the disclosures regarding the reclassifications made as a result of the IASB's October 2008 amendment to IAS 39 could have been better applied by issuers, CESR nonetheless believes that there remains an argument for permitting or requiring reclassification between measurement categories in strictly limited circumstances and where the standard is drafted in such a way as to allow for consistent application. Indeed, arguably, a classification model based on the fact that an instrument is managed on a contractual yield basis should be able to reflect changes in that assumption, albeit such changes would be expected to be infrequent. CESR would therefore support reclassification where the conditions for classification at inception are no longer met. Reclassifications should only be allowed prospectively, and should be accompanied with robust appropriate disclosure requirements. Furthermore CESR believes that such reclassifications should be supported by objective evidence and not based exclusively on management intent.

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?**

CESR supports the proposal in the ED to measure in general all equity instruments at fair value, and that such information provides decision-useful information to users. This said, CESR also recognises that sometimes, the fair value of an equity instrument might be difficult to assess reliably, for instance when the equity instrument is not quoted on an active market or when the market has become illiquid. Therefore CESR believes that the IASB should continue exploring alternative options for the measurement of non-listed equity instruments.

9. **Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? In such circumstances, which impairment test would you require and why?**

CESR can see some arguments for retaining the exemption from measuring equity instruments at fair value where that fair value cannot be reliably ascertained.

10. Do you believe that improved financial reporting results when fair value changes for particular investments in equity instruments are presented in other comprehensive income? If not, why?

CESR agrees that it may be more appropriate to reflect the fair value changes in some strategic, long-term equity investments in other comprehensive income rather than in profit and loss in cases where these equity investments are not essentially held with the aim of generating profit for the entity on the short term. CESR acknowledges the arguments presented to support the proposal to prohibit recycling. At the same time there could be other relevant arguments supporting a more flexible approach such as those relating to the incentives to hold equity investments. CESR would therefore recommend the IASB further explore the issue. If the Board decided to allow recycling in some circumstances, CESR believes that there would be a need for a robust and very clear principles for the recognition of the impairment of equity instruments in that category.

11. Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value of any investment in equity instruments (other than those that are held for trading), if it elects to do so only at initial recognition? If not:

   a. What principle do you propose to identify those for which presentation in other comprehensive income is appropriate?

   b. Should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet that principle?

CESR would point to our earlier response to question 7 on reclassification. Whenever an entity changes the assumptions behind how it manages instruments, this fact should be reflected in its financial reporting and become the subject of appropriate disclosures. However, CESR expects that such changes would only happen in strictly limited circumstances, and CESR finds it unlikely that an entity would change the assumptions behind how it manages equity instruments so much that the gains and losses made on such instruments were no longer relevant to the entity's profit and loss. The option should not however be implemented in such a way that an entity is effectively able to reclassify equity instruments whenever it wishes to realise gains.

12. Do you agree with the additional disclosure requirements proposed for entities that adopt the proposed IFRS early? If not, what would you propose instead and why?

CESR agrees with EFRAG that the additional disclosure requirements should not only apply to entities which early adopt the proposed IFRS for their 2009 financial statements but should be provided by all adopters at the point of transition.

13. Do you agree with the proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

CESR agrees with EFRAG that new standards should be applied on a retrospective basis, as such information is more useful for users of financial statements. However, CESR acknowledges that, in light of the scale of the changes proposed, some pragmatism will be needed to provide transition relief in particularly complex cases.

CESR notes the IASB's desire to deliver solutions to certain issues before the end of 2009, but believes combining this proposal with one to delay mandatory adoption until 2012 will raise significant issues relating to the comparability of issuers' financial statements produced during that period. However, delaying mandatory adoption until at least 2012 seems inevitable given the scale of the revisions the IASB is undertaking and the time needed for some issuers, particularly large and complex financial institutions, to make the systems changes that may be needed to meet the new requirements. CESR has concerns as to whether issuers will be able to apply a standard that is only ready in parts and without having a clear picture of how other aspects of the standard will develop. CESR reiterates its preference for the IASB and the FASB to work together to produce a comprehensive, converged, high quality standard for financial instrument accounting.

Bearing these comments in mind, CESR also notes that the IASB's current proposals have not fully addressed the previous issues raised with them in relation to the available for sale category. Given the likelihood that few (if any) preparers will implement the new standard for their 2009 year end, CESR believes that making certain technical changes to the existing IAS 39 (as described in our covering letter) would be a useful interim measure, providing short-term improvements to financial instrument accounting, whilst giving the IASB more time to complete its comprehensive review.

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?

Like EFRAG, CESR believes the alternative approach does not provide more decision useful information to users of financial statements.

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

Like EFRAG, CESR believes the possible variant of the alternative approach does not provide more decision useful information to users of financial statements.