EFRAG

European Financial Reporting Advisory Group

On 15 September 2010 EFRAG organised a user outreach event on the latest developments in the accounting for financial instruments.

This briefing note summarises the input received from analysts and regulators during the outreach event.

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Accounting for Financial Instruments

EFRAG user outreach event on 15 September 2010

The IASB and FASB started a joint project to improve their standards on accounting for financial instruments in 2009. At the end of May 2010, the FASB published an Exposure Draft on how to improve accounting for financial instruments. The comment letters on the FASB Exposure Draft will also be considered by the IASB as part of their convergence efforts with the FASB.

EFRAG organised a user outreach event on 15 September 2010 on accounting for financial instruments. More than 30 participants, representing a wide range of European stakeholders in financial reporting from eight different countries, attended the event.

Participants who registered for the event were asked, by way of an advance questionnaire, about their views on the key topics to be discussed during the meeting. Eight analysts and five regulators responded to the advance questionnaire.

This briefing note contains a short introduction of each of the topics and summarises the responses (percentages on the left side of each page) as well as analysts' and regulators' arguments and views raised during the outreach event. The questionnaire and the discussion during the meeting covered the ten main topics relating to the ongoing debate on accounting for financial instruments.

If you wish to obtain more information on this EFRAG outreach activity please contact Patrick Mommens (patrick.mommens@efrag.org) or Chiara Del Prete (chiara.delprete@efrag.org).

1. MEASUREMENT MODEL

ANALYSTS' VIEWS

Mixed Model 100%

The application of a mixed measurement model (amortised cost and fair value), based on an entity's business model as well as the characteristics of the financial instruments, provides the most relevant and useful financial information for understanding and comparing the performance and sustainability of reporting entities.

Fair value for all financial instruments 0%

Financial instruments should be measured at fair value, regardless of an entity's business model, because a symmetrical measurement of financial assets and financial liabilities for all reporting entities provides the most relevant and useful financial information for understanding and comparing the performance and sustainability of reporting entities.

The FASB proposal is to measure all financial instruments at fair value. The IASB has proposed a mixed measurement model (amortised cost and fair value), based on an entity's business model as well as the characteristics of the financial instruments.

Analysts' arguments for the use of a mixed measurement model

- The business model should be the main factor in determining the classification of a financial instrument because financial information is only relevant to the extent it portrays the business. For instance, when a bank holds loans for the purpose of collecting the contractual cash flows, measurement at amortised cost is considered the most useful approach. Measuring such loans at fair value results in the reporting of values that can only be obtained by immediate sale, which might be inconsistent with the going concern assumption.
- The reliability of fair values for loans that are not traded remains a concern.

Views and arguments of regulators

- The regulators supported the use of a mixed measurement model.
- The importance of the business model was confirmed by regulators.
- The regulators explained that the mixed measurement model is consistent with the business model of certain banks. They reported that the IFRS 9 criteria to apply amortised cost are too restrictive and therefore could lead to the use of fair values in cases where this measurement basis is of little relevance to users report on the economics of the financial instruments.
- In order to portray better the business model of an entity, the standard should contain a positive definition of the "fair value through profit or loss" category, linking this category to the trading activities of an entity. The need for a third measurement category (in addition to amortised cost and fair value) should not be ruled out.
- The regulators expressed concerns about the reliability of fair value measurements for instruments that are not listed. One approach mentioned was to report changes in fair value of illiquid instruments in Other Comprehensive Income ("OCI").

2. PRESENTATION AND DISCLOSURE OF FAIR VALUE INFORMATION

ANALYSTS' VIEWS

In the notes 38%

For financial instruments measured at amortised cost, fair value ("FV") information should be disclosed in the notes to the financial statements together with accompanying information.

On the face of the balance sheet 62%

For financial instruments measured at amortised cost, fair value information should be presented on the face of the balance sheet to ensure that this information is published at the same time as the balance sheet and not later when the full set of IFRS financials is published.

The FASB proposal is to present two measurement attributes (both fair value and amortised cost) on the face of the balance sheet for those financial instruments with loan/debt characteristics that the entity holds for collection/payment of contractual cash flows and chooses to measure at fair value through other comprehensive income. An alternative approach is to present the fair value information in the disclosure.

Analysts' arguments for disclosure in the notes

- Concerns were expressed about the reliability of fair value measurements for financial instruments that are not listed. This applies in particular to certain banks for which the majority of the loans held are not traded. Therefore, the usefulness of such fair value information is considered to be rather limited. Presenting the related fair values on the face of the balance sheet could be confusing and distort the picture analysts get from the financial information.

Analysts' arguments for the presentation on the face of the balance sheet

- The usefulness of fair value information diminishes over time. Requiring the presentation of fair value information on the face of the balance sheet would ensure that it is published timely.
- Requiring the disclosure of fair value information in the notes to the primary statements, would not necessarily ensure that the fair value information gets sufficient prominence. Measurement attributes on the face of the balance sheet attract more attention.
- For instruments held for the collection of cash flows, fair value is relevant in order to understand how the value of the financial assets reacts to a change in the economic environment. This is an essential part of the whole picture.

Views and arguments of regulators

- Unlike analysts, all regulators favoured the disclosure of fair value information in the notes of the financial statements, since this better reflects an entity's business model.
- Regulators observe that for financial assets held for collection of cash flows (e.g. loans for a traditional bank) it is essential to disclose expected losses and impairment. The relevance of fair value information is limited as it depicts gains and losses that in principle would not materialise if investments were held to maturity. In addition, for non-traded financial assets, the reliability of the fair value information was questioned. A robust impairment model is of utmost importance.
- The regulators favoured a better connection between accounting and prudential rules.

3. RECOGNITION OF CHANGES IN FAIR VALUE OF EQUITY INSTRUMENTS

ANALYSTS' VIEWS

Equity instruments not held for trading at FV-OCI

13%

Equity instruments not held for trading should be measured at fair value through other comprehensive income

Equity instruments always at FVTPL 62%

Changes in the fair value of equity instruments should always be recognised in profit or loss

Irrevocable option to measure certain equity instruments at FV-OCI

25%

An entity should have an irrevocable option to recognise changes in the fair value of certain equity instruments in OCI

The IASB has introduced an option to recognise, in other comprehensive income, changes in fair value of an equity instrument, instead of measuring the instrument at fair value through profit or loss.

Analysts' arguments for measuring at fair value through other comprehensive income the equity instruments that are not held for trading

- For equity instruments held for the long-term, short-term fluctuations should not impact profit or loss, as market prices do not always reflect long-term values.

Analysts' arguments for measuring at fair value through profit or loss all the equity instruments

- Fair value is the most relevant information for non-controlling investments in equities.
- Giving management an option on how to present the entity's performance is not appropriate.
- When applying the FVTPL approach, net income would equal the variance in net assets recognised in the reporting period, excluding cash flows to or from shareholders, thus appropriately reflecting the entity's performance.

Analysts' arguments for having an option to recognise changes in fair value of certain equity instruments through other comprehensive income

- Such an option would allow an entity to reflect better the reasons for holding equity instruments.
- The presentation (profit or loss or other comprehensive income) is not the key issue, because analysts focus on recurring earnings. Analysts adjust an entity's value for changes in fair value of assets that are considered to be non-recurring.

Views and arguments of regulators

- The majority of respondents were in favour of an irrevocable option for recognition of changes in fair value of certain equity instruments through other comprehensive income.
- The fair value of strategic or illiquid instruments should not be recognised in profit or loss as they are not intended to be realised, at least in the short-term, and measurement of such instruments at fair value may raise reliability concerns.
- It is necessary to gain a better understanding of the use of other comprehensive income in performance reporting.

4. RECYCLING CHANGES IN FAIR VALUE FROM OCI TO PROFIT OR LOSS

The IASB has proposed an option to recognise of changes in fair value of an equity instrument in other comprehensive income, instead of in profit or loss. In the IASB's approach these changes in fair value should not be subsequently transferred to profit or loss ('recycled' to profit or loss).

Analysts' arguments for recycling upon realisation

- Reclassification from OCI to profit or loss is a reclassification within the total comprehensive income, which correctly allows users to identify when potential future gains or losses have been changed into realised gains or losses (cash received or paid).
- A requirement always to recycle gains or losses upon realisation would improve comparability.

Analysts' arguments for recycling depending on the business model

- When long-term equity investments are realised, the resulting gains or losses need to be excluded from the result of the period in order to determine recurring earnings.

Views and arguments of regulators

- Respondents' views were split between the first alternative (recycling upon realisation) and the third alternative (recycling should depend on the business model).
- A requirement or prohibition to reclassify gains or losses from OCI to profit or loss should be based on a clear principle. To date, this is not the case.

ANALYSTS' VIEWS

Recycling upon realisation 50%

Changes in fair value should always be recycled from OCI to profit or loss upon disposal or settlement of the related financial instrument because all gains and losses should ultimately be reported in profit or loss.

Never recycle 0%

Changes in fair value should never be recycled from OCI to profit or loss because gains or losses should be recognised only once.

Recycling should depend on the business model 50%

Whether changes in fair value should be recycled from OCI to profit or loss upon disposal or settlement should depend on an entity's business model as well as the characteristics of the financial instruments.

5. EFFECTIVE INTEREST RATE

ANALYSTS' VIEWS

Effective interest rate net of expected losses

100%

Both contractual cash flows and initially expected credit losses should be considered. In this way, initially expected credit losses would affect profit or loss over the life of the financial asset. This approach reflects that a portion of the contractual interest rate compensates the lender for initially expected credit losses.

Contractual components only should be considered 0%

The effective interest rate should reflect only contractual cash flows. Initially expected credit losses would affect profit or loss when credit impairment is assessed. This approach results in the earlier recognition of initially expected credit losses within the first reporting period.

The IASB's proposal for amortised cost measurement requires an entity to apply an effective interest rate that reflects both the contractual cash flows and the initially expected credit losses. The FASB has proposed an amortised cost approach where the effective interest rate only reflects contractual components.

Analysts' arguments for the use of an effective interest rate net of Expected Losses

- Interest rates charged by financial institutions usually include a compensation for the customers' credit risk. Therefore, applying an effective interest rate that is net of initially expected credit losses better reflects economic reality.
- An effective interest rate net of expected credit losses would be in line with current prudential reforms.
- An expected loss approach is appropriate. The amortisation of credit losses over the life of the asset is a possibility, provided that detailed disclosure of (i) incurred losses, (ii) current provisioning and (iii) losses deferred to future periods is available, in order to perform a proper assessment of the credit quality and solvency position of the financial institution. Analysts explained that today they use information disclosed in Basel II - Pillar III reports.
- The use of an effective interest rate net of expected losses creates operational complexities that are as important as technical issues and need to be properly solved.

Views and arguments of regulators

- Respondents are in favour of a rate net of credit loss expectations
- The recognition in profit or loss of expected credit losses on initial recognition of a loan, resulting in a 'day-one loss', would not be a fair representation of the underlying economic activities of the entity.
- Recent debates seem to have demonstrated that an effective interest rate, including both contractual cash flows and the initially expected credit losses, is operationally difficult to apply. Therefore, it is worth exploring ways to simplify the EIR method, i.e. decoupling the EIR that could be applied in a way that results in a very close approximation of the integrated EIR approach (allocating the expected losses over the life of the instruments).
- The concern was expressed that the proposed IASB approach could result in under-provisioning for non-performing loans, compared to the current incurred loss model, especially for those loans (like mortgages) for which credit losses tend to materialise at the beginning of the asset's life. For this reason, a balance sheet approach would be more suited.
- It is not clear to what extent the model proposed by the FASB would result in a different level of provisioning compared to current market practice in the US.

6. CHANGES IN THE ESTIMATE OF EXPECTED CREDIT LOSSES

ANALYSTS' VIEWS

'Full catch-up' 38%

The effects of changes in credit estimate should be recognised in profit or loss in the period of the re-estimate and the entity should continue to use the same initial effective interest rate for interest recognition.

'Partial catch-up' 62%

Effects of changes in credit estimates should only be recognised in the period of the re-estimate to the extent that the change relates to current or prior periods. Changes in expected future cash flows should be allocated over the remaining life of the financial asset by revising the effective interest rate.

The IASB's approach to amortised cost and impairment requires en entity to recognise in profit or loss, in the period of the re-estimate, the changes in estimates of expected credit losses (so called 'full catch-up approach'). Under this approach the entity would continue to use the same initial effective interest rate for interest recognition. The alternative approach proposed by some constituents to defer to future periods some of the changes in estimates is often called 'the partial catch-up' approach.

Analysts' arguments for a 'full catch-up' approach

- A balance sheet approach, with immediate recognition in profit or loss of changes in estimates, is preferable, since such changes represent valuation errors made when the interest rate (including credit risk) was originally priced.
- A 'full catch-up' approach would be more appropriate since it is easier to apply.

Analysts' arguments for a 'partial catch-up' approach

- Expected losses that relate to future periods should be deferred, because its results in the reporting of a profit margin that is consistent with current management estimates.
- Concerns were expressed about the risk of recognising negative interest income if, as a result of the changes in estimates, the deferred expected future losses would exceed the future interest income. To address this concern, the use of a minimum EIR (probably not below the risk free interest rate), triggering a balance sheet adjustment, was proposed.

Views and arguments of regulators

- Respondents expressed views in favour of a partial catch-up approach.
- Deferring the effect of changes in expected credit losses better reflects the fact that adjustments to the original credit expectations will materialise in future periods and it reduces volatility in the reported results.

7. CREDIT IMPAIRMENT MODEL

ANALYSTS' VIEWS

Exclude forecasts 13%

When assessing impairment of a loan (or pool of loans), an entity should not take into account management forecasts at the reporting date because often it would be difficult to accurately forecast expected cash flows through the life of the loan(s) on the basis of forecasted future events. Impairment charges should be recognised based on facts existing at the reporting date.

Consider forecasts 87%

When assessing impairment of a loan (or a pool of loans), an entity should take into account management forecasts because (i) it better reflects lending decisions and (ii) estimation uncertainty and the necessity for management to use significant assumptions and judgement is inherent to financial reporting.

When assessing financial assets for impairment, the IASB's approach requires en entity to consider all the available information, including management's forecasts of future events. The FASB's approach requires entities to consider only existing facts and circumstances.

Analysts' arguments for excluding forecasts

- Valuation assumptions used for measuring the existing loan books should be consistent, in terms of credit losses, with current pricing conditions for new loans. Since current lending decisions are based on expectations that reflect existing facts at the reporting date, it is more appropriate to consider only past and present facts and circumstances.

Analysts' arguments for forecasting future events

- Considering forecasts of future events is more appropriate, because it is closer to the economic reality and reflects that decisions are made based on management forecasts.
- Analysts commented that a "long-term" forward-looking approach would cause reliability concerns and they questioned whether it is possible to make reasonable estimates for periods exceeding the short to medium term.
- Management's expectations for accounting purposes should always represent current assessments of future behavior, without considering at which point of the economic cycle the entity believes to be at, leaving to the analysts the task to adjust values in order to take into account 'through the cycle' adjustments.

Views and arguments of regulators

- Respondents were in favour of a forward looking approach.
- A well-supported average loss rate, based on prior experiences, could be a useful "sense check" in this area.
- Application guidance is needed in order to reduce the possibility for earnings management and to avoid diverging practices.
- Accounting standards and prudential rules should as much as possible be aligned, acknowledging that it is not possible to remove all differences. If a conflict arises between prudential requirements and the needs of investors, investors' needs should take precedence in developing accounting standards.

8. HYBRID FINANCIAL INSTRUMENTS

ANALYSTS' VIEWS

Always measure the entire hybrid financial instrument at fair value

13%

All hybrid financial instruments (containing embedded derivative features) should be reported in their entirety at fair value with all changes recognised in profit or loss.

Always bifurcate the embedded derivatives

13%

Since it is paramount that embedded derivatives are measured at fair value they should always be bifurcated from the host contract and accounted for separately when the host contract is not measured at fair value.

Bifurcate depending on the business model 74%

The requirement to bifurcate embedded derivatives should depend on the entity's business model as well as the characteristics of the host. This would allow the entity to measure at amortised cost debt components that the entity holds for collection of the contractual cash flows.

The IASB has eliminated the requirement to separately account for the embedded derivatives in a hybrid financial asset, retaining it only for the liabilities. The FASB has proposed to eliminate such a requirement from both assets and liabilities, therefore requiring en entity to measure the entire hybrid financial instrument at fair value.

Analysts' arguments for requiring bifurcation

- When analysing results, gains or losses from embedded derivatives are not eligible for forecasts and, particularly when financial markets are volatile, analysts would not consider gains or losses from embedded derivatives as part of the recurring earnings.

Analysts' arguments for bifurcation depending on the business model

- Linking the requirement to bifurcate with an entity's business model as well as the characteristics of the host contract, will best reflect risk management and the overall economics of the entity. However, such an approach could be operationally complex.

Views and arguments of regulators

- Like analysts, regulators argued that bifurcation, in particular for financial liabilities, should depend on the business model and characteristics of the financial instrument.
- Regulators explained that, at least on the liability side, instruments managed on a contractual yield basis and exhibiting basic loan features, should remain eligible for measurement at amortised cost. Such an approach is consistent with the entity's business model and avoids potential accounting mismatches.
- Some observed that, when various components of a hybrid instrument are managed on different bases, bifurcation is the best way to represent the nature and cash flows of the instrument.
- Some expressed a view in favour of an option to bifurcate embedded derivatives, when it is clear that the derivative and the host contract are not interconnected and can be separated without introducing complexity in the measurement of both the derivative and the host contract.

9. FV OPTION – ISSUER'S OWN CREDIT RISK

The IASB has proposed that, when the fair value option is applied for a financial liability, the changes in fair value due to changes in the entity's own credit risk should be accounted for in other comprehensive income rather than profit or loss.

Analysts' arguments for recognising gains or losses from changes in own credit risk in OCI

- Recognition in OCI is most informative, avoiding posting gains in profit or loss due to a deterioration of an entity's financial position.

Analysts' arguments for recognition in profit or loss

- This approach simplifies reporting and enhances comparability.

Analysts' arguments for a FVTPL option

- Only gains from changes in own credit risk that are demonstrably capable of being realised should be reported in profit or loss. Reference was made to the Danish mortgage companies: due to specific linkages between the bank's assets and liabilities, it is very important to be able to present gains or losses from changes in an entity's own credit risk in the income statement.

Analysts' arguments for the 'frozen credit spread'

- Shareholders are key users of financial reporting. In reporting the financial performance to the shareholders, entities should assume that they will fully meet their contractual obligations at face value, reflecting the going concern assumption.
- To avoid confusion about debt to equity ratios, it is essential that debt is measured at full face value.

Views and arguments of regulators

- Regulators' views were split among the 'frozen credit spread' method and the option for recognition in profit or loss to reduce accounting mismatches. A minority view was supporting recognition in OCI.
- From a prudential point of view, a regulator expressed concerns about the undue volatility generated in OCI due to changes in own credit risk. To address this concern, a prudential filter that eliminates gains or losses from changes in own credit risk would be applied.

ANALYSTS' VIEWS

Gains or losses from changes in an entity's own credit risk should be presented in OCI 13%

Presenting them in profit or loss would not result in useful information as an entity will generally not realise those gains or losses.

Gains or losses from changes in an entity's own credit risk should always impact profit or loss 13%

This simplifies reporting and enhances comparability.

There should be an option to present changes in an entity's own credit risk in profit or loss 24%

Entities should have such an option when doing so they would avoid accounting mismatches.

Frozen credit spread 50%

The FV of a financial liability should not take into account the effect of changes in an entity's own credit risk (frozen credit spread method). This would eliminate counter-intuitive results (gains should not result from the deterioration of an entity's financial position).

10. SYMMETRICAL REQUIREMENTS FOR FINANCIAL ASSETS AND LIABILITIES

ANALYSTS' VIEWS

Symmetrical requirements 50%

The same classification and measurement requirements, based on the characteristics of the instrument and business model tests, should apply to all (hybrid) financial assets and liabilities, in order to reduce complexity and enhance comparability.

Asymmetry 50%

Different classification and measurement requirements should apply to (hybrid) financial assets and liabilities, to reflect the different nature of financial assets and liabilities.

The IASB's approach to classification and measurement of financial instruments is not symmetrical and different requirements are introduced for financial assets and financial liabilities.

Analysts' arguments for symmetrical requirements

- The same classification and measurement criteria should be applied to both sides of the balance sheet in order to reduce complexity and enhance comparability.

Analysts' arguments against symmetry

- When measuring liabilities, the application of the going concern principle implies that it should be assumed that an entity will fully repay its debt.

Views and arguments of regulators

- Regulators did not express a preference between the two alternative approaches proposed.
- Some observed that the application of different criteria for assets and liabilities may result in an accounting asymmetry that may create accounting mismatches, which should be avoided.
- Some welcomed the IASB's proposal to maintain the bifurcation of embedded derivatives on the liabilities side, but expressed at the same time concerns that this might create inconsistencies with the assets side, where bifurcation would be prohibited under IFRS 9. Therefore, it was suggested to assess in due course whether bifurcation of hybrid financial assets would provide users with more decision-useful information.