

**DRAFT ENDORSEMENT ADVICE AND EFFECTS STUDY REPORT ON
IFRS 9 *FINANCIAL INSTRUMENTS***

INVITATION TO COMMENT ON EFRAG'S ASSESSMENTS

**Comments should be sent to commentletter@efrag.org or
uploaded via our website by 13 November 2009**

NOTE TO CONSTITUENTS

EFRAG has been asked by the European Commission to provide advice and supporting material on IFRS 9 *Financial Instruments* as published by the IASB in November 2009 ('IFRS 9' or 'the Standard'). In order to do that, EFRAG has prepared this draft technical assessment of the amendment against the criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing the costs and benefits that would arise from its implementation in the EU.

It is expected that the Accounting Regulatory Committee (ARC) will consider IFRS 9 at its meeting on 19 November 2009. In view of this time table, EFRAG's Supervisory Board has given permission to EFRAG to carry out its due process with regard to endorsement advice and effects study report on IFRS 9 on a fast-track basis. An implication of this fast track process is that the consultation period on EFRAG's draft endorsement advice and draft effects study report on IFRS 9 is shortened to two weeks compared to a normal consultation period that usually runs for at least one month. Furthermore, EFRAG has had to base its initial assessments on a pre-ballot draft of IFRS 9 made available to EFRAG by the IASB on a confidential basis. The IASB will post the near-final draft of IFRS 9 on its website accessible to subscribers, eIFRS, the same day or shortly after this Invitation to Comment is issued. The near final draft to be published by the IASB is a later draft of IFRS 9 than the pre-ballot draft entrusted to EFRAG on a confidential basis and therefore can differ from the version EFRAG TEG has assessed. The expectation is that the IASB will publish the final Standard so that EFRAG may finalise its endorsement advice and effects study report on 16 November 2009.

In view of the exceptional procedures that EFRAG have had to follow on this occasion, EFRAG would like to stress the following:

- (a) This draft endorsement advice is subject to the final text of IFRS 9 to be published by the IASB. If the final Standard differs from the pre-ballot draft on which this advice is based in such a way that would challenge some of the significant considerations made as part of its draft assessments, EFRAG retains the right to withdraw this draft advice and reconsider its assessment of the Standard; and
- (b) While EFRAG always reconsiders its draft advice in the light of comments made by constituents, under these exceptional circumstances EFRAG would like to note specifically that, in the event that constituents raise significant concerns that there has not been enough time to evaluate IFRS 9, or if they provide compelling evidence that challenges EFRAG's assessments of IFRS 9 against the endorsement criteria, EFRAG will give significant weight to such concerns in formulating its final advice to the European Commission or may decide to postpone

DRAFT
IFRS 9 – Invitation to Comment on EFRAG’s Assessments

finalisation of its advice.

Finally, it is noted that two EFRAG TEG members dissented from the draft endorsement advice and their views are set out in Appendix 4.

A summary of the key aspects of IFRS 9 is set out in Appendix 1.

Before finalizing its two assessments, EFRAG would welcome your views on the issues set out below. Please note that all responses received will be placed on the public record unless the respondent requests confidentiality. In the interest of transparency EFRAG will wish to discuss the responses it receives in a public meeting, so we would prefer to be able to publish all the responses received.

1 Please provide the following details about yourself:

- (a) Your name or, if you are responding on behalf of an organization or company, its name:

Karl Gadesmann

Head of Group Accounting and external Reporting

Volkswagen AG, Wolfsburg

- (b) Are you/your organisation or company a:

Preparer User Other (please specify)

- (c) Please provide a short description of your activity/ the general activity of your organisation or company:

Automotive Industry and related Financial Services

- (d) Country where you/your organisation or company is located:

Germany

- (e) Contact details including e-mail address:

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2 EFRAG’s initial assessment of IFRS 9 is that it meets the technical criteria for endorsement. In other words, it is not contrary to the true and fair principle and it

DRAFT
IFRS 9 – Invitation to Comment on EFRAG’s Assessments

meets the criteria of understandability, relevance, reliability and comparability. EFRAG’s reasoning is set out in Appendix 2.

(a) Do you agree with this assessment?

Yes No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG’s endorsement advice.

Although we have strong concerns over the quality and especially the wording of the standard with respect to the high (and from our point of view improper) pressure of time the Standard was developed, we do not object to your assessment on the standard in general. However, we can not agree to the fulfillment of the **comparability criteria** with respect to the **adoption rules**.

IFRS 9 is obligatory for financial years beginning on or after January, 1st 2013, what is the absolute minimum from our point of view (see our remarks down below). However, earlier adoption is allowed. Though the possibility of an earlier adoption is common, the period is much too long for such an elementary standard especially if we will have a quick endorsement, too. Further, with the guidance on the other aspects on financial instruments being finalized in the following years, also having an option for earlier adoption, the possibilities of the companies on how to treat their financial instruments will multiply, what is not in line with the intention of the IAS regulation having the view to harmonize the financial information presented by publicly traded companies in Europe.

We also can not agree to the fulfillment of the **understandability criteria** as long as the standard is not finalized regarding to the complex interaction between IAS 39 and IFRS 9.

(b) Are there any issues that are not mentioned in Appendix 2 that you believe EFRAG should take into account in its technical evaluation of the amendment? If there are, what are those issues and why do you believe they are relevant to the evaluation?

We have strong concerns over the way the standard is developed. We just made bad experience last year with the quality of simple standards that was done under high pressure of time by the IASB. Further, we can not agree on proposing standards only on several aspects on reporting on financial instruments, while the guidelines on the other aspects are not even drafted. The IASB guesses itself that three years are needed for implementing the new impairment rules. The new impairment rules are proposed to be finalized in 2010 what means that if we want to adopt classification and measurement together with the corresponding implementation rules, we will run out of time, even if IASB is keeping up its time table, what was in the past more the exceptional case. Therefore, we would prefer not setting binding time lines before we know the whole story.

DRAFT
IFRS 9 – Invitation to Comment on EFRAG’s Assessments

- 3 EFRAG is also assessing the costs that will arise for preparers and for users on implementation of IFRS 9 in the EU, both on initial adoption and in subsequent years. Some initial work has been carried out, and the responses to this Invitation to Comment will be used to complete that assessment.

The results of the initial assessment are set out in paragraphs 8, 11, 15 and 23 of Appendix 3. To summarise, EFRAG’s initial assessment of IFRS 9 is that:

- (a) For preparers, there may be significant year one costs arising from initial adoption of the Standard and not significant costs from transition and additional disclosure requirements; and moderate ongoing incremental costs.
- (b) For users, application of IFRS 9 is likely to involve significant additional costs in year-one and, for some users, moderate ongoing incremental costs.

Do you agree with this assessment?

Yes No

If you do not, please explain why you do not and (if possible) explain broadly what you believe the costs involved will be?

Volkswagen has had at December 31st 2008 about 180 investments in other companies, not consolidated or accounted at equity. Substantially all of these investments are not traded in a public market and are measured at cost. Total carrying amount of all other investments accounted at cost was at December 31st 2008 583 Mio. €, what is about 0.3 % of total assets (167,919 Mio. €). Measuring fair values for every investment at every quarter would mean a little bit more than “moderate incremental costs”.

This is true even as the IASB acknowledges in the meantime, that cost may be an appropriate estimate of fair value of equity investments. But the standard states that this is only the case **in limited circumstances** and not the normal case as it is in most industrial companies, today. We will know have prima facie the assumption that we must measure investments at fair value what is a fundamental change to the existing concept and will bring substantial more costs. When we have a clear indication that the value of an investment is at least cost we have no more work to do, today. With IFRS 9 we must test if there are indications for a higher fair value, too, and in case measure fair value based on a measurement model. Once we have left the cost base we must measure fair value to every balance sheet day. This is another big difference to the existing concept. At least, as the exception in IFRS 9 is limited to equity investments with the definition of equity in IAS 32 still pending we will face the discussion if the exemption can also be applied for e.g. an investment in a German unincorporated company.

Even if we apply the concept of materiality, what was the offhanded answer of IASB staff members to this problem, we still must regular terms proof the immateriality to our auditor, what still means more than moderate ongoing incremental costs notwithstanding the continuous danger of an enforcement action as the IASB is not able to give a even hindsight what materiality means.

DRAFT
IFRS 9 – Invitation to Comment on EFRAG’s Assessments

- 4 EFRAG’s initial assessment is that IFRS 9 will reduce complexity in the classification and measurement aspect of reporting financial instruments (see Appendix 3, paragraphs 17 and 19) and that the benefits to be derived from that are likely to exceed the costs involved (see Appendix 3, paragraph 24 and 25).

Do you agree with this assessment?

Yes No

If you do not, please explain why you do not and what you think the implications should be for EFRAG’s endorsement advice?

We agree that the final standard may reduce the complexity, but we can not see that this is a major advantage for companies other than several financial institutions. As long as the standard is still patchwork with many cross references on IAS 39 and with multiple options how to adopt the standards the complexity for prepares and users is increased.

As academic studies show¹ there is no significant preference for a fair value measured by model instead of a cost based measurer. Therefore we can not see how the high costs of measuring all investments at fair value can be justified.

- 5 EFRAG is not aware of any other factors that should be taken into account in reaching a decision as to what endorsement advice it should give the European Commission on the amendment.

Do you agree that there are no other factors?

Yes No

If you do not, please explain why you do not and what you think the implications should be for EFRAG’s endorsement advice?

¹ See Gassen/Schwedler: Attitudes towards Fair Value and Other Measurement Concepts: An Evaluation of their Decision-usefulness (http://www.standardsetter.de/drsc/docs/press_releases/080411_fairvalue-studie.pdf); the study shows in the attitude toward measurement concepts in figure 8 that when the users was asked to rank a set of measurement concepts for different asset classes in respect to their decision usefulness that users clearly “differentiate between mark-to-model and mark-to-market concepts when evaluating the decision-usefulness of fair values” and that there is even for financial instruments no significant preference between model based fair value (ranked with 48,4%) and lower of cost or market measurer(45,5 %) what is substance how we measure investments today.

APPENDIX 1 A SUMMARY OF KEY ASPECTS OF IFRS 9 FINANCIAL INSTRUMENTS

Background to the Standard

- 1 IFRS 9 has been developed in response to concerns that IAS 39 *Financial Instruments: Recognition and Measurement* ('IAS 39') is “difficult to understand, apply and interpret”. The financial crisis and pressures from G20 leaders and others to address financial reporting of financial instruments has led to the IASB and the FASB accelerating the timetable for the replacement of their standards on financial instruments. To ensure a timely response to calls to address concerns with IAS 39, the IASB has taken a phased approach to the development of the Standard. The first part of Phase 1 (that resulted in IFRS 9 as published by the IASB in November 2009) deals with classification and measurement of financial assets. The second part of Phase 1 will deal with classification and measurement of financial liabilities. Phase 2 will deal with impairment of financial assets carried at amortised cost (an exposure draft on this issue is expected to be issued in November 2009) and Phase 3 will address hedge accounting. The entire package is expected to be completed by the end of 2010. The IASB is also reconsidering requirements for derecognition of financial assets in a separate project with an intention to complete that project in 2010.

Objective and Scope

- 2 The objective of IFRS 9 is to set out new principles for the classification and measurement of financial assets so that the financial statements convey relevant and useful information about such assets to assist users in their decision-making.
- 3 IFRS 9 seeks to simplify the classification of financial assets under IAS 39 by removing numerous classification categories and associated impairment methods that resulted in significant complexities in the reporting of financial assets.

Classification and measurement under IAS 39

- 4 Classification refers to the basis on which financial assets are presented in the financial statements. It is important because it drives how they are measured (or valued), how any value changes are reflected in income and the way in which they are displayed in the financial statements.
- 5 In order to assess the new classification and measurement model in IFRS 9, it is important to understand the model currently required by IAS 39.
- 6 Currently IAS 39 requires that financial assets are measured on an on-going basis, according to the following classifications:
 - (a) *Fair value through profit or loss*: Financial assets are measured at fair value on the balance sheet with changes in fair value reported immediately in profit or loss.
 - (b) *Held to maturity*: Financial assets are measured at amortised cost.
 - (c) *Loans and receivables*: Financial assets are measured at amortised cost.
 - (d) *Available-for-sale*: Financial assets are measured at fair value on the face of the balance sheet with changes in fair value reported in other

DRAFT

IFRS 9 – Invitation to Comment on EFRAG’s Assessments

comprehensive income (a component of income that is separate from profit or loss). Gains and losses are recognised in profit or loss when realised, i.e. on derecognition, impairment or accrual of interest or dividends.

Classification under IFRS 9

- 7 Like IAS 39, IFRS 9 requires that financial assets are classified at either fair value or amortised cost and this classification determines their on-going measurement in the financial statements.
- 8 However, IFRS 9 requires that two tests need to be satisfied to classify financial assets at amortised cost:
 - (a) *The ‘Business Model’ Test*: The objective of an entity’s business model has to be to hold financial assets to collect contractual cash flows; and
 - (b) *The ‘Characteristics of the Instrument’ Test*: The contractual terms of the financial asset give rise on specified dates to cash flows that are only payments of principal and interest on the principal outstanding.
- 9 Where either of these tests is not satisfied, financial assets are classified at fair value.

The Business Model Test

- 10 The business model test differentiates between the objective of holding financial assets to collect contractual cash flows from the objective of realising fair value changes, however it accepts that some asset sales may occur without compromising the objective of holding financial assets to collect contractual cash flows. For example, it would be acceptable to sell some financial assets to meet investment policy criteria (e.g. due to credit downgrades) or to fund capital expenditures.
- 11 The business model test is applied at a higher level than an individual financial asset, although not necessarily as high as at the reporting entity level. For example an entity may apply the business model to a portfolio of financial assets.

The Characteristics of the Instrument Test

- 12 The characteristics of the instrument test requires that all contractual cash flows arising on a financial asset must be only payments of interest and principal on the principal outstanding for the currency in which the financial asset is denominated to be eligible for amortised cost. Interest paid must only reflect consideration for the time value of money and credit risk associated with the instrument over the life of the instrument.
- 13 Stand-alone derivatives include a characteristic of leverage and therefore are not eligible for amortised cost. Hybrid contracts that provide for contractual cash flows other than only payments of interest and principal on the principal outstanding are not eligible for amortised cost either. However, certain contractual terms affecting the cash flows arising on debt instruments such as prepayment options, extension options, interest rate caps and floors and reset options are, in some cases, considered payments of principal and interest. Such contracts are eligible for the

DRAFT
IFRS 9 – Invitation to Comment on EFRAG’s Assessments

amortised cost category provided that the entity’s objective of holding such financial assets is to collect contractual cash flows.

- 14 Equity instruments do not have characteristics of interest and principal and therefore are not eligible for the amortised cost category.

Fair value option

- 15 IFRS 9 permits an entity to designate an instrument, that would otherwise have been classified in the amortised cost category, to be at fair value through profit or loss if that designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an ‘accounting mismatch’).

Embedded derivatives

- 16 IFRS 9 has removed the requirement in IAS 39 to split-out and separately account (‘bifurcate’) derivatives embedded in (non-derivative) host financial assets. The Standard requires that a reporting entity assess the hybrid financial asset (i.e. the combined financial asset host and embedded derivative) in its entirety to determine whether the instrument’s cash flows are principal and interest on the outstanding principal.

Financial assets representing concentrations of credit risk

- 17 In some cases entities can be created with the sole purpose of investing in discreet pools of assets funded entirely by debt issued to investors who are paid a return based solely on the performance of the pool assets into which they have invested. These types of entities are generally known as securitisation vehicles. In some securitisation vehicles, the debt issued is contractually linked so that some investors receive payments from the pool of assets in priority to other investors (tranches). In such situations, the holders of different tranches only have the right to payments of principal and interest from the underlying pool of assets if the vehicle generates sufficient cash flows to satisfy the higher-ranking tranches. The result of such a structure is that the subordinated tranches have a higher concentration of credit risk than the credit risk of the underlying pool of financial assets.

- 18 The Standard provides additional guidance with regard to the application of the characteristics of the instrument test to an investment in a tranche of such a securitisation structure that if:

- (a) The contractual terms of the tranche investment satisfy “the characteristics of the instrument” test,
- (b) The underlying pool of financial instruments has particular cash flow characteristics that meet the ‘characteristics of the instrument test, and
- (c) The credit risk of the tranche is equal to, or lower than the average credit risk of the underlying pool of financial instruments,

such a tranche investment may be eligible for the amortised cost.

- 19 If a reporting entity is not able to “look-through” a securitisation structure to assess whether criteria (b) and (c) above are satisfied, it must classify the investment in the securitisation vehicle’s tranchised debt at fair value through profit or loss.

DRAFT

IFRS 9 – Invitation to Comment on EFRAG’s Assessments

- 20 Reassessment of the underlying instruments pool is not permitted. However, if the underlying assets pool can change subsequent to initial recognition in a manner that would prohibit classification at amortised cost, this would prohibit an investor measuring any tranche of such a securitisation structure at amortised cost.

Reclassification

- 21 IFRS 9 requires reclassification between fair value and amortised cost when there is a change in the entity’s business model. Entities will be required under IFRS 7 *Financial Instruments: Disclosures* (IFRS 7) to provide disclosures to make such changes transparent.

Investments in Equity Instruments

- 22 Since the cash flows generated by equity instruments do not represent payments of interest or principal (i.e. dividends are not payments reflecting the time value of money) equity instruments are not eligible to be categorised at amortised cost. The default category for equity instruments is therefore at fair value through profit or loss. However, the standard states that an entity can make an irrevocable election at initial recognition to present all fair value changes for equity investments not held for trading in other comprehensive income i.e. not included in profit or loss. These fair value gains or losses are not reported as part of a reporting entity’s profit or loss, even when a gain or loss is realised (effectively converted to cash) through disposal, extinguishment or impairment. Only dividends received from these investments are reported in the profit or loss where they represent a return on the equity investment (as opposed to a return of investment).

Measurement

Initial recognition

- 23 At initial recognition, that is when items are first presented in the financial statements, IFRS 9 requires financial assets to be measured at fair value. Directly attributable transaction costs are not added if the financial asset is classified at fair value through profit or loss but are added if a financial asset is classified as at amortised cost or if an equity instrument is designated as at fair value through other comprehensive income.

Subsequent to initial recognition

- 24 After initial recognition, financial assets continue to be measured in accordance with their classification under IFRS 9. Where a financial asset is classified and measured at amortised cost, it is required to be tested for impairment (loss of value) in accordance with the impairment requirements in IAS 39 i.e. based on an assets future cash flows without reference to market values. No write-down of the carrying amount of the financial asset is necessary due to impairment where the financial asset is measured at fair value since any decreases in fair value would already incorporate any impairment in the asset’s value.

Disclosures

- 25 IFRS 9 amends disclosures in IFRS 7. The key aspects of those amendments include disclosures with regard to:

- (a) initial application of IFRS 9,

DRAFT

IFRS 9 – Invitation to Comment on EFRAG's Assessments

- (b) financial assets for which the entity elects to present fair value changes through other comprehensive income,
- (c) reclassification of financial assets between the fair value and amortised cost categories following a change in the business model of an entity, and
- (d) a reconciliation of the gain or loss recognised in the statement of comprehensive income arising from the derecognition of financial assets and financial liabilities measured at amortised cost.

Effective date and Transitional Provisions

Effective Date

An entity must apply IFRS 9 for annual periods beginning on or after 1 January 2013. Earlier adoption is permitted.

Transition

- 26 Subject to certain modifications, a reporting entity must apply IFRS 9 retrospectively.
- 27 If the entity adopts IFRS 9 for periods beginning on or after 1 January 2011, the date of initial application will be the beginning of the reporting period. If the entity adopts the Standard for reporting periods beginning before 1 January 2011 the date of initial application can be any date between the issue of the Standard and 31 December 2010.
- 28 The date of initial application will be date at which the reporting entity determines the classification of its financial assets (i.e. based on the business model(s) at that date). The resulting measurement attribute is applied retrospectively unless the impracticability exemption applies in determining the amortised cost of certain financial assets.
- 29 If an entity adopts IFRS 9 for reporting periods beginning before 1 January 2012, the entity need not restate prior periods. Restatement of comparative information will be required if the reporting entity adopts the Standard for reporting periods beginning after 1 January 2012.
- 30 All reporting entities are required to provide transitional disclosures upon initial adoption.

APPENDIX 2

EFRAG’S TECHNICAL ASSESSMENT OF THE AMENDMENT AGAINST THE ENDORSEMENT CRITERIA

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG’s capacity as a contributor to the IASB’s due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as adviser to the European Commission on endorsement of the final IFRS or Interpretation on the issue.

In the latter capacity, EFRAG’s role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG’s thinking may evolve.

INTRODUCTION

- 1 IFRS 9 *Financial Instruments* as issued by the IASB on XX November 2009 sets out requirements for classification and measurement of financial assets.
- 2 EFRAG considered key aspects of IFRS 9 and assessed whether the information resulting from the application of IFRS 9 would meet the criteria for EU endorsement; in other words, that:
 - (a) it is not contrary to the ‘true and fair principle’ set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
 - (b) it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG was also required to consider whether it would be in the European interest to adopt the amendment.

- 3 EFRAG notes that IFRS 9 as issued by the IASB on xx November 2009 represents the first phase of the IAS 39 *Financial Instruments: Recognition and Measurement* replacement project and that the Standard will be amended in the future to deal with (a) the classification and measurement of financial liabilities; (b) the impairment of financial instruments, and (c) hedge accounting. The IASB has indicated that the complete package of changes will be completed by the end of 2010. The IASB is also working in revising derecognition requirements for financial instruments in a separate project. The IASB plans to publish a final amendment of the derecognition guidance in IAS 39 in the second half of 2010. For the purposes of carrying out the assessment, in this draft endorsement advice EFRAG’s analysis is based on the requirements set-out in IFRS 9 at the time this endorsement advice was issued and, as usual, does not take into account any changes that may or may not be made to accounting standards dealing with financial instruments in the future.

EVALUATION

Relevance

DRAFT

IFRS 9 – Invitation to Comment on EFRAG’s Assessments

- 4 According to the IASB’s Framework, information has the quality of relevance when it influences the economic decisions of users by helping them to evaluate past, present or future events or confirming, or correcting, their past evaluations. EFRAG considered whether the key aspects of IFRS 9 would result in the provision of relevant information—information that has predictive value, confirmatory value or both—and whether it might result in the omission of any information that is relevant.
- 5 IFRS 9 stipulates that in certain cases measuring financial assets at amortised cost accompanied by disclosures of fair value in the notes to financial statements provides relevant information to users and that in other cases the only relevant measure for financial assets is fair value. EFRAG agrees with this.
- 6 The requirements in IFRS 9 are based on the premise that the relevant measurement attribute (that is fair value or amortised cost) is determined by reference to:
 - (a) the way financial assets are being managed by an entity in accordance with its business model (‘business model’ test); and
 - (b) the contractual terms of the financial asset (‘the characteristics of the instrument’ test).
- 7 The amortised cost method allocates principal and interest arising from the amount advanced under a contract into the appropriate time period. IFRS 9 stipulates that this method of accounting for financial assets provides users with relevant information if an entity’s business model is to hold these financial assets with the objective to collect contractual cash flows rather than to realise fair value changes on such instruments and if the contractual terms of financial assets represent interest and principal that reflect the time value of money and creditworthiness of the borrower. In all other cases, IFRS 9 is based on the principle that fair value is the most relevant measurement attribute.
- 8 EFRAG considered whether the differentiation between the amortised cost category and the fair value category as stipulated by IFRS 9 results in the provision of relevant information to users. EFRAG noted the following arguments for and against IFRS 9 satisfying the criterion of relevance.

Arguments for

- 9 Some believe that information reported to users at amortised costs is relevant if an entity is a business that lends money to individuals or other entities and lending contracts represent only principal and related interest arising from such contracts. On the other hand, if for example, an entity acquires financial assets with the objective of realising fair value changes, fair value is the most relevant measurement attribute for such financial assets. Furthermore, if the cash flows arising on a financial asset do not represent just interest and principal, such as leverage in a stand-alone derivative or some other features in hybrid instruments, such financial assets should be measured at fair value to be of relevance to users. Some consider that IFRS 9 together with the disclosure requirements in IFRS 7 satisfactorily achieves such a distinction.
- 10 The Standard requires an entity to reclassify financial assets if it changes its business model. Some believe that this ensures that entities continue to report relevant information following such a change. Entities will be required by IFRS 7 to provide disclosures to make such changes transparent.

DRAFT

IFRS 9 – Invitation to Comment on EFRAG's Assessments

- 11 All equity instruments that fall in the scope of IFRS 9 are accounted for at fair value (because equity instruments do not have contractually determinable cash flows such as interest and principal). However, IFRS 9 gives entities the option on initial recognition to irrevocably elect to report fair value changes on equity investments not held for trading in other comprehensive income. Fair value gains and losses are not recycled into profit or loss. However dividends are reported in profit or loss when the entity's right to receive payment is established. Some believe that such an option enables entities to avoid reporting fair value fluctuations on equity investments in profit or loss if the entity believes that such fluctuations are not a major driver of their performance. This could be the case for example for investments that are strategic in nature. Dividends are deemed to be income from such investments and it therefore seems relevant to report them in profit or loss.
- 12 If applying the classification criteria described above causes an accounting mismatch to arise due to the fact that a related financial asset and a financial liability (for example, financial assets that are in a portfolio that backs a portfolio of financial liabilities) are accounted for on a different measurement basis, entities may elect to eliminate such an accounting mismatch—and thereby, some believe, will improve the overall relevance of the reported information—by applying the so called 'fair value option', i.e. to measure a financial asset at fair value by election. Alternatively, the entity can elect to apply hedge accounting if an accounting mismatch arises in relation to instruments that meet the hedge accounting criteria in IAS 39.

Arguments against

- 13 Some believe that reporting financial instruments at amortised cost would provide relevant information if it reflects the business model of an entity and consider that the characteristics of instruments test as set out in the Standard is so restrictive that it results in classification of some financial assets to be not in line with the role these financial assets play in a business model thus reducing the relevance of information provided to users.
- 14 The requirements in IFRS 9 might result in a financial asset that is at least partially managed by an entity in accordance with the business model to collect cash flows being prevented from being included in the amortised cost category. This would be the case, for example, for certain hybrid financial assets, such as a debt security whose return is linked to an equity index if the holder of the instrument manages the equity-linked component separately from the host debt instrument, with the former being managed on a fair value basis and the latter with an objective to collect the contractual cash flows. IFRS 9 requires the whole of the instrument to be measured at fair value since the equity indexed return would not represent a payment of interest or principal. Some argue that requiring entities to separate such hybrid instruments into a derivative component and a basic debt instrument component and account for the former at fair value and the latter at amortised cost would have enabled entities to provide more relevant information about such instruments.
- 15 Some believe that fair value information is relevant in the case of all financial assets and therefore fair value information should be given equal prominence in the balance sheet in reporting financial assets that fall into the amortised cost category rather than being merely reported in the notes. As IFRS 9 does not require such a presentation, some believe that it results in some relevant information not being presented appropriately.

DRAFT

IFRS 9 – Invitation to Comment on EFRAG’s Assessments

- 16 There is no consistently applied principle in the existing performance reporting model for distinguishing between gains and losses that should be recognised in net income and gains and losses that should be recognised in other comprehensive income, nor is there a consistently applied principle for determining which gains and losses should be recycled (or reclassified) from other comprehensive income to profit or loss when such recycling should take place. Nevertheless some believe that, when unrealised gains and losses are reported in other comprehensive income, it is relevant to recycle gains and losses on such assets to profit or loss when they are realised. In that regard the requirements in IFRS 9 that prohibit the recycling on realisation of gains and losses on equity investments that were initially recognised in other comprehensive income are viewed by some as not resulting in relevant information.
- 17 As stated earlier, an option in IFRS 9 to irrevocably elect on initial recognition to report fair value changes on equity investments not held for trading in other comprehensive income may help to align reported information with the business model of an entity thus improving relevance of reported information. However some believe that there is also a risk that entities may use the option to present fair value changes on equity instruments in such a way that is not in accordance with its business model thus distorting the relevance of provided information.
- 18 Hybrid financial assets fall within the scope of IFRS 9 and are not bifurcated. The classification and measurement of such instruments depends on whether, in their entirety, they have characteristics that are only principal and interest. Hybrid financial liabilities remain within the scope of IAS 39 which requires bifurcation of embedded derivatives that are not closely related to the host contract. Some consider that the fact that the treatment of hybrid instruments is different depending on whether the instrument is a financial asset or a financial liability may distort the overall relevance of provided information. While an existing possibility in IAS 39 to apply the fair value option to hybrid financial liabilities may mitigate the issue to some extent it will not resolve it completely.

Conclusion

- 19 Having identified the arguments for and against listed above, EFRAG observed that views differed on what constitutes relevant information in relation to reporting financial assets. The majority of EFRAG members concluded that IFRS 9 strikes a good balance (especially if considered together with the amended disclosure requirements in IFRS 7) in achieving a reasonable level of relevant information for users with different needs even though they recognised that IFRS 9 has some shortcomings. Therefore EFRAG believes that on balance IFRS 9 satisfies the criterion of relevance.

Reliability

- 20 The Framework explains that information has the quality of reliability when it is free from material error and bias, can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost. EFRAG has considered the following arguments as to whether information resulting from the application of IFRS 9 exhibits those qualities.

Arguments for

DRAFT

IFRS 9 – Invitation to Comment on EFRAG’s Assessments

- 21 Some argue that while the new classification model is not without its limitations, it nevertheless enables the business model to be faithfully represented through the measurement model. Furthermore, the new classification model does not seem to cause any new issues regarding ‘freedom from bias’ and ‘freedom from error’.
- 22 When entities report financial assets at fair value reliability concerns may arise in a situation where markets are illiquid. IFRS 7 requires disclosures about valuations of instruments whose inputs are derived from unobservable data. These disclosures provide transparency and additional information about the reliability of fair value measurement information provided.
- 23 While IFRS 9 requires that fair value should be determined for all unquoted equity instruments (and all derivatives on such instruments), it also provides guidance for measuring such instruments and that guidance explains that cost can be representative of fair value in some circumstances. Furthermore, IFRS 7 would require substantial disclosures that should enable users to appreciate the uncertainty around such valuations.

Arguments against

- 24 Some commentators consider that, when markets become illiquid, it affects the reliability of fair value reporting so significantly that fair value measurement through profit or loss should not be allowed in such circumstances. They contend that fair value measurement in illiquid markets may lead to the inappropriate recognition of gains in profit. They would prefer that such gains are not recognised in profit until they have been realised.
- 25 IFRS 9 requires entities to determine the fair value for unquoted equity instruments. Some commentators are concerned that requiring such instruments to be measured at fair value might result in measures that are not sufficiently reliable and may result in undue costs being incurred to collect data and obtain valuations in order to estimate fair value with some degree of reliability.

Conclusion

- 26 While IFRS 9 may cause some reliability concerns, the majority of EFRAG members concluded that those concerns would be mitigated by existing disclosures requirements in IFRS 7. Therefore, on balance EFRAG believes that IFRS 9 satisfies the criterion of reliability.

Comparability

- 27 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.
- 28 EFRAG identified and evaluated the following arguments for and against of IFRS 9 meeting the comparability criterion.

Arguments for

- 29 Some believe that IFRS 9’s classification requirements will achieve comparable reporting of financial assets within entities and among entities. This is because IFRS 9 classification requirements are based on a consistent classification approach based on a clear rationale that links classification and measurement to

DRAFT

IFRS 9 – Invitation to Comment on EFRAG’s Assessments

two distinctive criteria (the role of an instrument in a business model of an entity and characteristics of the instrument). IFRS 9 requirements also result in one impairment method for financial assets carried at amortised cost.

- 30 IFRS 9 requirements need to be applied retrospectively with some modifications and EFRAG believes that retrospective application will result in providing information that is comparable from one accounting period to the next. The retrospective application also ensures that no additional issues of relevance, reliability and understandability arise when entities adopt the new requirements.

Arguments against

- 31 Other commentators contend that while the classification requirements in IFRS 9 are largely principles-based, the Standard introduces some rules, for example, with regard to treatment of tranching securities (multiple contractually linked instruments that result in concentrations of credit risk). A risk of any rules-based requirement is that it may result in similar items being treated differently. For example, it is possible that some tranching securities would be classified as at fair value because they do not meet the additional requirements while other financial assets that expose an entity to similar risks and that are managed by the entity in accordance with the business model in a similar way would be carried at amortised cost.
- 32 As stated above, the Standard allows for financial assets to be optionally designated to be measured at fair value through profit or loss where they would otherwise be carried at amortised cost in accordance with the classification criteria in IFRS 9. Furthermore, IFRS 9 allows entities to elect to report fair value changes on equity instruments that are not held for trading in other comprehensive income. Such options enable entities to improve relevance of the reported information as noted above. However, entities may elect to apply an option to some but not all financial assets. Furthermore, while some entities may elect such options other entities, while being in similar circumstances, may decide not to do so. As a result the comparability of financial information between entities may be reduced.
- 33 As mentioned in the section on relevance, the requirements in IFRS 9 may result in a hybrid financial asset that is, at least partially, managed by an entity in accordance with a business model to collect contractual cash flows being prevented from being included in the amortised cost category. At the same time, if an entity entered into two separate contracts to achieve the same economic result the accounting would be different, the derivative would be measured at fair value while the debt instrument would be measured at cost.
- 34 Some are concerned that under IFRS 9 certain features included in hybrid contracts are considered related to payments of principal and interest on outstanding principal (for example an interest rate cap or floor) and thus may be eligible for being carried at amortised cost as part of the entire contract. However, if such features are acquired in a form of a separate derivative contract from the debt instrument they fail the “characteristics of the instrument” test and are measured at fair value. (However, it should be noted that this inconsistency can, to some extent, be mitigated by applying hedge accounting to a derivative that adjusts interest on a debt instrument but which is acquired as a separate contract.)
- 35 The effective date of IFRS 9 is 1 January 2013 and an early adoption is permitted. While a long lead period gives entities time to prepare for adoption of the Standard, the option to apply the Standard to any reporting period before the effective date could inhibit comparability between entities over a significant time span. This issue

DRAFT
IFRS 9 – Invitation to Comment on EFRAG’s Assessments

is however to some extent mitigated by the requirement to provide disclosures that highlight the effects from transition to IFRS 9 on reported information.

- 36 While the Standard requires modified retrospective application which enables users to compare financial information over time in spite of adoption of new requirements, entities that adopt IFRS 9 in 2009, 2010 and 2011 are not required to restate comparatives. While this measure is to facilitate earlier adoption of the reclassification and measurement requirements in IFRS 9, this could further inhibit comparability of financial information in successive accounting periods during the period prior to mandatory adoption.

Conclusion

- 37 EFRAG noted that IFRS 9 will not be free from some significant comparability concerns as described above. Nevertheless, the majority of EFRAG members believe that most significant issues of comparability are likely to arise only until the application of the Standard becomes mandatory and those concerns are at least partially mitigated by disclosure requirements. While some comparability concerns may remain thereafter, EFRAG does not consider those concerns significant. Therefore, EFRAG concluded that on balance the information about financial instruments reported in accordance with the requirements in IFRS 9 will achieve a sufficient level comparability and on that basis EFRAG believes that the criterion of comparability is satisfied.

Understandability

- 38 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business, economic activity and accounting and with the willingness to study the information with reasonable diligence.
- 39 Although there are a number of aspects to the notion of ‘understandability’, EFRAG believes that most aspects are covered by the discussion above about relevance, reliability and comparability (because, for example, information that represents something as similar when it is in fact dissimilar is not comparable, and that lack of comparability will mean it is also not understandable). Consequently, EFRAG’s considerations and conclusions reached above apply here as well.

Conclusion

- 40 EFRAG believes that IFRS 9 meets the criterion of understandability.

True and Fair

- 41 Having concluded that the information that results from the application of IFRS 9 will meet the criteria of relevance, reliability, comparability and understandability and being unaware of any other reason to be concerned about the accounting effect of IFRS 9, EFRAG sees no reason to believe that the amendment is contrary to the true and fair principle.

European Interest

- 42 EFRAG is not aware of any reason to believe that it is in the European interest not to adopt IFRS 9.

CONCLUSION

- 43 EFRAG’s overall conclusion is that IFRS 9 satisfies the criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

APPENDIX 3 EFRAG’S EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENT

INTRODUCTION

- 1 EFRAG has considered whether, and if so to what extent, implementing IFRS 9 as published by the IASB in November 2009 in the EU might involve preparers and users incurring one-off costs on initial adoption of the Standard and incremental on-going costs, and whether those costs combined are likely to exceed the benefits to preparers and users of financial statements.
- 2 EFRAG considered the effects of all the changes made in IFRS 9, compared to the existing IAS 39 *Financial Instruments: Recognition and Measurement* ('IAS 39'). EFRAG also considered the consequences the revisions to IFRS 9 would have on other existing IFRSs and the amendments thereto.
- 3 EFRAG based its initial assessment on the aspects of IFRS 9 that it believed most likely to be of relevance to an assessment of the costs and benefits of implementing the Standard. It is also worth noting that this is an overall assessment of costs and benefits and that how these fall amongst different entities and groups of users is likely to vary considerably.

EFRAG’S INITIAL ASSESSMENT

Year-one costs for preparers and users

Initial application of IFRS 9

- 4 Whenever accounting requirements change, preparers and users need to read and understand the new requirements and this will inevitably involve an incremental year-one cost.
- 5 Preparers are likely to incur significant incremental year-one costs applying the new requirements of IFRS 9 in respect of:
 - (a) Identifying, assessing and classifying 'businesses';
 - (b) Identifying, assessing and classifying financial assets, particularly those financial assets managed as part of a contractual cash flow business;
 - (c) Making relevant elections e.g. the fair value option, equity investments at fair value through other comprehensive income and designating or discontinuing hedge accounting;
 - (d) Incorporating the changes in classification and measurement into the financial reporting process. This process may include system changes and education of staff and management; and
 - (e) Assessing the financial statement impact of the amendments, including tax and regulatory impacts.

DRAFT

IFRS 9 – Invitation to Comment on EFRAG’s Assessments

- 6 Users will need to understand implications of the new requirements and what affect this has on performing their analysis and comparing year-to-year figures. Users will also need to consider the effects of the changes on ratios.
- 7 Another key issue for users is that the mandatory application date for IFRS 9 is 1 January 2013. Early adoption is permitted. This means that users will need to deal with a reduction in comparability between entities that adopt IFRS 9 early and those that adopt later. It is EFRAG’s view that the lack of comparability between entities over the extended implementation period (although partially mitigated by disclosures) will result in significant incremental costs to users.

Conclusion

- 8 EFRAG’s assessment overall is that there are likely to be not insignificant costs involved for both users and preparers in the initial application of IFRS 9.

Transition requirements

- 9 The requirements in IFRS 9 are to be applied on a modified retrospective basis. This means that the carrying amounts of financial assets will need to be provided from the beginning of the first comparative period and/or reporting period. EFRAG’s view is that modified retrospective application will not be a significant incremental cost to preparers compared to prospective adoption, since the most of the information required to apply the provisions of IFRS 9 retrospectively should be readily obtainable. EFRAG’s analysis is summarised in the table below.

Classification under IAS 39	Classification under IFRS 9	Availability of Retrospective Information	Incremental cost to preparers
Amortised Cost	Fair Value through Profit or Loss (FVTPL)	Fair value information available from IFRS 7 disclosures.	Not significant
Fair value through OCI	FVTPL	Fair value already reported on the balance sheet. Unrealised gains or losses reported in other comprehensive income.	Not significant
Fair value through OCI or FVTPL	Equity investment through OCI	No significant change in accounting treatment. Gains or losses on equity securities derecognised from earliest reporting date will need to be reinstated.	Not significant
Fair value through OCI	Amortised cost	Amortised cost information available since interest and impairment on debt instruments carried at fair value through OCI had to be recognised in profit or loss on the same basis as financial assets held at amortised cost.	Not significant

DRAFT
IFRS 9 – Invitation to Comment on EFRAG’s Assessments

Classification under IAS 39	Classification under IFRS 9	Availability of Retrospective Information	Incremental cost to preparers
FVTPL	Amortised Cost	<p>If impracticable to reconstruct the amortised cost of a financial asset, preparers can use the fair value at the date of initial application as the amortised cost. Comparative information can also be based on fair values at the end of each comparative period in this situation.</p> <p>Given impracticability exception to retrospective application and the potentially small population of financial assets impacted, incremental costs to preparers are likely to be insignificant.</p>	Not significant

- 10 With respect to users, retrospective application of IFRS 9 reduces the year one costs. However, since preparers will not be required to report comparatives if they early adopt in 2009, 2010 or 2011, transition will result in extra costs for users in those periods, although the impact will be mitigated by preparers providing a reconciliation of opening retained earnings for the period of initial adoption.

Conclusion

- 11 EFRAG’s assessment overall is that the incremental costs of the transition provisions of IFRS 9 will not be significant for both users and preparers.

Additional disclosures

- 12 IFRS 9 requires that on initial adoption certain one-off disclosures will be required.
- 13 The additional disclosure requirements will involve an increase in year-one costs for preparers as they have to gather the required information for the first time during the first year of adoption. However, EFRAG’s understanding is that generally the information required to produce the transitional disclosures will also be required to classify financial assets for measurement purposes in accordance with IFRS 9 in the primary financial statements and therefore the incremental disclosure costs are unlikely to be significant.
- 14 EFRAG also considered the effects of the additional disclosure on users of financial statements. EFRAG’s tentative view is that the incremental transition disclosures resulting from the adoption of IFRS 9 are likely to improve information provided to users on adoption.

Conclusion

- 15 EFRAG’s assessment is that the costs arising from the initial adoption disclosure requirements are likely to be not significant.

On-going application of IFRS 9

DRAFT
IFRS 9 – Invitation to Comment on EFRAG’s Assessments

Benefits to preparers

- 16 The incremental benefits for preparers that are likely to result from the ongoing application of IFRS 9 include:
- (a) *Less complex classification system:* IFRS 9 will result in a less complex classification and measurement system for financial assets for the following reasons:
 - i. *Reduction in measurement categories:* IFRS 9 has fewer classification categories for financial assets than previously under IAS 39. As a result, initial classification will be less complex, with consideration of the characteristics of the financial asset only required for instruments held by businesses that manage with the objective of collecting contractual cash flows and for certain equity investments.
 - ii. *Elimination of the available for sale category:* IFRS 9 reduces the accounting complexity involved in accounting for impairment losses and other recycling of gains/losses through the profit or loss statement.
 - iii. *Elimination of the requirements to bifurcate embedded derivatives:* Elimination of the bifurcation rules eliminates the need to apply these complex rules to hybrid financial assets and also eliminates the operational burden that bifurcation can represent.
 - (b) *Alignment of accounting and business views:* Where an entity has classified an instrument based on its business model (i.e. the characteristic of the instrument meant the financial asset was eligible for amortised cost measurement), there will be greater consistency between the way management view their financial assets and the way they are required to be accounted for under IFRS. This means that in these circumstances, management and staff will be able to better understand and explain financial reporting results.
- 17 In EFRAG’s view, the incremental benefits to preparers from the on-going application of IFRS 9 cited above are, as a group, significant. However, the way these benefits will apply to different preparers will vary. For example, some of the benefits listed above may not be significant for entities outside the financial sector. Furthermore, some entities in the financial sector might attain fewer benefits from the new classification model in IFRS 9 than others.

Benefits to users

- 18 Incremental benefits to users that are likely to result from the ongoing application of IFRS 9 include:
- (a) *Alignment of accounting and business views:* A mixed measurement model that more closely aligns with a reporting entity’s business model will provide more relevant information to users than the instrument-by-instrument classification model in IAS 39.

DRAFT

IFRS 9 – Invitation to Comment on EFRAG’s Assessments

- (b) *Less complex classification system:* The decrease in classification categories will result in a classification system that is easier to understand than that in IAS 39.
- (c) *Reduction in classification options:* The decrease in the areas where reporting entities have an option to designate a particular measurement category will be reduced. Decreases in options available to reporting entities will increase comparability in financial statements for users.

19 In EFRAG’s view, the incremental benefits to users from IFRS 9 as cited above are, as a group, significant.

Costs for preparers

- 20 Costs associated with determining fair value of unlisted equity instruments and derivatives linked to such unquoted equity instruments may increase. These costs will however be mitigated by the guidance included in IFRS 9 that clarifies that the cost of an instrument may be representative of its fair value in certain circumstances.
- 21 Ongoing disclosures that will be required by IFRS 7 (as amended by IFRS 9) for example upon reclassification where there is a change in the business model or in relation to dividends recognised on equity investments recognised at fair value through other comprehensive income in EFRAG’s view do not represent a significant increment in the disclosures requirements currently required by IFRS 7. Accordingly, EFRAG’s view is that IFRS 9’s on-going disclosure requirements will not result in significant incremental costs for preparers.

Costs for users

- 22 EFRAG notes that on an ongoing basis users may incur incremental costs in the analysis of those areas of reporting financial instruments where IFRS 9 results in information that is less relevant, reliable, understandable or comparable because extra efforts would be required looking for alternative data sources, etc. It is noted that not all users would share these concerns. Examples of such areas are:
- (a) It is a concern that the classification and measurement model required by IFRS 9 will, at least for some financial assets, provide less relevant information than currently reported under IAS 39. Examples of such financial assets include subordinated tranches of certain structured investment vehicles.
 - (b) Some consider that financial assets that are illiquid or whose fair values cannot be reliably measured should continue to be reported in accordance with the current available-for-sale model in IAS 39 or carried at amortised cost less impairment in order to reduce the risk that inappropriate fair value gains are reported in profit or loss.
 - (c) The elimination of the requirement to bifurcate embedded derivatives will reduce the relevance of information where fair value through profit or loss does not match the way a preparer views or manages the hybrid financial asset’s components. Hence elimination of the requirement to bifurcate financial assets is seen by some as deteriorating the information provided to users on the respective economic characteristics of the host instrument and the embedded derivative.

DRAFT

IFRS 9 – Invitation to Comment on EFRAG's Assessments

- (d) IFRS 9 prohibits the recognition of fair value gains or losses in profit or loss on equity investments designated as being held at fair value through other comprehensive income on initial recognition. That is fair value gains or losses cannot be recycled, even in the event of impairment or derecognition of the financial asset. Some consider that realised gains or losses should be reported in profit or loss and that continued recognition in other comprehensive income can result in treatment that is not reflective of economic substance of a financial asset that has been sold or impaired.

- 23 *Conclusion* EFRAG's assessment is that costs to some preparers and some users arising from the on-going application of IFRS 9 are likely to be moderate.

Overall conclusions about the costs and benefits of implementing IFRS 9 in the EU

- 24 EFRAG's overall assessment is that implementing IFRS 9 is likely to result for preparers and users in some significant incremental costs in year one and for some moderate costs on an ongoing basis. On the other hand, IFRS will reduce complexity of the classification and measurement model for financial instruments as compared to the classification and measurement model in IAS 39 and will result in significant benefits to users and some preparers.
- 25 EFRAG's initial assessment is therefore that the benefits arising from implementation of IFRS 9 are likely to exceed the costs.

APPENDIX 4

DISSENTING OPINIONS

1. Two EFRAG TEG members dissent from the draft endorsement advice that supports the adoption of IFRS 9 Financial Instruments. The reasons why they have elected to dissent are outlined below.
2. Both members believe that before IFRS 9 meets its effective date on January 1, 2013, subsequent changes to the Standard are very likely. These may be driven by convergence imperatives or implementation difficulties inherent in the rushed standard setting process, if for no other technical reasons. Therefore, they disagree with the statement in paragraph 3 of Appendix 2 that EFRAG TEG should not give any weight in its assessment of the Standard to the very temporary nature of IFRS 9 and the revised IAS 39 taken together. Indeed rapid and successive changes are likely to create disruption to the financial reporting of financial instruments that will compromise understandability and comparability, and generate undue costs for preparers and users. These members note this is why there is the widespread view, in Europe and elsewhere, that less piecemeal changes to, and more substantive improvements in, IFRS, are needed.
3. These members also contend that, IFRS 9, in its current form, will need to undergo changes if the final Standard is to meet the expectations that the awaited comprehensive revision of IAS 39 has raised, especially because of the financial crisis. This is because IFRS 9 fails to bring the benefits in relevance and reliability that are expected to flow from a mixed measurement approach, which is based on the business model and the characteristics of the instruments tests. In their view, the very restrictive conditions that are set for the amortised cost category undermines the relevance expected from the mixed measurement approach. Indeed, in their view, the very strict definition of interest along with the elimination of any bifurcation of embedded derivatives introduces a bias towards more fair value measurements than the rationale behind a mixed measurement model would conceptually call for. The extent of that bias may, in their view, distort basic and widely used performance indicators in the banking industry, such as net interest margin. The consequences of that bias need to be fully assessed in practice, before IFRS 9 is considered for endorsement. Also, the elimination of any separate accounting for derivatives embedded in non-derivative financial assets results, they believe, in a lack of comparability between financial assets which in substance are similar.
4. Both dissenting members are concerned about the asymmetrical treatment of financial assets and liabilities that they believe results from IFRS 9 dealing exclusively with financial assets (and financial liabilities remaining with the scope of IAS 39).
5. In addition to the above, both members share most other relevance, reliability and comparability concerns raised in Appendix 2 of EFRAG’s draft endorsement advice letter. Finally, both members note that the asymmetry that is introduced in the classification and measurement of financial assets and financial liabilities and some of the comparability concerns raised in EFRAG’s draft letter would be solved if early adoption was not contemplated.