EFRAG

European Financial Reporting Advisory Group

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Financial Accounting Standards Board
Attn. Technical Director, File Reference No. 1810-100,
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PO Box 5116
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International Accounting Standards Board
30 Cannon Street
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Dear Sir / Madam

Re: Exposure Draft, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the FASB's Exposure Draft *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* ('the FASB Exposure Draft') that was published on 26 May 2010.

EFRAG is a private sector body established to provide input into the development of IFRSs issued by the International Accounting Standards Board (IASB) and to provide the European Commission with technical expertise and advice on the technical quality of IFRSs.

EFRAG is commenting on the proposals in the FASB Exposure Draft, both in response to a request made by the IASB on 27 May 2010 and with a view to contributing to the development of high-quality accounting standards for financial instruments, suitable for use in global capital markets. As such, this letter does not necessarily reflect the conclusions that EFRAG would reach on endorsement of IFRSs for use in Europe in its capacity as adviser to the European Commission.

As part of the response to the recent financial crisis, the Group of Twenty (G-20) called on accounting standard setters to work urgently to achieve a single set of high-quality global accounting standards. Consequently, the FASB and the IASB jointly affirmed their commitment to achieve convergence of IFRSs and US GAAP and we understand that the FASB Exposure Draft forms part of the global convergence project of the IASB and the FASB. Nevertheless, the FASB Exposure Draft marks a significantly different approach to financial instruments accounting than that taken by the IASB[1] and EFRAG is concerned about the difficulties the two Boards may face in reconciling differing views on this project.

Whilst we recognise the commitment on convergence made by the IASB and FASB to the G-20, we believe that this commitment should not be met at the expense of quality. In our view, a 'high-quality' accounting standard on financial instruments for world-wide use must be capable of reflecting the range of business models that exists globally. Therefore, EFRAG does not support the proposals in the FASB Exposure Draft as it believes that they do not give appropriate emphasis to the business model; nor are the proposals capable of reflecting the range of business models that exist.

In this letter, EFRAG formulates its recommendations to both the FASB and IASB on how to meet best the objective of achieving a single high-quality standard on financial instruments. Our views are presented in detail in Appendix 1 to this letter and summarised below.

In our view, the FASB proposals do not provide a basis for a high-quality standard on accounting for financial instruments. We are supportive of the broad direction set by the IASB in its project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. Therefore, we believe that the directions set by the IASB should form the basis for the development of a converged standard. We support, more specifically, the following elements in the IASB's approach:

- classification criteria based on the characteristics of the financial instruments and the business model used by the entity in managing those financial instruments;
- a mixed measurement model that allows financial instruments to be reported at either amortised cost or fair value, depending on the business model;
- reclassification required when there is a change in the conditions that lead to initial classification;
- primary financial statements that reflect one measurement attribute only for each financial instrument;
- impairment of financial assets measured at amortised cost based on an expected loss approach that uses all available credit-related information, including forecasts of future events and future economic conditions; and
- recognition of fair value changes due to changes in an entity's own credit risk outside profit or loss, when liabilities are designated under the fair value option, except in extremely rare circumstances where the fair value changes of financial assets are directly linked to an issuer's own credit risk.

However, we consider that both Boards should work together to develop a standard in the direction set by the IASB. In our view, a high-quality standard on financial instruments starts from the principles in IFRS 9 *Financial Instruments* (IFRS 9) and incorporates the following:

- greater emphasis on the business model whilst remaining faithful to a need to consider the characteristics of the financial instrument;

[1] IFRS 9 *Financial Instruments* and IASB Exposure Drafts on *Financial Instruments: Amortised Cost and Impairment* and the *Fair Value Option for Financial Liabilities.*

- separate accounting for embedded derivatives for both hybrid financial assets and hybrid financial liabilities;
- recognition in profit or loss of realised gains and losses on equity instruments measured at fair value when unrealised changes are recognised in other comprehensive income; and
- consistent measurement of financial assets and financial liabilities when they are linked together.

Furthermore, EFRAG would not encourage the use of additional requirements (disclosure or otherwise) as a means to bridge the differences between the IASB and the FASB models on accounting for financial instruments, where the two models remain different despite the efforts to convergence. In our view, the solution rests in having converged principles that are developed in the directions set by the IASB, as explained above.

Finally, the Boards have proposed to allow financial instruments to be measured at fair value through other comprehensive income, albeit in different circumstances and for different instruments. In this context, EFRAG considers that IASB and FASB should work together to define better the use and purpose of other comprehensive income, before changing the way in which changes in fair value are reported.

Summary of EFRAG Recommendations: IASB Directions

Classification criteria

EFRAG supports classification criteria that differentiate between financial instruments measured at amortised cost and financial instruments measured at fair value based on the characteristics of the financial instruments and the business model adopted by the entity in managing those financial instruments.

We disagree with the multiple measurement options presented in the FASB Exposure Draft (i.e. fair value through other comprehensive income for debt instruments carried for collection or payment of contractual cash flows, amortised cost option for eligible short-term receivables and amortised cost for liabilities creating an accounting mismatch). We believe instead that to increase comparability and reduce complexity, the choice of measurement attribute follows directly from the characteristics of the financial instrument and the business model used by the entity in managing the financial instrument.

Mixed measurement model

EFRAG strongly believes that financial instruments accounting should be based on a mixed measurement model. In our view, debt instruments that are held for the collection or payment of contractual cash flows are more appropriately measured at amortised cost, since this measurement attribute best represents the potential future cash flows that the entity will achieve. Therefore, giving prominence in the statement of financial position to the fair value measurement, of such debt instruments, as proposed by the FASB, could be misleading, as it would reflect gains that might be never realised and losses that are not expected to occur. In addition, the recent debates on measurement at fair value of financial liabilities and the effects of changes in the entity's own credit risk have highlighted that fair value measurement is not necessarily suited to financial liabilities.

Reclassification

As proposed by the IASB, reclassification should be required for financial instruments when current circumstances indicate that the business model for the instrument has changed; should reclassification not be required, the use of an inappropriate measurement attribute could undermine the relevance of the resulting financial reporting.

Primary financial statements reflecting one measurement attribute only

For each financial instrument, only one measurement attribute should be reflected in the primary financial statements. The choice of measurement attribute follows directly from the characteristics of the financial instrument and the business model used by the entity in managing the financial instrument. Amortised cost is the measurement attribute that best represents the business model for debt financial instruments held for collection or payment of contractual cash flows. Presenting the fair value for such financial assets and liabilities implicitly assumes an exit value and such information is not useful in assessing the financial performance of an entity that does not intend to exit or liquidate its core business.

In addition, the presentation of two measurement attributes on the face of the statement of financial position, as proposed by the FASB for certain debt instruments, may result in additional complexity and over-detailed primary statements. This could obscure key messages and complicate, rather than improve, the communication between preparers and users of financial statements. Where amortised cost is deemed relevant for primary financial statements, the measurement at fair value may play the role of providing supplementary information but such information can be presented much more clearly in the notes to the financial statements than on the face of the primary statements.

Expected loss approach for impairment

The amortised cost and impairment model for financial assets should be based on an expected loss approach founded on the conceptual principles proposed by the IASB. An entity's estimate of impairment losses should reflect all existing information including expected future developments and forecasts of future events and economic conditions. This would ensure that management estimates reflect, on a timely basis, appropriate forward-looking information and that a greater range of information about the credit quality of financial assets is incorporated in reported measurement.

We consider that requiring an entity to isolate credit information that relates to past and existing trends from that which relates to forecasts of future developments adds complexity and judgement to the estimation process and could result in reduced comparability.

We agree with the IASB's proposal that credit losses expected at initial recognition should be allocated over the life of the financial asset. As a result, net interest revenue reflects that some of that interest is paid in compensation for credit losses expected on initial recognition. Gains and losses resulting from changes in estimates of future cash flows should be recognised in the period of the re-estimate, to the extent that the change relates to current or prior periods.

Finally, given the importance of the interest margin in financial analysis by users, we believe that separate recognition of effective interest components (i.e. fees, points received, transaction costs and other premiums and discounts), credit loss expectations and other fair value adjustments provides more decision-useful information than a net presentation of these amounts.

Own credit risk

When liabilities are designated under the fair value option, fair value changes due to changes in an entity's own credit risk should not affect profit or loss, except in extremely rare circumstances where the fair value changes of financial assets are directly linked to an issuer's own credit risk. This would address long-standing concerns that it is misleading to report the effects of changes in own credit risk of liabilities not held-for-trading purposes in profit or loss.

Summary of EFRAG Recommendations: Suggested improvements for the formulation of the final standard

Greater emphasis on the business model

In developing a single, high-quality accounting standard for financial instruments, the boundaries between amortised cost and fair value measurement should more closely reflect the business model. However, we acknowledge that the characteristics of the instrument must also be considered.

In addition, in the assessment of credit risk losses for financial assets, consideration should be given to the amortised cost measurement resulting from the application of a forward-looking approach to expected losses. This approach would allow an entity to reflect properly credit risk in the adjustments to expected cash flows without introducing additional variables such as liquidity premiums and other adjustments.

Separate accounting for embedded derivatives

We encourage the development of a simplified and principles-based identification of embedded derivatives to be separately accounted for at fair value though profit or loss. The same principle should be applied to bifurcation of embedded derivatives for both hybrid financial assets and hybrid financial liabilities.

Investments in equity instruments

We believe that equity investments not held-for-trading should be accounted for differently from equity investments held-for-trading and measured at fair value through profit or loss. Specifically, equity investments not held-for-trading should be measured at fair value with changes in fair value recognised in other comprehensive income, subject to an impairment test. Reclassification to profit or loss upon realisation of gains and losses resulting from subsequent measurement should be maintained, until an in-depth debate has taken place on: (i) performance reporting, (ii) the use of other comprehensive income and (iii) reclassification from other comprehensive income to profit or loss.

Consistent measurement of financial assets and liabilities that are linked together

We recognise that a mixed measurement model can result in accounting mismatches. EFRAG believes that requiring the measurement of all financial instruments at fair value is not the best solution to address accounting mismatches. A mixed measurement model should be combined with an option that allows for a consistent measurement basis for financial assets and financial liabilities that better reflects the links existing between those assets and liabilities.

Other matters

Equity method of accounting for investments in associates

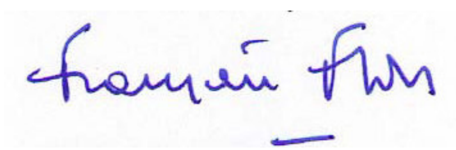
EFRAG disagrees with the change to the criteria for the use of the equity method of accounting that the FASB proposes and believes that the debate on accounting for financial instruments should not encompass changes to the accounting standards applicable to investments in associates.

Core deposits

EFRAG strongly disagrees with the proposed re-measurement approach for core deposits in the FASB Exposure Draft. We do not consider that the use of a hypothetical measure based on alternative funding costs provides relevant information about the actual benefit provided by a core deposit base. We also consider that it is inappropriate to consider the accounting treatment of core deposit intangibles separately from other similar intangibles.

If you wish to discuss our comments further, please do not hesitate to contact Chiara Del Prete or me.

Yours sincerely



Françoise Flores
EFRAG, Chairman

APPENDIX 1

SCOPE

Questions for all respondents

> **Question 2**
>
> The proposed guidance would require loan commitments, other than *loan commitments* related to a revolving line of credit issued under a *credit card arrangement*, to be measured at fair value. Do you agree that loan commitments related to a revolving line of credit issued under a credit card arrangement should be excluded from the scope of this proposed Update? If not, why?

Response to Question 2

1 EFRAG agrees that where necessary operational concerns can justify the adoption of simplified accounting requirements. However, such simplified accounting treatment should be applicable to all financial instruments having the same economic substance, rather than for specific contractual types.

2 Therefore, EFRAG questions why the scope exemption is limited to certain credit card commitments and suggests it should apply to all loan commitments with similar features. Furthermore, EFRAG believes that accounting treatment of the loan commitment should be independent from the classification and measurement of the loan when drawn.

> **Question 3**
>
> The proposed guidance would require deposit-type and investment contracts of insurance and other entities to be measured at fair value. Do you agree that deposit-type and investment contracts should be included in the scope? If not, why?

Response to Question 3

3 This response does not address the measurement of insurance contracts, which is not part of this FASB Exposure Draft. These proposals pre-empt any proposal from the Boards' joint project on insurance contracts. We therefore urge both Boards to consider the inclusion of insurance contracts within a financial instruments standard as part of the project on insurance contracts.

4 However, subject to future decisions in insurance, in particular on unbundling of insurance contracts, EFRAG believes that contracts that involve a significant insurance risk should be accounted for as insurance contracts, regardless of the industry sector of the reporting entity. EFRAG agrees that deposit-type and investment contracts that do not have significant insurance risk and that otherwise meet the definition of a financial instrument should be included within the scope of the standard on financial instruments.

Question 4

The proposed guidance would require an entity to not only determine if they have significant influence over the investee as described currently in Topic 323 on accounting for equity method investments and joint ventures but also to determine if the operations of the investee are related to the entity's consolidated business to qualify for the equity method of accounting. Do you agree with this proposed change to the criteria for equity method of accounting? If not, why?

Response to Question 4

5 EFRAG disagrees with the change to the criteria for the use of the equity method of accounting that is being proposed by the FASB.

6 EFRAG believes that the debate on accounting for financial instruments should not encompass changes to the accounting for investments in associates.

7 Finally, EFRAG is not aware that a need to change the accounting for investments in associates exists.

INITIAL MEASUREMENT

Questions for all respondents

Question 8

Do you agree with the initial measurement principles for financial instruments? If not, why?

Question 9

For financial instruments for which qualifying changes in fair value are recognized in other comprehensive income, do you agree that a significant difference between the transaction price and the fair value on the transaction date should be recognized in net income if the significant difference relates to something other than fees or costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact? If not, why?

Question 10

Do you believe that there should be a single initial measurement principle regardless of whether changes in fair value of a financial instrument are recognized in net income or other comprehensive income? If yes, should that principle require initial measurement at the transaction price or fair value? Why?

Question 11

Do you agree that transaction fees and costs should be (1) expensed immediately for financial instruments measured at fair value with all changes in fair value recognized in net income and (2) deferred and amortized as an adjustment of the yield for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income? If not, why?

Response to Questions 8, 9, 10 and 11

8 EFRAG believes that:

(a) a financial asset (liability) should be initially measured at its fair value plus (minus), in case of a financial asset (liability) not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition of the financial asset (liability);

(b) putting aside transaction costs, fair value will generally equal the transaction price. If at initial recognition of a financial instrument a difference between fair value and transaction price exists, the entity should recognise the difference between the transaction price and the fair value as a gain or loss only if that fair value is evidenced by observable market prices or, when using a valuation technique, by observable market data.

SUBSEQUENT MEASUREMENT

Questions for all respondents

Question 13

The Board believes that both fair value information and amortized cost information should be provided for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows. Most Board members believe that this information should be provided in the totals on the face of the financial statements with changes in fair value recognized in reported stockholders' equity as a net increase (decrease) in net assets. Some Board members believe fair value should be presented parenthetically in the statement of financial position. The basis for conclusions and the alternative views describe the reasons for those views. Do you believe the default measurement attribute for financial instruments should be fair value? If not, why? Do you believe that certain financial instruments should be measured using a different measurement attribute? If so, why?

Question 15

Do you believe that the subsequent measurement principles should be the same for financial assets and financial liabilities? If not, why?

Question 23

The proposed guidance would establish fair value with all changes in fair value recognized in net income as the default classification and measurement category for financial instruments. An entity can choose to measure any financial instrument within the scope of this proposed Update at fair value with all changes in fair value recognized in net income, except for core deposit liabilities which must be valued using a re-measurement approach. Do you believe that a default classification and measurement category should be provided for financial instruments that would otherwise meet the criteria for qualifying changes to be recognized in other comprehensive income? If not, why?

Response to Questions 13, 15 and 23

9 EFRAG strongly supports the adoption of classification criteria that differentiate between financial instruments measured at amortised cost and financial

instruments measured at fair value, based on the business model adopted by the entity in managing financial instruments, along with an assessment of the characteristics of the financial instrument itself.

10 The business model and characteristics of the instrument tests should drive classification of both financial assets and financial liabilities.

11 A mixed measurement model based on the business model allows for a faithfully representation of different business models. For a traditional bank, measurement at amortised cost of financial assets and liabilities classified mainly in the banking book would better reflect how financial instruments contribute to the entity's net results and financial position (i.e. based on their contractual cash flows). However, for an investment bank, measurement at fair value of financial assets and liabilities that are mainly classified in the held-for-trading category would better reflect their contribution to the entity's result and financial position.

12 We understand from users that amortised cost provides more decision-useful information than fair value for assets and liabilities held for collection or payment of contractual cash flows.

13 We strongly disagree with the approach proposed by the FASB, which requires measurement at fair value in the statement of financial position of financial assets that the entity manages on a contractual yield basis and that are not held for sale in the short term. Reporting of financial assets and liabilities at fair value, implicitly assumes an exit or 'liquidation'. Such information is not useful in assessing the financial performance of an entity that does not intend to exit or liquidate its core business.

14 EFRAG believes that requiring measurement of all financial instruments at fair value is not necessarily the best solution to reducing accounting mismatches. Measuring all financial assets and liabilities at fair value would not reduce accounting mismatches resulting from non-financial items accounted on a cost basis. Measuring all financial assets and liabilities at fair value would not reduce accounting mismatches due to financial assets and liabilities having different maturities.

15 In our view, a mixed measurement model should be combined with an option that allows for consistent measurement and recognition for financial assets and financial liabilities, in order to best reflect the links existing between those assets and liabilities.

16 In addition, EFRAG is doubtful about the proposal for measuring all financial liabilities at fair value. In fact, recent debates on measurement at fair value of financial liabilities and on the effects of changes in an entity's own credit risk have highlighted that fair value measurement is not necessarily suited for financial liabilities that are neither derivatives nor held-for-trading, unless it would reduce eventual accounting mismatches.

17 In conclusion, we believe that the IASB's mixed measurement model clearly leads to better, more decision-useful, financial reporting than the FASB proposals.

Question 14
The proposed guidance would require that interest income or expense, credit impairments and reversals (for financial assets), and realized gains and losses be recognized in net income for financial instruments that meet the criteria for qualifying changes in fair value to be recognized in other comprehensive income. Do you believe that any other fair value changes should be recognized in net income for these financial instruments? If yes, which changes in fair value should be separately recognized in net income? Why?
Question 22
Do you believe that the recognition of qualifying changes in fair value in other comprehensive income (measuring the effects of subsequent changes in interest rates on fair value as well as reflecting differences between management's and the market's expectations about credit impairments) will provide decision-useful information for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows? If yes, how will the information provided influence your analysis of an entity? If not, why?

Response to Questions 14 and 22

18 EFRAG believes that, to represent fairly the way an entity operates and how it is affected by risks, financial instruments that have certain debt characteristics and that are held for collection or payment of contractual cash flows should be measured at amortised cost. Amortised cost best represents the future cash flows that the entity will achieve from holding these instruments. In EFRAG's opinion, it is unhelpful to give undue prominence in the statement of financial position to the fair value of such instruments, as such measurement would reflect gains that might never be realised and losses that are not expected to occur.

19 Fair value information for financial instruments held for collection or payment of contractual cash flows can be useful in several circumstances, but it seems obvious that such information can be presented much more clearly in the notes to the financial statements than on the face of the primary statements.

20 In addition, many debt instruments held for the collection or payment of contractual cash flows (such as loans and receivables due from customers) are not marketable and their fair value is the result of a subjective measurement based on non-observable variables.

21 We observe that during the recent financial crisis users of financial statements called for enhanced disclosures on asset quality and credit risk, rather than for the increased use of fair value measurement.

22 The proposal to measure at fair value in the statement of financial position the financial instruments held for collection or payment of contractual cash flows triggers the recognition in other comprehensive income (OCI) of fair value changes which are not relevant in depicting the business model adopted by the entity for the financial instrument in question. Therefore, it does not provide decision-useful information on an entity's performance. EFRAG is not convinced of the advantages of measuring financial instruments at fair value in the statement of financial position and retaining traditional concept of performance in profit or loss, while reporting a 'residual' in OCI.

23 Before extending the use of OCI to all financial instruments held for collection or payment of contractual cash flows, EFRAG believes that a proper debate is necessary on fundamental issues related to performance reporting such as (a) the notion of performance and the impact of business models on it, (b) the content of performance statement(s) and (c) recycling.

24 In addition, as part of this debate, EFRAG believes that measurement at fair value with changes in fair value recognised in OCI, subject to an impairment test, should be applied to the equity investments that the entity does not intend to sell in the short term. The impairment test could be based on the lower of cost or fair value, with reversal of losses. Reclassification to profit or loss upon realisation of gains and losses resulting from subsequent measurement should be maintained, until an in-depth debate has taken place on: (i) performance reporting, (ii) the use of other comprehensive income and (iii) reclassification from other comprehensive income to profit or loss. Differentiating the impact in profit or loss of changes in value of equity instruments, whether they are held-for-trading or for accretion in value, would in our view bring useful information to users.

25 Finally, for the measurement of unquoted equity instruments a reliability exception should be available. We believe that there are cases where the costs of determining the reliable fair value of unquoted securities would exceed the benefits of the resulting information.

Question 16

The proposed guidance would require an entity to decide whether to measure a financial instrument at fair value with all changes in fair value recognized in net income, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at amortized cost (for certain financial liabilities) at initial recognition. The proposed guidance would prohibit an entity from subsequently changing that decision. Do you agree that reclassifications should be prohibited? If not, in which circumstances do you believe that reclassifications should be permitted or required? Why?

Response to Question 16

26 EFRAG disagrees with the proposal not to permit reclassification of financial instruments when this reflects a real change in the business model of an entity. If measurement is based on the business model under which a financial instrument is used, then if after initial measurement essential changes in the business model occur, such changes should be reflected in the financial reporting and the financial instrument should be reclassified accordingly.

27 The FASB states that its proposal not to allow reclassification would prevent some forms of earnings management. We are not convinced by this statement and believe that this proposal would reduce the relevance of the financial information. In particular, continuing to require classification of financial instruments based on historical facts and circumstances that have subsequently changed, would not result in decision-useful financial reporting.

SUBSEQUENT MEASUREMENT

Question 17

The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is appropriate? If not, why? Do you believe that the remeasurement amount should be disclosed in the notes to the financial statements rather than presented on the face of the financial statements? Why or why not?

Response to Question 17

28 EFRAG believes that the proposed measurement approach for core deposit liabilities is not appropriate. We agree with the alternative views expressed in paragraph BC248 of the FASB Exposure Draft, specifically that:

(a) the introduction of a special new measurement attribute that only applies to core deposit liabilities introduces unnecessary complexity;

(b) the proposals would result in the measure of a core deposit which reflects the cost of alternative funding, i.e. an opportunity cost. This measure is purely hypothetical and not representative of the actual benefit attributable to the lower cost of funding provided by a core deposit base. In fact, before providing such volumes of alternative funding, any third party would assess creditworthiness of the financial institution and the continuity of a stable core deposit base would play a key role in a positive outcome of this assessment. The measure therefore does not reflect reality and is not useful information.

(c) the intent of the proposed guidance is to address the accounting for financial instruments, not intangible assets. EFRAG believes that it is not appropriate to address the measurement of core deposit intangibles in isolation. For example, why should core deposit intangibles be measured differently from a customer intangible related to a credit card portfolio? We consider that guidance on accounting for internally generated intangible assets, including core deposits, would be better dealt with as a separate standard that develops relevant principles that are applied consistently.

29 In addition, we note the following:

(a) if the unit of account is the individual deposit then it would appear that a withdrawal by customers would give rise to a loss. If the unit of account is the portfolio of core deposits then we would like to understand why the portfolio level is preferable and how such portfolios are defined;

(b) the re-measurement model described in the FASB Exposure Draft for core deposits would significantly rely on non-observable inputs, thus introducing additional subjectivity in financial reporting.

30 Given that EFRAG does not believe that the proposed approach for the re-measurement of core deposits is appropriate, it follows that we do not think these amounts should be reported on the face of the financial statements or in the accompanying notes. Again, we agree with the alternative views on this topic and

believe that deposits are best reported in the statement of financial position at the amount at which they can be withdrawn on demand.

Question 18

Do you agree that a financial liability should be permitted to be measured at amortized cost if it meets the criteria for recognizing qualifying changes in fair value in other comprehensive income and if measuring the liability at fair value would create or exacerbate a measurement attribute mismatch? If not, why?

Response to Question 18

31 As per our responses to questions 13, 15 and 23 and to questions 14 and 22, EFRAG strongly supports a mixed measurement approach, based on the business model and the characteristics of the financial instruments.

32 We consider that financial liabilities, except for derivatives and financial liabilities held-for-trading, should be subsequently measured at amortised cost because this measurement better reflects the nature and use of those liabilities. In our view, financial liabilities that are not derivatives or held-for-trading, are generally issued for funding purposes and paid at maturity. Amortised cost is a more appropriate reflection of the payment of contractual cash flows than short-term fair value fluctuations, which in our view are not necessarily relevant to users or management.

33 EFRAG acknowledges that any mixed measurement model will lead in some cases to accounting mismatches as a result of differences in accounting treatment between financial instruments and between financial instruments and non-financial items. Amortised cost is generally the measurement attribute that best represents the business model adopted for financial liabilities and in order to reduce accounting mismatches, an option should exist allowing for the adoption of a consistent measurement basis for financial assets and financial liabilities, in order to better reflect the links existing between those assets and liabilities.

34 In addition, we observe that the FASB is proposing that the amortised cost option for liabilities is made irrevocably at initial recognition. This proposal, prohibiting any subsequent reclassification, ignores current facts and circumstances and could easily lead to financial information that is internally inconsistent with the criteria used at initial recognition. Finally, EFRAG is doubtful about the proposed 50 per cent test for qualifying for measurement at amortised cost, since we do not believe that such a 'bright line' test would necessarily provide meaningful results.

35 In conclusion, EFRAG supports:

(a) the measurement at amortised cost of financial liabilities that are neither derivative instruments nor those held-for-trading;

(b) the separation of embedded derivatives of hybrid financial liabilities and the requirement to account for such embedded derivatives at fair value through profit and loss;

(c) the presence of an option allowing for the adoption of a consistent measurement basis for financial assets and financial liabilities, if a consistent measurement better reflects the links existing between those assets and liabilities.

Questions for users

Question 24
The proposed guidance would provide amortized cost and fair value information on the face of the financial statements. The Board believes that this would increase the likelihood that both measures are available to users of public entity financial statements on a timely basis and that both measures are given equal attention by preparers and auditors. Do you believe that this approach will provide decision-useful information? If yes, how will the information provided be used in the analysis of an entity? If not, would you recommend another approach (for example, supplemental fair value financial statements in the notes to the financial statements or dual financial statements)?
Question 35
For financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income, do you believe that the presentation of amortized cost, the allowance for credit losses (for financial assets), the amount needed to reconcile amortized cost less the allowance for credit losses to fair value, and fair value on the face of the statement of financial position will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?

Response to Questions 24 and 35

36 EFRAG does not agree with the proposal to present two different measurement attributes for the same financial instruments on the face of the statement of financial position. We believe that only one measurement attribute should be reflected in the primary financial statements for a given financial instrument and that this measurement attribute should be either amortised cost or fair value, depending on the business model and the characteristics of the instrument.

37 Requiring to present both amortised cost and fair value on the face of the statement of financial position for financial instruments held for collection or payment of contractual cash flows would result in a confusing representation, since:

(a) amortised cost is the measurement attribute that best represents the business model for these instruments;

(b) fair value measurement is not relevant since it presents gains that might never be realised and losses that are not expected to occur;

(c) presenting the fair value implicitly assumes an exit value and such information is not useful in assessing the financial performance of an entity that does not intend to exit or liquidate its financial assets and liabilities; and

(d) for the same financial instrument an entity can only have one business strategy to be represented in the financial reporting.

38 In addition, as already explained in our response to Questions 14 and 22, many debt instruments held for the collections or payments of contractual cash flows are not marketable. The requirement to measure such financial instruments at fair value in the statement of financial position would result in increased use of reported amounts based on non-observable variables, greater subjectivity and reduced comparability among entities.

39 EFRAG is also concerned about the level of detail required on the face of the primary statements and the additional complexity introduced by this proposal. We believe that the requirement may result in over-detailed primary statements, which can obscure key messages and could complicate rather than improve the communication between preparers and users of financial statements.

40 We consider that for clarity and relevance reasons, additional information, if and when appropriate, is better presented in the notes to the financial statements.

Question 25

For hybrid financial instruments that currently would require bifurcation and separate accounting under Subtopic 815-15, do you agree that recognizing the entire change in fair value in net income results in more decision useful information than requiring the embedded derivative to be bifurcated and accounted for separately from the host contract? If yes, how will the information provided be used in the analysis of an entity? If not, for which types of hybrid financial instruments do you believe that it is more decision useful to account for the embedded derivative separately from the host contract? Why?

Question 26

IFRS 9 requires hybrid financial assets to be classified in their entirety on the basis of the overall classification approach for financial assets with specific guidance for applying the classification approach to investments in contractually linked instruments that create concentrations of credit risk. Also, for hybrid financial liabilities, the IASB, in order to address the effects of changes in the credit risk of a liability, tentatively has decided to retain existing guidance that requires embedded derivatives to be bifurcated and accounted for separately from a host liability contract if particular conditions are met. Do you believe that the proposed guidance for hybrid financial instruments or the IASB's model for accounting for financial hybrid contracts will provide more decision-useful information? Why?

Response to Questions 25 and 26

41 We observe that the following main views have been expressed by constituents in commenting on the proposals leading to IFRS 9:

(a) except for the issue of own credit risk, there is not a need to change the IAS 39 requirements for financial liabilities; concerns raised by the IAS 39 classification and measurement requirements arose, in fact, mainly on the asset side and the IASB has addressed them in IFRS 9;

(b) applying different classification and measurement principles to assets and liabilities and different accounting criteria for derivatives that are embedded in the same contractual type of host, depending on whether they are assets or liabilities, would result in increasing complexity, lack of comparability and accounting mismatches (although the latter could be eliminated by applying the fair value option);

(c) the existing requirements for bifurcation, which are based substantially on the same principle under US GAAP and have been retained by the FASB Exposure Draft for identification of embedded derivatives, are rules-based and difficult to apply.

42 From its own outreach activities, EFRAG understands that constituents express the following main views in favour of retaining separate accounting of embedded derivatives for assets:

(a) Separate accounting has the advantage of reflecting in the financial reporting how hybrid instruments are treated by the entity for risk management purposes; and

(b) Separate accounting is a means of ensuring that, where instruments have a significant debt component, this component would be accounted for at amortised cost, provided that amortised cost would better represent the business model adopted for such instruments.

43 EFRAG would welcome joint efforts of the FASB and the IASB for the development of converged requirements leading to the identification of embedded derivatives and the classification of financial instruments. The aim of these efforts should be to improve the classification criteria and achieve a simple, symmetrical and principle-based approach to the bifurcation of embedded derivatives. We summarise below the directions that, in EFRAG's view, the joint effort of the two Boards should take.

(a) The principle defining the boundaries between amortised cost and fair value measurement should more closely reflect the business model adopted for the different contractual cash flows present in a financial instrument, giving great emphasis to the business model. We acknowledge, however, that the characteristics of the instrument must also be considered. For example, it is worth considering whether a difference in the nature of cash flows bundled in one contract and in a business model applied to those cash flows would justify identification of a unit of account at a different level than the entire contract.

(b) In the definition of the boundaries between amortised cost and fair value with reference to credit risk features related to financial assets held for collection of contractual cash flows, consideration should be given to the amortised cost measurement resulting from the application of a forward looking approach to expected losses. This approach, unlike the incurred loss approach for amortised cost, would allow an entity to properly reflect credit risk in the adjustments to expected cash flows, without introducing additional variables under fair value measurement, such as liquidity premiums and other adjustments. Provided that amortised cost best represents the business model adopted by the entity for a financial instrument, this would allow a broader adoption of the amortised cost measurement compared to the requirements of IFRS 9.

Questions for all respondents

Question 27

Do you believe that measuring certain short-term receivables and payables at amortized cost (plus or minus any fair value hedging adjustments) will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?

Response to Question 27

44 When applying the objective of the amortised cost model to short-term trade receivables, attention should be given to the relevance of the resultant information compared to a cost measurement. In particular, requiring that an entity provides information about the 'effective return of a financial asset' assumes that the entity holds a financial asset for the purposes of earning revenue from it; this may be generally the case for financial institutions. For other entities, whose primary assets are short-term trade receivables, the notion of effective return has less relevance, since providing deferred payment is part of selling their product. Such trade receivables are not held to generate interest revenue and eventual related impairment costs are seen as a business expense. For these reasons, entities should consider the relevance of the information resulting from the application of the effective return to short-term trade receivables.

Questions for all respondents

Question 32

For financial liabilities measured at fair value with all changes in fair value recognized in net income, do you agree that separate presentation of changes in an entity's credit standing (excluding changes in the price of credit) is appropriate, or do you believe that it is more appropriate to recognize the changes in an entity's credit standing (with or without changes in the price of credit) in other comprehensive income, which would be consistent with the IASB's tentative decisions on financial liabilities measured at fair value under the fair value option? Why?

Question 33

Appendix B describes two possible methods for determining the change in fair value of a financial liability attributable to a change in the entity's credit standing (excluding the changes in the price of credit). What are the strengths and weaknesses of each method? Would it be appropriate to use either method as long as it was done consistently, or would it be better to use Method 2 for all entities given that some entities are not rated? Alternatively, are there better methods for determining the change in fair value attributable to a change in the entity's credit standing, excluding the price of credit? If so, please explain why those methods would better measure that change.

Question 34

The methods described in Appendix B for determining the change in fair value of a financial liability attributable to a change in an entity's credit standing (excluding the changes in the price of credit) assume that the entity would look to the cost of debt of other entities in its industry to estimate the change in credit standing, excluding the change in the price of credit. Is it appropriate to look to other entities within an entity's industry, or should some other index, such as all entities in the market of a similar size or all entities in the industry of a similar size, be used? If so, please explain why another index would better measure the change in the price of credit.

Question 36

Do you believe that separately presenting in the performance statement significant changes in the fair value of financial liabilities for changes in an entity's credit standing (excluding the changes in the price of credit) will provide decision-useful information? If yes, how will the information provided influence your analysis of the entity? If not, why? Do you believe that changes in the price of credit also should be included in this amount? If so, why?

Response to Questions 32, 33, 34 and 36

45 As we stated in our response to Question 18, in our view:

(a) amortised cost should be used in general as the measurement attribute for financial liabilities that are neither derivatives nor held-for-trading;

(b) embedded derivatives of hybrid financial liabilities should be separated from the host contract and accounted for at fair value through profit or loss;

(c) there should be an option that allows for consistent measurement and recognition for financial assets and financial liabilities, in order to best reflect the links existing between those assets and liabilities.

46 EFRAG believes that, when financial liabilities are designated under the fair value option, fair value changes due to changes in an entity's own credit risk should not be recognised in profit or loss. We think that the ultimate test of what is the appropriate accounting treatment is whether the approach provides users with the most useful information. Users tell us that reporting changes in own-credit is not useful information; indeed, if the effects of changes in own credit risk are reflected in the subsequent measurement of liabilities, users will generally adjust the financial statements to remove those effects if the amounts are material.

47 In addition, we consider that it is counter-intuitive, potentially misleading and confusing to recognise gains from the deterioration of an entity's financial situation.

48 However, in extremely rare circumstances where the fair value changes of financial assets are directly linked to an issuer's own credit risk, the effects of changes in the credit risk of the liability should be recognised in profit or loss if this reduces an existing accounting mismatch.

49 In our view changes in fair value attributable to changes in the entity's own credit risk should be gross of changes in the price of credit, for the following reasons:

(a) we have concerns about the relevance of the amount that results from isolating the entity's specific credit spread. In fact, we understand that when concerns were raised on the misleading representation of profits resulting from deterioration in the credit quality of an entity, reference was made to changes in the overall credit spread applied to the entity's debt;

(b) separating the two components (changes of price of credit and changes in the entity's specific credit spread) introduces additional complexity, relies on non-observable inputs and requires significant management judgement. For example, in recent market turbulences, credit spreads often reflect the market perception of a systemic risk rather than entity specific elements, making more difficult to isolate the entity specific elements;

50 With reference to the methodology applied to measure the changes in fair value attributable to changes in the entity's own credit risk, we believe that an entity should be allowed to adopt methodologies that provide a faithful representation. The FASB should not prescribe the use of a single predefined methodology.

CREDIT IMPAIRMENT

Question 37

Do you believe that the objective of the credit impairment model in this proposed Update is clear? If not, what objective would you propose and why?

Question 38

The proposed guidance would require an entity to recognize a credit impairment immediately in net income when the entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s). The IASB Exposure Draft, Financial Instruments Amortised Cost and Impairment (Exposure Draft on impairment), would require an entity to forecast credit losses upon acquisition and allocate a portion of the initially expected credit losses to each reporting period as a reduction in interest income by using the effective interest rate method. Thus, initially expected credit losses would be recorded over the life of the financial asset as a reduction in interest income. If an entity revises its estimate of cash flows, the entity would adjust the carrying amount (amortized cost) of the financial asset and immediately recognize the amount of the adjustment in net income as an impairment gain or loss. Do you believe that an entity should immediately recognize a credit impairment in net income when an entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s) as proposed in this Update, or do you believe that an entity should recognize initially expected credit losses over the life of the financial instrument as a reduction in interest income, as proposed in the IASB Exposure Draft on impairment?

Response to Questions 37 and 38

51 We expressed our detailed views on amortised cost, impairment and interest recognition in EFRAG's Comment Letter to the *IASB Exposure Draft, Financial Instruments: Amortised Cost and impairment*, issued on 29 June 2010. We make reference to the details of our position as presented in that letter and summarise below our key observations.

52 We support the directions of the IASB impairment model, in preference to the FASB impairment model.

53 However, we believe that IASB and FASB models are not directly comparable. The FASB's objective is to establish a model for recognition and measurement of credit impairment of financial assets measured at fair value with qualifying changes in fair value recognised in other comprehensive income. Given that the fair value of financial assets will be the primary basis for reporting the entity's financial position, the FASB's impairment model is primarily focused on the allocation of impairment losses from other comprehensive income to profit or loss.

54 A key element of the FASB's proposals is that it does not differentiate between initially expected credit losses and changes in estimates of cash flows (relating to credit) over the life of the financial asset. Under the proposals in the exposure draft, an entity recognises a credit impairment immediately in profit or loss when the entity does not expect to collect all contractual amounts for originated financial assets and all amounts originally expected to be collected for purchased financial assets. This approach differs from the IASB's proposals on credit impairment which differentiates between credit losses expected on initial recognition and subsequent changes in estimated cash flow relating to future credit losses.

55 In EFRAG's view, this means that under the FASB's proposals, a change in expectations about the collectability of cash flows due to credit impairment will impact profit or loss in the period of that estimate. This would be the case even on initial recognition.

56 EFRAG does not agree that credit losses should be recognised on initial recognition when the entity believes that it will not recover all the contractual cash flows (or initially expected cash flows for purchased assets).

57 EFRAG is supportive of a credit impairment model that is based on estimates of expected cash flows (both principal and interest) that eliminates the need for an incurred loss trigger, including the elimination of a 'probability threshold.' Additionally, we believe that forward-looking information on credit losses should be considered when estimating the collectability of cash flows of financial assets. We think this is decision-useful because it enables entities to reflect, on a timely basis, a greater range of information about the credit quality of financial assets in the financial statements.

58 We support the general principles of the IASB's proposal of a revenue recognition model that reflects the initial assessment of credit risk, thus allocating initially expected credit losses over the life of the asset, for the following reasons:

(a) the resulting pattern of interest income reduced by initially expected credit losses provides useful information about the effective return on a financial asset. The resulting delay in interest revenue recognition resulting from the spread of initial expected credit losses reflects that some of the interest revenue is paid in compensation for future expected credit losses.

(b) The resulting revenue recognition would improve consistency between pricing (or purchase consideration) on initial recognition (with credit risk reflected implicitly or explicitly in an instrument's contractual interest rate) and its ongoing measurement. It also addresses the systematic overstatement of revenue under the incurred loss model in the periods before credit losses were incurred.

59 Unlike the IASB proposal to recognise the effects of changes in estimate in the period of re-estimate, EFRAG believes that gains and losses, resulting from subsequent changes in the estimate of future credit losses for a forward looking approach to impairment, should be recognised in the period of the re-estimate, to the extent that the change relates to current or prior periods. We believe that changes in estimates of future cash flows should not be recognised immediately in profit or loss, since they relate partially to future periods. However, as discussed in paragraph 69 below, we note that there are certain practical considerations in making such an approach operational.

Question 39

Do you agree that credit impairment should not result from a decline in cash flows expected to be collected due to changes in foreign exchange rates, changes in expected prepayments, or changes in a variable interest rate? If not, why?

Response to Question 39

60 We believe that changes in estimates of cash flows due to prepayments, foreign exchange rates and changes in interest rates should be in general excluded from an assessment of 'credit impairment,' as far as they do not trigger any credit impairment. For example, considering a loan denominated in foreign currency, gains and losses from translation into the entity's functional currency should be excluded from impairment, but if the change in foreign exchange rate is such that the capacity of the borrower to fulfil its obligation is affected, this circumstance should result in credit impairment.

61 Credit impairment shown separately from other changes in expected cash flows provides useful information about the quality of a financial asset and the debtor's ability to perform under contractual terms. Value changes such as those resulting from foreign exchange, changes in interest rates and prepayments are due to the existing contractual terms and are therefore different in nature to credit impairments and should be shown separately.

62 When and how changes in expected cash flows arising from changes in expectations of prepayments, foreign exchange and interest rates impact profit or loss, depends heavily on the measurement model adopted for the underlying asset. For financial assets held at amortised cost (per the IASB model), EFRAG believes that the reported measure of the financial asset should reflect any kind of revision for the expected cash flows, including, where appropriate, a change in the prepayment level compared to what was initially estimated, changes in foreign exchange and variable interest rates. However, we consider it important to differentiate between changes in estimates that relate to changes in the credit quality of the asset (i.e. the ability of the debtor to perform its obligations) and other changes in value. Therefore, we support the IASB's proposals to separately present gains and losses as a result of changes in estimates of future credit losses from changes in cash flows resulting from other factors (e.g. prepayments). We believe that changes in exchange rates should not result in impairment but in foreign exchange gain or losses that should be recognised in accordance with the relevant standard.

63 In addition, changes in variable interest rates should not result in impairments or adjustments to the carrying amount of floating rate financial assets measured at amortised cost.

CREDIT IMPAIRMENT AND INTEREST INCOME RECOGNITION

Question 41

Do you agree that if an entity subsequently expects to collect more cash flows than originally expected to be collected for a purchased financial asset, the entity should recognize no immediate gain in net income but should adjust the effective interest rate so that the additional cash flows are recognized as an increase in interest income over the remaining life of the financial asset? If not, why?

Question 48

The proposed guidance would require interest income to be calculated for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income by applying the effective interest rate to the amortized cost balance net of any allowance for credit losses. Do you believe that the recognition of interest income should be affected by the recognition or reversal of credit impairments? If not, why?

Question 53

The method of recognizing interest income will result in the allowance for credit impairments presented in the statement of financial position not equalling cumulative credit impairments recognized in net income because a portion of the allowance will reflect the excess of the amount of interest contractually due over interest income recognized. Do you believe that this is understandable and will provide decision-useful information? If yes, how will the information provided be used? If not, why?

Question 54

The proposed guidance would require interest income to be calculated for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income by applying the effective interest rate to the amortized cost balance net of any allowance for credit losses. Thus, the recognition of a credit loss would result in a decrease in interest income recognized. Similarly, a reversal of a previously recognized credit loss would increase the amount of interest income recognized. The IASB Exposure Draft on Impairment proposes that an entity calculate interest by multiplying the effective rate established at initial recognition by the amortized cost basis. The IASB's definition of amortized cost basis is the present value of expected future cash flows discounted by the effective interest rate established at initial recognition and, therefore, includes credit losses recognized to date. Thus, as initially expected credit losses are allocated over the life of the instrument, the amount of interest income decreases. Both the FASB's and the IASB's models for interest income recognition are similar in that the recognition of an impairment reduces the amount of interest income recognized. However, as noted in the questions above, the timing of credit impairments and the determination of the effective interest rate differ in the two proposed models. Thus, the amount of interest income recognized under the two proposed models will differ. Do you believe that the FASB's model or the IASB's model provides more decision-useful information? Why?

Question 55

Do you agree that an entity should cease accruing interest on a financial asset measured at fair value with qualifying changes in fair value recognized in other comprehensive income if the entity's expectations about cash flows expected to be collected indicate that the overall yield on the financial asset will be negative? If not, why?

Response to Questions 41, 48, 53, 54 and 55

64 The response below addresses questions 41, 48, 53, 54 and 55.

65 In their effort to develop a converged proposal on accounting for financial instruments, we would encourage the FASB to work with the IASB with a particular focus on impairment and interest income recognition. This is in fact a key component of a converged approach for financial instruments. The aim of the joint effort of the two Boards should be to ensure global comparability of book values and interest recognition, resulting from the application of the amortised cost measurement.

66 We agree with the IASB's proposals that initially expected credit losses should be allocated over the life of the financial asset. Nevertheless, EFRAG is concerned with the use of the effective interest rate for the allocation of initially expected credit losses over the life of the financial asset. In particular:

(a) estimating the timing and amount of initially expected credit losses is very difficult at the individual financial asset level and generally becomes more reliable at the portfolio level;

(b) contractual interest and credit risk are generally managed separately. We understand from constituents that these factors may make the allocation of initially expected credit losses estimated at the portfolio level, using the effective interest estimated at the individual asset (or for closed portfolio level) impractical;

(c) allocation of the initially expected credit losses using the effective interest rate can be operationally burdensome. We would be supportive of approaches that approximate the allocation profile achieved by the proposals in the IASB *Exposure Draft Financial Instruments: Amortised Cost and Impairment*, but which 'decouple' the effective interest rate calculation from the allocation of initially expected losses;

(d) as highlighted by the IASB's Expert Advisory Panel, operational difficulties arise because financial institutions and others typically store comprehensive contractual and accounting data (in particular effective interest rate data) and expected losses data information in separate systems ('accounting' and 'risk' systems).

<u>Accounting for changes in cash flow estimates</u>

67 With reference to accounting for changes in estimates, EFRAG disagrees with both the FASB and IASB proposals to recognise the effects of changes in estimates in profit or loss in the period of re-estimate. As explained in our Comment Letter on the IASB Exposure Draft*, Financial Instruments: Amortised*

Cost and Impairment, issued on 29 June 2010, EFRAG would support an impairment model that:

(a) provides for recognition of changes in estimated future cash flows in those future periods, rather than in the period of the re-estimate. In this way, changes in estimates would be reflected in such a manner that the carrying amount of the financial asset represents credit losses that relate to periods up until the reporting date;

(b) provides for allocation of changes in expected future cash flows over the remaining life of the financial asset, to the extent that the net interest margin is sufficient to absorb that allocation;

(c) provides that, if the change in estimate allocation is not compensated by the future net interest margin (i.e. it is, in effect, onerous), the non-compensated portion of the gain or loss is recognised in the period of the re-estimate. As a result, the statement of financial position would represent a current assessment of future cash flows based on current and future credit conditions.

68 EFRAG acknowledges that in the context of an expected credit losses model (i.e. requiring to spread initially expected credit losses over the life of the financial asset), it would also be possible to recognise a gain without having recognised a loss in profit or loss, as a result of a change in estimate in the past. EFRAG would support a neutral model, requiring the treatment of favourable and adverse changes in expected cash flows to be symmetrical. For example, spreading the effect of favourable changes in estimates, whilst recognising adverse changes in profit or loss, immediately would result in a biased model.

69 We recognise that a model with the characteristics presented in the above two paragraphs might result in operational complexities similar to those that might occur under the model proposed by IASB in its Exposure Draft. Therefore, we are supportive of the work the IASB is doing with the Expert Advisory Panel with the aim of developing a less complex and more operational expected loss model for impairment.

<u>Interest income recognition</u>

70 Since the interest margin (before credit losses) is a key indicator for users of financial statements of financial institutions, EFRAG is supportive of an effective return approach to amortised cost and interest income recognition that would provide the allocation of initially expected credit losses over the life of the financial asset, while requiring a separate allocation of both interest revenue (fees, points received, transaction costs and other premiums and discounts) and initially expected credit losses.

71 We disagree with the approach proposed by the FASB for interest income recognition, i.e. requiring the application of the effective interest rate (excluding credit losses) to the amortised cost less cumulative credit allowance, for the following reasons:

(a) we believe that this approach would result in bringing subjectivity (due to the measurement of credit allowance) into the reported interest income for financial assets;

(b) we have concerns about the relevance of a credit allowance that does not reflect the amount of net cumulative impairments accounted for in profit and loss;

(c) the proposed approach would result in mixing the effects of interest recognition with reversals of impairment losses.

72 EFRAG would support a method for interest income recognition that would separately identify interest revenues (i.e. fees, points received, transaction costs and other premiums and discounts) from credit losses, also for financial assets with a negative yield (i.e. with cumulative past and expected cash inflows lower than initial outflow). We are concerned about the introduction of specific recognition rules to be applied only in certain circumstances.

Questions for users

Question 43 The credit impairment model in this proposed Update would remove the probable threshold. Thus, an entity would no longer wait until a credit loss is probable to recognize a credit impairment. An entity would be required to recognize a credit impairment immediately in net income when an entity does not expect to collect all of the contractual cash flows (or, for purchased financial assets, the amount originally expected). This will result in credit impairments being recognized earlier than they are under existing U.S. GAAP. Do you believe that removing the probable threshold so that credit impairments are recognized earlier provides more decision-useful information?
Question 44 The proposed guidance would require that in determining whether a credit impairment exists, an entity consider all available information relating to past events and existing conditions and their implications for the collectibility of the cash flows attributable to the financial asset(s) at the date of the financial statements. An entity would assume that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset(s) and would not forecast future events or economic conditions that did not exist at the reporting date. In contrast, the IASB Exposure Draft on impairment proposes an expected loss approach and would require an entity to estimate credit losses on the basis of probability-weighted possible outcomes. Do you agree that an entity should assume that economic conditions existing at the reporting date would remain unchanged in determining whether a credit impairment exists, or do you believe that an expected loss approach that would include forecasting future events or economic conditions that did not exist at the end of the reporting period would provide more decision-useful information?

Questions for preparers and auditors

Question 46 [...] Do you agree that an entity should assume that economic conditions existing at the reporting date would remain unchanged in determining whether a credit impairment exists, or do you believe that an expected loss approach that would include forecasting future events or economic conditions that did not exist at the end of the reporting period would be more appropriate? Are both methods operational? If not, why?

Response to Questions 43, 44 and 46

73 The incurred loss model for credit impairment has been criticised and the need to identify a trigger event for impairment recognition has been seen as a factor contributing to the late recognition of credit losses in the recent global financial crisis. EFRAG supports the development of an alternative to the incurred loss impairment model for financial assets that uses more forward-looking information about credit losses and aims to eliminate the delay in recognition of credit losses. In particular, EFRAG agrees that the probability threshold for the recognition of an impairment loss should be eliminated, allowing in this way earlier recognition of impairments.

74 EFRAG is supportive of an expected loss approach for measuring impairment and agrees that expected cash flows used for measuring the financial assets at amortised cost should reflect not only past and existing conditions but all the existing information about expected future developments. EFRAG supports the inclusion of forecasts for future events or economic conditions as a way for reflecting more forward-looking information in the measurement of credit losses for financial assets. We think this would result in more relevant information, because it enables entities to reflect, on a timely basis, a greater range of information about the credit quality of financial assets in their reported measurement.

75 In addition, we consider that requiring an entity to isolate credit information that relates to past and existing trends, from that which relates to forecasts of future developments, adds complexity and judgement to the estimation process that could result in reduced comparability.

Question 50

The proposed guidance would permit, but would not require, separate presentation of interest income on the statement of comprehensive income for financial assets measured at fair value with all changes in fair value recognized in net income. If an entity chooses to present separately interest income for those financial assets, the proposed guidance does not specify a particular method for determining the amount of interest income to be recognized on the face of the statement of comprehensive income. Do you believe that the interest income recognition guidance should be the same for all financial assets?

Interest Income – Questions for users

Question 52

Do you believe that the method for recognizing interest income on financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?

Response to Questions 50 and 52

76 As mentioned in the response to Questions 41, 48, 53, 54 and 55, EFRAG would support a method for interest income recognition that would separately identify

interest revenues (i.e. fees, points received, transaction costs and other premiums and discounts) from credit impairment losses.

77 Given the importance that the interest margin has for users, particularly for those interested in financial institutions, we believe that a consistent methodology for interest recognition should apply to all financial instruments, regardless of the classification in fair value through profit or loss or amortised cost measurement categories.

78 We do not support the proposal to require a separate presentation of interest income or expenses for financial instruments measured at fair value through profit or loss, since we believe that changes in fair value capture all the relevant information for financial instruments held-for-trading purposes.

HEDGE ACCOUNTING

Questions for all respondents

Question 56
Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?

Response to Question 56

79 EFRAG supports the objective of simplifying hedge accounting in a way that appropriately reflects how risk is managed by an entity.

80 EFRAG recognises that the overall classification and measurement framework for financial instruments set out in the FASB Exposure Draft is fundamentally different from that in the IASB proposals and therefore the application of the hedge accounting provisions would be different.

81 Nevertheless, EFRAG is supportive of a simplification of existing guidance for hedge effectiveness and for the removal of a quantitative assessment of hedge effectiveness. EFRAG therefore supports the adoption of qualitative criteria to assess effectiveness, as this would help reduce complexity in applying the hedge accounting rules.

Question 57 Should no effectiveness evaluation be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term? Why or why not?
Question 58 Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? Why or why not?

Response to Questions 57 and 58

82 As explained above, EFRAG would encourage a simplification of the existing requirements for hedge accounting that reflects an entity's risk management activities.

83 Nevertheless, we are not convinced that the FASB's proposals would result in substantial simplification. In fact, although the effectiveness test would be performed only at inception and only in certain circumstances thereafter, the underlying accounting model would still require an entity to recognise the impact of ineffectiveness in profit or loss. For this reason, an entity would still need to measure at each reporting date the changes in fair value of the derivative, the changes in the fair value of the hedged item attributable to the hedged risk and the ineffectiveness that occurred in the period.

84 In addition, should this proposal be adopted, detailed implementation guidance would be needed to identify appropriately those circumstances that evidence ineffectiveness, in order to ensure comparability between entities.

Hedge Accounting – Questions for users

Question 59

Do you believe that a hedge accounting model that recognizes in net income changes in the fair value and changes in the cash flows of the risk being hedged along with changes in fair value of the hedging instrument provides decision-useful information? If yes, how would that information be used? If not, why?

Response to Question 59

85 EFRAG accepts that requiring a symmetrical recognition of ineffectiveness, arising from the cumulative changes in fair value from the hedged item being either higher or lower than cumulative changes in fair value from the hedging instrument, could be seen as a simplification of accounting treatment for cash flow hedges.

86 Nevertheless, EFRAG does not agree with the proposed requirement and believes that, in a cash flows hedge, ineffectiveness due to cumulative changes in fair value of the hedged item being in excess of those from the hedging instrument (i.e. underhedging) should not be recognised as this avoids recognition of gains and losses on transactions that do not yet exist (i.e. highly probable forecast transactions).

APPENDIX 2

Comment letters issued by EFRAG on accounting for financial instruments

EFRAG Comment Letter on the *IASB Exposure Draft, Fair Value Option for Financial Liabilities*, issued on 17 July 2010

EFRAG Comment Letter on the *IASB Exposure Draft, Financial Instruments: Amortised Cost and Impairment*, issued on 29 June 2010

EFRAG Comment Letter on the *IASB Exposure Draft, Financial Instruments: Classification and Measurement*, issued on 21 September 2009

EFRAG Comment Letter on the *IASB Discussion Paper, Reducing Complexity in Reporting Financial Instruments*, issued on 30 September 2008