



14 September 2010

Our ref: ICAEW Rep 92/10

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Chère Mme Flores

FASB Exposure Draft *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*

1. The ICAEW welcomes the opportunity to comment on EFRAG's draft comment letter, published in June 2010, on the FASB's Proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. The views expressed in this response reflect our working party's current discussions and may be subject to further development before we make our final submission to the IASB.
2. The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

MAIN POINTS

IFRS 9 is a better basis for the development of a converged standard

3. We agree with EFRAG that IFRS 9 *Financial Instruments* provides a better basis for the development of a converged standard. While there may be minor improvements needed to IFRS 9 as entities gain experience in implementation, we would not support significant changes being made by the IASB to facilitate convergence. We also agree with EFRAG that the fair value measurement model contained in the Proposed Accounting Standards Update (ASU), which does not appear to provide more relevant or reliable information or to pass any reasonable cost-benefit test, is not consistent with a high quality accounting standard. We discourage the IASB from considering that similar information to the ASU can be provided by additional disclosure requirements. In our view, disclosures that serve to reconcile the two

approaches would result in essentially requiring both fair value and amortised cost data to be held for financial instruments where amortised cost provides the more relevant information. This would raise similar practical and cost-benefit concerns to the proposals in the ASU. IFRS 7 contains sufficient disclosure requirements for fair value information.

Substantial reform to existing IFRS 9 requirements is not necessary

4. We agree with EFRAG's support for the elements of the approach in IFRS 9 not with the list of ideas for incorporation into a converged standard. We support the balance between the characteristics of the instrument and the business model as set out in IFRS 9. The IASB's approach for financial assets does not perpetuate the rules for embedded derivatives, which we consider to be an important reduction in complexity. While we agree that the IASB and FASB need to develop a principles basis for OCI which will determine what is recognised in OCI and when and whether recycling is required, this is a wider issue than financial instruments. In the absence of a suitable methodology for impairment of equity securities, we can accept the approach in IFRS 9 which does not include recycling on disposal. We support the fair value option and consider that this is sufficient to address accounting mismatches. We believe that, ideally, the final standard for financial instruments should use consistent principles, language and concepts as far as possible for assets and liabilities and that it should be possible to develop a bifurcation approach for liabilities based on the characteristics of the financial asset notion in IFRS 9. Nevertheless, we consider the approaches developed by the IASB so far to be more acceptable than those in the ASU and do not believe that substantial changes should be made to IFRS 9.

Classification criteria should reflect the way the business is managed and the nature of the instrument

5. We agree with EFRAG that the measurement basis should be determined by reference to the characteristics of the instrument in question and the entity's business model. In our view, where amortised cost provides more useful information, amortised cost should be used in both net income and in the statement of financial position. Measuring items at fair value in the statement of financial position but at amortised cost in net income is complex to prepare and to understand and, therefore, seems unlikely to meet any reasonable cost-benefit test. In addition such an approach would result in less useful information in the statement of financial position and perpetuate the use of Other Comprehensive Income (OCI) as a "dumping ground" and result in the recycling of additional gains and losses without a clear conceptual basis. The meaning and, therefore, the information value of the fair value movements recognised in OCI is not clear. Also, we note that the concept of "realised gains and losses" may not be applied consistently in different jurisdictions and, therefore, may not provide a suitable basis for determining when items should be recycled.

Financial instruments should be reclassified if there is a change in the business model

6. We support the requirements in IFRS 9 that financial instruments must be reclassified if there is a change in the business model, with appropriate disclosure. If reclassifications are not required, financial instruments would be reported in a way that does not reflect the business model and, as a result, is inconsistent with the principles of the financial reporting standard. The ASU does not permit reclassification if there is a change in business model. FASB is concerned that if reclassifications were allowed, an entity may manage earnings by "selling winners and holding losers." We do not support this analysis. We believe the approach in the ASU actually encourages such earnings management. With recycling, this is exactly what could happen; entities will be encouraged to sell FV-OCI items with unrealised gains and discouraged from selling FV-OCI items with unrealised losses.

Primary financial statements should reflect one measurement attribute only

7. We agree with EFRAG that only a single measurement attribute should be reflected in the primary statements. However, we believe that EFRAG's point would be strengthened were it to also caution over the significant operational issues connected with recording both measurement bases. In order to provide a reconciliation of amortised cost to fair value on the face of the statement of financial performance and facilitate the recycling of realised gains and losses from OCI to profit or loss, entities would essentially have to maintain both amortised cost and fair value accounting data, including movements over time, for all financial instruments where amortised cost provides the more relevant information. The difficulties and complexity of producing and controlling all this data should not be underestimated. The proposed increased volume of information on the face of the statement of financial position, driven by the number of measurement options that are available in the ASU will make it more difficult for users to understand all the information presented. Fair value information can be more understandably presented in the notes.

Impairment

8. We do agree with EFRAG and with many other commentators, including the Financial Crisis Advisory Group and the Basel Accounting Task Force, that accounting standard setters should explore incorporating a broader range of available credit information, including more forward looking information, in determining loan loss allowances, to allow an earlier identification of credit losses. We are not convinced that the IASB's model as set out in its exposure draft, *Financial Instruments: Amortised Cost and Impairment*, is the best way of improving existing practice in terms of relevance, reliability and understandability of the information it provides. Nevertheless, we remain of the view that the IASB, together with the Expert Advisory Panel, will be able to build on some of the concepts underlying the exposure draft to develop a model that is operational. Therefore we support the thrust of EFRAG's comments on impairment.
9. While there may be merits in the FASB approach to impairment, which is less prescriptive and potentially more operational, we agree that there are conceptual concerns, particularly with the recognition of all expected losses immediately based on current economic conditions and the requirement for there to be an actual change in current economic conditions before there can be a change in the recognised losses. However, we are not convinced that forecasts of the future should be used to determine impairment without some guidance about how these are evidenced. We are concerned that the language used by EFRAG; 'all existing information', does not acknowledge the varying quality and validity of different sources. It is important that estimates are based upon reliable information.

Extending fair value for liabilities increases recognition of the effects of own credit risk

10. We agree with EFRAG's highlighting of own-credit as an example of the problems in extending fair value to liabilities which are not held for trading. We are concerned that requiring fair value to be used for financial liabilities where amortised cost is the more relevant measure increases the amount of fair value movements recognised relating to changes in an entity's own credit. As the IASB confirmed during the outreach for its deliberations on the fair value option for liabilities, there is general agreement amongst the entire constituency, that presenting gains and losses arising from changes relating to the entity's own credit risk in profit or loss is counterintuitive and undermines the usefulness of net income. The operation of paragraph 21 of the ASU would result in fair value movements relating to own credit being included in profit or loss where the financial liability has an embedded derivative. We do not believe that presenting fair value movements related to own credit in a separate line item in net income adequately addresses these concerns and would encourage non-GAAP measures. It would also result in additional financial liabilities being measured at fair value with fair value movements included in OCI, which could undermine the usefulness of reported equity in the statement of financial position.

OTHER MATTERS

Equity method of accounting for investments in associates

- 11.** We agree with EFRAG's opposition to the proposed changes to the conditions for applying the equity method of accounting in the ASU. Having significant influence seems sufficient and necessary to distinguish the investment from others where fair value is the more relevant measurement. We would not support similar changes being made to IFRS.

Core deposits

- 12.** Like EFRAG we do not support the approach to core deposits in the ASU and do not think it has conceptual merit. We do not support the introduction of another measurement basis, which would be inconsistent with the aim of reducing complexity and agree with EFRAG's concerns about introducing the recognition of intangible assets and the hypothetical nature and subjectivity of the measurement, particularly as there is certainty about the amount that will ultimately be repaid.

Hedge accounting

- 13.** We agree with EFRAG's response to question 56, supporting the simplification of hedge accounting. Like EFRAG, we believe that the ASU does achieve simplification through its adoption of a qualitative assessment for hedge effectiveness. We also believe that the ASU's presumption of reasonable effectiveness is a useful simplification.
- 14.** However, we note that for cash flow hedges under IAS 39, only ineffectiveness due to excess cash flows on the hedging instrument (that is, the derivative) is recognised in profit or loss. We support this approach because it prevents non-existent gains or losses being recognised and suggest that this is maintained in future hedge requirements under IFRS. Consequently, we do not support the proposal in the ASU to change the basis of recognition of ineffectiveness for cash flow hedges to recognise both over and under hedging. We also support IAS 39's position on macro hedging. We believe that recognising that entities may hedge portfolios rather than engage in one-to-one hedging strategies, better reflects risk management policies. Similarly, we do not support the approach in the ASU which attempts to restrict de-designation. This is inconsistent with dynamic hedging strategies and would result in significant operational complexity.

ANSWERS TO SPECIFIC QUESTIONS

Would you support efforts by the IASB in the directions specified in paragraphs 80-82 of the draft EFRAG response? If so, do you have any specific proposal to make?

- 15.** We do not agree with EFRAG's criticisms of the treatment of embedded derivatives under IFRS 9. The embedded derivative rules in IFRS and US GAAP are complex and aim to prevent abuse rather than to set clear principles. We support the approach taken in IFRS 9 to eliminate the bifurcation of embedded derivatives for financial assets and set principles for determining when the characteristics of the instrument as a whole are appropriate for amortised cost treatment. The ASU retains all the existing rules for embedded derivatives to differentiate between those financial assets and liabilities that are permitted to have fair value movements recognised in OCI and those required to have fair value movements recognised in net income. This approach is open to criticism because it would require the reporting of fair value movements through net income (FV-NI) for instruments where the embedded component is a relatively small part of the overall instrument. As noted above, it also results in more financial liabilities being measured at fair value through net income, which we consider is inappropriate.
- 16.** While we remain of the view that, ideally, the final standard for financial instruments should use consistent principles, language and concepts as far as possible for assets and liabilities and that it should be possible to develop a bifurcation approach for liabilities based on the characteristics of the financial asset notion in IFRS 9, we consider the approaches developed by the IASB so far to be more acceptable than those in the ASU.

Please contact me should you wish to discuss any of the points raised in this letter or the attached draft response.

Yours sincerely

A handwritten signature in black ink, appearing to read "J. Boulton". The signature is fluid and cursive, with a long horizontal stroke extending from the end.

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