DRAFT COMMENT LETTER

Comments should be submitted by 13 September 2010 to Commentletters@efrag.org **In particular, EFRAG would be grateful to receive answers to the question it raises in paragraph 82 of Appendix 1 to this Draft Comment Letter.**

XX Month 2010

Financial Accounting Standards Board
Attn. Technical Director, File Reference No. 1810-100,
401 Merritt 7
PO Box 5116
Norwalk
CT 06856-5116
USA

cc.: International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

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 in its capacity as adviser to the European Commission on endorsement of IFRSs for use in Europe.

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 for 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;
- 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
- changes in fair value of a financial liability attributable to an entity's own credit risk impacting profit or loss, when such liabilities are measured at fair value for the sole purpose of reducing accounting mismatches.

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.

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 better define the use and purpose of other comprehensive income.

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 fair value accounting for financial liabilities is elected in order to reduce accounting mismatches, fair value changes due to changes in an entity's own credit risk should not affect profit or loss. 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?

Notes for EFRAG's constituents

1 *The FASB Exposure Draft proposes loan commitments to be measured at fair value, except for loan commitments related to a revolving line of credit issued under a credit card arrangement, which are required to be measured according to Subtopic 310-20 'Non-refundable fees and other costs'[2]. As presented in Appendix B to the FASB Exposure Draft[3], for loan commitments in the scope of the proposals, potential lenders classify loan commitments in the same manner as the loan once funded was classified. If a loan measured at fair value with changes in fair value recognised in other comprehensive income is funded, accounting for the commitment fee would be a yield adjustment of the related loan. Potential borrowers and issuers of lines of credit issued as part of credit card arrangements would be excluded from the scope.*

2 *As explained in paragraph BC134 of the Exposure Draft, the Board considered implementation issues that could be encountered by issuers in measuring certain types of loan commitments at fair value. In particular, for practical reasons the scope exception was provided for lines of credit under credit card arrangements, considering the generally small balances of the associated credit card receivables, the revolving nature of these lines of credit, and the high volume of these lines of credit and related receivables. Therefore, credit card fees would continue to be accounted for under Subtopic 310-20.*

3 *Under IFRS, only some loan commitments are within the scope of IFRS 9 and IAS 39 (i.e., loan commitments that the entity designates as financial liabilities at fair value through profit or loss; loan commitments in presence of a past practice of selling the assets resulting from loan commitments shortly after the origination; loan commitments that can be settled net in cash or by delivering or issuing another financial instrument). For commitments within the scope, subsequent measurement would depend on the terms of the instrument and the entity's*

---

[2] Paragraph IG85 of the FASB Exposure Draft.

[3] IG 81-86 of the FASB Exposure Draft.

circumstances; for commitments outside the scope, provisions in IAS 37 shall be applied.

Response to Question 2

4 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.

5 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?

Notes for EFRAG's constituents

6 *Paragraph BC39 of the FASB Exposure Draft explains that investments in life insurance contracts should be excluded from the scope of the proposed guidance because the contracts have an insurance element; such contracts generally are purchased for funding purposes, for example, to fund deferred compensation agreements or postemployment death benefits, and the entity purchasing life insurance is either the owner or beneficiary of the contract. The FASB determined that it would be inappropriate to address policyholder accounting as part of this project.*

7 *According to paragraph BC40 of Exposure Draft, the FASB believes that life settlement contracts do not have a direct insurance element. These contracts do not involve an insurable interest, and the investor is not a policyholder. Therefore, the Board decided that life settlement contracts should be included in the scope of the proposed guidance.*

8 *IFRS 4 defines an insurance contract as "A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."*

Response to Question 3

9 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.

10 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?

Notes for EFRAG's constituents

11 *The FASB Exposure Draft is proposing to change the criteria for use of the equity method of accounting. As a result of the proposed change, in order to qualify for the application of the equity method, two conditions need to be met: (i) the investor needs to have significant influence over the investee and (ii) the operations of the investee need to be considered related to the investor's consolidated operations.*

12 *If only one of the two criteria is met, the investor shall account for the investment in the equity security at fair value with all changes in fair value recognised in profit or loss.*

13 *The FASB Exposure Draft presents factors to be considered in determining whether the activities of an investee are related to an entity's consolidated operations. These factors include the line of business in which they both operate, the level of transactions between the investee and the entity, and the extent to which management are common to both parties.*

14 *In addition, the FASB Exposure Draft is proposing to eliminate the option to measure at fair value investments in equity securities that qualify for the equity method of accounting. The application of the equity method would be a requirement if the two conditions described in the paragraph above are met and fair value option would be precluded.*

Response to Question 4

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

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

17 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?

Notes for EFRAG's constituents

18 *The response below addresses Questions 8, 9, 10 and 11.*

19 *The FASB Exposure Draft[4] requires financial instruments to be initially recognised at fair value if all subsequent changes in their fair value will be recognised in profit or loss. Those financial instruments with a qualifying portion of subsequent changes in fair value to be recognised in other comprehensive income (i.e., financial instrument for which the entity's business strategy is to hold for collection or payment of contractual cash flows) are initially measured at transaction price.*

20 *For financial instruments measured at fair value with changes in fair value recognised in profit or loss, transaction fees and costs would be recognised in profit or loss as expenses upon initial recognition. For financial instruments measured at fair value with changes in fair value recognised in other*

[4] The proposed guidance is addressed in paragraphs 12-17, IG7-IG9 and BC46-BC48 of the FASB Exposure Draft.

comprehensive income, transaction fees and costs would be deferred and recognised in profit or loss as a yield adjustment of the related financial instrument over the life of the instrument. These proposals are broadly similar to IFRS existing requirements. A financial asset (liability) is measured initially 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) (IFRS 9 paragraph 5.1.1 and IAS 39 paragraph 43).

21 *For financial instruments recognised at transaction price, if reliable evidence indicates that the transaction price differs significantly from the fair value, and the entity determines that the difference is at least partially due to the existence of elements (other than transaction fees and costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact) the entity shall initially measure the financial instrument at its fair value and shall account for any other element or elements in the transaction in accordance with their nature, recognising any asset or liability. If the entity cannot reasonably identify the other element involved in a transaction, the entity should recognise a Day 1 gain or loss in profit or loss.*

22 *Recognition of Day 1 profits is generally only possible under IFRS in respect of financial instruments that are measured using observable inputs. The requirements of paragraphs AG76 and AG76A of IAS 39, in effect, prohibit the recognition of Day 1 gains in respect of other financial instruments.*

Response to Questions 8, 9, 10 and 11

23 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?

Notes for EFRAG's constituents

24 *The response below addresses questions 13, 15 and 23.*

25 *As explained by the FASB in the Summary of the Exposure Draft, in the FASB's view*

> *"...a consistent measurement model for all financial instruments should improve both comparability across entities and consistency in how an entity accounts for different financial instruments. Many have said that there should be symmetry between the accounting for financial assets and the financial liabilities funding those assets. This may be particularly relevant for financial institutions as financial liabilities are incurred in order to support related financial asset activity. Asset-liability management is core to the business strategy and analysis of financial institutions. Changes in market variables affect valuations of both financial assets and financial liabilities. Accordingly, like financial assets in the proposed model, many financial liabilities of financial institutions would be measured at fair value (with amortised cost also being presented for certain financial liabilities)".*

26 *In addition, in paragraph BC8, FASB observes that*

> *"although accounting requirements were not the cause of the recent global financial crisis, the crisis highlighted particular issues with the present mixed-attribute measurement model for financial instruments. In brief, the present mixed-attribute measurement model sometimes provides inadequate information that an entity and its advisors and investors need to effectively assess risk. The present model relies too heavily on subjective classification of financial instruments that determines either or both their measurement attribute and how the resulting gains or losses are recognized".*

27 *In the Comment Letter to the FASB Exposure Draft Financial Instruments: Classification and Measurement, EFRAG expressed a preference for the mixed measurement model. In particular, the "IASB considered the possibility of introducing a single measurement category for all financial assets and financial liabilities but concluded, as paragraph BC13 explains, that measuring all financial assets and financial liabilities at fair value is not the most appropriate approach to improve the financial reporting for financial instruments. It is therefore proposing that a mixed measurement model be retained. We agree with this decision and reasoning."*

28 *In addition, in the Comment Letter to the Discussion Paper Reducing Complexity in Reporting Financial Instruments, EFRAG expressed the following view: "we think it is premature, and perhaps even inappropriate, to decide under current circumstances that the only appropriate measure for financial instruments is fair value and that any changes to IAS 39 should represent a step towards that objective."*

Response to Questions 13, 15 and 23

29 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.

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

31 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.

32 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.

33 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.

34 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.

35 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.

36 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.

37 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?

Notes for EFRAG's constituents

38 *The response below addresses questions 14 and 22*

39 *The FASB Exposure Draft requires financial instruments that an entity, under its business strategy, holds for collection or payment(s) of contractual cash flows to be measured at fair value in its Statement of Financial Position, with changes in fair value in each period recognised in other comprehensive income. The FASB explains that in this way profit or loss will continue to reflect business strategy, since only changes arising from interest accruals, credit impairments, and realised gains and losses would be recognised in profit or loss each reporting period, while all other changes in fair value from these instruments would be recognised in other comprehensive income.*

40 *In paragraph BC100 of the FASB Exposure Draft, the FASB states that:*

> *"The Board believes that recognizing qualifying changes in fair value for financial instruments for which an entity's business strategy is to hold for collection or payment of contractual cash flows in other comprehensive income also would enable entities to preserve most of the traditional concept of net income (including net interest margin) and earnings per share. Also, the Board believes that (a) information about the realization of cash flows is important for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows and (b) amortized cost would provide information on current-period cash flow realizations in net income. The Board believes that the portion of the change in fair value that is recognized in other comprehensive income would provide additional information by indicating either (a) the gains or losses that may be realized if the financial instruments cannot be held to collection or payment(s) of contractual cash flows or (b) the amount of opportunity gain or loss if the financial instruments are held to collection or payment(s) of contractual cash flows. The fair value also would provide users with the best available information of the market's assessment of an entity's expectation of its future net cash flows, discounted to reflect both current interest rates and the market's assessment of the risk that the cash flows will not occur."*

41 *In paragraph BC58 of the Exposure Draft, the FASB states that:*

> *"... Also, the Board believes that fair value information would now likely be available at the time of earnings releases rather than only being disclosed later in the notes to the financial statements for public entities. ..."*

Response to Questions 14 and 22

42 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.

43 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.

44 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.

45 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.

46 The proposal to recognise in other comprehensive income (OCI) the fair value changes of financial instruments held for collection or payment of contractual cash flows would introduce volatility in equity that does not represent results of 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 remains to be 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. Before extending the use of OCI to 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.

47 Finally, 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.

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?

Notes for EFRAG's constituents

48 *As explained in paragraph BC105 of the FASB Exposure Draft, the FASB decided not to allow an entity the option to reclassify instruments between categories because:*

> *"The Board is concerned that if reclassifications were allowed, entities may measure financial instruments that they initially elected to measure at fair value with qualifying changes in fair value recognized in other comprehensive income at fair value with all changes in fair value recognized in net income to recognize gains in net income on appreciated financial assets for which an entity is not recognizing losses. The Board believes that if reclassifications are allowed, an entity may manage earnings by selling winners and holding loser. In addition, because the Board took a top-down approach to management's intentions for classification purposes, the Board believes that presenting realized gains and losses separately on the performance statement would be sufficient for users to evaluate management's financial instrument activities".*

49 *IFRS 9 requires that, if the entity's business model for managing a financial asset changes, that asset should be reclassified.*

Response to Question 16

50 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.

51 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?

Notes for EFRAG's constituents

52 *The response below addresses questions 17.*

53 *The proposed guidance is addressed in paragraphs 95-96, IG22-IG24, BC123 and BC248 of the Exposure Draft.*

54 *The proposals require core deposits to be measured at the present value of the average core deposit balances discounted over the average estimated life at a rate equal to the difference between the cost of next alternative available source of funding and the cost of providing services to the deposit holders.*

Response to Question 17

55 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.

56 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.

57 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 withdrawable 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?

Notes for EFRAG's constituents

58 *The FASB is proposing that a financial liability may be carried at amortised cost if:*

(a) *The liability meets the criteria for the measurement at fair value with changes in fair value recognised in other comprehensive income; and*

(b) *Measurement at fair value would create or exacerbate a measurement attribute mismatch between recognised assets and liabilities;*

(c) *This option is irrevocably made at the issuance of the financial liability.*

59 *IASB tentatively has decided to retain existing guidance for financial liabilities except for financial liabilities measured at fair value under the fair value option. IFRS currently measures most financial liabilities (including core deposit liabilities) at amortised cost if they are not held-for-trading.*

60 *The proposed guidance would provide an amortised cost option for qualifying financial liabilities, while IFRS provides a fair value option for qualifying financial liabilities.*

61 *As explained in paragraphs BC117-BC122 of the FASB Exposure Draft, the amortised cost option for financial liabilities was introduced to address many of the concerns raised about the volatility introduced in income from an asset-liability mismatch, for entities other than financial institutions, arising from measuring financial liabilities at fair value when significant nonfinancial assets are not measured at fair value. For the FASB Exposure Draft, a mismatch exists if:*

(a) *the financial liability is contractually linked to an asset not measured at fair value (a financial liability that is collateralised by an asset, or is contractually required to be settled upon the derecognition of an asset, is contractually linked to that respective asset); or*

(b) *the financial liability is issued by and recorded in, or evaluated by the chief operating decision maker as part of an operating segment for which less than 50 percent of the segment's recognised assets are subsequently measured at fair value; or*

(c) *the financial liability meets neither item (a) nor (b) but is the liability of a consolidated entity for which less than 50 percent of consolidated recognised assets are subsequently measured at fair value.*

However, the FASB notes that measurement attribute mismatches cannot be entirely avoided unless all assets and liabilities are recognised at fair value (including intangible assets that are currently unrecognised).

62 *It is worth noting that in paragraph BC249 of the Exposure Draft, two alternative views are reported: "Ms. Seidman and Mr. Smith believe the amortized cost exception provided in the proposed guidance for some financial liabilities lacks an underlying concept, is rules based in nature, and would not be operational. They fear it would become an albatross for the Board, requiring interpretation and causing compliance issues in practice. They would rather have a clear principle behind the classification of liabilities that is primarily driven by the variability of cash flows and the business model of the entity".*

Response to Question 18

63 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.

64 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.

65 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.

66 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.

67 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?

Notes for EFRAG's constituents

68 *The response below addresses questions 24 and 35.*

69 *The proposed guidance is addressed in paragraphs 86 and BC157-BC158 of the FASB Exposure Draft. The main argument in favour of this approach is summarised in paragraph BC157 as follows: "The Board believes that this would enable an entity to preserve the information available to users today, while also providing additional relevant information about the fair value of those instruments."*

Response to Questions 24 and 35

70 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.

71 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.

72 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.

73 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.

74 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?

Notes for EFRAG's constituents

75 *The response below addresses questions 25 and 26.*

76 *The FASB Exposure Draft retains the existing US GAAP guidance[5] for identification of embedded derivatives and requires hybrid financial instruments, that would otherwise have been required to be bifurcated under existing guidance, to be classified and measured in their entirety at fair value with changes in fair value recognised in profit or loss. Similarly, IFRS 9 has eliminated the separate accounting of embedded derivatives for financial assets, while the IASB tentatively decided to retain IAS 39 guidance for bifurcation of hybrid financial liabilities.*

77 *US GAAP and IAS 39 guidance for identification of embedded derivatives is broadly similar and provides for a separate accounting of embedded derivatives that present economic characteristics and risks not closely related to those of the host contract, although differences between the two standards may arise in practice in the determination of whether an embedded derivative is closely related.*

78 *The FASB Exposure Draft is proposing the following characteristics for identification of non-hybrid financial instruments eligible for amortised cost measurement[6]:*

(a) *debt instrument with a principal amount returned at maturity;*

(b) *no prepayment is contractually set such that the holder would not recover substantially all of the initial investment;*

(c) *business model of the entity is to hold the financial instrument for collection or payment of contractual cash flows.*

79 *With the due process for the IASB Exposure Draft, Fair Value Option for Financial Liabilities, the IASB will complete the classification and measurement phase of the IAS 39 replacement project. Based on the IASB Exposure Draft Fair Value Option for Financial Liabilities and the requirements of IFRS 9, the requirement for classification and measurement of financial assets and financial liabilities will be different.*

Response to Questions 25 and 26

80 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;

---

[5] Subtopic 815-15

[6] For such financial instruments the FASB Exposure Draft allows to recognise changes in fair value in other comprehensive income.

(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.

81 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.

82 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.

Question for EFRAG Constituents

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

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

83 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

84 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.

85 EFRAG believes that, when financial liabilities are measured at fair value in order to reduce accounting mismatches, 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.

86 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.

87 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;

88 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

Notes for EFRAG's constituents

89 *The FASB's proposed impairment model differs from both the incurred loss model (as per IAS 39) and expected loss model as proposed by the IASB in its Exposure Draft Financial Instruments: Amortised Cost and Impairment:*

(a) *unlike an incurred loss model, an entity does not wait until a credit loss is probable to recognise a credit impairment. Instead, it assesses at the financial reporting date the amount of cash flows expected to be collected for its financial assets, compared to the contractual amounts due (or, for purchased financial assets, the amount originally expected);*

(b) *unlike an expected loss model, an entity considers all available information relating to past events and existing conditions, but assumes that existing conditions would remain unchanged for the remaining life of the asset, without forecasting future events that do not exist at the reporting date. Instead, the IASB Exposure Draft on impairment proposes an expected loss approach that would require an entity to estimate credit losses on the basis of probability-weighted possible outcomes;*

(c) *unlike the IASB's expected loss model, all credit impairments would be recognised in the period in which they are estimated and initially expected credit losses would not be recognised at a constant rate over the life of the financial asset on the basis of expectations upon origination or acquisition.*

90 *EFRAG recently expressed its view on the same topic, in the 29 June 2010 Comment Letter on the Exposure Draft Financial Instruments: Amortised Cost and Impairment, the views expressed here reflect our comments to the IASB.*

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?

Notes for EFRAG's constituents

91 *The FASB states the following objective for impairment in the FASB Exposure Draft*

> *"the objective of the guidance related to credit impairment 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 recognized in other comprehensive income on the basis of an entity's expectations about the collectability of cash flows, including the determination of cash flows not expected to be collected. An entity's expectations about collectability of cash flows shall include all available information relating to past events and existing conditions but shall not consider potential future events beyond the reporting date."*

92 *As explained in paragraphs BC42 and BC43 of the IASB's Exposure Draft Financial Instruments: Amortised Cost and Impairment: "impairment is an integral part of amortised cost measurement". "Overall, because the proposed impairment approach is based on expected credit losses, the proposals would result in an expected cash flow approach to amortised cost measurement".*

93 *The application of the impairment model proposed by the FASB will be restricted upon election by the entity to certain short-term receivables measured in the statement of financial position at amortised cost and to debt instruments that are held for collection of contractual cash flows for which the entity elects to apply fair value in the statement of financial position (with changes in fair value recognised in other comprehensive income). In contrast, under the IASB proposals the expected cash flow approach to amortised cost represents the required approach for effective return recognition and statement of financial position measurement for financial instruments held for collection or payment of contractual cash flows.*

Response to Questions 37 and 38

94 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.

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

96 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.

97 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.

98 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.

99 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).

100 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.

101 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.

102 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.

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?

Notes for EFRAG's constituents

103 *The FASB Exposure Draft proposes that changes in cash flows expected to be collected that relate to changes in foreign exchange rates, changes in expected prepayments, or changes in a variable interest rate shall not in and of themselves give rise to a credit impairment. For financial assets with contractual interest rates that vary on the basis of subsequent changes in an index or rate estimates of cash flows expected to be collected in future periods shall be recalculated at each reporting date on the basis of the index or rate as it changes over the life of the financial asset. An entity shall not project changes in the index or rate for purposes of estimating cash flows expected to be collected. In some circumstances, it may be difficult to isolate the effect of a change in one specific component from the overall change in cash flows. When changes in expected cash flows due to variable rates or prepayments cannot be separated from the overall decline in expected cash flows, an entity shall account for the entire decline in cash flows expected to be collected as a credit impairment.*

104 *In its response to the IASB, Request for Information ('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach, EFRAG expressed the following view on Impairment of Variable Rate Instruments:*

"When a financial instrument becomes impaired, future interest cash flows are in effect treated as repayments of principal rather than interest revenue. Under the Expected Loss Model there are two possible approaches to treating this 'repayment of principal' to variable rate instruments:

(a) *Approach A: Recalculate the effective interest rate (based on the forward curve as updated from time to time) so that the still-expected future interest and principal receipts are discounted to the carrying amount; or*

(b) *Approach B: Keep the effective interest rate constant after impairment and treat changes in the carrying amount resulting from changes in variable benchmark interest rate as a 'catch-up', reflecting the fact that changes in cash flows more appropriately reflect repayments of principal rather than variable interest receipts."*

EFRAG supported Approach A, since Approach A recalculates the effective interest so that the still expected future interest receipts and the still expected principal receipts are discounted to the carrying amount. However, EFRAG also noted that, although a similar recalculation occurs under the current incurred loss model, these will increase in regularity and range of application across instruments under the Expected Loss Model and that will probably mean that Approach A is the more complex and costly of the two approaches for preparers to implement.

Response to Question 39

105 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.

106 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.

107 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.

108 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?

Notes for EFRAG's constituents

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

109 *The FASB Exposure Draft requires that, after the initial recognition of impairment in profit or loss, a subsequent impairment (or reversal of credit impairment) is measured and recognised in profit or loss based on changes in the present value of cash flows expected to be collected, compared to the previous estimate. The discount factor to be used for this exercise is the effective interest rate as measured at the date of origination or acquisition.*

110 *The above accounting treatment would apply to all the circumstances, except for purchased assets acquired at an amount that included a discount related to credit quality. For such assets, if the reassessment indicates an improvement in expected cash flows compared to the cash flows initially expected, the entity recalculates the effective interest rate based on revised expected cash flows and discounts the expected cash flows at the revised effective interest rate on a prospective basis.*

<u>Interest income recognition</u>

111 *For financial assets measured at fair value, with qualifying changes in fair value recognised in other comprehensive income, the FASB proposes that an amount of*

interest income should be recognised in profit or loss. This amount shall be determined by applying the financial asset's initial effective interest rate to the amortised cost balance, net of any allowance for credit losses. The FASB believes that this requirement would be successful in avoiding the recognition of interest income on the principal that is not expected to be collected. The requirement would remove a feature of the existing accounting treatment that, in the FASB's view, has contributed to the reporting of higher interest income in the earlier years on lower credit quality financial assets, even though an entity expects to have losses in the future on some portion of those assets.

112 *The FASB Exposure Draft requires that the difference between the amount of interest contractually due and the amount of interest receivable, accrued on the basis of the above accounting treatment, is recognised as an increase in the allowance for credit losses. If, as a result of this requirement, the cumulative allowance for credit losses would exceed the entity's estimate of future cash flows not expected to be collected, a reversal of impairment expense is recognised in profit or loss. This requirement would also result in cumulative credit impairments recognised in profit or losses not equalling the cumulative allowance for credit losses.*

113 *The FASB Exposure Draft requires*[7] *an entity to cease accruing interest income for a financial asset only if the expectations about cash flows expected to be collected indicate that the overall yield on the financial asset will be negative, that is the total cash flows expected to be collected are less than the original cash outflow for the financial asset.*

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

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

115 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.

116 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

[7] Paragraph 82 of the FASB Exposure Draft.

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>

117 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. Instead, EFRAG is supportive of 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.

118 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.

<u>Interest income recognition</u>

119 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.

120 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.

121 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?

Notes for EFRAGs constituents

122 *The FASB Exposure Draft requires that an entity assesses at the financial reporting date the amount of cash flows expected to be collected for its financial assets, compared with the contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected upon acquisition of purchased financial asset(s). An entity should not wait until a credit loss is probable to recognise a credit impairment.*

123 *The FASB decided*[8] *that the impairment model should not be based on a notion of incurred losses and a credit loss need not be deemed probable of occurring to recognise a credit impairment. The FASB explains that removing the probability threshold would result in an entity recognising credit impairments in profit or loss earlier, on the basis of its expectations about the collectability of cash flows rather than on a potentially arbitrary recognition threshold.*

124 *"The expected loss approach to impairment for financial assets eliminates the requirement for a 'trigger event' thus enabling entities to use a broader range of credit-related forward looking information and, where appropriate, recognise impairment losses on financial assets earlier."*

---

[8] As explained in paragraph BC174 of the FASB Exposure Draft.

125 *It should be noted that, as reported in paragraph BC175 of the Exposure Draft, the FASB believes that the proposed approach does not represent an 'Expected loss approach':*

> *"Under an expected loss approach, an entity would forecast expected cash flows over the life of a financial asset or pool of financial assets and would recognize credit impairment of its financial assets in net income on the basis of those expectations. The Board believes the model in the proposed guidance is different from an expected loss model because it would require an entity to consider the effects of past events and existing conditions in estimating the cash flows it expects to collect in future periods that make up the remaining life of its financial assets, but it would not permit an entity to forecast future events or economic conditions in developing those estimates as would occur in an expected loss model. In addition, the Board understands that the timing of recognition of credit impairments under an expected loss model would differ from the timing of recognition of credit impairments under the model in the proposed guidance. Under an expected loss model, the Board understands that an entity would recognize a constant rate of credit impairments through the life of the financial asset based on expectations about losses on the date of acquisition or origination, with any changes from initial expected credit impairments recognized in the period of the change. With respect to the timing of recognition, under the model in the proposed guidance, all credit impairments would be recognized in the period in which they are estimated, rather than being allocated and recognized at a constant rate over the life of the financial asset on the basis of expectations upon origination or acquisition. The Board decided not to pursue an expected loss model because the Board believes that oftentimes it would be difficult for an entity to accurately forecast expected cash flows through the life a financial asset on the basis of forecasted future events. The Board also believes that it would be inappropriate to allocate an impairment loss over the life of a financial asset".*

Response to Questions 43, 44 and 46

126 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.

127 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.

128 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

129 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.

130 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.

131 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?

Notes for EFRAG's constituents

132 *The FASB Exposure Draft*[9] *contains the following guidance on hedge effectiveness: "The qualifying criteria for designating a hedging relationship requires that the hedging relationship, at its inception and on an ongoing basis, is expected to be reasonably effective (rather than highly effective) in achieving offsetting changes in fair values or cash flows attributable to the hedged risk during the period of the hedging relationship. The risk management objective expected to be achieved by the hedging relationship and how the hedging instrument is expected to manage the risk or risks inherent in the hedged item or forecasted transaction shall be documented. For most relationships, compliance with the reasonably effective criterion is demonstrated by a qualitative (rather than quantitative) assessment that establishes that an economic relationship exists between the hedging instrument and either the hedged item in a fair value hedge or the hedged transaction in a cash flow hedge. A quantitative assessment is necessary if a qualitative assessment cannot establish compliance with the reasonably effective criterion."*

Response to Question 56

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

134 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.

135 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.

[9] Paragraph 113 of the FASB Exposure Draft

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?

Notes for EFRAG's constituents

136 *Paragraph 117 of the Exposure Draft proposes that, after inception of the hedging relationship, an entity reassesses effectiveness qualitatively (or quantitatively, if necessary), only if changes in circumstances suggest that the hedging relationship is no longer reasonably effective. As explained in paragraph BC218 of the Exposure Draft;*

> *"to provide for further simplification, the Board decided that, after inception of the hedging relationship, an entity would need to qualitatively (or quantitatively, if necessary) reassess effectiveness only if changes in circumstances suggest that the hedging relationship may no longer be reasonably effective. Thus, the need for reassessing effectiveness at least quarterly would be eliminated unless changes in circumstances suggest that a hedging relationship may no longer be reasonably effective. The Board believes that the costs of compliance would be reduced because an entity would not have to develop sophisticated quantitative statistical models to prove a hedging relationship is effective in situations in which it is obvious that a hedging relationship is effective. Users of financial statements also would be served by not having to deal with on-again, off-again hedge accounting for the same derivative and hedged item."*

Response to Questions 57 and 58

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

138 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 requirements to recognise the impact of ineffectiveness in net income would still be applicable. As a result, at each reporting date an entity would need to measure (i) the changes in fair value of the derivative, (ii) the changes in the fair value of the hedged item attributable to the hedged risk and (iii) the ineffectiveness that occurred in the period.

139 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?

Notes for EFRAG's constituents

140 *Under current guidance, paragraph 89 of IAS 39 requires for fair value hedges that:*

(a) *gain or losses from re-measuring the hedging instrument at fair value shall be recognised in profit or loss;*

(b) *gain or losses on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised in profit or loss.*

141 *Under current guidance, paragraphs 95 and 96 of IAS 39 require for cash flow hedges that:*

(a) *the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised in other comprehensive income; and*

(b) *the ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss. In particular, only ineffectiveness due to the derivative's change in fair value being greater than the change in the hedge item's fair value (i.e. overhedging) is recognised immediately in profit or loss.*

142 *The requirements presented in the two paragraphs above are similar to existing US GAAP. In particular, as explained in paragraph BC225 of the Exposure Draft, "Topic 815 requires ineffectiveness to be recognized in net income only when the cumulative change in fair value of the actual derivative exceeds the cumulative change in fair value of the hypothetical derivative (referred to as an overhedge). ... The basis for conclusions in Statement 133 states that the reason for not recognizing ineffectiveness on underhedges is that only ineffectiveness due to excess expected cash flows on the derivative should be reflected in net income, because otherwise a nonexistent gain or loss on the derivative would be deferred in other comprehensive income and recognized in net income."*

143 *As explained in paragraphs BC226 to BC228 of the Exposure Draft,*

"The proposed guidance would require that measurement of hedge ineffectiveness be based on a comparison of the change in fair value of the actual derivative designated as the hedging instrument and the present

> *value of the cumulative change in expected future cash flows of the hedged transaction. For example, that could be accomplished by comparing the change in fair value of the actual derivative and the change in fair value of a derivative that would mature on the date of the forecasted transaction and that would provide cash flows that would exactly offset the hedged cash flows. ... The primary objective of cash flow hedge accounting is to manage the timing of recognition in income of the gains and losses on a derivative instrument used to lock in or fix the price of a future transaction. ... However, locking in or fixing the price of the future transaction would occur only if an entity entered into a derivative that would mature on the date of the forecasted transaction and that would provide cash flows that would exactly offset the hedged cash flows. ... The Board believes that ineffectiveness should be recognized in net income if an entity enters into a derivative that would not mature on the date of the forecasted transaction and provide cash flows that would exactly offset the hedged cash flows (that is, not locking in or fixing the price). ... The Board believes that it is preferable to treat overhedges and underhedges consistently."*

Response to Question 59

144 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.

145 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).

146 Similarly, if cumulative changes in the fair value of the *hedged transaction* are greater than those of the *hedging instrument* because the entity is designating only a portion of the cash flows of the *hedged transaction* as a *hedged item*, one should not treat the unhedged part of a transaction as an underhedge.

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