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RE: FASB ED *Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*

The Committee of European Securities Regulators (CESR), through its standing committee on corporate reporting (CESR-Fin), has considered the FASB's Exposure Draft (ED) *Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*.

We thank you for the opportunity to comment on this ED and are pleased to provide you with the following comments.

CESR notes that the Group of Twenty (G20) called in its various reports on accounting standard-setters to work urgently to achieve a single set of high-quality global accounting standards. Consequently the FASB and IASB affirmed their commitment jointly to achieve convergence of IFRS and US GAAP. Nevertheless, the FASB exposure draft marks a significantly different approach to financial instruments accounting than the one taken by the IASB in IFRS 9 – *Financial Instruments: Classification and Measurement* as published in November 2009 and the proposed amendments set out in the various exposure drafts published since then as part of developing a new standard on financial instruments accounting.

CESR usually does not provide comments on exposure drafts prepared by national standard-setters. We however understand that the FASB ED forms part of the global convergence project of the IASB and the FASB. CESR is therefore commenting on the proposals in the FASB ED 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.



1. Convergence

CESR would have preferred that the IASB and the FASB follow the recommendation presented in the report of the Financial Crisis Advisory Group (FCAG) and of the G20 to work on joint comprehensive proposed amendments to financial instruments accounting. We think that the IASB and FASB should have opted for the same approach in an area as important as financial instruments – and that not only for convergence reasons.

The IASB has taken a phased approach to the development of the standard on the financial reporting of financial instruments (IFRS 9). This makes it difficult to compare the two proposals. CESR is nevertheless concerned that the FASB's proposals are significantly different from the approach followed by the IASB and that they will increase divergence in some areas.

CESR is highly supportive of convergence between IFRS and US GAAP. This should however not happen at the expense of the quality of financial reporting. We have therefore assessed the proposed amendments as set out in the FASB ED and believe that the IASB's approach is preferable in many areas and more specifically in connection with the mixed measurement model.

2. Classification and Measurement of Financial Instruments

As stated in our comment letter on the IASB's Exposure Draft on *Classification and Measurement on Financial Instruments*, CESR is supportive of the mixed measurement model proposed by the IASB.

Even if the model proposed by the FASB would reduce complexity given nearly all instruments will be classified at fair value, CESR agrees with the IASB that amortised cost provides decision-useful information for financial instruments with basic loans features that are managed on a contractual yield basis. Indeed, CESR acknowledges that there are a number of issues surrounding fair value which need to be addressed before such a measurement model could be adopted for all financial instruments.

CESR believes that consideration of the way financial instruments are managed (the so called *business model*) is relevant in preparing decision-useful financial information and thus for the classification of financial instruments. We believe that prominence should be given to this criterion.

CESR believes there could be some value to the IASB further considering whether bifurcation of a hybrid contract with a financial asset host would provide users with more decision-useful information. In its comment letter to the IASB on the ED *Classification and Measurement*, CESR expressed some doubts regarding the proposal to eliminate the requirements relating to the treatment of embedded derivatives as, even if it simplifies the accounting treatment, it might create some drawbacks (many types of convertible debt will be measured at fair value). In the ED *Fair value option for financial liabilities*, the IASB proposes to maintain the current rules provided by IAS 39 – *Financial Instruments: Recognition and Measurement* as far as bifurcation of embedded derivatives in liabilities is concerned.

CESR has some sympathy to study further the bifurcation requirements for embedded derivatives. Hence, CESR is not convinced by the FASB's proposal to forbid any bifurcation for embedded derivatives (for both financial assets and financial liabilities).

When commenting on the IASB's proposed amendments CESR expressed a view against the prohibition of reclassification. Indeed, a reclassification seems relevant (in strictly limited circumstances) when the conditions for classification that were met at inception of the instrument are subsequently no longer met. Furthermore, reclassifications should only be allowed prospectively and should be accompanied with robust disclosure requirements.



CESR thinks that fair value changes due to changes in an entity's own credit risk caused by the re-measurement of its liabilities designated under the fair value option should not impact profit or loss unless it creates an accounting mismatch. However, CESR is concerned that even on this subject, the IASB's and FASB's proposals are not fully identical (i.e. the FASB proposes that the amount presented separately excludes changes due to changes in the credit price).

The IASB and FASB proposals differ as regards the use of fair value through Other Comprehensive Income (OCI). IFRS 9 prohibits any recycling of fair value changes from OCI to profit or loss whereas the FASB proposes that these changes be recycled to profit or loss when the instrument is sold, redeemed or extinguished. Bearing in mind the prominence given by users of financial information to the reported profit or loss we highly regret the lack of convergence the Boards are presenting.

CESR is of the opinion that the re-measurement value basis for core deposits is not appropriate. The re-measurement approach for core deposits appears to rely heavily on management's judgement. It therefore bears the risk of decreasing comparability between financial institutions. Furthermore, based on the provisions for re-measuring core deposits, CESR understands that the proposal is creating a new valuation model (that has some similarities with fair value but that is not fair value). We believe that the creation of such a new model will not simplify the accounting of financial instruments and will result in less comparability for users of financial statements.

3. Amortised Cost and Impairment

CESR is supportive of incorporating more forward looking information about credit losses into the amortised cost model. On this aspect, unlike the IASB's proposal, the FASB's proposal does not seem to meet the expectations outlined in the report of the G20 since expectations of future economic conditions are not taken into account in the assessment of impairment.

CESR believes that the impairment model should eliminate the probability threshold for the recognition of an impairment loss and allow an earlier recognition of impairment expenses than under the incurred loss model.

CESR is concerned by the difficulty of estimating the timing and amount of expected credit loss over the entire life of the instrument. As stated in our comment letter to the IASB, CESR would welcome further guidance so it might better understand the proposals and principles of the model developed by the IASB. At this stage, it is however quite impossible to assess the relevance of the IASB's proposal on this aspect since the way the Board will incorporate the work performed by the Expert Advisory Panel is still unknown. This is one of the reasons why our comment letter requests the IASB to re-expose its final proposal after deliberation on the comments it has received on the ED *Financial Instruments: Amortised Cost and Impairment*.

CESR concurs with the FASB as regards the separate presentation of interest charges and impairment charges because this presentation is more granular and will therefore provide more information to users of the financial statements.

4. Presentation of Financial Instruments on the Face of the Balance Sheet

CESR notes that IFRS 9 does not significantly change the presentation of financial instruments on the face of the balance sheet whereas the FASB's proposal introduces many important changes:

- (a) financial instruments measured at fair value through Other Comprehensive Income (OCI) will be distinguished from financial instruments measured at fair value through profit and loss,
- (b) the cost of financial instruments measured at fair value through OCI will be presented on the face of the balance sheet together with fair value, with a reconciliation between the two.



CESR is of the view that the first proposal is a minor change. We agree that information provided as part of the second proposal is important. However we think it is likely that it will increase complexity and create confusion for users of financial information. We think that the same level of information could be provided to users of financial statements through disclosure notes. CESR prefers the IASB approach and would recommend the IASB to adopt such an approach as only a “second-best” solution to reach comparability with US GAAP because we feel that presenting two values on the face of the statement of financial position for the same asset (or liability) is very likely to create confusion amongst users.

I would be happy to discuss all or any of these issues further with you.

Yours sincerely,

Fernando Restoy
Chairman of CESR's Corporate Reporting Standing Committee