



30 September 2010

Our ref: ICAEW Rep 101/10

Your ref: 1810-100

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Dear Sir / Madam

**ACCOUNTING FOR FINANCIAL INSTRUMENTS AND REVISIONS TO THE ACCOUNTING  
FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

The ICAEW is pleased to respond to your request for comments on the FASB Exposure Draft *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. A copy of this letter will also be supplied to the International Accounting Standards Board.

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

Yours sincerely

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## ICAEW REPRESENTATION

### ACCOUNTING FOR FINANCIAL INSTRUMENTS AND REVISIONS TO THE ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

**Memorandum of comment submitted in July 2010 by the ICAEW, in response to the FASB's Exposure Draft *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* published in May 2010.**

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## INTRODUCTION

1. The ICAEW welcomes the opportunity to comment on the consultation paper *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* published by the FASB.

## WHO WE ARE

2. The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance, which has over 775,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure that these skills are constantly developed, recognised and valued.

## MAJOR POINTS

4. ICAEW is commenting on the Proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the ASU) in response to a request for comments by IFRS constituents made by the IASB on 27 May 2010. The G20 meeting in Toronto in June 2010 re-emphasised the importance they place on achieving a single set of high quality improved global accounting standards. We support this aim, provided the production of 'high quality' standards takes precedence over the creation of a single set of standards. Therefore we are particularly interested in providing feedback to the IASB to ensure that it is well placed to consider whether and how to reconcile any differences between IFRS requirements and US GAAP. In addition, because this project is part of the global convergence project, we agree that it is important for the FASB to receive feedback on the proposed model from the international community. We attach our responses to recent IASB proposals on financial instruments as we refer to these responses in this letter.

### **Many users do not support a full fair value model**

5. As set out in BC246, we note that the FASB's own research revealed that the clear majority of investors found both fair value and amortised cost information useful with views fairly evenly divided between those who prefer fair value information included in the statement of financial performance and those who would prefer fair value information to be readily available but not be the basis for reporting equity and comprehensive income. Further evidence of this view can be found in a report published by PwC in June 2010 *What Investment Professionals say about Financial Instrument Reporting*, detailing the findings of a survey they had conducted among a statistically based sample of investment professionals. 51% of survey respondents were based in the United States. The survey showed that 71% of respondents believed that the measurement model should reflect an entity's business intent or business model, while 68% believed that the instrument's characteristics should influence its measurement. Therefore, whilst we agree that users are interested in the fair values of all financial instruments, we believe that for financial instruments where amortised cost provides the more relevant measurement, fair value information is more appropriately provided in the notes to the financial statements. We do not support including fair value information on the face of the statement of financial position, even parenthetically, where it is not the more relevant measure. Parenthetical disclosure of fair value would of necessity be at an aggregated level and the disclosures required by IFRS 7 provides more meaningful information.

## **We support a mixed measurement model for financial instruments accounting**

6. As we stated in our response to *ED/2009/7 Financial Instruments: Classification and Measurement*, we agree with the IASB that amortised cost provides more relevant information in financial statements for simple financial instruments which are held for the collection or payment of contractual cash flows. The relevance of amortised cost measurement is also recognised by FASB, resulting in the ASU including an option for the financial statements to include a reconciliation from amortised cost to fair value on the face of the statement of financial position and preserving most of the existing aspects of reporting net income and earnings per share using amortised cost measures where this reflects the business strategy. In our view, where amortised cost provides more useful information reflecting the way the business is managed and the nature of the instrument, amortised cost should be used in both net income and in the statement of financial position. Measuring items at fair value in the statement of financial position but at amortised cost in net income is complex to prepare and to understand and, therefore, seems unlikely to meet any reasonable cost-benefit test. In addition such an approach would result in less useful information in the statement of financial position and perpetuate the use of Other Comprehensive Income (OCI) as a 'dumping ground' and result in the recycling of additional gains and losses without a clear conceptual basis. The meaning and, therefore, the information value of the fair value movements recognised in OCI is not clear. Also, we note that the concept of 'realised gains and losses' may not be applied consistently in different jurisdictions and, therefore, may not provide a suitable basis for determining when items should be recycled.

## **IFRS 9 'Financial Instruments' provides a better basis for convergence**

7. We do not support the fair value measurement model proposed by the ASU, which does not appear to provide more relevant or reliable information or to pass any reasonable cost-benefit test. More importantly, we do not consider that the ASU forms a reasonable basis for convergence. We have sympathy with many of the alternative views of Ms Seidman and Mr Smith expressed in the ASU and in particular agree with them that IFRS 9 provides a much better basis for a converged standard than the ASU. Indeed the principles for the classification of financial assets is final in IFRS 9, although additional material is in progress on financial liabilities, impairment and hedge accounting. These principles are based on the characteristics of the instrument and the business model, which we strongly support. We agree with the IASB that a third criteria based on the marketability of the instrument, is not necessary. Therefore marketable securities should not be required to be at fair value where they would otherwise be appropriately measured at amortised cost. In addition, the IASB approach for financial assets does not perpetuate the rules for embedded derivatives, which we consider to be an important reduction in complexity. While there may be minor improvements needed to IFRS 9 as entities gain experience in implementation, would not support significant changes being made by the IASB to facilitate convergence.
8. We will also discourage the IASB from considering that similar information to the ASU can be provided by additional disclosure requirements. In our view, disclosures that serve to reconcile the two approaches would result in essentially requiring both fair value and amortised cost data to be held for financial instruments where amortised cost provides the more relevant information. This would raise similar practical and cost-benefit concerns to the proposals in the ASU. IFRS 7 contains sufficient disclosure requirements for fair value information.

## **Complexity of including both measures in the financial statements**

9. In order to provide a reconciliation of amortised cost to fair value on the face of the statement of financial performance and facilitate the recycling of realised gains and losses from OCI to profit or loss, entities would essentially have to maintain both detailed amortised cost and fair value accounting data, including movements over time, for all financial instruments where amortised cost provides the more relevant information. We were concerned about the practicalities of implementing the IASB's proposals for an expected cash flow approach to impairment and believe that the requirements of the ASU would add even further to the

complexity and costs. For example, loans would need to be tracked in different portfolios for determining fair value, for effective interest and for impairment and these different portfolios would have to be reconciled to portfolios maintained to determine fair values to meet the presentation and recycling requirements. The difficulties and complexity of producing and controlling all this data should not be underestimated.

10. The proposed increased volume of information on the face of the statement of financial position, driven by the number of measurement options that are available in the ASU will make it more difficult for users to understand all the information presented. There is clearly a desire on the part of FASB for entities to provide fair value information for those financial instruments that are measured on an amortised cost basis and amortised cost for those financial instruments that are at fair value through other comprehensive income (FV-OCI). To increase comparability and reduce complexity we prefer the IASB approach, which allows financial instruments to be reported at either amortised cost or fair value depending on the business model, with fair value disclosure for all financial instruments clearly set out in the notes to the financial statements.
11. In addition, the ASU would increase the number of instruments measured on a recurring basis using level 3 fair values. This will result in an increase in what some see as less useful information being included in the primary financial statements and a greater need for additional disclosures and sensitivity analysis, which is not without cost for both preparers and users.
12. The FASB appears to understand the operational difficulties of its proposal since it has decided to defer the application of the effective date for the majority of banks and credit unions in the United States. We agree with the alternative view that questions whether the intended benefits of the ASU could be achieved in a timely fashion, if at all, and whether the classification and measurement model would meet the cost-benefit test. We suggest that, if the model is pursued, the FASB should conduct field testing to determine whether the proposals are capable of being applied in practice by entities of all sizes.
13. Where financial instruments are held for the receipt or payment of contractual cash flows and are not readily traded in active markets, we do not agree that the inclusion of fair values in the statement of financial position is necessary or even helpful in increasing the likelihood that such fair values are available on a more timely basis and are given equal attention with amortised cost measures by preparers and auditors. If considered necessary, which would need to be demonstrated on cost-benefit grounds, the frequency and timeliness of fair value information can be increased by mandating disclosure of these values, rather than changing the measurement basis in the statement of financial position. Where amortised cost provides the more relevant measurement basis, we do not support including fair value information on the face of the statement of financial performance either as a footnote or in parenthesis. For presentation purposes, we believe that additional fair value information, for example, a fair value statement of financial position, should be provided in a note to the financial statements where the information can be shown in a more coherent and understandable form.

#### **Liabilities**

14. In our view, particularly for those long-term liabilities that fund the business as a whole, amortised cost provides a better indication of the expected future cash flows arising from liabilities, than fair value. Fair value is the more relevant measurement for financial liabilities that are held for trading or linked to financial assets carried at fair value. We support a fair value option to ensure that matched positions are recognised as such. We are concerned that requiring fair value to be used for financial liabilities where amortised cost is the more relevant measure increases the quantum of fair value movements recognised relating to changes in an entity's own credit. As the IASB confirmed during the outreach for its deliberations on the fair value option for liabilities, there is general agreement that presenting gains and losses arising from changes relating to the entity's own credit risk in profit or loss is counterintuitive and undermines the usefulness of net income. The operation of paragraph 21 of the ASU would result in fair value movements relating to own credit being included in profit or loss where the financial liability has an embedded derivative. We do not believe that

presenting fair value movements related to own credit in a separate line item in net income adequately addresses these concerns and would encourage non-GAAP measures. It would also result in additional financial liabilities being measured at fair value with fair value movements included in OCI, which could undermine the usefulness of reported equity in the statement of financial position.

15. As an exception, the ASU permits an entity to measure a financial liability subsequently at amortised cost where measuring the liability at fair value would create or exacerbate a measurement attribute mismatch of recognised assets and liabilities. While we support amortised cost measurement for such instruments, which are a sub-set of financial liabilities for which we consider amortised cost the more appropriate measurement, we do not generally support exceptions to principles in accounting standards. It is preferable to ensure that the underlying principle itself results in the most relevant and reliable information. We are also of the view that this exception, which creates a bright line rule based on a 50% quantitative test, is unlikely to be operational and is likely to create additional complexity for users in understanding how and why the rule has been applied. Overall, we consider that the IASB's approach as set out in *ED/2010/4 Fair Value Option for Financial Liabilities* provides a more suitable basis for convergence than the ASU.

#### **Embedded derivatives**

16. The embedded derivative rules in IFRS and US GAAP are complex and aim to prevent abuse rather than to set clear principles. We support the approach taken in IFRS 9 to eliminate the bifurcation of embedded derivatives for financial assets and set principles for determining when the characteristics of the instrument as a whole are appropriate for amortised cost treatment. The ASU retains all the existing rules for embedded derivatives to differentiate between those financial assets and liabilities that are permitted to have fair value movements recognised in OCI and those required to have fair value movements recognised in net income. This approach is open to criticism because it would require the reporting of fair value movements through net income (FV-NI) for instruments where the embedded component is a relatively small part of the overall instrument. As noted above, it also results in more financial liabilities being measured at fair value through net income, which we consider to be inappropriate.
17. While we remain of the view that, ideally, the final standard for financial instruments should use consistent principles, language and concepts as far as possible for assets and liabilities and that it should be possible to develop a bifurcation approach for liabilities based on the characteristics of the financial asset notion in IFRS 9, we consider the approaches developed by the IASB so far to be more acceptable than those in the ASU.

#### **Core deposits**

18. We do not support the approach to core deposits in the ASU and do not think it has conceptual merit. We do not support the introduction of another measurement basis, which would be inconsistent with the aim of reducing complexity. Even if it were appropriate to measure such liabilities at fair value, which we do not consider to be the case, the fair value should be determined in the same way as any other financial instrument. Since fair value ascribes some value to the customer relationship resulting in the recognition of an internally generated intangible asset, which is inconsistent with the treatment of other internally generated intangible assets, we believe this consequence further supports the view that amortised cost is the more relevant measurement basis for deposits. We have concerns about the relevance and understandability of a measurement that is not based on the actual period end balance and market interest rates. We do not believe that users will obtain benefit from the resulting information when it will be composed of changes in the determination of the core amount as well as changes in interest rates, costs of maintaining branches, and other subjectively determined components? While judgement is inherent in financial reporting, we are uncomfortable in extending judgement to determining balances and the difference between two unobservable interest rates when there is certainty about the amount that will ultimately be paid to satisfy the liability, which would produce a more useful (and reliable) measure. In addition there is an inconsistency in the approach to the unit of account.

The proposed measurement approach for core deposits seems to envisage measurement at the portfolio level but for other financial instruments the unit of account is the individual financial instrument. It is not clear why a portfolio calculation is acceptable for core deposits but not for other financial instruments.

### Capital instruments

19. In our response to *ED/2009/7 Financial Instruments: Classification and Measurement*, we raised concerns over issued debt instruments that contain some features that are not consistent with the characteristics test because they result in variability in cash flows for the holder of the instrument but where the features are similar to equity for the issuer. These features would result in the entire liability being measured at fair value through profit or loss. Examples of such features include the ability to defer interest without resulting in default, in the case of certain subordinated liabilities, or conversion features which are not required to be separated in accordance with IAS 32 *'Financial Instruments: Presentation'*. It seems anomalous to measure equity at cost and some debt instruments at amortised cost but for other debt instruments with these equity-like features to be measured at fair value. We, therefore, support the approach taken by *ED/2010/4 Fair Value Option for Financial Liabilities*, which results in such debt securities remaining at amortised cost. We agree with views obtained during the IASB outreach that the treatment of assets and liabilities need not be symmetrical. Similarly, we support separating equity components from debt instruments in accordance with IAS 32.
20. The ASU requires a symmetrical approach to financial assets and liabilities. As a result, we have the same concerns with the approach as that identified in our response to *ED/2009/7 Financial Instruments: Classification and Measurement*. The accounting for subordinated debt with equity-like features will gain increasing prominence as the Basel Committee is currently consulting on proposals to ensure the loss absorbency of regulatory capital at the point of non-viability. Requiring such instruments to be measured at fair value through profit or loss by the issuer increases the problem of recognition of gains and losses relating to own credit and, as set out above, we consider that the IASB's proposals would result in more meaningful reporting for these instruments.

### Impairment

21. We agree with many commentators, including the Financial Crisis Advisory Group and the Basel Accounting Task Force, that accounting standard setters should explore incorporating a broader range of available credit information, including more forward looking information, in determining loan loss allowances, to allow an earlier identification of credit losses. We are not convinced that the IASB's model as set out in its exposure draft, *Financial Instruments: Amortised Cost and Impairment*, is the best way of improving existing practice in terms of relevance, reliability and understandability of the information it provides. The application of this approach is likely to be complex and the cost of implementation would be substantial and take significant time. However, we remain of the view that the IASB, together with the Expert Advisory Panel, will be able to build on some of the concepts underlying the exposure draft to develop a model that is operational.
22. Although starting from the position of allocating fair value movements between net income and OCI rather than using amortised cost, the approach to amortised cost impairment in the ASU has some merit in that it would appear to be more operational than the approach proposed by the IASB. The ASU does not require entities to forecast the timing and amount of lifetime expected cash flows. It does not include the additional complexity of differentiating between initial expectations and changes in expectations and it puts a clear parameter around management judgement about future economic conditions and is thereby much less subjective and, therefore, easier to audit. It also appears to be less prescriptive than the IASB's approach, which increases the chance that it can be more readily implemented by a variety of businesses, including those outside financial services, without the need for practical expedients. In many ways, it would appear to operate in a manner similar to existing IAS 39 *'Financial Instruments: Recognition and Measurement'*, although with the removal of the 'probable' or 'incurred' threshold for recognising losses, which proved to be determined

inconsistently in practice. Those with sympathy for making incremental changes to the IAS 39 approach rather than developing an entirely new method with considerable operational complexity, will find much to support in the ASU's approach.

23. However, we have some concerns with the approach set out in the ASU. This approach recognises all expected losses immediately based on current economic conditions, which in itself raises conceptual issues. In addition, possible future economic conditions are precluded from being included in the determination of expected losses. While this may ensure full recognition of losses at an early stage in a downturn, the approach may not work as well at the bottom of the cycle. For example, if the historical loss rate has been 2% in the past but is now considered to be 4% based on current market conditions, entities would immediately provide at 4% for the entire remaining life of the loans. A provision level based on the long run historical rate of 2% would not be allowed until there is evidence in the current economic conditions that the situation is consistent with a loss rate of 2%. On the other hand, if the current economic conditions suggest that the adjusted loss rate should be 1%, there would need to be an actual change in circumstances before the foreseeable losses can be recognised. This moves the trigger event to the current economic conditions and may not incorporate all the information of which the entity is aware or be sufficiently forward looking to meet concerns raised in the crisis and would create an artificial construct.
24. The approach in the ASU also increases complexity by requiring that interest is recognised based on the effective interest rate times the loan balance net of the impairment allowance. Although this approach is currently required by IAS 39 for impaired loans, extending such a requirement to all loans will create additional systems issues. There are also complications when interest that exceeds the interest that can be recognised is paid and further complications if loans are purchased at an amount which includes expected future losses. While, arguably, the FASB approach is less operationally complex than the IASB approach, it will still result in significant systems issues that will need to be resolved. Given the differences in approach to impairment and interest recognition, it seems unlikely that the amounts recognised in profit or loss would be consistent or that the differences could be meaningfully explained.
25. It may be that, when the IASB completes its work in considering feedback received on its model to ease the operational difficulties, there will be less difference than at first appears between the two approaches. However, we continue to support a model that addresses impairment in the 'good book' separately from that in the 'bad book' as outlined in our response to the IASB exposure draft. Such a model is more consistent with how loans are managed and, therefore, has the potential to be both operational and provide the most useful information.

## **Hedge accounting**

### **Effectiveness testing**

26. In our response to the IASB 2008 discussion paper *Reducing complexity in reporting financial instruments* we noted that the most complex area in financial instrument accounting was hedge accounting. We suggested a re-examination of the area to clarify the principles and remove unnecessary rules since we thought that the very detailed and specific rules in the standards may make hedge accounting so difficult to achieve that the accounting diverged from the economics of the hedging strategy. This makes it difficult for companies to explain their hedging strategy in terms of the accounting result and for users to understand how the hedge accounting result relates to the underlying economics. Therefore, we support efforts made to simplify hedge accounting requirements. We also favour the approach to hedge accounting in IAS 39, for example applying a principled approach to "benchmark" interest rates rather than a strict definition, and the direction of the IASB's current considerations to permit entities to hedge identifiable and reliably measurable components as part of bifurcation by risk and contractually specified and reliably measurable non-financial risk components for financial and non-financial contracts.

27. In that response we also suggested that the IASB should consider the idea of a qualitative rather than a quantitative assessment of the effectiveness of the hedge relationship based on the economic relationship. We would not include an anticipation of reasonable hedge effectiveness for financial instruments because we do not see why hedge accounting should not be recognised even if the hedge is only say, 20% effective, provided hedges are documented at the start and all ineffectiveness is recorded in profit or loss. Therefore, we encourage the IASB to consider some of the simplifications proposed in the ASU. In particular the requirement that a hedging relationship is expected to be reasonably effective (rather than highly effective) and that this is demonstrated qualitatively rather than quantitatively. However, we question whether it is necessary to have any threshold for expected effectiveness. We also question whether it will be possible to ensure that the notion of “reasonably effective” together with a requirement to reassess effectiveness if there are changes in circumstances that suggest that the hedging relationship is no longer reasonably effective, does not create additional rules-based requirements in practice. Other language in the ASU, for example, in paragraph 118 where effectiveness is assessed by using a derivative that settles within a reasonable period of time of the cash flows related to the hedged transaction, where the reasonable time period is defined as resulting in a minimal difference between the forward rate on the derivative and the forward rate on a derivative that exactly offsets the changes in cash flows of the forecast transaction, may also result in a rules-based interpretation of the final standard.

#### Dedesignation

28. Entities often hedge dynamically and need to adjust the hedge over time, consistent with their risk management strategy. For this reason we disagree with the rules preventing dedesignation of the hedging relationship once it has been established unless the hedge is no longer expected to be reasonably effective or the hedging instrument is sold, terminated or exercised. As acknowledged in BC 222, the same effect as dedesignation could be achieved by terminating the hedging derivative and purchasing a new, similar derivative. This calls into question whether the requirements are operational and whether it is reasonable to expect entities to incur additional transaction and other costs to be able to hedge dynamically. The acquisition of an “offsetting” derivative and “concurrent” documentation would be required to terminate the hedge relationship, language which could encourage a rules-based interpretation of the new standard. Also both derivatives are not permitted to be used in a new hedge relationship, resulting in entities having to undertake additional market activity, thereby giving rise to increased risk, as well as additional costs in tracking “used” derivatives. The existing requirements in this area seem preferable to the approach in the ASU.

#### Ineffectiveness in cash flow hedges

29. Under IAS 39 only ineffectiveness due to excess cash flows on the hedging instrument (that is, the derivative) is recognised in profit or loss for cash flow hedges. We support this approach because it prevents non-existent gains or losses being recognised and suggest that this is maintained in future hedge requirements under IFRS. Consequently, we do not support the proposal in the ASU to change the basis of recognition of ineffectiveness for cash flow hedges to recognise both over and under hedging

#### We support IASB approach to macro hedging

30. IAS 39 also includes an approach to hedge accounting that recognises that entities may hedge portfolios rather than engage in one to one hedging strategies. We understand that the IASB is considering portfolio hedging and hedging net positions in its review of hedge accounting. We support the IASB in this initiative as it has the potential to result in hedge accounting that better reflects risk management and is thus more understandable to users. If the IASB's deliberations result in more fundamental changes to hedge accounting that will better meet the needs of users, this approach would create a better basis for convergence.

## Associates and investments in subsidiaries

31. We disagree with the proposed changes to the conditions for applying the equity method of accounting in the ASU. Paragraph 130 of the ASU requires the investor to have both significant influence over the investee and that the operations of the investee are considered related to the investors consolidated operations in order to apply equity accounting. If equity accounting is not applied, the investment is fair valued through profit or loss. We do not agree that equity accounting should be addressed in the financial instrument standard and, more importantly, we do not consider that the requirements are operational or would provide the most relevant information. For example, for reporting entities that are conglomerates, it will be difficult, if not impossible, to determine whether the investee's operations are sufficiently related to the investor's many and wide ranging operations. Some entities diversify their businesses by acquiring stakes in companies which operate in different products, services or markets. Having significant influence seems sufficient and necessary to distinguish the investment from others where fair value is the more relevant measurement. We would not support similar changes being made to IFRS.

## Reclassification

32. We support the requirements in IFRS 9 that financial instruments must be reclassified if there is a change in the business model, with appropriate disclosure. If reclassifications are not required, financial instruments would be reported in a way that does not reflect the business model and, as a result, is inconsistent with the principles of the financial reporting standard. The ASU does not permit reclassification if there is a change in business model. As set out in BC 105, FASB is concerned that if reclassifications were allowed, entities may choose to reclassify fair value movements from OCI to net income in order to recognise gains in net income on financial assets which are increasing in value, but avoid recognising losses in net income on financial assets which are decreasing in value. If reclassifications are allowed, an entity may manage earnings by "selling winners and holding losers." We do not support this analysis. We believe the approach in the ASU actually encourages such earnings management. With recycling, this is exactly what could happen; entities will be encouraged to sell FV-OCI items with unrealised gains and discouraged from selling FV-OCI items with unrealised losses.

## GAAP DIFFERENCES

33. One of the aims of the project is to achieve convergence. We support this aim provided it is consistent with the development of high quality standards. However, we note that the following key GAAP differences in financial instrument accounting between IFRS and FASB have either not yet been addressed or will be created if the Boards pursue their different approaches. We are pointing out these differences without providing solutions, which we think can only be developed through outreach and due process to determine which approach is more consistent with the objectives of financial reporting.

### ***'Day 1' gains and losses and initial recognition***

#### *IFRS*

IAS 39 AG 76 states that the best evidence of the fair value of a financial instrument at initial recognition is the transaction price (i.e. the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instruments or based on a valuation whose variables include only data from observable markets. Consequently 'day 1' gains and losses are deferred in the absence of appropriate evidence.

#### *FASB*

Entities are not precluded from recognising 'day 1' gains and losses on financial instruments reported at fair value even when all the inputs to the measurement model are not observable.

## **Foreign exchange differences**

### **IFRS**

IAS 21 *The Effects of Changes in Foreign Exchange Rates* paragraph 28 requires exchange differences on the translation of monetary items, including debt securities, to be recognised in profit or loss. Under IFRS 9, non-monetary financial assets i.e. equity investments that are non-trading and carried at fair value, gains and losses, including the exchange component of the gain or loss, are recognised directly in profit or loss unless the entity has elected to present gains and losses on that investment in OCI.

### **FASB**

Foreign exchange gains and losses on debt securities reported at fair value through OCI are reported in OCI. For equity investments all changes in fair value including the exchange component of the gain or loss, are recognised directly in income.

## **Measurement of own credit**

### **IFRS**

IFRS 7.10 requires disclosure in the notes to the financial statements of the amount of the change in the fair value of a financial liability designated as at fair value through profit or loss that is attributable to changes in the credit risk of that liability. Guidance on how to determine that amount is provided in B4 or the use of an alternative method the entity believes more faithfully represents the amount of the change can be used. ED /2010/4 *Fair Value Option for Financial Liabilities* proposes that the amount calculated to be attributable to changes in the credit risk of the reporting entity's liability and recognised in income should be transferred to OCI on the face of the income statement.

### **FASB**

BC 165 states that the FASB recognises that there may be several different methods to determine changes in the entity's own credit standing and the proposed guidance does not prescribe a method for determining that change. However, Appendix B sets out methods which are inconsistent with IFRS 7. Paragraph 94 of the ASU requires separate presentation on the face of the statement of OCI of the amount of significant changes in the fair value of financial liabilities arising from changes in the entity's own credit standing during the period. Separate presentation is required for changes in the entity's own credit standing for financial liabilities for which all changes in fair value are recognised in net income.

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# APPENDIX

## Question Table

The table below lists each of the questions in the FASB Exposure Draft; it shows our comments on that question and links to the appropriate paragraph in our response which explains in more detail.

Question	Our comment	Reference to relevant paragraph in our letter
<b>Scope</b>		
<i>Questions for All Respondents</i>		
1-3	We have no specific comments on scope but do not support the ASU as a whole.	
4	No.	31
<i>Questions for Users</i>		
5-7	We consider that fair value is the more relevant measurement for financial liabilities that are held for trading or linked to financial assets carried at fair value. Otherwise, amortised cost provides more useful information.	14
<b>Initial measurement</b>		
<i>Questions for All Respondents</i>		
8	We prefer the approach in IFRS 9/IAS 39	
9	We note that this represents a difference to IFRS	33
10	We prefer the approach in IFRS 9/IAS 39	
11	We do not agree with fair value measurement through OCI for financial instruments where amortised cost provides the more relevant measurement. We have concerns with recognition in OCI and recycling.	6
<i>Questions for Preparers and Auditors</i>		
12	We prefer the approach in IFRS 9/IAS 39.	
<b>Subsequent measurement</b>		
<i>Questions for All Respondents</i>		
13	We do not support fair value as the default measurement attribute. We support a mixed measurement model.	6 and 10
14	We support a mixed measurement model.	6
15	No	14
16	No.	32
17	No.	18

Question	Our comment	Reference to relevant paragraph in our letter
18	Yes but the ASU includes only a sub-set of those liabilities which we believe should be at amortised cost.	15
19	No comment.	
20	No comment.	
21	No	19
<i>Questions for users</i>		
22	See answer to 14 above	
23	No. We prefer the mixed measurement approach in IFRS.	6, 7 and 10
24	No	5
25	No	16 and 17
26	We prefer the approach in IFRS 9.	16 and 17
27	Yes	
<i>Questions for preparers and auditors</i>		
28	No	9
29	No	9
30	No	15
31	No	18
<b>Presentation</b>		
<i>Questions for All Respondents</i>		
32	We support the proposed IASB approach of recognition in OCI.	14 and 33
33	We prefer the IASB's approach	33
34	We prefer the IASB's approach	33
<i>Questions for Users</i>		
35	No.	9 to 13
36	We support the proposed IASB approach of recognition in OCI	14 and 33
<b>Credit impairment</b>		
<i>Questions for All Respondents</i>		
37	Yes but we have concerns.	23
38	We have concerns about both approaches.	21 to 25
39	Yes but we have noted there is a difference in the treatment of foreign exchange more generally.	33
40	No. We agree entities should use the best information available to them, which will be entity specific.	22
41	The treatment of changes in cash flow expectations for purchased financial assets will depend on the impairment model finally adopted.	24

Question	Our comment	Reference to relevant paragraph in our letter
42	No. We prefer the approach in IAS 39 explained in BC123	
<i>Questions for users</i>		
43	Yes but we have concerns with the approach in the ASU.	
44	We believe an expected loss model would incorporate an element of forward looking information.	23
45	Yes but we have concerns with the approach in the ASU.	23
<i>Questions for Preparers and Auditors</i>		
46	We have operational concerns with both approaches.	21 to 25
47	Yes.	23
<b>Interest income</b>		
<i>Questions for All Respondents</i>		
48	No. We prefer interest income to be reported separately from credit losses.	24
49	No. It is conceptually difficult to understand.	24
50	No. Interest income is not relevant for trading assets.	
51	The approach to interest seems overly complicated.	24
<i>Questions for users</i>		
52	We prefer the approach in IFRS 9/IAS 39.	
53	No. We do not believe the excess of interest receivable added to the impairment allowance is understandable .	24
54	We have concerns with both approaches which seem overly complex.	21
55	Yes. We do not agree revenue should be recognised when it is not expected to be received.	
<b>Hedge Accounting</b>		
<i>Questions for All Respondents</i>		
56	Yes. We support simplification of the hedge accounting requirements.	26
57	We support simplification of the hedge accounting requirements.	27
58	Yes.	27
<i>Questions for Users</i>		
59	No.	29
60	We better alignment of hedge accounting to risk management.	

Question	Our comment	Reference to relevant paragraph in our letter
<i>Questions for Preparers and Auditors</i>		
61	We prefer the IASB's approach.	29
62	We are concerned that proposed simplifications should not inadvertently introduce additional rules.	27
63	Yes	28
64	Yes	28
<b>Disclosures</b>		
<i>Questions for All Respondents</i>		
65	No	9 to 13
<i>Questions for Users</i>		
66	No comment	
67	No comment	
<b>Effective date and transition</b>		
<i>Questions for All Respondents</i>		
68-71	We have concerns whether the proposals can be implemented.	9 to 13