EUROPEAN COMMISSION
Internal Market and Services DG

The Director-General

Brussels, 27 OCT. 2008 -38626
MARKT.F.3/AD D(2008) 47947

Dear Sir David,

Subject: Further issues related to IAS 39

The ongoing financial crisis requires all parties to seek urgent solutions, which requires a creative and flexible approach. We welcome the IASB's prompt response to the ECOFIN Council of 7 October. We now expect the IASB to clarify certain practical aspects to ensure the effective implementation of the recently adopted amendments to IAS 39. Moreover, the endorsement of the IASB's recent amendments to IAS 39 and IFRS 7 on 15 October was only a first step in an ongoing process to comprehensively address accounting issues raised in the context of the financial turmoil.

At the meeting of the Accounting Regulatory Committee held on that day, the Commission indicated that it would urgently consult stakeholders with a view to identify other issues under IAS 39 and IFRS 7 that may require consideration in view of the ongoing financial turbulence. Accordingly, on 21 October, the Commission organised a meeting with European stakeholders including representatives of preparers, investors, auditors and regulators. During this meeting, participants emphasised the need to address challenges posed by the financial turmoil on an ongoing basis and identified a need for further action on some issues of importance. In view of the global nature of the financial crisis, globally coordinated solutions are preferable, while taking into account the European context and the urgency created by the ongoing financial turmoil. These solutions should be subject to appropriate due process strictly tailored to reflect the urgency of the situation.

Sir David Tweedie
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In the short-term, an urgent (before the end of this month) need for further guidance in the application of fair value in illiquid markets was identified, notably on the use of mark-to-model. In the meantime, the EU's Level 3 Committees (CESR, CEBS, CEIOPS) have issued a joint statement which clarifies the position for the national supervisory authorities in the EU. I understand that the report of the IASB's Expert Advisory Panel on fair value measurement in inactive markets will be published soon and we consider that this should be fully in line with the content of the IASB's press release of 2 October, which was well received, and should be fully consistent with the statement of the Level 3 Committees.

Moreover, we consider that three specific issues should be addressed in time for the publication of year-end results, i.e. a solution ensuring that (a) financial assets presently classified under the Fair Value Option can be reclassified into other categories and not measured at fair value, for the same reasons and under the same conditions as the assets reclassified out of the held-for-trading category; (b) clarification is provided whether synthetic CDOs include embedded derivatives; and (c) adjustments to impairment rules applicable to available-for-sale financial assets are made. These issues should be read in the light of the more detailed explanation in the annex.

I urge the IASB to work towards developing solutions as soon as possible and to devote the necessary level of resources to these tasks. This should ensure that solutions must be available in good time, i.e. in December, to allow preparers to draw-up year-end financial statements

Finally, recent developments raise broader issues related to the role of fair value accounting for financial instruments which we intend to explore further with all stakeholders as a matter of urgency. This issue should also be comprehensively addressed in the context of ongoing IASB projects. There may be a need to adjust the timetable of ongoing projects to reflect the immediate needs of the current crisis.

I look forward to continued close co-operation with the IASB to resolve these matters of mutual concern.

Jörgen Holmquist

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Enclosure: 1

c.c.: Ms. P. Berès MEP, European Parliament ECON Committee Chair,
Member States delegates in the Accounting Regulatory Committee,
Mr. F. Restoy, CESR-FIN Chair,
Mr. G. Tidström, EFRAG SB Chair,
Mr. S. Enevoldsen, EFRAG TEG Chair

ANNEX

Fair Value Option

We welcome the amendments the IASB made to IAS 39 earlier this month to permit certain reclassifications out of the held-for-trading and available-for-sale categories. The impact of these changes is limited to instruments that have to date been categorised as held-for-trading or available-for-sale. Many of our biggest financial institutions (including many insurers) have used the fair value option to eliminate or significantly reduce measurement mismatches that would otherwise have arisen between assets and liabilities or to ensure that assets and/or liabilities managed on a fair value basis are measured on that basis. However, the virtual disappearance of some markets may have had an impact on the way these instruments are managed. Currently, following IAS 39, a decision is made on initial recognition to apply the Fair Value Option and no subsequent change in the classification is permitted.

It is important that financial instruments currently classified under the Fair Value Option can be reclassified into other categories and that are not, or no longer, measured at fair value. This should be possible due to the same reasons and under the same conditions as the assets reclassified out of the held-for-trading category.

Embedded derivatives

In relation to embedded derivatives there is a difference in treatment under IFRS and US GAAP that needs to be addressed. IAS 39 AG 30 (h) has been consistently interpreted as requiring separation of an embedded credit derivative in an investment in a "synthetic CDO". As a consequence, European companies using IFRS have to account for these embedded derivatives separately and measure them at fair value with changes in fair value recognised in the profit and loss account, unless the host contract is classified as at fair value through profit or loss.

In contrast, US GAAP does not require an embedded derivative to be recognised separately: paragraph 14B of FAS 133 (inserted into FAS 133 by FAS 155) states that changes in cash flows attributable to changes in the creditworthiness of an interest resulting from securitized financial assets and liabilities (including derivative contracts) that represent the assets or liabilities that are held by the issuing entity shall not be considered to be an embedded derivative. Thus, as a result, the credit risk component of synthetic CDOs in US GAAP would not need to be recognised separately. If the synthetic CDO is classified—or reclassified—in an accounting category measured at amortised cost, its credit risk component would not need to be measured at fair value. It would be submitted only to credit risk impairment tests.

Urgent action is needed to clarity whether, under IAS 39, "synthetic CDOs" include embedded derivatives.

Impairment of Available For Sale (AFS) items

Debt securities

In IAS 39 there are differences in how an impairment loss is recognised depending on whether the debt instrument is accounted for as an AFS instrument at fair value through equity or at amortised cost. If there is objective evidence that an asset is impaired, in the first case the impairment recognised in profit and loss corresponds to the difference between its carrying value and fair value, and in the latter case it corresponds to the difference between its carrying value and recoverable amount determined on expected future cash flows.

However, under current market circumstances, fair values are changing because of general market factors, including illiquidity, as well as changing expectations of future cash flows on specific debt instruments, which means that when a 'fair value impairment test' is being applied, the losses that are being recognised in the income statement are greater than the change in recoverability of the underlying debt instrument. In effect, changes in liquidity risk are being included in impairment losses.

The approach for available for sale debt securities should be changed. Impairment losses should be determined similarly to the way impairment is recognised for held to maturity instruments and loans and receivables; the balance of the fair value decline in excess of incurred credit losses would be maintained in equity. Thus, only credit losses would result in impairment losses in the income statement.

Equity instruments

Under the existing requirements under IAS 39, impairments of available for sale equity instruments are required to be recognised in the income statement, but reversals of impairments through the income statement are prohibited. This has the undesired effect that entities are being required to recognise in their income statement some losses on their equity investments, knowing that if the price subsequently recovers they will not be able to recognise gains in the same statement. This apparent lack of balance is very concerning.

There should be a possibility of reversing impairment losses not only for debt securities, but also equity instruments.

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International Accounting Standards Board®

14 November 2008

Mr Jörgen Holmquist
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European Commission
SPA 2 00/94
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Belgium

Dear Mr Holmquist

I am writing to provide you with an update of the IASB's response to the credit crisis and how the IASB is addressing the various issues, including those raised in your letter of 27 October. As you know, the IASB has already taken a number of significant steps to improve accounting guidance based on the recommendations particularly of the Financial Stability Forum (FSF) but also of other stakeholders and commentators. Since your letter was received, the IASB issued a staff summary and its expert advisory panel's report on fair value measurement when markets are no longer active—measures which Commissioner McCreevy welcomed.

Your letter raises a number of additional issues related to the application of IAS 39 and IFRS 7 for IASB consideration. As with other issues that have emerged during the crisis, the IASB is ready to take urgent action to improve the application of fair value principles, where necessary, and is committed to working with the US Financial Accounting Standards Board (FASB) to ensure globally consistent solutions. Together, the IASB and the FASB have established a process for the rapid consideration of the issues raised in your letter and by other stakeholders.

The boards are holding three public round tables on 14 November in London, on 25 November in Norwalk, Connecticut, and on 3 December in Tokyo. The purpose of the round tables is to identify accounting issues that may require the urgent and immediate attention of the boards to improve financial reporting and help enhance investor confidence in financial markets. By holding the round tables on that timetable, the IASB will be able to consider an appropriate and expeditious course of action at its December meeting. We will seek to do so in such a way that ensures a consistency between IFRSs and US GAAP.

As our Trustees noted in their letter to the G20 meeting, any further IASB action needs to take proper account of the views of all stakeholders in order to develop accounting standards that provide transparent financial information to market participants. Stakeholders, particularly investors, have been very clear about this point in representations to us. This was a view also clearly expressed at the 21 October meeting of European stakeholders organised by the European Commission.

We at the IASB are committed to responding urgently to the unprecedented situation facing financial markets. With the round tables beginning this week, the IASB and the FASB will shortly be in a position to develop a common view on the issues raised in your letter and on any other issues raised or coming out of the round tables.

Sincerely,

David Tweedie
Chairman

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International Accounting Standards Board®

17 December 2008

Mr. J. Holmquist
European Commission
B-1049 Brussels
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Dear Jörgen,

Following my letter of 14 November, I am writing to provide you with a further update of the IASB's response to the financial crisis and how the IASB is addressing the various issues, including those raised in your letter of 27 October. As requested by most interested parties, and as you are aware, we are working closely with our counterparts in the United States, the Financial Accounting Standards Board (FASB), to ensure that we achieve consistent accounting treatments under US generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRSs). The G20 emphasised the need for aligned responses in its recent communiqué.

Your letter raised four areas for the IASB to consider: 1) the need for guidance on fair value in illiquid markets; 2) the existing impairment rules applicable to available for sale instruments; 3) clarification regarding whether CDOs include embedded derivatives; and 4) the possibility for reclassification of some financial assets out of the fair value option into other categories.

Fair value guidance published

As you know, only days after receiving your initial letter of 27 October, the IASB issued guidance related to the first point. The European Commission recognised our response, and we appreciated Commissioner McCreevy's support for our guidance.

Remaining three issues under consideration

On the remaining three issues, the IASB and the FASB have taken the following steps. First, at their joint meeting in October, the boards agreed on the need for common approaches on the remaining three issues and other issues emanating from the financial crisis. Second, the boards agreed to establish a high level advisory group to advise the boards about standard-setting implications of the global financial crisis and potential changes to the global regulatory environment. Hans Hoogervorst, the chairman of the Dutch market regulator, and

Harvey Goldschmid, a former US SEC commissioner, are chairing that global group. Finally, of immediate relevance to the issues raised in your letter, the boards rapidly convened public round tables in Europe, North America and Asia. The final round table was held on 3 December in Tokyo. As you know, the European Commission participated at the London meeting, held on 14 November.

These round tables have informed our approach on each of the remaining three issues. It was a clear message of participants at these round tables that the IASB should continue to take urgent action to improve the application of fair value principles, where necessary, but such action must be in conjunction with the FASB to ensure globally consistent solutions. A further clear message was that, any steps to amend fair value accounting, taken without proper regard to the well-established and supported standard-setting due process, would further undermine already scarce confidence in financial markets.

At our meetings this week, and based upon the input received at the round table meetings, we have now agreed upon a course of action on the remaining three topics:

- **Immediate proposal for enhanced disclosure of impairment of financial assets**: This topic dominated the discussion at all of the round-table meetings. Many participants expressed their preference for one impairment model that is common to IFRSs and US GAAP. However, users of financial statements and preparers differed in their preferred approach. Most participants (and almost all the users of financial statements) urged the boards not to attempt to change the recognition or measurement requirements for 2008 reporting periods, given that this is a complex area of accounting and that changes might undermine transparency and investor confidence. However, both the IASB and FASB have asked their staffs to consider together how existing requirements relating to non-reversal of impairment losses might be changed, and to report back to the boards in the next month. We will also address the broader question of impairment as part of an urgent broader project on financial instruments in 2009 (described below as part of our ongoing work), which both boards would hope to complete in a matter of months and not years. This will also be a topic for consideration by the advisory group.

  With the desire to provide the most meaningful possible information for this year end, the IASB and the FASB are both proposing a change in disclosure requirements for impairments. This will enable companies to disclose the profit or loss that would have been recorded if all financial assets (other than those categorised at fair value through profit or loss) had been measured using amortised cost (ie using an incurred loss model) or all had been measured using fair value. We are publishing an exposure draft next week and are asking for comments by mid-January. This will enable any possible change to take effect for 2008 year end accounts.

- **Clarification of the accounting treatment of embedded derivatives provided by the FASB:** Your letter called for the need to clarify any possible difference in the accounting treatment between IFRSs and US GAAP. Both boards believe that the standards are consistent, and the FASB has now agreed to issue mandatory implementation guidance to ensure that US GAAP is applied in the same way as IFRS. The FASB will publish the draft statement shortly. This guidance will ensure that US practice is in line with IFRSs, providing a necessary level playing field.

- **Reclassification and the fair value option (FVO):** Three issues were raised by participants in round tables—the scope of the FVO, the eligibility criteria in IAS 39 and irrevocable designation. Many participants were concerned about any changes that might lead to inappropriate use of the FVO. Many supported reconsideration of the FVO alongside a broader reconsideration of the classification categories. Almost all the users of financial statements at the round tables said that permitting reclassification out of the fair value option now, without proper consideration of all the issues, would not improve financial reporting or enhance investor confidence in financial markets—reclassifications out of the fair value option would permit losses to be hidden. In addition, many users said that they simply reconstruct earnings to try to eliminate the effect of any reclassification, to the extent that disclosed information permits them to do so (and if an entity did not provide sufficient detailed information at every reporting date, investors suffered a significant loss of overall information about the performance of the entity).

  Both boards find the views of these user participants compelling and believe that any change in the fair value option should only occur as part of a broader examination of accounting for financial instruments. We are committed to such an examination as a matter of priority and will also seek the advice of the advisory group on this issue.

  Furthermore, both boards note that the standards on the FVO already provide a level playing field, and any unilateral action would reduce comparability and create divergence, in direct contrast to the approach set out by the G20 communiqué.

Ongoing work of the IASB

The IASB will continue to identify and address any accounting issues that it believes require urgent and immediate attention to improve financial reporting and enhance investor confidence in the financial markets.

As urged by many participants at the round tables, the IASB will also address the broader issue of improving the impairment requirements and the related classification issues (including the fair value option and transfers between the categories) as quickly as possible including, if necessary, a condensed due process, as for example is already under way for the proposed impairment disclosures. This will include addressing the role of fair value measurement for financial instruments. To avoid divergence in the global capital markets, the IASB intends to consider these issues in conjunction with the FASB.

I look forward to continued close co-operation on these matters in order to improve financial reporting and enhance investor confidence in these difficult times. Please do not hesitate to contact me if you have any questions on the matters discussed in this letter or on any other matter.

Yours sincerely,

David Tweedie
Chairman