Appendix
Submissions for the London public roundtables

Some submissions reflect the views of the organisation. Other submissions reflect the views of the individual participant.

1. UBS
2. European Commission
3. Institut der Wirtschaftsprüfer (IDW)
4. PricewaterhouseCoopers
5. Deutsche Bank
6. Markit
7. Fédération des Experts Comptables Européens (FEE)
8. KPMG
9. HSBC
10. BDO International
11. German Accounting Standards Board
12. European Insurance CFO Forum
13. Institute of Chartered Accountants of Scotland (ICAS)
14. CEA (the European Federation of Insurers and Reinsurers)
15. Standard & Poor’s
16. Citigroup
17. JP Morgan
18. Morgan Stanley
19. Ernst & Young
20. European Savings Bank Group
21. DFCG
22. Australia and New Zealand Banking Group Limited
23. Association of British Insurers
24. Investment Management Association
25. BNP Paribas

Global Financial Crisis Roundtable Meeting
14 November 2008
UBS Input

We believe that the following accounting issues require the urgent and immediate attention of the Boards so as to improve financial reporting and help enhance investor confidence in financial markets.

Improving transparency—a disclosure framework

We are supportive of the steps the IASB is taking and has taken to deal with issues related to the credit crisis, for example, the IFRS 7 amendments currently being proposed. We believe that markets function optimally when sufficient information is available for investors and other financial statement users to understand the economic position and performance of the entities using those markets. We believe that the Boards should take additional steps to better understand those information requirements and develop an overarching disclosure framework for financial reporting. Additionally, investor groups and preparers responding to the Boards on various disclosure issues appear at times to be diametrically opposed. As part of a process to develop a disclosure framework, we believe that the Boards should sponsor a task force of investors and preparers to discuss the form and content of disclosures needed to provide sufficient information to understand the economic position and performance of an entity with particular attention being paid to the unique activities of large financial institutions. The Task Force's report would provide a blueprint for improving financial disclosures and bridging the gap between those two groups.

Eliminating all differences between IFRS and US GAAP on key topics

Differences between IFRS and US GAAP undermine market confidence in accounting standards, jeopardize independent standard setting and harm the trust that investors place in financial reporting. Current differences and potential differences that may arise in the areas of financial instruments, fair value measurement, consolidation and derecognition require the combined efforts of both the IASB and the FASB and support of financial regulators to entirely eliminate. We believe that the goal should be joint standards with the same wording on those extremely important topics. The Boards at this moment have the opportunity to do that for consolidation and derecognition. Capital markets cannot afford different accounting solutions on those topics. We believe that joint standards (with the same wording) will greatly strengthen the faith and confidence of investors in the accounting standards and the financial reporting that rely on them.

Impairment—financial instruments

Impairment models for financial instruments are different under IFRS and US GAAP. Those models also are not consistent within the two accounting frameworks. A joint solution is needed for both frameworks. That solution should cover all classes of financial instruments and produce a consistent model for dealing with expected loss from credit risk, regardless of whether the instrument is carried at amortized cost or as available-for-sale.

Due process and establishment of the monitoring group

The recent amendments to IAS 39 were performed without the benefit of a public comment period. We believe that public comment periods are a necessary element to produce high quality accounting standards. We believe that the establishment of the monitoring group as proposed in the current IASCF constitutional review may further strengthen the structure of the IASCF and the IASB to support the carrying out of all due process steps. That work should be completed as soon as possible.

GLOBAL FINANCIAL CRISIS ROUNDTABLE MEETING – 14 NOVEMBER 2008

ISSUES TO BE RAISED

Fair Value Option - Reclassification

On 13 October 2008 the IASB issued amendments to IAS 39 that permit reclassifications out of the held-for-trading category if justified by rare circumstances. The related IASB's Press Release considered that the deterioration of the world's financial markets that has occurred during the third quarter of 2008 is a possible example of these rare circumstances. However, reclassification is not allowed for items designated as at fair value through profit or loss (Fair Value Option). Many financial institutions have in the past used the fair value option to eliminate measurement mismatches between assets and liabilities or for assets and/or liabilities managed on a fair value basis. However, deterioration of financial markets may have had an impact on the way these instruments are managed. Hence, this raises the need to allow for reclassification out of the fair value option due to changes in circumstances.

Allowing financial instruments classified under the Fair Value Option to be reclassified due to the same reasons and under the same conditions as assets reclassified out of the held-for-trading category would help to better reflect the impact of the current economic environment on the way financial instruments are managed.

Embedded derivatives

There is a difference between IFRS and US GAAP in considering if "synthetic CDOs" include embedded derivatives to be recognised separately. IAS 39 AG 30 (h) has been interpreted as requiring separation of an embedded credit derivative in a "synthetic CDO". As a consequence, companies using IFRS have to account for an embedded credit derivative separately - or have to designate the whole "synthetic CDO" as - at fair value through profit or loss. In contrast, paragraph 14B of FAS 133 (inserted by FAS 155) states that the credit risk component of an interest that represent securitized financial instruments (including derivative contracts) held by the issuing entity shall not be considered as an embedded derivative. As a result, the credit risk component of "synthetic CDOs" would not be recognised separately under US GAAP. If the "synthetic CDO" is classified—or reclassified—in an accounting category measured at cost, its credit risk component would not be measured at fair value.

Urgent action is needed to clarify whether, under IAS 39, the credit risk component of "synthetic CDOs" is an embedded derivative to be recognised separately.

Impairment of Available For Sale (AFS) items

<u>Debt securities</u>

In IAS 39 there are differences in how an impairment loss is recognised depending on whether the debt instrument is accounted for as at fair value through equity (AFS) or at amortised cost (Held To Maturity, Loans And Receivables). 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 to the difference between its carrying value and recoverable amount determined on expected future cash flows.

Under current market circumstances, fair values are significantly changing because of general market factors, including stronger risk-adverse attitude on liquidity and credit risks. As a result, losses recognised in the income statement when a ‘fair value impairment test’ is applied are greater than the change in recoverability of the debt instrument and the difference with impairment tests made on items measured at amortised cost is broadened.

Impairment losses for available for sale debt securities should be determined similarly to impairment losses for held to maturity instruments and loans and receivables. The balance between fair value changes and incurred credit losses would continue to be recognised in equity. Thus, impairment losses recognised in the income statement would be comparable.

Equity instruments

Under IAS 39, impairments of available for sale equity instruments have to be recognised in the income statement based on certain objective evidence. However, reversals of these impairments through the income statement are prohibited because (IAS 39 BC130) it would be difficult to distinguish reversals of impairment losses from other increases in fair value. However, this creates an apparent lack of balance between losses being recognised in the income statement and subsequent recovery being recognised in equity. This accounting treatment is also inconsistent with the one used to reverse impairment losses in all other cases (AFS debt instruments, held to maturity or loans and receivables) which are recorded under the same accounting headings where they were initially recognised. We also note that positive fair value changes are normally recognised under the same accounting headings as negative fair value changes.

There should be a possibility of reversing impairment losses not only for debt securities, but also for equity instruments. This would enhance consistency in the presentation of impairment losses and their reversal for all accounting categories and all types of financial instruments.

Submission 3

IDW

INSTITUT DER WIRTSCHAFTSPRÜFER

Institut der Wirtschaftsprüfer
in Deutschland e. V.

Wirtschaftsprüferhaus
Tersteegenstraße 14
40474 Düsseldorf
Postfach 32 05 80
40420 Düsseldorf

TELEFONZENTRALE:
+49 (0)211 / 45 61 - 0

FAX GESCHÄFTSLEITUNG:
+49 (0)211 / 454 10 97

INTERNET:
www.idw.de

E-MAIL:
info@idw.de

BANKVERBINDUNG:
Deutsche Bank AG Düsseldorf
BLZ 300 700 10
Kto.-Nr. 7480 213

Mr Robert P. Garnett
Chairman of the International Financial
Reporting Interpretations Committee
30 Cannon Street
London EC4M 6XH
United Kingdom

Düsseldorf, 27 October 2008
482/468

Dear Mr Garnett

Fair Value Measurement of Financial Instruments in Inactive Markets: Determining the Discount Rate for Present Value Computations (IAS 39)

Occasioned by the extreme developments within the financial markets during the past few weeks, the IASB and the FASB have recently discussed a number of accounting and reporting issues arising in the context of the global financial crisis, including the application of the fair value hierarchy of IAS 39 and the fair value measurement of financial instruments in markets that are no longer active. These issues have become even more important since the markets for plain vanilla bonds and other standard financial instruments have become inactive for longer periods, as has been experienced on markets for (certain) securitisation instruments. The inactivity of a market for a particular financial instrument is strongly evidenced by both a significant widening of the bid-ask-spread in the brokered markets for that financial instrument (indicative prices only), and no trading volume, respectively a significant decrease in the volume of trades relative to historic levels as well as other relevant factors (see IASB's press release of 14 October 2008, which refers to guidance previously issued in a FASB Staff Position). An inactive market can still exist, despite the incidence of isolated transactions. In such situations, however, the preparer needs to justify why the assumption of an illiquid market is appropriate.

In an active market, the best evidence of fair value is quoted prices (IAS 39.48A). If the market for a financial instrument is not active (illiquid), an entity

GESCHÄFTSFÜHRENDER VORSTAND:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands;
Dr. Klaus-Peter Feld, WP StB CPA;
Manfred Hamannt, RA

establishes fair value by using a valuation technique. Valuation techniques include discounted cash flow analysis (IAS 39.AG74). Indeed, such discounted cash flow techniques are becoming increasingly relevant because, under such conditions as have been faced recently, it is often neither possible to deduce fair value from recent arm's length market transactions in the particular financial instrument nor to draw upon current fair values of other instruments that are substantially the same.

One crucial aspect of applying discounted cash flow techniques is the determination of the discount rate for present value computations in inactive markets. As you are certainly aware, this topic has been the subject of widespread debate between preparers of financial statements, auditors and other interested parties.

After intense and comprehensive deliberation, we have developed a proposal as to how to adequately understand IAS 39 in this context, which we explain below. We have discussed this proposal with the German Federal Government, the BaFin (the German securities, banking and insurance supervisor) and the Deutsche Bundesbank (German Central Bank), all of whom support the approach.

Discounted cash flow models usually forecast cash flows generated by the financial instrument and discount these cash flows using a term and risk adequate yield curve. This yield curve consists of three major components, i.e. the basic risk-free interest rate, the credit spread and the liquidity spread. These spread components have to be distinguished between components that are observable on the market and components that are not observable on the market.

In liquid markets the credit spread, i.e. the premium over the basic interest rate for credit risk, may be derived from observable market prices for traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings (IAS 39.AG82(b)). In illiquid (inactive) markets valuation techniques that comprise discounted future cash flows and related credit risk are used to arrive at an appropriate determination of fair value.

The liquidity spread basically reflects supply and demand in those financial instruments. In active markets the liquidity spread can be derived from internal rates of return and is observable. In illiquid markets the liquidity spread is not observable because it is neither quoted separately (e.g. by a broker or pricing service agency) nor indirectly deducible from transaction prices.

According to IAS 39.AG78, subsequent to initial recognition, an entity may not have information from recent transactions to determine the appropriate spread over the basic interest rate for use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed on initial recognition. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.

Applying this principle to the case of a liquidity spread that is no longer observable on the market, an entity uses, as a starting point, the latest observable amount of this spread component (i.e. when the market was last deemed to be active). Subsequently, when evidence of an adverse change exists, this spread component has to be increased by a premium which must be determined on the basis of both the nature of the specific instrument and the relevant market conditions. However, the maximum amount of this liquidity risk may not exceed the liquidity risk of a non-tradeable loan or receivable which, except in terms of its tradeability, is comparable to the security to be measured.

We support our proposal as to how to adequately understand IAS 39 as follows: In our opinion, the concept underlying IAS 39's fair value hierarchy is that (objective) price information obtained from the market is more relevant and reliable than (subjective) management estimates. However, this concept does, at the same time, acknowledge that market information is only superior as long as markets are functioning properly, at least to a certain degree. Consequently, the fair value hierarchy also requires a (successive) transition from a market-based to a model-based valuation when markets are becoming inactive and no longer provide useful inputs for one or more parameters affecting the value of a financial instrument at the measurement date (such as interest rate spreads containing a credit and liquidity risk element). In such circumstances, model-based valuation should aim to calculate the value of a financial instrument that could reasonably be expected to be the price market participants would agree upon, were they acting in a rational manner.

According to IAS 39.AG75 the objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. The reference to "normal" business considerations should not be misinterpreted as implying that no "stressed" business considerations may be taken into account. Rather, in our view, the reference to "normal" business considerations serves firstly to distinguish between "normal" market conditions on the one hand and forced transactions, involuntary liquidations, distress sales on the other, and secondly to eliminate from the valuations, market behaviour that is clearly not indicative of fair value.

We would be pleased to answer any questions that you may have or discuss any aspect of this letter. Moreover, we would be pleased to provide IFRIC with a more detailed in-depth analysis, which would also include practical issues that need to be addressed in the model-based valuation described above.

Yours sincerely

Klaus-Peter Naumann
Chief Executive Officer

Submission 3

IDW
INSTITUT DER WIRTSCHAFTSPRÜFER

Institut der Wirtschaftsprüfer
in Deutschland e. V.

Wirtschaftsprüferhaus
Tersteegenstraße 14
40474 Düsseldorf
Postfach 32 05 80
40420 Düsseldorf

TELEFONZENTRALE:
+49 (0)2 11 / 45 61 - 0

FAX GESCHÄFTSLEITUNG:
+49 (0)2 11 / 454 10 97

INTERNET:
www.idw.de

E-MAIL:
info@idw.de

BANKVERBINDUNG:
Deutsche Bank AG Düsseldorf
BLZ 300 700 10
Kto.-Nr. 7480 213

Sir David Tweedie
Chairman of the
International Accounting Standards Board
30 Cannon Street

London EC4M 6XH
United Kingdom

2 October 2008
542/575

Dear Sir David

Re.: Draft Document: IASB Expert Advisory Panel: Measuring and disclosing the fair value of financial instruments in markets that are no longer active

We appreciate the opportunity to contribute to the ongoing debate on the issue of fair value measurement and to comment on IFRSs in the light of the recent period of market turmoil. We welcome the work undertaken by the IASB Expert Advisory Panel, resulting in useful educational guidance on the measurement and disclosure requirements of the IFRSs in general. However, we would like to submit the following comments:

Recently, a study has been published in Germany (Pellens, Sawazki, Zimmermann, Accounting does matter – IFRS-Fair Value Accounting: Fluch oder Segen?) which comes to the conclusion that in times of falling market prices fair value measurement can cause severe distortions and can induce a systematic downwards spiral. According to the findings of this study, fair value measurement is the most appropriate measurement base in efficient markets, however, it does not work as soon as an active market ceases to exist. The results of this research paper broadly corroborate the IDW's views on this issue. Admittedly, there is no bright line between active and inactive markets.

Taking into account the study's conclusion and the ongoing market turmoil, we would like to submit the following proposals which are, in our view, appropriate to avert or at least reduce the danger that the measurement requirements of IFRSs add to the tightening of a market turmoil. We are convinced that our proposals will be able to contribute to reducing exaggerations in market fluctuations caused by short-term psychological effects:

- If the market of the respective financial instrument is inactive, in determining fair value, entities may not refer to market prices and transaction prices respectively, stemming from thinly-traded financial instruments or even a single transaction. Instead, a valuation technique should be used in these special circumstances, in particular models based on the discounted cash flow method, i.e., the cash flows resulting from a financial instrument would have to be forecasted and discounted.

  Despite the concerns we have in general pertaining to the reliability and thereby the relevance of fair values determined by valuation techniques, we believe that in the context of thinly-traded financial instruments the reduced reliability of fair values based on valuation techniques has to be accepted in order to be able to obtain relevant measurements for the respective financial instruments. Market prices distorted by short-term psychological effects clearly are less relevant, even if they are more reliable.

- A reclassification of a financial instrument measured at fair value through profit or loss (held for trading) into a category measured at (amortised) cost should be allowed provided that both of the following conditions are met:

  - An active or liquid market does not exist (any more).
  - The business strategy or rather management's intent or ability pertaining to the respective financial instrument has changed as a consequence of market developments.

  This proposal is supported by the above mentioned study which can be obtained via the following email-address: presse@oppenheim.de.

  Up to now, IAS 39 allows for reclassifications in case of financial instruments classified as available-for-sale (cf. IAS 39.50 et seqq.). Therefore, in our opinion, it is consistent with current requirements on the classification of financial instruments on initial recognition to refer to the business strategy or rather management's intent or ability. Taking into account the condition of an absence of an active or liquid market ensures reliability and prevents abuse. Alternatively, we could imagine an obligation to reclassify financial instruments when an active or liquid market ceases to exist.

  In case of a reclassification, the fair value carrying amount of the financial instrument on that date would be deemed as (amortised) cost, similar to the requirements in IAS 39.54. After reclassification, at the end of each reporting period, there would be an obligation to assess whether and to which extent the financial instrument is impaired or uncollectible (cf. IAS 39.58 et seqq.). In case of an impairment, the amount of the loss would have to be recognised through profit or loss.

We would be pleased to answer any questions that you may have or discuss any aspect of this letter.

Yours sincerely

Klaus-Peter Naumann
Chief Executive Officer

Norbert Breker
Technical Director
Accounting and Auditing

Impairment of AFS debt securities

The issue: The impairment models for debt at amortised cost and available for sale debt instruments are inconsistent with each other: both recognise losses only when there is a credit-related event but each measures the impairment loss differently. Impairment for debt held at amortised cost is solely related to the impact of credit loss events on the contractual cash flows in the instrument, which is consistent with the incurred loss measurement trigger. Impairment on AFS debt, however, reflects the entire change in fair value including the impact of market factors (eg changes in interest rate and liquidity) in addition to credit loss events. This is inconsistent with the IFRS requirement for a credit-related event to trigger initial recognition of impairment and creates application and interpretation difficulties, particularly in determining the extent to which recoverability of underlying cash flows has been impaired, and in deciding when subsequent impairment or reversals of impairment are recognised.

One possible solution: Calculate impairment for all debt instruments on the same basis. Thus, impairment losses on available-for-sale debt instruments would be measured based on the difference between the asset's carrying amount and the present value of estimated future cash flows using the original effective interest rate (the recoverable amount).

Potential impact on quality of financial reporting and investor confidence: From a financial reporting perspective, this achieves consistency with the incurred loss model of reporting which requires there to be objective evidence of the occurrence of a credit-related impairment event. It is also consistent with the requirement to measure interest income on an effective interest rate basis for all debt instruments. From an investor confidence perspective, at a time when active markets have disappeared for many debt instruments this would allow investors to distinguish between the ability for the entity to recover the underlying cash flows and the decline in fair value due to illiquidity in the market.

It also has implications for regulatory capital management for those territories where declines in fair value of AFS debt instruments are only recognised for regulatory capital purposes on the basis of the recognition of impairment in the income statement.

We recognise that US GAAP has a different trigger for the recognition of impairment on AFS debt securities (other than temporary impairment) and no ability to reverse impairment subsequently. We would encourage both boards to work together to achieve a consistent impairment model based on the above proposal.

Accounting issues where improvements would enhance investor confidence in financial markets

Overview

Deutsche Bank (the Bank) submits the following comments regarding solutions to improve financial reporting for discussion at the round table. Many of these are explained more fully in our comment letter on reducing complexity submitted to the IASB in September.

The Bank supports the joint IASB / FASB approach which we think is crucial in ensuring that the efforts will work in the interests of financial transparency and investor confidence. We do not believe that European customised solutions will serve either European or non-European organisations. Different sets of standards for different banks that operate in the same international markets would drive confusion, reduced comparability and lack of trust with investors, counterparties and depositors.

We welcomed the actions taken by the IASB in October to enable certain reclassifications to be made out of the fair value through profit and loss and available for sale classifications. In our comment letter on reducing complexity we expressed support for such reclassifications.

We recognise the short time frame and reduced due process followed for the reclassification amendment and the need for this in this instance. However, for other areas of IAS 39 and IFRS 7 that need attention, some of which relate to matters which are not inconsistent between IFRS and U.S. GAAP, we believe it is appropriate that the IASB and the FASB work together to prioritise and develop considered and consistent solutions over a reasonable time frame within established due process.

The Bank believes the best contribution that the accounting standard setters can make towards enhancing investor confidence is through reduced complexity in accounting and reporting of financial instruments and improved quality and transparency of financial instrument disclosures. The IASB has a project on reducing complexity. We recommend that the IASB brings forward its time table regarding this project and its project on fair value measurement. The report from the IASB Expert Advisory Panel provides recommendations to improve disclosures about fair value. We recommend that the IASB encourages preparers of financial statements to consider the guidance and good practice described in this paper as they design their disclosures.

Specific areas of focus

The following are our suggestions for improving certain aspects of IAS 39/IFRS7.

<u>Mixed Measurement Model</u>

The Bank supports a mixed measurement model which matches the financial reporting with the business model and intent. To achieve this, we believe its should have the following three categories:

(i) instruments carried at fair value though the profit and loss;

(ii) available for sale equity instruments carried at fair value with changes reported separately from fair value changes on instruments carried at fair value through profit or loss; and

(iii) debt instruments carried at amortised cost.

For those financial instruments which are not managed on a fair value basis and have a defined maturity (debt instruments), the amortized cost category is the most appropriate as it reflects the expected cash flows. For equity instruments, which typically lack a maturity date, we support the use of the existing available for sale classification for holdings not managed on a fair value basis.

The Bank supports the elimination of the held to maturity category as the tainting rules cause unnecessary complexity and as a consequence the classification is not widely used. The definition of loans and receivables in IAS 39.9 would need to be amended so that debt securities with quoted prices in active markets could be measured at amortised cost. This would also allow entities to align the accounting classification with the business model and risk management of certain financial instruments.

Any decision not to classify and measure financial instruments at fair value through profit or loss should be accompanied by appropriate disclosures to explain why the financial instruments are not carried at fair value through profit or loss and how they are managed.

We also believe that to increase the usefulness of financial information and reduce complexity in reporting requires a complete solution that incorporates a review of both the measurement bases and the presentation and disclosure requirements for financial instruments.

<u>Calculation and Reporting of the Impact on Own Credit</u>

The IASB Expert Advisory Panel has recommended more disclosure regarding the amount of any change in fair value attributable to own credit. However, there should be a full review of the principle and practice of applying the fair value option to "own debt". Financial institutions have taken different approaches to the measurement of the fair value of "own debt" which has caused significant differences in the level of reported gains/losses between them.

<u>Simplification of Hedge Accounting Rules</u>

Hedge accounting is considered complex by many users and preparers of financial statements. In a mixed measurement model hedge accounting provides a valuable tool for financial statement preparers to communicate to financial statement users how a business manages the various financial risks it is exposed to.

Therefore, it is important that hedge accounting should be retained, but we believe that there are opportunities to simplify certain aspects of the current hedge accounting requirements.

<u>Impairment of AFS Debt and Equity Instruments</u>

As noted above, our recommendation for the mixed measurement model is to eliminate the AFS debt instrument classification altogether. However, in the event that the classification remains then we believe it is important to address the impairment model. We believe that the impairment guidance in IAS 39 is overly complex and inconsistent. The impairment analysis is triggered by <u>any</u> objective evidence that an asset is impaired; then depending on the classification or type of asset the impairment analysis differs as follows.

- Different impairment triggers for debt and equity investments

- For equity investments the impairment test is based on a significant <u>or</u> prolonged decrease in value, where as US GAAP is an “and” test. This results in greater impairments under IFRS than US GAAP.

- Different measurement bases for impairment for investments at amortised cost (loans and receivables) and AFS debt investments

- Treatment of decreases/increases in fair value of AFS debt investments following impairment, where the subsequent fair value change is due to changes in interest rates only; the question arises on how this should be represented, additional impairment or reversal of impairment?

Our suggestion would be that the IASB consider aligning the requirements for the measurement of impairment between AFS debt instruments and loans and receivables. This change would resolve the inconsistency regarding the amount that is recognised as impairment and how to reflect subsequent changes in fair value of AFS debt investments.

For equity investments we suggest that the test be changed from “or” to “and” to more appropriately reflect decreases in value that persist rather than short term volatility in markets and align IFRS and US GAAP. Furthermore, the prohibition of fair value increases being taken through the profit and loss account on an impaired equity instrument classified as available for sale is unnecessarily onerous.

<u>Allow the FVO in IAS 39 to be used without restriction</u>

Removal of the qualification restrictions for use of the FVO would simplify financial reporting. This will also create a level playing field between U.S. GAAP and IFRS filers as U.S. GAAP allows an unrestricted FVO for financial instruments. The FVO should continue to be an election permitted at inception only and should continue to have adequate disclosure.

<u>Elimination of IAS 39 scope restrictions</u>

Both financial and non financial instruments are often used in trading strategies. However, the accounting standard scopes out certain instruments from IAS 39, thereby preventing them from being measured at fair value through profit or loss. Examples are set out in our reducing complexity comment letter.

<u>Allow entities to apply a FVO to certain instruments (both financial and non financial) which are currently scoped out of IAS 39</u>

To increase the usefulness of financial statements the application of the FVO should be extended to certain non financial instruments. For example, storage and transportation contracts are contracts which are used in commodity trading strategies and investments in Associates.

<u>Foreign exchange on available for sale equity instruments</u>

Equity securities are considered by IFRS to be non-monetary assets. As such foreign exchange movements on equity instruments classified as available for sale is reflected in equity rather that through profit or loss. This creates complexity as the foreign exchange effect is reported differently to that arising on other financial instrument classifications. It also causes accounting asymmetry where the instrument is funded by a debt instrument. To reduce this complexity, the Bank believes the treatment of foreign exchange differences arising from available for sale equity instruments should be taken directly through profit or loss.

markit™

Level 5
2 More London Riverside
London
SE1 2AP

+44 20 7260 2000 Office
+44 20 7260 2001 Fax
www.markit.com

IASB Roundtable: Summary of Markit's views

Fair value, the only long term solution

- Only the consistent use of fair value accounting across institutions and products globally has the potential to maximise transparency and comparability. A common definition of fair value will be the cornerstone of the convergence of separate sets of standards, and we welcome the joint work of the IASB and the FASB in this respect.

Sources of data

- Even if trading activity is limited a wealth of observable data will often be available which will be an accurate reflection of fair value in many cases.
- The argument that in the current crisis market prices do not reflect the "fundamental value" of an asset is mostly not backed by empirical evidence.
- Allowing the use of internal assumptions to determine the "fundamental" value of an asset encourages institutions to muddle through, allowing them to publish "surprise profits" on the back of hidden losses. The option to re-classify products has to be seen in a similar light. Both changes are likely to prolong the period needed to sort out the problems, while reducing transparency and confidence in the market place, the opposite of what is needed.

The role of fair value in the crisis and the need for changes

- Fair value accounting was certainly not the cause of the market crisis, and it actually had the beneficial impact of revealing losses in a timely and transparent fashion. It should hence be maintained in its original form while regulatory or financial stability concerns should be addressed separately.
- Recent pressure exercised by politicians and special interest groups has blurred the concept of fair value to a significant degree already. We do not think that amendments to the definition or application of fair value, let alone an outright suspension, can have any lasting beneficial impact.
- The potential pro-cyclical effects of fair value accounting require investigation, and potentially the implementation of some remedial measures. The analysis should take into account periods of falling as well as of rising prices. Also, potential measures should be devised and implemented by regulatory bodies, and should not impact the actual definition of fair value.

The role of the accounting standard setters

- Both the IASB and the FASB have played a key role in providing additional guidance in a timely fashion where needed. Statements by the *IASB Expert Advisory panel* were particularly helpful and we share most of its views.
- Political pressure and special interests have recently influenced not only on the direction but also the speed with which amendments to accounting standards were implemented. For some changes, too little time was given to collect and consider feedback, or to investigate potential unintended consequences. Undue political influence needs to be restricted, and the independence of the standard setting process must be maintained.

Exit price

- The use of two different prices, i.e. bid and offer, depending on your position, in accounting for the same instrument will result in a loss of comparability.
- The use of a "mid" price as a practical expedient to determine a price within the bid/offer range should hence be accepted.

Two-level hierarchy

- The use of just two levels in the fair value hierarchy would increase clarity and reduce administrative cost compared to the three-tiered approach in FAS 157.
- Level 1 valuations will be based on observable inputs and carry a sufficient degree of confidence, while Level 2 valuations will be based mostly on unobservable inputs using a model.

Submission 7

FEE (Federation of European Accountants) considerations for the IASB Roundtable on global financial crisis of 14 November

The financial crisis is a global phenomenon that calls for a global reaction. FEE is strongly committed to robust, high quality global principle-based financial reporting standards and supports the objective of creating a single set of global standards. Global financial markets require financial information prepared in accordance with global standards for reasons of competitiveness and comparability and for capital raising purposes. We welcome in this respect the creation by the IASB and FASB of a global advisory group with a wide range of stakeholders to ensure that reporting issues arising from the crisis are considered in an internationally coordinated and transparent manner. We welcome the organisation of the Roundtables to identify financial reporting issues highlighted by the global financial crisis.

We note that the endorsement of amendments to IAS 39 and IFRS 7 published by IASB on 13 October 2008 was a necessary step in the process of restoring a level playing field and creating confidence in financial markets, a decision which is fully supported by the accountancy profession. We appreciate that, given the critical circumstances of the financial crisis, it was necessary to omit the due process normally applied in standard setting at various levels. Any further amendments to IAS 39 and IFRS 7 which might be suggested should be given full consideration as to their implications and potential unintended consequences and be subject to an appropriate due process and proper consultations of all stakeholders. If it were to be concluded that certain urgent issues remain to be solved, in an accelerated manner, consideration will need to be given how this due process may be shortened. Sustainable solutions need to be found at global level respecting the due process so that the resulting reporting can also be assessed for auditability.

In the recently held stakeholder meeting organised by the European Commission, the accountancy profession did not itself identify any issues that from its perspective are so urgent that they need to be solved before year end. We have provided input to the draft of the European Commission and in relation to the letter would like to note the following:

- We consider that it is important for the IASB to address (at least) some if these issues in the annex to the letter as soon as possible.
- We believe that it is important that an appropriate due process is followed in order to allow enough time to constituents to consider and comment upon the proposed changes.
- We could consider that given the extraordinary situation, due process should be accelerated to a reasonable extent and that constituents be asked to comment faster than before.

Furthermore, in its comment letters on the Discussion Paper on Reducing Complexity in Reporting Financial instruments the profession has identified issues that need to be addressed in a revision of IAS 39 respecting the normal due process (we refer in this respect to the FEE comment letter of 1 October states that there is significant complexity in the current reporting of financial instruments and that there is a need to reduce this complexity recognising that by nature the subject of financial instruments is complicated, given the diversity of financial instruments and the related management methods ("business models").). Solutions issued around 31 December will anyhow be too late for preparers and their auditors since it would not leave sufficient time for preparation of the year end financial statements. Any late solutions or not well thought through solutions will impose extra burdens on preparers. There is also a risk that the publication of the year end results will be delayed.

Overall issues

- Structure and process for standard setting
  - issue identification and prioritisation
  - balancing rapid response with global responsibilities
  - importance of due process to support legitimacy of IASB and high quality standards
- Interaction of capital market reporting with regulatory capital requirements

Fair value accounting for financial instruments

- Relevance of fair value for investor-oriented reporting
- Priorities for improving current fair value requirements and application

European requests for further amendments to IAS 39

- Ability to reclassify instruments out of "fair value option" classification
- Embedded derivatives – synthetic CDOs
- Impairment of AFS financial assets
  - Debt securities – measure impairment based only on credit losses
  - Equity instruments – allowing reversal of impairment losses
  - Both suggestions warrant further accelerated consideration
  - Additionally, consider whether parallel changes to US GAAP other-than-temporary impairment model appropriate

Classification and reclassification of financial instruments

- Implementation issues arising from October amendments
  - (Re)classification criteria - clarification as to following would be beneficial:
    - Whether instruments reclassified under 50D and 50E are required to meet definition of loans and receivables (L&R) at time of reclassification, at initial recognition or at any previous point in time
    - Whether reclassified instruments must meet definition of the category they are being reclassified into at that time
    - Whether items (re)classified as L&R must meet the definition on an ongoing basis to remain there
    - What reclassifications beyond those specifically mentioned in IAS 39 are permitted
  - Embedded derivatives. IASB should take action to resolve scope conflict with IFRIC 9 regarding re-assessment of separation of embedded derivatives for assets reclassified out of trading

Progress on consolidation project

- Encourage efforts of IASB and FASB to produce converged high-quality guidance
- Consolidation project
  - Focus on resolving identified SIC 12 application issues (reassessment of control, managed funds) and responding to FSF re improved disclosures around off-balance sheet entities (with focus on risk)

Simplification of hedge accounting

- IASB and FASB should consider working together in medium-term to simplify hedge accounting rules and resolve some practical burdens and application difficulties, in particular:
  - A more objectives-oriented approach to hedge designation and documentation
  - Replacing detailed requirements for quantitative effective testing based on high effectiveness with a qualitative approach based on a standard of reasonable effectiveness, supported by recognition of all ineffectiveness in P&L on a current basis

Submission 9

IASB Global Financial Crisis Round Table Meeting

1. Impairment of AFS debt securities

Issue:

IAS 39.67 & 39.68 requires the entire cumulative loss that has been recognised directly in equity to be transferred to profit or loss when there is objective evidence that the asset is impaired. For example, there has been a significant decline in the fair value of many high quality debt securities which in many cases is caused by large increase in credit spreads rather than fundamental deterioration in the underlying cash flows which support the valuations. As a consequence, there is considerable risk that financial institutions will be required to record impairment losses which overstate the losses that are likely to be realised where the financial institution has the intent and ability to hold the securities for the long term. Furthermore, as a consequence of overstating the initial impairment losses, the reversal of losses that occurs when assets recover is also overstated, leading to unwarranted volatility in reported income.

Solution/improvement in financial reporting:

A more appropriate basis of measurement of impairment of AFS debt securities is to record as the amount of the impairment only the amount that reflects the present value of the expected shortfall in future cash flows, with the balance of the fall in fair value recorded in equity.

Investor confidence in financial markets would be improved because reported impairment losses would be a more accurate reflection of the actual impairment losses in cash flow terms, and the associated unwarranted volatility in reported results would be removed.

2. Reversal of impairment for AFS equity securities

Issue:

IAS 39.69 prohibits the reversal of impairment losses on AFS equity securities. Impairments in equities will be recognised under IAS 39.61 because significant declines in fair values can arise solely because of falls in the general level of market prices rather than for company-specific reasons.

Solution/improvement in financial reporting:

Removal of the prohibition on reversing impairment losses in respect of AFS equity securities through profit or loss. Such impairment losses should be reversed when there is a clear objective evidence that market values have recovered.

Investor confidence in financial markets would be improved because movements in the economic value of AFS equity securities would be more fairly reflected in income.

Any such reversals of impairment would be explained in disclosures, providing better information to investors than in the current accounting treatment.

3. Hedge accounting – removal of bright line hedge effectiveness test

Issue:

Under IAS 39, one of the conditions required to qualify for hedge accounting relates to the hedge being highly effective throughout the financial reporting periods. Given that all hedge ineffectiveness is recorded in the income statement, the current model, in which hedge accounting could fail if "bright line" prospective and retrospective tests are not met, is unnecessary as well as being both costly to implement and maintain.

Solution/improvement in financial reporting:

Consistent with one of FASB's proposals, the Board should consider the use of a qualitative approach to effectiveness testing, both at inception and on an ongoing basis, which could be supported by a quantitative test where deemed appropriate. For example the Board should consider changing the effectiveness testing criteria to "reasonably effective".

Investor confidence in financial markets would be improved because the economic effect of the hedging strategies of financial institutions would be reflected in financial statements.

4. Own credit spread

Issue:

In line with IAS 39 paragraph AG69, the fair value of a financial instrument should reflect the credit quality of the instrument. Where an entity issuing its own debt designates the financial liability at fair value through profit or loss, there may be a significant decline in the fair value of the debt instrument, due to large increases in credit spreads, causing gains to be recognised in the income statement. This reflects the increased cost to any entity of issuing debt in the market at current market rates. However, in reality it is highly unlikely that an entity would be able to recognise these unrealised gains, and therefore they should not be recognised in profit or loss.

Solution/improvement in financial reporting:

The fair value gains and losses due to movements in own credit spread should be recognised in equity and continue to be disclosed in line with the requirements of IFRS 7.10.

Investor confidence in financial markets would be improved because gains and losses on movements in own credit spread, being theoretical in nature, would be separately disclosed outside of the income statement, providing a clearer picture of performance.

Suggested agenda items – BDO

1. Issues to be addressed in the short term

While we believe that it is appropriate for the Boards to address the issues at 1.1 and 1.2 below in the short term, we also consider that this process should include appropriate (albeit accelerated) due process. This is necessary in order that unintended consequences arising from proposed amendments are identified and dealt with before the amendments are issued in final form.

1.1 EC letter dated 27 October 2008

We consider that the issues set out in the EC letter should be debated as priority agenda items at the roundtable meeting. We encourage the Boards jointly to address the issues raised, making appropriate changes to both IFRS and US GAAP so that (as far as possible) the accounting requirements of both GAAPs are aligned. Such an approach will improve the consistency of globally reported financial information.

1.2 Embedded derivatives

Issue

The recent amendments to IAS 39 permit the reclassification of certain financial assets from FVTPL to another IAS 39 category. IFRIC 9, the issue of which predated the reclassification amendments to IAS 39, prohibits the reassessment of embedded derivatives after the initial recognition of a financial instrument. This has led to inconsistency in approach. Some suggest that on reclassification out of FVTPL, IFRIC 9 applies and therefore no reassessment for embedded derivatives on reclassification is permitted. Others argue that, because IFRIC 9 was not written in contemplation of the permission to reclassify financial assets out of FVTPL, it should not be applied in those circumstances with embedded derivatives being identified and (if appropriate) separated on the date of reclassification.

The issue is linked to the EC issue covering embedded derivatives which identifies a further inconsistency between IFRS and US GAAP.

Suggested approach

The application of IFRIC 9 should be clarified with amendments being made as appropriate.

Regardless of whether the clarification of IFRS requirements means that a reassessment for embedded derivatives is required on reclassification out of FVTPL, an inconsistency exists between IFRS and US GAAP in accounting for certain embedded derivatives in synthetic CDOs, which should be eliminated. This issue is discussed in the EC letter, and might be addressed by amending IAS 39.AG30(h).

How will this improve financial reporting and enhance investor confidence?

Inconsistency among IFRS financial statements, and among financial statements prepared in accordance with IFRS and US GAAP, will be reduced.

2. Other issue – impairment

Issue

In addition to the issues set out above, we note that IFRS and US GAAP have different approaches for the recognition and measurement of impairment losses on debt securities classified as AFS.

Suggested approach

We encourage the IASB and FASB to work together in order to eliminate differences in approach. We consider that there is less urgency for this issue than those set out above, although we believe that the Board should again adopt an accelerated due process.

How will this improve financial reporting and enhance investor confidence?

Inconsistency among financial statements prepared in accordance with IFRS and US GAAP will be reduced.

Deutsches Rechnungslegungs Standards Committee e.V.
Accounting Standards Committee of Germany
Der Standardisierungsrat®

DRSC e. V. • Zimmerstr. 30 • 10969 Berlin

Telefon +49 (0)30 206412-12
Telefax +49 (0)30 206412-15
E-Mail info@drsc.de

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

United Kingdom

Berlin, 11 November 2008

Dear David,

IASB/FASB round table on global financial crisis on 14 November 2008

The German Accounting Standards Board (GASB) appreciates the opportunity to participate in the above mentioned round table. We believe that the following accounting issues should be discussed.

Issues with short-term relevance:

- **Applying the recent amendments made to IAS 39 and IFRS 7**: It should be clarified that reclassifications into the 'loans and receivable' category can be made when the market for those instruments is inactive at the date of the reclassification, regardless whether that market was active or inactive at the date of initial recognition.
- **Fair value option**: We suggest the Boards consider allowing a reassessment in cases in which an entity exercised the fair value option based on correlations, e.g. interest rates present in normal economic circumstances that existed on initial recognition, when these correlations disappeared or changed significantly due to the current crisis.
- **Embedded derivatives**: Clarification is needed for those cases in which a derivative is embedded in another contract and such host contract can be reclassified to another category under the recent amendments to IAS in regard of how to account for the embedded derivative (separation or reclassification of the whole instrument) considering IFRIC 9. A sub-question in this area is the treatment of 'synthetic CDOs', which under IAS 39 contain embedded derivatives that, unlike under US-GAAP, need to be separated.
- **Guidance on Fair Value measurement in inactive markets**: We would like to discuss whether the existing guidance is assessed by market participants as being adequate. We would further like to suggest a discussion whether market exaggerations that occur although markets are not considered inactive need to be considered in full in determining the fair value.

Issues with mid-term relevance:

- **Tainting rules** for financial instruments classified as held-to-maturity (we refer to our comment letter dated 19 September 2008 on the Discussion Paper: Reducing Complexity in Reporting Financial Instruments).
- **Impairment rules in IAS 39**: IAS 39 prohibits the reversal of impairment losses through profit or loss for investments in equity instruments classified as available for sale. This unequal treatment compared to debt instruments should be reviewed.

Finally we like to point out that currently guidance and clarifications provided by the IASB are found in various non-authoritative papers. We suggest incorporating that guidance into a single document on an authoritative level.

We are pleased to further discuss any aspects of this letter.

Yours sincerely

s/n Liesel Knorr

Victoria Blackburn
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

10 Novembre 2008

Dear Victoria,

This letter is drafted on behalf of the European Insurance CFO Forum, which is a body representing the views of 20 of Europe's largest insurance companies. It represents a consensus view on issues relevant to the European insurance industry. We are taking this opportunity to respond to your request for agenda items for the forthcoming Roundtable. We believe that we have set out the key issue that we would expect to be discussed, our suggested solution and the rationale for our proposed changes, in our letters to Sir David Tweedie on 10 October and 30 October. I have reiterated the key points made in that letter below for your convenience. I have also made reference to other issues referred to in the European Commissions' letter to the IASB dated 27 October which also represent important agenda items.

We stated in our letters our concerns with the continued application of mark-to-market accounting instead of mark-to-model for those financial instruments for which there is no longer substantial market liquidity given that mark-to-market values can be significantly lower than the genuine economic value of the positions. Furthermore, we noted that accounting classification and business intent are no longer aligned and that the assessment of solvency is also impacted by current accounting rules. Therefore, we proposed some measures designed to reflect the business intent and the value of the instruments held and therefore attempt to dampen the negative spiral of the current crisis.

We urged the IASB to allow reclassification, at fair value on the date of transfer, from the "fair value through profit and loss" (FVTPL) category to another category for both trading assets **and** assets designated at fair value by option if there is an unequivocal change in business intent to hold the instruments in the foreseeable future as a result of the lack of market liquidity leading to market conditions which no longer permit entities to manage the assets and have the corresponding performance evaluated on a fair value basis or giving rise to newly created mismatches situations.

The fair value option can be used under very specific circumstances, mainly in cases of mismatches, the application of asset and risk management strategies based on fair value, or the existence of embedded derivatives. In addition, the election of the fair value option is also limited to those cases where fair value can be determined reliably. **The rationale behind the reclassification of assets out of the financial instruments measured at fair value upon inception category is that there should be a possibility to reclassify such assets under the rare circumstances where *the conditions* which permitted the financial instruments to be designated at fair value through profit or loss at inception *are no longer met*.** Such circumstances include precisely the current market environment, where especially assets and risk management strategies were strongly modified over recent months.

We would therefore fully support reclassifications of financial instruments from the fair value option category, either into assets Held-to-maturity, Available-for-sale or Loans & Receivables. **Such reclassifications would not only be in line with the existing underlying rationale behind the IAS 39 designations, but would also allow a better reflection of the economic reality and asset management strategy of companies.** Keeping assets under the categories elected upon acquisition when the precise reasons for which such elections were made possible no longer exist could mislead investors and could result in an aggravation of the current downward spiral of extreme volatility, increase in spreads, asset value decreases and negative earnings, given the weight of insurance companies in the economy.

We note that the European Commission in their letter of 27 October was also pointing out areas of inconsistencies regarding impairment or embedded derivatives and we would also support the resolution of these issues as well.

We believe that these proposals should represent a global solution to a global problem and therefore both the IASB and FASB should include it in their accounting standards. It is also imperative that these proposals are adopted as an immediate solution and it is our strong preference for these changes to be enacted by the IASB.

We acknowledge that the IASB have made recent efforts to react to the credit crisis. However, from an insurer's standpoint, the measures taken until now may have been seen as useful to banks (October 13 amendment) or users (additional proposed disclosures) but do not specifically address certain issues for the insurance industry.

We look forward to having the opportunity to answer any questions you may have on these issues at the coming roundtables.

Yours faithfully

Amélie Breitburd
Chair of the Technical Working Group
European Insurance CFO Forum

Submission 13

ICAS submission to IASB roundtable on global financial crisis

Issue	Proposed solution	How does this improve financial reporting and enhance investor confidence?
Complexity and length of corporate reporting The global financial crisis has highlighted problems with the overall corporate reporting package, rather than with specific financial reporting standards. Specifically, the current volume, complexity and level of detailed disclosure of corporate reports mean that the key messages, issues and judgments can be obscured. This contributes to a lack of understanding on the part of users of corporate reporting.	The IASB should develop a year-end reporting standard requiring entities to produce a brief, self-contained summary report signed by the directors. Such a report would be no more than 10 pages, setting out in plain language a consistent message of the entity's performance and financial position, making clear the key issues and judgements, and should be capable of standing alone without reference to a more detailed annual report.	Focussing on a concise summary would force entities to report with more clarity and would contribute to a more effective communication of the key issues between an entity and its shareholders and other users of its financial reports. This would have a positive impact on preparers by encouraging them to consider the audience they are reporting to and the information they are communicating, rather than on complying with voluminous regulatory and disclosure requirements. This in turn will enhance investor confidence in financial reporting.
Measurement of financial instruments Much of the complexity relating to the accounting for financial instruments derives from the fact that there are currently different measurement bases. This has resulted in a proliferation of rules and exceptions to these rules, which are complex to apply and interpret.	The standards on financial instruments should be developed to require measurement of all financial instruments at fair value. ICAS has previously published a paper on this topic which we attach with this submission. This new fair value model would have to be developed in conjunction with a new model of financial statement presentation which would permit a meaningful presentation of changes in the value of financial instruments.	This would improve and simplify financial reporting, by providing greater clarity and consistency in the reporting of financial instruments. Investors would have greater confidence in a simpler model, in which changes in fair value measurements would be readily identifiable and understandable.
Understanding of fair value The current crisis has highlighted a general lack of understanding of fair value measurement, in particular its usefulness and relevance when markets are illiquid.	The IASB should develop a discussion paper explaining why fair value is considered to be the most useful and relevant measurement base for the reporting of financial instruments. This should be aimed at a wide audience in order to inform the quality of debate going forward. ICAS would be happy to work with the IASB in developing such a document.	Many of the current criticisms of the fair value model arise from a lack of knowledge amongst participants in the financial reporting debate. A discussion document as described would be valuable in educating participants and therefore allowing the IASB to build a broad base of support for future work on financial instruments.
Alignment with US GAAP There remain some inconsistencies between IFRS and US GAAP in relation to the reclassification of financial instruments. This results in a lack of comparability in reporting.	The IASB should complete its work to align IFRS with US GAAP in relation to reclassifications.	Enhancing comparability will provide greater confidence to preparers and users of financial reports.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SCOTLAND

Principles not Rules: Report on Proceedings of Financial Instrument Workshops

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http://www.icas.org.uk

The Institute of Chartered Accountants of Scotland

21 Haymarket Yards, Edinburgh EH12 5BH

Tel: 0131 347 0237

Fax: 0131 347 0111

E-mail: mcrickett@icas.org.uk

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IAS 39 'Deconstruct' Workshop Participants

Alex Brougham	European Head of Accounting Policy, Morgan Stanley (Chairman)
Hugh Shields	Director and Head of Financial Reporting, Barclays Capital (Facilitator)
Kumar Dasgupta	Associate Director, Technical Accounting Group, Barclays Capital
Martin O'Donovan	Technical Officer, The Association of Corporate Treasurers
Andrew Spooner	Director, Deloitte
Sandra Thompson	Director, Global Accounting Consulting Services, PricewaterhouseCoopers
Sam Wilkins	Manager of Treasury Accounting and Control, ScottishPower

Financial Instruments 'Blank Sheet' Workshop Participants

Marjorie Marker	Managing Director, Corporate Risk Management & Derivatives, Barclays Capital (Chairman)
Hugh Shields	Director and Head of Financial Reporting, Barclays Capital (Facilitator)
Mark Kirkland	Senior Vice President, Global Head of Financial Risk & Cash Services, Philips
Louise McSweeney	Head of Client Accounting, Technical Accounting Group, Barclays Capital
Colin Martin	Director, Financial Management, Financial Services Advisory, KPMG
Gary Romain	UK Head of Technical Accounting, Barclays Capital
Shannon Warren	Managing Director, Accounting Policy, JPMorgan Chase & Co.
Chris Weidler	Head of US GAAP Accounting, Technical Accounting Group, Barclays Capital
Paul Wilkinson	Group Treasurer, Tomkins Plc

It should be noted that the Workshop participants were acting in their personal capacity and were not representing the organisations for which they work.

CONTENTS

SECTION ONE - INTRODUCTION AND SUMMARY

Introduction

As part of the *Principles versus Rules* project, it was decided to focus specifically on an area of much recent controversy, financial instrument accounting. This part of the project can be seen as having two key purposes:

- to explore whether, or to what extent, the current version of IAS 39 can be distilled into higher level principles; and
- to explore what an alternative model for financial instruments might look like if one were to start afresh.

To achieve the above, two 'brainstorming' sessions were held by two different groups of financial instrument accounting experts. The first group focused on IAS 39 (the 'deconstruct' workshop) whereas the second explored the subject from a 'blue sky' perspective (the 'blank sheet' workshop). The first group made reference to the material prepared by the IASB for the IAS 32 and IAS 39 roundtable discussions in 2003.

Summary

Section two describes the thought process that went into the attempt to deconstruct IAS 39 into principles. Because IAS 39 is a mixed measurement model, the group found it extremely difficult to develop a coherent and consistent set of principles from IAS 39. This is manifested in the large number of exceptions in IAS 39 compared to the principles identified (as set out in section three of this document). For illustrative purposes, Appendix I to this document identifies various exceptions relevant to just two areas: recognition and derecognition; and measurement of financial assets and liabilities. A complete listing of exceptions for all areas in IAS 39 would run to hundreds of pages.

The IAS 39 group's broader discussion of principles and rules was also revealing. One key point is that the group found it difficult to express formally how a rule differs from a principle. However, the group also felt that the distinction may not matter in the sense that there is always going to be some kind of spectrum which ranges from high-level principles to more detailed guidance or rules. By implication, the group clearly accepted that one cannot have principles alone without any additional guidance at all. The group was also clear on another critical point: it is not the role of accounting standards to anticipate abuse and incorporate rules to prevent such abuse.

Section four describes the thought process which went into the development of a new model for financial instruments from a 'blue sky' perspective. This discussion was far more wide-ranging and involved several iterations to arrive at the model described in section five. The group ultimately settled on a model in which all financial instruments are reported at fair value, both initially and subsequently. However, the group was also clear that there remains work to do to ensure that this measurement approach is fairly presented in performance reporting terms. Furthermore, the group started with the premise that the model should be consistent with the overarching concepts contained in a Framework or Concepts Statement.

The second group's broader discussion of principles and rules was relatively consistent with the IAS 39 group. The group felt that there should be a clear hierarchy of overarching concepts, principles that reflected the overarching concepts and then guidance to support the principles. The group also agreed that the model should not contain anti-abuse or policing provisions.

In summary, the 'brainstorming' sessions illustrated the difficulty of developing a principles-based approach where the model is based on mixed measurement and is supported by many complex rules. On the other hand, while it is not trivial to develop a principles-based approach where the model is based on full fair value model, it is more conceptually possible and will result in far fewer exceptions.

The final report Principles Not Rules, which incorporates some of the findings of these sessions, is available from ICAS or at www.icas.org.uk.

SECTION TWO - DECONSTRUCTING IAS 39 INTO PRINCIPLES - THE THOUGHT PROCESS

The distinction between principles and rules

The initial discussion of the group revolved around the distinction between 'principles' and 'rules'. The group agreed that principles are high-level, general statements which leave room for judgement. They are based on the objectives of financial reporting and do not contain bright lines. However, it is difficult to define a principle with any degree of clarity. While it is relatively easy to identify a rule it is often difficult to identify a principle.

The group realised that it did not come to a conclusive decision as to what a principle is and how it would differ from a rule or a concept. Given the importance of the issue the group recommended that the question "what is a principle and what are its distinguishing characteristics" be addressed in future.

As principles are high-level statements a principles-only standard would not be sufficiently detailed to ensure any degree of real comparability, especially in a global context given the variety of cultures that apply International Financial Reporting Standards (IFRS). The objective therefore was to arrive at a principles-based standard and not a principles-only standard. The group was of the view that standards that are principles based may be less subject to abuse.

One view was that there is a spectrum between high-level principles and detailed rules. Cultural and legal background determines to a large extent where we operate within this spectrum.

The group concluded that robust accounting is a function of:

- accounting standards;
- preparers applying accounting standards sensibly/ fairly; and
- auditors and regulators enforcing the principles where required.

The group believed that it is not the role of accounting standards to anticipate abuse and incorporate rules to prevent such abuse.

In view of this the group concluded that a principles-based approach is practicable if:

- companies comply with the spirit of the principles; and
- principles are enforced in spirit by auditors and regulators.

Identifying the principles in IAS 39

In determining the principles in IAS 39 the group looked for consistency between the various requirements in the Standard, for example, consistency of principles in recognition and de-recognition of financial assets and liabilities. There was a view that scope and definitions could never be based on principles.

However, each time a principle was developed it was necessary to include exceptions to arrive at the requirements in IAS 39. Given the number of exceptions for any given principle in IAS 39 the group found it difficult to conclude whether the requirements were based on principles with exceptions or whether they were a collection of rules. It became clear that it is difficult to develop a coherent and consistent set of principles in an accounting standard that is based on mixed measurement and supported by many complex rules.

SECTION THREE - DECONSTRUCTING IAS 39 - THE PRINCIPLES IDENTIFIED

Scope

- The Standard applies to cash and contracts for cash.

Measurement

- All financial assets and financial liabilities that result from transactions shall be measured at initial recognition at their fair value.
- Subsequent measurement shall reflect the nature of the instrument and/or the purpose for which it is held.
- All derivatives should be at fair value - this was considered to be a rule rather than a principle.

Impairment

- If a past event results in a decrease in the expected future cash flows from a financial asset, then the asset shall be re-measured to reflect the revised expectations.

Hedge accounting

- When a financial asset or financial liability is in a hedging relationship:
  - to the extent the hedging relationship is not effective, ineffectiveness is recognised immediately in the income statement;
  - to the extent the hedging relationship is effective, the offsetting gains and losses on the hedging instrument and the hedged item are recognised in the income statement at the same time;
  - only items which meet the definitions of assets and liabilities are recognised as such in the balance sheet; and
  - all intra-group items are eliminated on consolidation.

Recognition

- An entity shall recognise a financial asset or a financial liability on its balance sheet when the entity becomes a party to the contractual provisions of the instrument (IAS 39.14).

Derecognition - assets

- An entity shall derecognise a financial asset:
  - when the contractual rights to the cash flows from the financial asset expire (IAS 39.17(a)); or
  - to the extent that the risks and rewards of ownership of the financial asset have been transferred.
- Exception (to the second principle above) - If an entity neither retains nor transfers substantially all the risks and rewards of ownership of the financial asset, but transfers control, the entity shall derecognise the asset.
- Note: The need for such a substantial exception caused the group to question whether it had correctly identified the second derecognition principle. An alternative second principle could be "in a way that reflects the extent to which the risks and rewards of ownership of the financial asset have been transferred and/or whether control of the financial asset has been transferred". The group was concerned that this alternative is too vague to be a principle.

Derecognition - liabilities

- An entity shall derecognise a financial liability when the entity ceases to be a party to the contractual provisions of the instrument, *ie.* when the contractual obligation is discharged, cancelled or expires (IAS 39.39).

SECTION FOUR - DEVELOPING PRINCIPLES FOR FINANCIAL INSTRUMENTS - THE THOUGHT PROCESS

The distinction between principles and rules

The group initially focused on the difference between a principle and a rule. Common defining themes emerged and the group quickly concluded that nomenclature was not important, rather, what was required was a clear hierarchy of overarching principles (*eg.* the conceptual framework), principles that reflected the overarching principles and then guidance to support the principles. What needed to be clearer was the hierarchy and what guidance related to what principle. There was some support for the ability to override provisions lower down in the hierarchy by use of provisions higher up in the hierarchy.

An accounting standard should therefore be written so as to satisfy the high level concepts contained in the relevant Framework or Concept Statement, such as reliability, usefulness and consistency. Once it is determined which measurement and recognition approach best satisfies these concepts, the degree of guidance and examples required will necessarily vary. Such guidance should be drafted so as to maximise the extent to which the high level concepts are met and manage conflicts between those concepts. It was thus agreed that:

- there is a place for both principles and more detailed guidance, along with explanations and examples;
- conflicts between different guidelines and principles should be avoided; and
- where guidance is necessary to assist the preparer and aid consistency, the necessary principles and examples should be included. However, overly inflexible or prescriptive requirements are inappropriate. Obviously striking the right balance between the two is not easy.

The group also unanimously agreed that there were currently too many 'rules' which were there for anti-abuse purposes. These should not feature so frequently in a standard on financial instruments but should be part of the regulator's powers.

Identifying financial instrument principles

Initial measurement of financial instruments

The group quickly agreed that initial measurement on the balance sheet should be at fair value but the group could not quickly agree on what should happen when fair value was not equal to exchange value. This was left open.

Subsequent measurement of financial instruments

The group debated at length on subsequent measurement and views were expressed on whether corporates and financial institutions should have different measurement models. Those who worked more with corporates were more supportive of a cost-based model for corporates.

All agreed that substance and management intent were important in subsequent measurement but that policing and auditing management intent might be difficult. All agreed that auditor power and independence would need to be re-visited if this was a workable model.

Some consensus was finally reached and a new model for financial instruments outlined. A critical issue in the success of this model concerns recycling:

SECTION FOUR - DEVELOPING PRINCIPLES FOR FINANCIAL INSTRUMENTS - THE THOUGHT PROCESS (Continued)

- after much debate, the group could not agree precise details on the recycling model but did agree that more guidance on Income Statement geography and the performance statement project might be key to the model. The lack of agreement on recycling was probably the cause of most tensions and debate in the group; and
- all agreed that the hedge accounting criteria should be less onerous and that management intent/substance of an economic hedge should play a larger role in permitting hedge accounting than strict quantitative rules

Derecognition

Initially the group was supportive of a model under which an entity accounted for what it had retained so that the fact that an entity owned certain assets before acquiring its retained interest should not differ to the accounting if the retained interest had been bought in the market place. However the group could not then agree on how and when profit should be recognised. This was another area of tension and hot debate in the group.

A brief discussion revealed that symmetric accounting for assets and liabilities would not work and that legal extinguishment is more relevant for liabilities.

SECTION FIVE - DEVELOPING PRINCIPLES FOR FINANCIAL INSTRUMENTS - A NEW MODEL

General Comments

- The model should be consistent with overarching principles contained in a Framework or Concepts Statement.
- The model should not contain anti-abuse or policing provisions. This should be dealt with outside the standard-setting process.
- Broad principles should be supported by guidance which: provide a resolution where the overall principle conflicts with various overarching principles from the Concepts Statement; aid implementation; or give alternate treatments based on the substance and purpose of a transaction.
- The new model is based on the current income statement recognition model.

Model

- Initial Recognition:
  - All financial instruments should be initially reported on the balance sheet at fair value.
  - Additional guidance would be required in situations where the fair value does not equal the exchange value.
- Subsequent Measurement:
  - All financial instruments should be reported each period on the balance sheet at their fair value.
  - The change in fair value should be reported in period income on the Income Statement for financial instruments which are part of a trading portfolio as indicated by the way they are managed. This would include derivatives which are not part of a valid hedge relationship.
  - The change in fair value should be reported in Equity or Other Comprehensive Income for all other financial instruments.
    - For these instruments, the recognition of income effects should reflect the substance and purpose for holding these financial instruments. For example, the interest income recognised from interest producing assets should be recognised in earnings on an accrual basis.
    - Hedge accounting guidance and criteria would need to be developed . The intention would be to enable such derivatives to be marked through Equity or Other Comprehensive Income. If the derivatives could not be shown to be part of a valid hedge relationship, they would be marked to fair value through earnings.
    - Impairment recognition is based on loss in fair value. Guidance relating to financial institutions and loan loss reserves would need to be developed.
- Derecognition of Financial Liabilities:
  - This would be based on release from primary legal liability.
- Derecognition of Financial Assets:
  - The criteria for derecognition for most financial assets would be risks and rewards, when it is essentially an “all or nothing” situation. That is, derecognise assets when all risks and rewards are passed to the buyer; continue to recognise assets when all the risks and rewards of ownership are retained by the seller.

SECTION FIVE - DEVELOPING PRINCIPLES FOR FINANCIAL INSTRUMENTS - A NEW MODEL (Continued)

- The difficult question concerns the criteria for derecognition on partial sales where some of the risks or some of the rewards are passed.
  - While the criteria were not set, it was generally agreed that the entity should account for the risks and rewards it has retained. Whether to take the full gain on removing all the assets and replacing them with cash and a retained interest either at fair value or at allocated cost was not conclusively decided.

Unresolved Issues

- Greater guidance is required on the presentation of items in the Income Statement to promote consistent reporting between companies. In addition, it was suggested that the Income Statement should focus on industry sectors to make performance of the different sectors more transparent.
- Consideration should be given to how a revised performance reporting model would affect the new approach.
- Non-financial exposures which are part of a trading activity should be marked to fair value through earnings, similar to the approach suggested above for financial instruments.
- The question was also raised whether there should be different approaches for different industries or operating segments, *eg.* a different model for financial institutions *versus* manufacturers.
- The question also arose as to the treatment of derivatives used to create synthetic long positions, that is , whether these positions should be accounted for in a manner similar to a cash long position or as a derivative that is marked to market through earnings. An example would be writing credit default protection which puts the writer in the same position as holding the underlying bond. There were concerns expressed that the accounting for both the cash long and the derivative should be the same but the open question was how to recognise income and impairment on the derivative. One suggestion was to accrue the income on the premium, similar to recognising interest income on the long holding, and provide for losses similar to IAS 37 on contingent liabilities, as opposed to a mark to market model.

APPENDIX I
EXCEPTIONS TO IAS 39 PRINCIPLES IDENTIFIED
EXTRACT FOR ILLUSTRATIVE PURPOSES

The following pages illustrate both the complexity of IAS 39 and the exceptions which exist in relation to the high level principles identified in section three. This section is illustrative only and not exhaustive.

In relation to hedge accounting, it can be seen that IAS 39's provisions in this area modify the accounting which would otherwise prevail. Thus, for example, IAS 39 specifies that loans and receivables shall be measured at amortised cost using the effective interest method. However, if such loans are hedged for interest rate risk and fair value hedge accounting is applied, then the carrying value of the loans is adjusted for the fair value movement which is due to changes in interest rate risk. In so doing, hedge accounting modifies amortised cost accounting and instead permits the loans to be measured on a "partial" fair value basis. This appendix also gives an indication of the complex and onerous nature of the conditions which require to be met in order to satisfy hedge accounting criteria and thus permit this alternative accounting approach to be applied.

In relation to recognition and derecognition, it can be seen that IAS 39 sets out numerous and detailed provisions in respect of particular scenarios.

PRINCIPLE IDENTIFIED	WORDS IN THE STANDARD REFLECTING THE IDENTIFIED PRINCIPLES	EXCEPTIONS
Measurement		
All financial assets and financial liabilities that result from transactions shall be measured at initial recognition at their fair value. Subsequent measurement shall reflect the nature of the instrument and/or the purpose for which it is held.	When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets: (a) loans and receivables as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method;	**Hedge accounting** Hedge accounting recognises the offsetting effects on profit or loss of changes in the fair values of the hedging instrument and the hedged item. Hedging relationships are of three types: (a) fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss. (b) cash flow hedge: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss. (c) hedge of a net investment in a foreign operation as defined in IAS 21. A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

PRINCIPLE IDENTIFIED	WORDS IN THE STANDARD REFLECTING THE IDENTIFIED PRINCIPLES	EXCEPTIONS
	Measurement (continued)	
	(b) held-to-maturity investments as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method; and (c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost. After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, except for financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which shall be measured at cost.	**Hedge accounting (continued)** A hedging relationship qualifies for hedge accounting under paragraphs 89-102 if, and only if, all of the following conditions are met: (a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk; (b) The hedge is expected to be highly effective (see Appendix A paragraphs AG105-AG113) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship; (c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss; (d) The effectiveness of the hedge can be reliably measured, *ie.* the fair value or cash flows of the hedged item which are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured; and (e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

PRINCIPLE IDENTIFIED	WORDS IN THE STANDARD REFLECTING THE IDENTIFIED PRINCIPLES	EXCEPTIONS
Initial Recognition		
An entity shall recognise a financial asset or a financial liability on its balance sheet when the entity becomes a party to the contractual provisions of the instrument.	An entity shall recognise a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument.	**Regular way** A regular way purchase or sale of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting. A regular way purchase or sale of financial assets is recognised using either trade date accounting or settlement date accounting. The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets. For this purpose assets which are held for trading form a separate category from assets designated at fair value through profit and loss. A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date. The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date. Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes. The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognised for assets carried at cost or amortised cost; it is recognised in profit or loss for assets classified as financial assets at fair value through profit or loss; and it is recognised in equity for assets classified as available for sale.

<table>
<tr><th>PRINCIPLE IDENTIFIED</th><th>WORDS IN THE STANDARD REFLECTING THE IDENTIFIED PRINCIPLES</th><th>EXCEPTIONS</th></tr>
<tr><td colspan="3">Derecognition - Financial Assets</td></tr>
<tr><td rowspan="3">Derecognise when the contractual rights to the cash flows from the financial asset expire.

Derecognise to the extent the risks and rewards of ownership of an instrument have been transferred.</td><td rowspan="3">An entity shall derecognise a financial asset when, and only when:
(a) the contractual rights to the cash flows from the financial asset expire; and
(b) it transfers the financial asset and the transfer qualifies for derecognition.

If the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

If the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset.</td><td>Regular way sale

Same as the previous section on recognition.</td></tr>
<tr><td>Transfer of a financial asset

An entity shall derecognise a financial asset when, and only when it transfers the financial asset as set out in paragraphs 18 and 19.</td></tr>
<tr><td>Pass-through conditions

When an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met:
(a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition;
(b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows; and
(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.</td></tr>
</table>

PRINCIPLE IDENTIFIED	WORDS IN THE STANDARD REFLECTING THE IDENTIFIED PRINCIPLES	EXCEPTIONS
Derecognition - Financial Assets (continued)		
		Control If the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. If the entity has not retained control, it shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.
		Continuing Involvement If the entity has retained control, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset. If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset, the entity continues to recognise the transferred asset to the extent of its continuing involvement. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example: (a) when the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of (i) the amount of the asset and (ii) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount'); (b) when the entity's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in case of a written put option on an asset that is measured at fair value, the extent of the entity's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price; and

PRINCIPLE IDENTIFIED	WORDS IN THE STANDARD REFLECTING THE IDENTIFIED PRINCIPLES	EXCEPTIONS
Derecognition - Financial Assets (continued)		
		Continuing Involvement (continued) (c) when the entity's continuing involvement takes the form of a cash-settled option or similar provision on the transferred asset, the extent of the entity's continuing involvement is measured in the same way as that which results from non-cash settled options as set out in (b). When an entity continues to recognise an asset to the extent of its continuing involvement, the entity also recognises an associated liability. Despite the other measurement requirements in this Standard, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is: (a) the amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost; or (b) equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value. The entity shall continue to recognise any income arising on the transferred asset to the extent of its continuing involvement and shall recognise any expense incurred on the associated liability. For the purpose of subsequent measurement, recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other and shall not be offset. If an entity's continuing involvement is in only a part of a financial asset (*eg.* when an entity retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the entity retains control), the entity allocates the previous carrying amount of the financial asset between the part it continues to recognise under continuing involvement, and the part it no longer recognises on the basis of the relative fair values of those parts on the date of the transfer.

PRINCIPLE IDENTIFIED	WORDS IN THE STANDARD REFLECTING THE IDENTIFIED PRINCIPLES	EXCEPTIONS
Derecognition - Financial Assets (continued)		
		Continuing Involvement (continued) The difference between: (a) the carrying amount allocated to the part that is no longer recognised; and (b) the sum of (i) the consideration received for the part no longer recognised and (ii) any cumulative gain or loss allocated to it that had been recognised directly in equity shall be recognised in profit or loss. A cumulative gain or loss that had been recognised in equity is allocated between the part which continues to be recognised and the part which is no longer recognised on the basis of the relative fair values of those parts. The following are examples of how an entity measures a transferred asset and the associated liability. **All assets** If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount'). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognised in profit or loss on a time proportion basis and the carrying value of the asset is reduced by any impairment losses.

PRINCIPLE IDENTIFIED	WORDS IN THE STANDARD REFLECTING THE IDENTIFIED PRINCIPLES	EXCEPTIONS
		Derecognition - Financial Assets (continued)
		Continuing Involvement (continued) Assets measured at amortised cost If a put option obligation written by an entity or call option right held by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at amortised cost, the associated liability is measured at its cost (*ie.* the consideration received) adjusted for the amortisation of any difference between that cost and the amortised cost of the transferred asset at the expiration date of the option. For example, assume that the amortised cost and carrying amount of the asset on the date of the transfer is CU98 and that the consideration received is CU95. The amortised cost of the asset on the option exercise date will be CU100. The initial carrying amount of the associated liability is CU95 and the difference between CU95 and CU100 is recognised in profit or loss using the effective interest method. If the option is exercised, any difference between the carrying amount of the associated liability and the exercise price is recognised in profit or loss. Assets measured at fair value If a call option right retained by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the asset continues to be measured at its fair value. The associated liability is measured at (i) the option exercise price less the time value of the option if the option is in or at the money, or (ii) the fair value of the transferred asset less the time value of the option if the option is out of the money. The adjustment to the measurement of the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the call option right. For example, if the fair value of the underlying asset is CU80, the option exercise price is CU95 and the time value of the option is CU5, the carrying amount of the associated liability is CU75 (CU80 - CU5) and the carrying amount of the transferred asset is CU80 (*ie.* its fair value).

PRINCIPLE IDENTIFIED	WORDS IN THE STANDARD REFLECTING THE IDENTIFIED PRINCIPLES	EXCEPTIONS
Derecognition - Financial Assets (continued)		
		Continuing Involvement (continued) Assets measured at fair value (continued) If a put option written by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the associated liability is measured at the option exercise price plus the time value of the option. The measurement of the asset at fair value is limited to the lower of the fair value and the option exercise price, because the entity has no right to increases in the fair value of the transferred asset above the exercise price of the option. This ensures that the net carrying amount of the asset and the associated liability is the fair value of the put option obligation. For example, if the fair value of the underlying asset is CU120, the option exercise price is CU100 and the time value of the option is CU5, the carrying amount of the associated liability is CU105 (CU100 + CU5) and the carrying amount of the asset is CU100 (in this case the option exercise price). If a collar, in the form of a purchased call and written put, prevents a transferred asset from being derecognised and the entity measures the asset at fair value, it continues to measure the asset at fair value. The associated liability is measured at (i) the sum of the call exercise price and fair value of the put option less the time value of the call option, if the call option is in or at the money, or (ii) the sum of the fair value of the asset and the fair value of the put option less the time value of the call option if the call option is out of the money. The adjustment to the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the options held and written by the entity. For example, assume an entity transfers a financial asset which is measured at fair value while simultaneously purchasing a call with an exercise price of CU120 and writing a put with an exercise price of CU80. Assume also that the fair value of the asset is CU100 at the date of the transfer. The time value of the put and call are CU1 and CU5 respectively. In this case, the entity recognises an asset of CU100 (the fair value of the asset) and a liability of CU96 [(CU100 + CU1) - CU5]. This gives a net asset value of CU4, which is the fair value of the options held and written by the entity.

PRINCIPLE IDENTIFIED	WORDS IN THE STANDARD REFLECTING THE IDENTIFIED PRINCIPLES	EXCEPTIONS
Derecognition - Financial Liabilities		
Derecognise when the entity ceases to be a party to the contractual provisions of the instrument.	An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished - *ie.* when the obligation specified in the contract is discharged or cancelled or expires	An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability.

APPENDIX II

WORKING GROUP MEMBERS

Hugh Shields (Chairman)
(Director and Head of Financial Reporting, Barclays Capital)

Alex Arthur
(University of Aberdeen)

Michelle Crickett (Secretary)
(Assistant Director, Accounting and Auditing, ICAS)

Professor Christine Helliar
(University of Dundee and ICAS Director of Research)

Professor Pauline Weetman
(University of Strathclyde)

David Wood
(Executive Director, Technical Policy, ICAS)

CRITICAL REVIEW GROUP MEMBERS

David Cairns
(International Financial Reporting Consultant and Visiting Professor, London School of Economics)

Keith Cochrane
(Director of Finance, ScottishPower)

Isobel Sharp
(Partner, Deloitte & Touche LLP and ICAS Junior Vice-President)

Professor Stephen Zeff
(Rice University)

Geoffrey Mitchell
(Director, Barclays Bank plc)

Global financial crisis roundtable – 14 October 2008

1. **Mark to model when market are illiquid**

The educational guidance released by the IASB on 31 October is an improvement for insurers who have to determine fair value when markets become inactive. This has been welcomed by the EU 3 Level 3 Committees and the European Commission.

However, we are concerned that the IASB educational guidance requires that when preparers mark to model in level 2 or 3 of the hierarchy of fair value, management need to estimate what a market participant would require in order to take on the asset. In current market circumstances, market participants would likely require a high liquidity premium to transfer the asset, which brings preparers back to market prices when they exist. Preparers need to be allowed to adjust fair value (ie: not to take into account the big credit spreads currently observed) to reflect the long term perspective of their business (especially for long term insurance business).

2. **Possibility to reclassify out of FVTPL assets designated with the FVO**

The recent amendment of IAS 39 does not apply to assets designated with the FVO. It only concerns the trading portfolio which is not significant for most European insurers. The FVO is used by insurers mainly to:

- Avoid an accounting mismatch (by example to value assets backing contracts where the risk is born by the policyholder)
- Value assets which are managed and their performance measured on a fair value basis

European insurers would like to have the possibility to reassess if the conditions that led to the decision to exercise the FVO at initial recognition are still met. If not, we would like to have the possibility to reclassify those assets out of the FVTPL. This could be the case when market disappear for some financial assets (market become illiquid) or when the market price does not reflect any more the fair value of the assets (ie: in rare circumstances, like those imposed on the possibility to reclassify out of the trading portfolio). In those cases, we believe that the rationale for using the FVO is not longer met and therefore we would like to reclassify those assets.

It is important to notice that the recent amendment of IAS 39 has introduced flexibility for trading assets but not for but not for assets designated at fair value through P&L by option. The underlying market conditions justifying the reclassification out of the trading portfolio also apply for the assets designated with the FVO.

3. Impairment rules

3.1 Reversal of impairment of equity classified in AFS

Currently, the impairment of a AFS equity goes into the income statement but the reversal of such impairment goes through OCI. We support that the reversal impairment on AFS equities would be booked through income statement with appropriate (and exhaustive) disclosures, including the reasons, conditions and circumstances triggering the reversal. Those disclosures would help to develop the market discipline needed to support the credibility of financial reporting.

3.2 Alignment of impairment of bond securities between HTM and L&R

Currently the triggers and the benchmark to calculate an impairment on a bond security vary depending if the security is classified as HTM and L&R. We recommend that those rules should be aligned. In addition, we believe that the fact that the benchmark for computing the impairment on a bond security classified as HTM is the market value in not consistent with the requirement and the management intention to hold the asset until maturity. Indeed, using the market price lead insurers to recognize the impact of interest rate changes which is not relevant as the security is held until maturity.

The McGraw-Hill Companies

STANDARD & POOR'S

Ratings Services
20 Canada Square
Canary Wharf
London E14 5LH
+44 (0)20 7176 3800 Tel
+44 (0)20 7176 7565 Fax

Ms. Victoria Blackburn
Project Administrator
International Accounting Standards Board
Via email

Dear Victoria,

The following information is provided in anticipation of participating in the IASB/FASB Roundtable later this week on the topic of the Global Financial Crisis.

Standard & Poor's Ratings Services (Standard & Poor's) appreciates the opportunity to provide the IASB and FASB our comments on steps that could be taken to improve financial reporting to address the global financial crisis and more generally. The views expressed in this submission represent those of Standard & Poor's Ratings Services and do not address, nor are they intended to address, the views of any other division of The McGraw-Hill Companies. Further, we intend our comments to address the analytical needs and expectations of credit analysts.

There are two items that we plan to emphasize in relation to the impact that short term changes might have on the quality of financial statement information provided in the context of our analysis. The first is that, regardless of the accounting methods applied, disclosure is critical to understanding and interpreting the accounting data provided. The second relates to due process considerations, and concerns that changes made in haste, potentially without adequate input from various parties affected, could do more harm than good.

Disclosure

We believe there is still an urgent need for clear and comprehensive disclosure in financial statements, and that some of the market issues now being faced may have been exacerbated by a lack of transparency. While many improvements have been made in response to greater informational needs of market participants, lender and investor confidence requires ongoing provision of clear information and consistent delivery against the expectations developed on the basis of the information provided. Longer term, accounting changes may help alleviate some problems noted by banks and others. However, comprehensive and clear disclosure should be an ongoing feature for providing transparency regardless of the accounting methods applied.

The following points relate to information provided in disclosures, which we believe represent a significant opportunity for improving transparency to the market with information that enables better analysis.

Disclosure model generally – In our view, the following framework for disclosure could result in more clear and comprehensive disclosure that would provide information on:

- The scope of consolidation and why significant entities are included or excluded;
- The group's transactions/positions (including risks and contingencies, both on and off balance sheet, relating to consolidated and unconsolidated entities) and their business purpose;
- Information on asset-liability relationships between transactions, and risk management practices;
- Accounting policies/method applied, together with assumptions and estimates, and the difference from reasonable alternatives that could have been used;
- What amounts are included in which financial statement line items and how are they linked – including related assets, liabilities, earnings and equity changes, and cash flows;

- Additional information to give a sense of how amounts of assets/liabilities will likely develop to their ultimate realization/disposition (sale, collection, payment, settlement, amortization, etc.);
- Subsequent event disclosures that make clear significant developments after the balance sheet date, including significant market movements in asset fair values, credit deterioration, etc.; and
- The link between accounting policy disclosures and actual relevant consequences in the financial statements. Reiteration in the footnotes to the financial statements of the text of various accounting requirements alone is not very helpful, particularly when there is no sense of significance given.

Arguably, much of this could be viewed as already called for, at least in concept, by the existing standards. However, we find that actual disclosure often falls short of comprehensively communicating this information. We would be happy to discuss more detailed examples with the Boards or their staff. Taking this framework as an approach for communicating key relevant information, and applying it to significant items or categories of items, could result in financial reporting that is significantly more transparent in relating reported amounts and their context of underlying transactions and risks.

Disclosure of fair value We believe that the challenges in estimating fair value are significant. However, we also believe they are not insurmountable in the context of an adequately disclosed process of arriving at the values used in accounting and disclosure, which informs market participants of the significant drivers of change in the amounts. In addition, more clear disclosure of financial asset types held, and whether they are accounted for at fair value or their fair value is disclosed, could in our view assist market participants.

Disclosure of interim information - While many improvements have been made in response to market participants' greater informational needs, we believe that lender and investor confidence requires the ongoing provision of clear information in interim as well as annual and ad hoc reporting, and consistent delivery against expectations developed on the basis of the information provided. For example, we note that early examples of Q3 2008 disclosure of asset reclassifications recently permitted under IFRS seem to be limited in detail at best. We believe the full level of disclosure required in the amended IFRS 7 would be most helpful to market participants if made when the transfer is initially announced. We also note that information on the fair value of financial assts and liabilities is not always provided in interim financial statements. In the current market, we expect these have changed materially from prior year end amounts.

Disclosure of information on expected cash flows - We believe that the disclosure of additional meaningful information on more "fundamental" values of assets--based, for example, on expected cash flows to maturity--could play a role in restoring trust in the banking system. But, in our view, it would not serve the market well if such values were used in place of fair value as the continued use of fair value over time provides a consistent and meaningful measurement objective for analysis. To the extent that a bank's management believes that there are significant differences between the fair value amounts presented in the balance sheet and a more "economic" value based on expected cash flows to maturity (or as a result of default and expected recovery), then we believe the disclosure of this material information would benefit the market. Where such supplemental information is disclosed, we believe it would also be of considerable use to market participants for banks to disclose how the information has been derived. We also believe that it could be an important element in rebuilding confidence over time, when cash flows actually realized are compared to these past disclosures.

Due Process

We believe that any move to carve out elements of IFRS by the European Union would have significant implications for the quality of financial reporting in Europe and how it is viewed globally. We are also concerned that such a move, if taken at this crucial point when even the U.S. is considering implementing IFRS, could harm longer-term prospects for a global set of accounting standards, particularly if changes result in further differences from U.S. GAAP. We believe that any changes in IFRS should be made by the IASB, and be subject to appropriate due process. This way, changes in IFRS would apply to all companies that comply with IFRS, not just those in Europe. As a global standard setter, the IASB, in our view, will need to demonstrate that it is independent of regional or political influence, and deliver standards that provide information capable of meeting the needs of a broad range of users of financial statements, including investors, lenders, and analysts.

We continue to support the efforts of the Boards to make changes that move to a converged set of standards that will enable analysis by providing useful information to market participants. We welcome the joint efforts of the IASB and FASB to inventory and debate ideas on potential changes in accounting that could help address the current financial crisis, but we believe that any such ideas should be subjected to a more 'normal' due process that provides for input, particularly on complex topics such as financial instruments and their accounting. We agree that in the longer term, lessons learned from a more considered review of the role accounting has played in recent market developments could no doubt contribute to future improvements in accounting principles globally.

More specifically, we support evaluating issues such as the number of categories and accounting methods for financial assets and characteristics that distinguish when each should be used, and more consistent impairment methodologies across categories that reveal more information about expected losses. However, we would be concerned if significant changes were rushed to completion without an opportunity to fully evaluate their consequences. Further, investor and lender confidence in financial reporting should be considered as an overriding factor, as without such confidence, any change in accounting would not succeed in addressing this aspect of the current financial crisis.

In the case of the recent change to allow certain financial asset reclassifications, we note that the due process, which normally helps to ensure the discovery of unintended consequences so that they can either be avoided or better anticipated, was limited. We believe that this change to IFRS represented a path of least resistance to quickly address capital and earnings concerns, and the fact that the flexibility introduced was already available to U.S. banks made it an easy target. While this was a fairly straight forward change to address a particular problem, questions of interpretation and further potential changes have emerged and we believe additional unintended consequences may still emerge.

We also believe that while the changes have permitted some banks to avoid Q3 declines in asset fair values that would have been detrimental to their reported earnings and regulatory capital base, from a financial analysis standpoint, the permitted reclassifications render the balance sheet carrying amounts of transferred assets less meaningful (because it is neither fair value nor a typical amortized cost, rather fair value--as of a somewhat arbitrary reclassification date--that has then been amortized) and generally do not facilitate effective comparisons. Earnings analysis will, in our view, continue to be at least as complex, with various amortization elements being introduced for this new option. We also believe that removing fair value from the accounting by transferring assets to categories that apply amortized cost makes meaningful information less transparent, and if fair value information is presented less frequently in annual reports only, then we believe that the market would be losing important interim information altogether. Such issues for financial analysis, which we believe is important for investors, lenders and analysts, would normally be raised and considered in the course of the due process for an accounting change.

We also provide a copy of an article published by Standard & Poor's on November 3, 2008, titled 'European Banks: IFRS Revisions Allow Banks Certain Options To Avoid Fair Value Accounting'. This article mainly addresses the changes already made to allow certain asset reclassifications and provide guidance on determining fair value in illiquid markets, but it also touches on many of the issues summarized in this letter.

We look forward to participating in the Roundtable session later this week.

Best regards,

Sue Harding
Managing Director and European Chief Accountant
Standard & Poor's Ratings Services

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November 3, 2008

European Banks: IFRS Revisions Allow Banks Certain Options To Avoid Fair Value Accounting

European Chief Accountant:
Sue Harding, London (44) 20-7176-3734; sue_harding@standardandpoors.com

Criteria Officer, European Banks:
Arnaud De Toytot, Paris (33) 1-4420-6692; arnaud_detoytot@standardandpoors.com

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European Banks: IFRS Revisions Allow Banks Certain Options To Avoid Fair Value Accounting

As European banks continue to face a tumultuous market, policy makers and others are seeking new ways to restore the confidence of lenders and investors so that more adequate market liquidity can be restored. In the past few weeks, Standard & Poor's has observed that various politicians, banks, and insurers have renewed calls to suspend fair value accounting in favor of less volatile measures, both in Europe and in the U.S. Some of these calls appear to be motivated by concerns that fair values may not be representative of the "true" or "economic" value of assets marked-to-market by banks and other institutions under International Financial Reporting Standards (IFRS) and U.S. generally accepted accounting principles (U.S. GAAP). Other concerns apparently relate to the ability to determine an appropriate fair value when markets have become less liquid, and assessing the role of fair value accounting in fueling pro-cyclical behaviors. The latter would include excess risk taking during the good times, and more recently fear and other issues sparking the sale of assets at prices that crystallize significant losses, which then become market references for even lower fair values used in accounting and capital measures.

Following market declines up to Sept. 30--the end of the third quarter reporting period for many banks--the conflict over fair value accounting came to a head in Europe. Banks, whose capital adequacy is computed by regulators with reference to the trading book measured at fair value, faced the prospect of severe declines in earnings and capital measures which, in market conditions only a few weeks before, had been significantly better. Such market volatility put some banks in an extremely difficult position. As a result, the International Accounting Standards Board (IASB) relieved the pressure by changing IFRS. It introduced several new options to reclassify assets in certain circumstances out of the trading book and the available for sale (AFS) categories, categories which require mark to market accounting, and into categories that require amortized cost accounting. The IFRS reclassification options were, in our view, essentially brought into line with existing flexibility under U.S. GAAP.

In this report, we comment on the recent developments related to fair value accounting under IFRS and potential implications for our analysis. These include:

- IASB Expert Advisory Panel guidance on estimating fair value. We believe the guidance will be helpful to market participants by providing more certainty on requirements for estimating fair value, and making the significant judgments that will still be required.
- IASB changes in IFRS that allow the option to reclassify assets as early as the reporting of results for the already completed third quarter of this year. From a financial analysis standpoint, we believe that the permitted reclassifications will render the balance sheet carrying amounts of transferred assets less meaningful (because it is neither fair value nor a typical amortized cost, rather fair value--as of a somewhat arbitrary reclassification date--that has then been amortized) and will generally not facilitate effective comparisons. Earnings analysis will, in our view, continue to be at least as complex. From a credit analysis standpoint, we expect there to be a trade-off of potentially higher capital requirements in exchange for more predictable ones that should be less of a moving target for banks. In our view, assets transferred to the banking book may on average require capital that is several times the level required if they had been left in the trading book. However, we do not expect increases in capital requirements to be significant overall, as a multiple of a modest capital requirement would still be modest. We believe that changing IFRS represented a path of least resistance to quickly address capital and

earnings concerns, and the fact that the flexibility introduced was already available to U.S. banks made it an easy target.

- Calls to abandon fair value for other measures of value. We believe that the disclosure of additional meaningful information on more "fundamental" values of assets--based, for example, on expected cash flows to maturity--could play a role in restoring trust in the banking system. But, in our view, it would not serve the market well if such values were used in place of fair value.

We also believe there is still an urgent need for banks to show clear and comprehensive disclosure. Such disclosure would include the particular assets held by banks, the appropriateness of their accounting classification, significant assumptions and estimates made, and details of the related reported amounts on the balance sheet and in earnings. While many improvements have been made in response to market participants' greater informational needs, we believe that lender and investor confidence requires the ongoing provision of clear information in interim as well as annual and ad hoc reporting, and consistent delivery against expectations developed on the basis of the information provided. Early examples of disclosure of reclassifications seem to be limited in detail at best. We believe the full level of disclosure would be most helpful to market participants if made when the transfer is initially announced.

Guidance On Fair Value Under IFRS

In response to the recommendations of the Financial Stability Forum in their report, "Enhancing Market and Institutional Resilience," the IASB established an Expert Advisory Panel on measuring and disclosing the fair value of financial instruments in markets that are no longer active. A draft of this group's report was published in September and the final report was published on Oct. 31, 2008.

We note that the report aims to provide additional guidance about the processes used and the judgments made when measuring fair value. Like recent U.S. GAAP guidance, it does not change the requirement for fair value to represent the price at which a transaction would occur between market participants on the balance sheet date. Both the IASB and FASB have confirmed that they believe their respective guidance on fair value is consistent.

The IASB also published an update on the draft guidance, which reiterated that the intention in measuring fair value is to establish the price at which an orderly transaction would take place, not the price in a forced liquidation or distressed sale. We observe that the update noted that in times of market dislocation, not all market activity arises from forced liquidations or distressed sales, and that cases in which transactions are ignored as being distressed should be relatively rare, such as when there is only one buyer or an unreasonable time in which to sell.

The guidance also indicates that regardless of the level of market activity, a current transaction price for the same or similar instruments normally provides the best evidence of fair value and estimates of fair value must reflect the current market at the time, even if distressed. The guidance provides that an entity's own assumptions about future cash flows and risk adjusted discount rates are to be used when relevant observable inputs are not available and a valuation model is used. Furthermore, as companies must apply their own judgment, the report acknowledges that fair value may differ from company to company, stressing that disclosure is key to providing transparency.

We believe the guidance will be helpful to market participants by providing more certainty on requirements for estimating fair value, and making the significant judgments that will still be required. We do not believe the guidance is intended to be authoritative--it's not a standard or interpretation--but we believe it will be applied by banks. While the guidance is not supposed to represent a change in IFRS, we expect that there may be some changes in the specific application of the requirements as they call for a significant level of judgment on the part of banks that may now be made within a narrower scope. For example, we believe that banks that have been reluctant to adjust market prices or use inputs to models that are unobservable in the market may be inclined or even compelled to take such steps if necessary to achieve a better estimate of the price that would have been achieved in a sale on the balance sheet date. At the other extreme, we believe it will provide certainty to some banks that fair value should be a best estimate in the current (dislocated) market, and not some other more optimistic value.

We are aware of many difficulties and uncertainties in determining what single value should be taken as "fair value" for reporting purposes, given the broad range of potential estimates. We believe that clearer disclosure on methods used, assessments of how observable transaction prices (even if these are few) have been taken into account in the valuation, and statements about why the approach taken is considered appropriate would benefit the market.

Calls To Expand Asset Reclassifications Under IFRS

We note that the IASB relaxed IFRS on assets required to be accounted for at fair value. In an "emergency" response to the current market conditions, changes to IFRS were published by the IASB and approved by the European Commission for use in Europe within one week.

European finance ministers met on Oct. 7 to address whether current fair value accounting should be suspended, or whether banks (in particular) should be allowed to reclassify assets from categories that require fair value accounting to categories that do not. We understand that ministers welcomed the guidance on estimating fair value provided by the IASB Expert Advisory Panel, but turned their attention to the potentially greater flexibility to reclassify assets to categories that avoid fair value accounting under U.S. GAAP.

On Oct. 13, the IASB voted to change IAS 39 and allow certain additional reclassifications of assets. It published the new requirements later that day. This was, in our view, an extraordinary step that skipped the normal due process of soliciting public comments from all parties, including investors and analysts. We believe this was done for the express purpose of meeting demands from EU finance ministers to level the playing field on reclassifications with U.S. banks and that the IASB demonstrated its willingness to help on a perceived problem, rather than its support for a desired change, particularly as the change only adds to the options within IFRS. The European Commission has approved the changes for use by European companies.

Despite these momentous steps, taken with unprecedented speed, we understand that there are still further discussions that could lead to additional changes or even a European override of the IASB's standards. We believe that such a move to override IFRS would have significant implications for the quality of financial reporting in Europe and how it is viewed globally. We are also concerned that such a move, if taken at this crucial point when even the U.S. is considering implementing IFRS, could harm longer-term prospects for a global set of accounting standards, particularly if changes result in further differences from U.S. GAAP. As a global standard setter, the IASB, in our view, will need to demonstrate that it is independent of regional or political influence, and deliver standards that provide information capable of meeting the needs of a broad range of users of financial statements, including investors and analysts.

We agree that in the longer term, lessons learned from a more considered review of the role accounting has played in recent market developments could no doubt contribute to future improvements in accounting principles globally. However, we believe that any changes should be made by the IASB, and be subject to appropriate due process. This way, changes would apply to all companies that comply with IFRS, not just those in Europe.

New Opportunities To Reclassify Assets Under IFRS

The following discussion sets out our opinions on how the new classification options will likely work, in contrast with our views of the present regime.

Any discussion of reclassification of assets is of course set in the context of the original classification decisions taken for each new asset. Appendix 1 summarizes both classification and reclassification of financial assets under IFRS, including reclassifications that existed in IFRS before this recent change. For some time, banks have had an opportunity to exercise discretion and be more cautious when they initially classify assets by not classifying them as trading, but we believe that doing so does usually increase capital requirements.

The new reclassifications are not requirements, but options. We therefore believe that some banks may take them up in circumstances that others will not, with consequences for reported equity (including other comprehensive income) and earnings, as well as capital. We expect that after an initial take-up of reclassifications following this change, there will be smaller-scale reclassifications in the future. According to IFRS, some circumstances must be met before reclassifications can be made--for example, the asset-holder must not intend to sell the asset, and in some cases must intend to hold the asset for the foreseeable future or to maturity. As a result, we would expect that banks that do reclassify assets may have brought their accounting classifications more into line with their intentions to realize value from the assets by holding them rather than selling them, but inconsistencies may remain for other assets and other banks.

Under the requirements, the changes allow loans and receivables to be reclassified out of the category fair value through profit or loss (FVPL) or AFS, as long as the bank has the intention to hold them for the foreseeable future or until maturity. What some banks deem to be "foreseeable" may differ from others. The changes also allow certain other transfers to be made out of FVPL in rare circumstances when the asset is no longer held for the purpose of selling it in the near term. Assets classified in FVPL under the fair value option (FVO) are not eligible (the same as under U.S. GAAP). As a result, if loans and receivables were originally classified as FVPL by choice under the FVO, they cannot, according to the requirements, be transferred. Derivatives are also not eligible, but if related hedged assets are transferred, banks may consider designating derivatives as hedges to mitigate earnings volatility.
Once reclassified, banks will not, according to the rules, be able to transfer assets back to FVPL (even if intentions to hold change, or if the fair values of the assets improve).

Any transfers out of FVPL and AFS are made at fair value. Prior write-downs are not reversed, but Q3 losses can be avoided, as any date back to July 1, 2008, can be selected as the transfer date. The IASB has subsequently clarified that banks choosing to reclassify assets at a date between July 1 and Oct. 31, 2008, must make the decision to do so by Nov. 1, 2008. For banks that report on a half-yearly basis, the same deadline applies. Several banks have already reported Q3 results and did not reclassify. We believe that it is possible some might restate Q3 for decisions taken by Oct. 31 to reclassify as of July 1, 2008.

The reclassification date selected is, in our view, somewhat arbitrary, particularly in this transitional period, and it would appear that even different dates can be selected for different assets. After Nov. 1, 2008, reclassifications take effect only from the date when the decision to reclassify is made.

Once assets are transferred to loans and receivables (L&R) or held-to-maturity (HTM), an effective interest rate is determined that represents the discount rate implied by the difference between the transfer date fair value and the estimated cash flows the entity expects to recover. The asset value is then amortized at this rate.

Normally, if expected cash flows are subsequently increased, this would, under IAS 39, result in an uplift of the value of the assets (new expected cash flows are usually discounted at the old effective interest rate and an adjustment is made to the carrying value of the asset). However, the IASB made an exception for reclassified assets that will mean a new effective rate is calculated and applied over time, rather than immediately adjusting the carrying amount. If expected cash flows decline and the asset is impaired, the same effective interest rate should continue to apply and the assets are written down to the value of the new lower expected cash flows discounted at this rate. Additionally, any remaining loss in other comprehensive income (OCI) for assets previously classified as AFS is also charged to earnings immediately.

Reclassifications of assets other than loans and receivables are expected to be "rare." The revised IAS 39 describes rare circumstances as resulting from a single event that is unusual and highly unlikely to recur in the near term. The IASB's press release confirmed that the deterioration in the world's financial markets that occurred in the third quarter of this year is a possible example of rare circumstances cited in the IFRS amendments, and therefore justified the immediate changes in IFRS.

The term "rare" is imported from U.S. GAAP, specifically FASB Statement of Financial Accounting Standards No. 115. Transfers from trading to amortized cost should be rare according to that standard, and guidance issued previously by the SEC has reinforced this position, such that these types of transfers have not generally occurred in the past. It is not clear whether the rare criteria will also be met by Q3 market deterioration under U.S. GAAP, which would allow the possibility of reclassification to also become a reality under U.S. GAAP. In Europe, we expect that without the consistency of a single regulator (such as the SEC in enforcing U.S. GAAP), rare may not be quite so rare.

The recent changes to allow further reclassifications were made within IFRS (as issued by the IASB). As a result, they should, in theory, become available to all companies that apply IFRS, not just those in the EU (and not just banks). Beyond Europe, specific take-up will, in our view, depend on the process through which IFRS is implemented on a country-by-country basis, however. For example, the Australian Accounting Standard Board has subsequently approved the changes, allowing them to be incorporated into IFRS in Australia.

It does not appear that the changes in IFRS are intended to be temporary. However, like any current standards, they remain in place unless or until the IASB votes to change them again, typically subject to extensive due process that allows for input from all parties that could be affected.

Disclosure Of New Reclassifications

To provide transparency (and possibly some disincentive to transfer), a long list of disclosures has been developed that should allow for adjustments to recast the accounting as if the transfer had not been made (see table 1). The requirements are written to apply to a single financial asset. In practice, we expect disclosures will be made at a much higher level of aggregation, although we would encourage that aggregation only be used for very similar items. For example, ongoing disclosure of the carrying amounts and fair values of reclassified assets could be disclosed both by the category the assets are sitting in and the category they were transferred from, by type of asset (such as mortgage loans in L&R that had been transferred from FVPL, currently at a carrying value of x and fair value of y). For each of these, fair value gain or loss information would be provided as well as earnings information. It would also be helpful to market participants, in our view, if disclosures identified specifically where in the income statement the separate gain, loss, income, and expense items identified were classified.

Table 1

IFRS 7 Disclosures Required For New Reclassifications
(a) The amount reclassified into and out of each category.
(b) For each reporting period until de-recognition, the carrying amounts and fair values of all financial assets that have been reclassified in the current and previous reporting periods.
(c) If a financial asset was reclassified in accordance with the "rare" situation, the facts and circumstances indicating that the situation was rare. (d) For the
reporting period when the financial asset was reclassified, the fair value gain or loss on the financial asset recognized in profit or loss or other comprehensive income in that reporting period and in the previous reporting period.
(e) For each reporting period following the reclassification (including the reporting period in which the financial asset was reclassified) until de-recognition of the financial asset, the fair value gain or loss that would have been recognized in profit or loss or other comprehensive income if the financial asset had not been reclassified, and the gain, loss, income, and expense recognized in profit or loss.
(f) The effective interest rate and estimated amounts of cash flows the entity expects to recover, as at the date of reclassification of the financial asset.

Early examples of disclosure of reclassifications seem to be limited in detail at best. We believe the full level of disclosure would be most helpful to market participants if made when the transfer is announced. Furthermore, such references to transferring "a portion of the liquidity portfolio" does not provide adequate insight as to the nature of the assets transferred and "because we intend to hold them for the foreseeable future" does not provide much insight on why they are held and why the change in classification has been made.

Additionally, while the effective interest rate and estimated amounts of cash flows expected to be recovered at the date of transfer is a required disclosure, if expected cash flows change, the disclosure need not be updated under IFRS 7. We think such additional updated disclosure, however, would likely provide extremely meaningful information.

We also note that for assets previously classified as AFS, the amount of prior losses (or gains) deferred in OCI remains in OCI, subject to amortization to earnings or transfer to earnings at the date the instrument matures or the date the assets become impaired. We believe the amounts relating to assets no longer classified as AFS should be identified separately as they are of a different nature than those relating to assets that continue to be classified as AFS.

The IASB chose to focus on reclassification alone, which was the specific area of difference highlighted by the European Commission, so that reclassification opportunities are now similar to U.S. GAAP. A level playing field has not, in our view, fully been reached due to the complexity of and different approaches to financial instrument accounting in U.S. GAAP and IFRS. For example, impairment requirements differ in details of what triggers impairment and how it is measured, and the emphasis placed on the fair value of instruments versus expected cash flows. We believe that it is therefore possible that U.S. companies could now potentially be disadvantaged if forced to take impairment charges earlier under U.S. GAAP.

Existing Opportunities To Reclassify Assets Under IFRS

As we highlighted in our article "FAQ: IFRS Reporting And Options For Banks In A Souring Market," published on Dec. 20, 2007, on RatingsDirect, IFRS previously offered few opportunities to reclassify assets. Existing reclassifications are also shown in Appendix 1.

Reclassifications into HTM are permitted, in our view, where there is a change in the intention to hold to maturity. Prior to the recent changes, reclassification either into or, more to the point, out of the FVPL category could not be made except for rare circumstances where a reliable measure of fair value is no longer available for investments in equities that do not have a quoted market price in an active market and whose fair value cannot be reliably measured, and any derivatives that must be settled by delivery of such unquoted equity instruments. A similar transfer from AFS is also permitted by the rules under these circumstances. For these transfers, disclosure requirements are more limited than are shown in Table 1 for newly permitted transfers. In our view, market participants would benefit if the same level of disclosure were applied to all transfers.

While the IASB has opened up the possibility to reclassify from AFS to L&R, it still does not appear to us that the reverse is anticipated by IAS 39. We believe it would be useful if the IASB clarified this point.

Capital

Many European banks have had to raise capital in difficult conditions after taking large mark-to-market write-downs of their assets. Mark-to-market losses (and gains) on the trading book are typically automatically included in capital adequacy calculations. We have observed that, typically, no filter or adjustment is applied by regulators. This contrasts with AFS assets that are marked-to-market for accounting purposes, for which the related gains or losses in OCI are often, but not always, neutralized in capital calculations so that volatility of the capital adequacy ratio is avoided.

Reclassifying assets out of FVPL that no longer (or perhaps never did) meet the criteria for trading will allow further fair-value declines to be excluded from capital requirements, but banks will also not likely benefit from future gains until the assets are sold or mature. We have observed that classification as FVPL typically also attracted lower capital charges. Assets transferred to the banking book (AFS, L&R, or HTM) will usually attract more costly capital requirements--on average several times the level required if they had been left in the trading book. In considering whether to avail themselves of the new options to reclassify assets, there is, in our view, a trade-off to be considered by banks of potentially higher capital requirements in exchange for more predictable capital and reported earnings.

We do not expect increases in capital requirements to be significant overall, as a multiple of a modest capital requirement would still be modest, and some of the assets may have already been reclassified for regulatory capital purposes. However, any increase in capital could well improve banks' preparation to weather poor market conditions. As the new reclassifications are optional, we expect that banks who take advantage of these opportunities will ensure that their Tier 1 capital position can already absorb any increase in requirement, or that they can be assured of raising any necessary capital.

We believe that addressing capital requirements could, of course, be achieved through means other than changing the accounting, such as additional regulatory discretion. Precedents for adjustments are well established through the system of prudential filters, though these do not apply to the trading book and we believe this is unlikely to change. We believe that in the future, regulators are likely to require higher levels of capital for trading activities. We also note that transparency of entity-specific regulatory capital calculations could also be improved.

In our opinion, changing the accounting, rather than changing how it is used in regulatory capital calculations, as we have already described, has the unfortunate consequence of diminishing the utility of reported asset amounts for analysts and investors, as well as introducing additional accounting options to IFRS. Where the reclassification option is taken, less volatile but less meaningful amounts will also be included in regulatory capital calculations. We don't view this as a step forward in the long term.

Confidence Of Lenders And Investors--Restoring Market Liquidity

In our opinion, the most urgent need in the market is restoration of trust and liquidity. However, reclassifications may, in our view, also give rise to accusations over earnings management, and certainly the ability to select assets that have declined over Q3 and avoid the related charge to earnings by reclassifying them at the July 1 date gives opportunity for this. Analysts are unlikely, in our view, to be able to distinguish opportunistic transfers to avoid further write-downs from situations in which the intention to hold the assets has changed, possibly because prices have declined, and the assets will be held for the foreseeable future.

We believe that removing fair value from the accounting by transferring assets to categories that apply amortized cost makes meaningful information less transparent. While volatility in accounting caused by fair value changes may demand a market response, if the market reaction to smooth earnings is to rest easy, there could be a benefit to market pricing even though the same information is just being presented differently--in the footnotes instead of on the balance sheet. However, if fair value information is presented less frequently in annual reports only, then we believe that the market would be losing important interim information altogether.

Standard & Poor's Credit Analysis

We believe that reclassifications that will be most attractive to banks include reclassifying equity and debt instruments from trading to AFS and debt instruments and loans and receivables to L&R or HTM, as applicable. Banks that were active in the origination and distribution of loans of various types will likely find these options particularly attractive.

As a general matter, the same assets accounted for differently should make no difference to our ratings. However, as with any accounting change, we consider further issues. For example, the different accounting treatment may permit us to learn new information on risk exposures, it may affect other items that have more tangible consequences, such as capital requirements and market sentiment changes, or it may drive changes in actual behavior of a bank. In regard to the latter, we would be concerned if, in this case, reporting fair value information in a less visible way were to contribute to a delay in addressing risk management weaknesses, given that reported earnings would no longer focus attention on transferred assets. In the case of this particular accounting change, we note that the due process, which normally helps to ensure the discovery of unintended consequences so that they can either be avoided or better anticipated, has been limited. As a result, we believe additional unintended consequences may still emerge.

In our analysis, we examine various factors in arriving at a view of the context in which financial statement information is produced. We attempt to analyze the drivers of fair value changes and relationships of various amounts in assets, liabilities, earnings, changes in total equity, and cash flows. In some cases, we make adjustments to reported amounts in accordance with our published analytical criteria (see "Financial Institutions Group Provides More Transparency Into Adjustments Made To Bank Data," published on April 26, 2007, on RatingsDirect) and we publish the adjustments we have made. We also consider the implications of remaining differences in reporting in our peer analysis of banks and the relevant regulatory capital treatment.

The key issue when it comes to valuation of assets is what value will ultimately be realized from an asset and how. If everything were simple, fair value would be highly relevant for assets that will be sold, and a present value of cash flows would provide significant insight into the realization of assets that will be held to maturity (or in the alternative, default and recovery). However, rarely are things so simple.

While we believe that many banks have generally classified assets in categories that were consistent with their intentions and expectations at the time, these may well have changed for reasons within or outside their control. In particular, we believe that many banks are holding assets that they originally intended to have sold by now. Aligning the accounting method with how value stemming from the asset is currently expected to be realized has inherent appeal. However, focusing on the reclassifications of assets under IFRS, this alignment approach has, in our view, significant implications for analysis. It is also easy to see the potential for a biased approach of reporting gains when prices are up and avoiding losses when prices are down.

Additionally, we believe that some banks may have classified assets as trading when they didn't actively trade them. Incentives for this approach include capital requirements often being several times lower for assets classified as trading versus all other categories, and, in our view, punitive requirements around the use of the HTM category if assets are sold. Additionally, it may have been expected that fair value gains and losses on hedges of such assets would naturally be matched in earnings and avoid volatility of reported equity. While there is a definition of trading in IAS 39 (see Appendix 1), we believe it has been interpreted in a fairly relaxed manner, which has encouraged its use.

Financial Analysis

We expect that transfers made currently will be made at depressed fair values (although many may choose to avoid even further write-downs that would have resulted in Q3 or even the entire second half of 2008). Consider, for example, a debt instrument that had been classified as FVPL that is transferred to loans and receivables. When fair value accounting was applied, the balance sheet value had a clear meaning--it was the best estimate of the price that would have been realized in a market transaction on the day. After transfer, the balance sheet value will, in our view, have less meaning. It will simply be the result of the fair value at the day it happened to have been transferred to L&R, plus subsequent amortization of the discount implied by comparing that fair value to the expected cash flows, less any impairments taken after the transfer. In our view, this is not an improvement, does not enhance the ongoing visibility of amounts expected to be realized if held to maturity, and the reported values will not facilitate analytical comparisons.

In our view, the same accounting would have resulted had the bank sold the asset and then bought it back, this time classifying it in the new category. However, in that case, any remaining amount in OCI will have been included in earnings upon the sale, so there would not be a residual amount in OCI that is no longer related to AFS assets.

We also understand that some banks may have been less diligent in estimating fair values for assets that are not accounted for at fair value. We consider it important for the same level of diligence to be applied so that these disclosed amounts also truly represent a best estimate of fair value in the context of market conditions at the time.

Earnings analysis is also likely to remain at least as complicated. Earnings before the transfer included any currency translation effect, interest (or dividends), and further change in fair value. While this created significant volatility, large mark-to-market gains and losses were typically quite apparent in the financial statements.

Once assets are reclassified, earnings will be required to include any currency translation, interest (or dividends), amortization of the discount implied by comparing that fair value to the expected cash flows at that date (assuming these are higher), and any provisioning for impairment. Transfer at a fairly depressed fair value could give the appearance of a healthy and stable yield based on the difference between fair value at the reclassification date and expected cash flows, but it merely represents the reversal of some or all of the prior mark-to-market losses. While gains to recover value up to the amount that is ultimately achieved are real, we believe it would be important in financial analysis to understand this component of earnings.

If the loan had been classified as available for sale, the scenario potentially becomes even more complicated. For instruments that have a fixed maturity, gains and losses previously deferred in equity under the AFS accounting model are, according to IFRS, amortized to earnings using the effective interest method, which produces a constant yield over the term to maturity. For instruments that do not have a fixed maturity, the gain or loss continues to be deferred in equity until the asset is sold or disposed of. If the asset is subsequently impaired, any gain or loss in OCI is reclassified from equity to earnings. Impairment would be determined under the L&R rules. This same approach applies to transfers from AFS to HTM. The residual amount included in OCI would only be the unamortized portion of the loss at the date of transfer. As such, we believe it has limited meaning--simply the portion of losses that have not yet been charged to earnings to reduce the yield on the asset in its current classification.

These examples illustrate some of the issues we believe will become important in analyzing reported amounts if reclassifications become significant. As already mentioned, comprehensive disclosures of the particular nature of assets reclassified, rationale for the transfer, and the amounts involved would be important for our analysis. These issues will be considered as we evaluate the specific plans for reclassification by banks and the rationale for transfers.

Our Adjustments

We will also consider whether any update to our adjustment criteria is warranted, but expect that a more qualitative approach can be taken. Our adjustments primarily relate to our measure of adjusted total equity (ATE) and core earnings.

Removing assets from mark-to-market accounting under FVPL will, in our view, lead to less volatility in ATE as related mark-to-market gains and losses will no longer flow to it. As a result, ATE won't benefit from fair value gains if asset values recover, but nor will it decline with further losses. Under our established criteria, we typically neutralize all gains or losses relating to assets classified as AFS. For assets that have been transferred out of AFS, we will evaluate the amount of unamortized losses that remain in OCI. Ideally, we would exclude these from the adjustment if they represent real economic losses. Typically, we would also consider adjusting for any latent losses that are not accounted for, and review in detail disclosure of expected cash flows. We would also likely note the significance of differences between the carrying amount of assets on the balance sheet and their fair values disclosed in the footnotes to the financial statements, as these may indicate the existence of latent losses.

Under our established criteria for core earnings, mark-to-market volatility of assets classified as FVPL has not historically been removed from reported earnings, although we have considered its influence on core earnings in our analysis of trends over the long term. Following the transfer under IFRS, earnings will include a smooth yield on the assets, and possibly an even greater amount of amortization or impairment relating to the prior losses transferred from OCI, itself related to assets that had been classified as AFS. Only when cash flows are expected to be 100% of the original cost amount will the yield on transferred assets not be exceeded by amortization of losses previously deferred in OCI.

We will continue to evaluate various components of earnings and attempt to classify them as appropriate in more detailed elements of our earnings analysis. If losses on assets transferred from AFS continue to be deferred rather than amortized, we will take this into account in evaluating the quality of earnings, as yields will appear to be stronger simply because related losses continue to be deferred.

Calls For "Fundamental" Or "Smoothed" Asset Valuation

Although we are concerned whenever there is reason to believe that accounting may not fully reflect the business or economic purpose for holding various assets, we do not believe that some other "fundamental," "intrinsic," "economic," "smoothed," or similarly described measure should be used in place of fair value. In our view, more judgment is required to be applied in distressed and less liquid markets, but the continued use of fair value over time provides a consistent and meaningful measurement objective for analysis. We believe that alternative measures could, in reality, be even more subjective than fair value, and vary even more from institution to institution.

We believe that the challenges in estimating fair value are significant. However, we also believe they are not insurmountable in the context of an adequately disclosed process of arriving at the values used in accounting and disclosure, one which informs market participants of the significant drivers of change in the amounts. Additionally, when immediate liquidity becomes a significant issue--as was the case prior to the introduction of various governmental support measures--we believe estimates of current market values are highly relevant, particularly as banks may suddenly lose the ability to hold assets to maturity, choosing instead to sell the assets to fund unexpected liquidity pressures that have developed for reasons that are partly out of their control. Fair values are also, in our view, very relevant in the context of the M&A transactions taking place.

If banks fail to show market participants the extent to which values have deteriorated or are volatile in an obvious manner, the key need to restore investor and lender confidence won't be addressed. Indeed, it may have the reverse effect. However, we believe that the disclosure of additional information on values expected to be realized to supplement information on fair values used in the accounting could be most beneficial, where the amounts expected differ significantly from the current amount achievable through selling the asset.

Additional Information On Value Expected To Be Realized

In our view, there is little to prevent the disclosure of additional meaningful information on more "fundamental" values of assets, and we believe such disclosure could help restore trust. To the extent that a bank's management believes that there are significant differences between the fair value amounts presented in the balance sheet and a more "economic" value based on expected cash flows to maturity (or as a result of default and expected recovery), then we believe the disclosure of this material information would benefit the market. Such information would, in our view, likely assist market participants in distinguishing between assumed declines in expected cash flows versus the additional factors that are included in an estimate of an instrument's fair value, such as liquidity.

Where such supplemental information is disclosed to improve transparency, we believe it would also be of considerable use to market participants for banks to disclose how the information has been derived. For example, if an amount representing expected cash flows on a discounted basis is disclosed, information on the key assumptions in estimating cash flows (including recoveries) and relevant discount rate would, in our view, likely be material. We also believe that it could be an important element in rebuilding confidence over time, if banks actually realized these cash flows.

Table 2

Related Research

	Published date
Financial Institutions Continue To Rally Against Fair Value Accounting	Oct. 14, 2008
Is it Time to Write Off Fair Value?	May 27, 2008
FAQ: Will Banks That Apply IFRS Consolidate More Special Purpose Entities?	Dec. 20, 2007
FAQ: IFRS Reporting And Options For Banks In A Souring Market	Dec. 20, 2007
Financial Institutions Group Provides More Transparency Into Adjustments Made To Bank Data	April 26, 2007

Table 3

Appendix 1: Summary of IFRS Classification and Reclassification of Financial Assets

Classification Category	Classification Criteria	Reclassification To: Fair Value Through Profit or Loss (FVPL)	Reclassification To: Available for sale (AFS)	Reclassification To: Loans and Receivables (L&R)
Fair Value Through Profit or Loss (FVPL)	Financial assets held for the purpose of selling in the near term, or part of a portfolio for which there is evidence of recent short-term profit-taking. Loans and receivables are included if the bank originally intended to sell them either immediately or in the near term. This category also includes derivatives (before hedge accounting). Subject to certain restrictions, this category can also be selected for any financial asset under the Fair Value Option (FVO).		NEW OPTION. Not permitted for derivatives or assets originally classified under the FVO. Transfers of other assets can be made in rare circumstances if the assets are no longer held for the purpose of selling in the near term.	NEW OPTION. Not permitted for derivatives or assets originally classified under the FVO. L&R can be transferred if the entity has the intention and ability to hold them for the foreseeable future (loans) or to maturity (debt securities). No 'rare' criteria.
Available for sale (AFS)	All financial assets that are within the scope of IAS 39 (excludes: subsidiaries, most associates and joint ventures, leases, pensions, insurance contracts, for example) and have not been included in another category. Loans and receivables are required to be included where the bank may not recover substantially all of its initial investment other than because of credit deterioration.	Not permitted.		NEW OPTION. L&R can be transferred if the entity has the intention and ability to hold them for the foreseeable future (loans) or to maturity (debt securities).
Loans and Receivables (L&R)	Loans and receivables that have fixed payments and maturity and are not quoted, other than those classified as FVPL or AFS.	Not permitted	We do not believe this is permitted.	

Table 3

Appendix 1: Summary of IFRS Classification and Reclassification of Financial Assets(cont.)				
Held to Maturity (HTM)	Assets with fixed payments and maturity that the entity intends to, and has the ability to, hold to maturity.	Not permitted	EXISTING REQUIREMENT Reclassification is made when there is a change in the intention to hold to maturity. As a result, all assets in HTM may be required to be transferred.	Not applicable (assets eligible for L&R would not initially be classified as HTM)
Cost (suspension of fair value)	Equities that do not have a quoted market price in an active market and whose fair value cannot be reliably measured, and any derivatives that must be settled by delivery of such unquoted equity instruments.	EXISTING REQUIREMENT. Fair value accounting is resumed when fair value becomes reliably measured.	EXISTING REQUIREMENT. Fair value accounting is resumed when fair value becomes reliably measured.	Not permitted.

*Updated for changes to IAS 39, October 2008.

Additional Contact:

Financial Institutions Ratings Europe; FIG_Europe@standardandpoors.com

Global Financial Crisis Roundtable Meetings: Proposed Topics for Discussion

Impairment Guidance for Available-for-Sale (AFS) and Held-to-Maturity (HTM) Debt Instruments

The current guidance on impairment of AFS and HTM debt instruments is not consistent between US GAAP and IFRS, and not consistent with the guidance for loans:

Issue	Current US GAAP	Current IFRS	Proposal
Impairment *triggers* for AFS debt instruments	Credit impairment, plus other impairments without "intent and ability" to hold until recovery	Only credit impairment	Limit impairment triggers to credit impairment
Impairment *triggers* for HTM debt instruments	Credit impairment	Credit impairment	No changes required, but proposed changes to AFS are consistent
Impairment *measurement* for AFS debt instruments	Total decline in fair value	Total decline in fair value	Limit impairment measurement to credit impairment
Impairment *measurement* for HTM debt instruments	Total decline in fair value	Credit impairment	Limit impairment measurement to credit impairment

The proposal would reduce the complexity that arises today from having different triggers and measurement of impairment for loans, AFS and HTM debt instruments. It would enhance investor confidence by providing better information on the expected cash flows to be generated by the entity.

Joint Projects on Consolidation (Including Special Purpose Entities) and Derecognition

The FASB and IASB are currently working on separate projects on consolidation (including special purpose entities) and derecognition of financial assets. It is vital that the Boards work together and issue joint standards on these topics. For the consolidation project, the Boards could build off the current proposed principles of "power" and "benefits." The proposal would reduce the complexity and resources required to reconcile between the GAAP regimes and, for US GAAP reporters, to adopt multiple standards in the near term as US GAAP reporters move to IFRS. It would also enhance investor confidence by providing one global standard on these critical issues.

Joint Projects on Disclosures of Involvement with Special Purpose Entities

US GAAP currently has more detailed disclosure requirements on involvement with special purpose entities, and the FASB has issued an Exposure Draft with additional proposed requirements. The Boards should work jointly on a fast-track project to improve the disclosure requirements for special purpose entities. It will be critical that the Boards permit professional judgment for entities to disclose the key structures and significant risks that arise from their involvement with special purpose entities. The proposal would enhance investor confidence through improved disclosure requirements and a "level playing field" between US GAAP and IFRS reporters.

Submission 17

IASB/FASB Roundtable 14/11/08 - The Global Financial Crisis: Key Accounting Issues for Consideration

Developing converged standards in key areas

The credit crisis has highlighted several key differences between US GAAP and IFRS, particularly in relation to financial instruments, which have resulted in a lack of comparability between the results of financial institutions as well as varying levels of transparency in disclosure of their key exposures. In some cases, these differences have also contributed to differing amounts of capital being held against similar exposures. Examples include SPE consolidation, financial asset de-recognition, and accounting for loans.

While the FASB and IASB are responding quickly to certain specific issues (e.g. the amendment of FAS 140 to eliminate the qualifying SPEs concept, and the October 2008 amendment to IAS 39 to allow transfers of assets between accounting categories), their approach does not address a number of the fundamental differences between the two accounting frameworks. Therefore, the Boards should:

- Combine the separate IASB and FASB projects on consolidation and work towards a new standard (focussed on SPE consolidation) by the middle of 2009;
- Accelerate the development a converged standard on financial instrument de-recognition; and
- Accelerate the work towards developing a converged accounting model for all financial instruments, including loans.

The development of converged guidance in the short term in these crucial areas is a key step towards ensuring that all financial institutions report similar exposures consistently, thereby rebuilding confidence.

Amending the AFS Impairment Model

Under both US GAAP and IFRS financial assets classified as available-for-sale (AFS) are impaired down to their fair value if there is an impairment trigger, although the trigger under each regime is different. This can result in entities reporting losses in earnings due to reduced market liquidity for an asset, even though there has been little or no credit related impairment of that asset. This result is not reflective of management's intent and may result in pro-cyclical accounting as AFS assets are generally held for the longer term, for example to manage a bank's structural interest rate exposure. Therefore, the impairment model for AFS securities should be brought into line with the credit based impairment analysis for amortised cost assets (e.g. FASB Statement No. 114 *Accounting by Creditors for Impairment of a Loan*).

Improvements to disclosures on financial instruments

Two key issues during the crisis were the market's concerns over the level of banks' exposures to key risks and a lack confidence in their valuation of some of those exposures. This has emphasised the need to improve disclosures of key risk exposures and the valuation of instruments in illiquid markets. The Boards and regulators have made efforts to improve disclosures in this area and some large financial institutions have made detailed disclosure of their key exposures. However, the Boards should undertake a joint project to overhaul financial instruments disclosures, working closely with financial institutions and risk managers, which at a minimum should:

- Require US GAAP reporters to provide 'holistic' disclosure of exposures to risk across all financial instruments;
- Require entities to include more detailed disclosure of the key risk exposures given current market conditions;
- Ensure IFRS reporters report financial instrument disclosures on a more timely basis; and
- Supplement the reconciliation of the opening and closing balances the fair value of instruments classified within level 3 of the fair value hierarchy (the level 3 roll-forward table) with data, based on management's existing reporting processes, that allows users to understand the entity's overall exposure to unobservable risk parameters.

Transparent disclosure of an entity's exposure to key risk parameters on a timely basis will enhance the confidence of credit markets.

1) Prioritisation of the establishment of a consistent and converged framework for accounting for financial instruments, including fair value measurement and disclosure. In particular, a consistent definition of fair value as an exit price (including a consistent approach to the recognition of day one profits), simplification of the measurement and disclosure requirements for available for sale assets, a consistent fair value hierarchy, and consistent financial instrument disclosures based on the principles of IFRS 7.

2) Greater focus on a converged framework for consolidation and derecognition.

3) Assurance that proper due process will always be followed for the development and issue of new accounting requirements.

We hope that the above will be helpful, but if you would like anything further, please do not hesitate to contact one of us.

The Global firm of Ernst & Young welcomes the initiative launched by the IASB and the FASB to respond to the current economic circumstances and the opportunity to participate in the roundtables on this subject. It is important that any further changes to IFRS or US GAAP as a consequence of the credit crisis are coordinated so as to result in convergence on these issues to the greatest extent possible and are made with sufficient due process.

Except as mentioned below, we do not believe that there any issues that should be raised at the roundtables as potential improvements that were not already proposed by the European Commission in its letter to the IASB of 27 October:

i) amendment of the impairment measurement requirements for available for sale (AFS) debt instruments so as to be consistent with those for loans and receivables, consistent with our recommendations in our response to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments*, together with changes to US GAAP so as to introduce impairment assessment requirements for such instruments similar to those already contained in IFRS;
ii) reclassification of financial instruments out of the recorded at fair value though profit or loss category where they were originally designated into this category using the fair value option;
iii) the removal of the need to separate credit derivatives embedded in 'synthetic CDOs' under IFRS;
iv) reversal through profit or loss of impairment of AFS equity instruments.

In addition, while changing the recent reclassification amendments to IFRS, we encourage the IASB to adjust the wording so as to make them clearer and, in particular, to clarify when other types of embedded derivatives must be separated from a financial instrument reclassified from recorded at fair value through profit or loss.

During the roundtable, we would like discuss how standard setters should assess the impacts of accounting standards on financial stability.

We will provide an illustration by looking at how measurement and hedge accounting principles may influence retail banks in developping either "originate and hold" or "originate and distribute" business models :

- The financial crisis and the retail banks business models : "originate and distribute" versus "originate and hold"

- How mesurement principles accomodate the various business models of retail banks : fair value measurement versus mixed measurement models

- impacts of hedge accounting rules for financial institutions holding risky assets on their balance sheet : should we allow gain and losses on hedging instruments to be carried forward ? If yes, under which conditions?

- One single matter to be raised : Specific issues generated by the current financial crisis on the practical aspects of the IAS 36 impairment exercise.

I would like to add revenue recognition at the inception of structured transactions as a topic that the IASB should consider reviewing. We need to be comfortable that up front profits are real, and not merely a construct based on models of future outcomes that may or may not eventuate.

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The members of the Financial Reporting Council endorse your concerns.

They have raised two additional issues. The first issue is that the valuation of unlisted exposures is significant during periods of crisis. There is a risk that valuation updates lag the reality of the environment and the opportunity to exists to ignore reality. This has been a particularly large issue in superannuation in unlisted assets like mortgage trusts, unlisted property and infrastructure. The best performing funds have a large exposure to unlisteds. These are illiquid and if redemptions rose would be challenged with declining prices for the assets and few buyers. Current unit prices mask the potential risks.

The second issue relates to revaluing of non financial assets in a very uncertain market, where items such as industrial property can be significantly affected. The concern is that such devaluations may trigger breach of covenants based on ratios, with resultant going concern issues. This may be a little controversial as it is suggesting that the accounting rules may be forcing the going concern issue which would otherwise not be a matter for discussion.

In summary, the subjects I'd wish to see covered and some or all of which I'd therefore be prepared to raise would be:

- Whether it is right to be changing standards to such a short term timescale i.e. for reporting year ends of 31 December
- The need for due process on any changes that are made
- The need to ensure that the information needs of investors are not compromised by any changes
- To suggest that information should be improved and that, at least in the shorter term, additional disclosure rather than changes to standards would best need investor needs
- Specifically, to suggest greater disclosure of underlying assets and liabilities, and therefore of leverage, risks and rewards that investors are exposed to, held in off-balance sheet vehicles

- **Stakeholder** meeting 21 October – do not believe letter reflects views.
- any **amendments** should only be after **due process** and within the IASB's framework.
- IASB to **accelerate its effort**s, complex areas as the fair value option, embedded derivatives, and the impairment of AVS assets - changes by December result in **unhelpful** reporting and have unintended consequences. - confuse **users** and reduce **comparability** and **consistency** in financial reports.
- Opportunity to **present results more favourably** and could potentially mean a rush to the bottom in terms of standards
- Supports the **convergence of IFRS and US GAAP** to achieve a harmonized set of global accounting standards that are comparable. However, the proposals in the letter are inconsistent with this. On the one hand, the letter proposes changing accounting for embedded derivatives to eliminate differences between US GAAP and IFRS and on the other, proposes a change to the fair value option that increases the divergence between the two. **If current IFRS is better then the IASB should maintain the difference and it should be US GAAP that changes, it should not seek to diverge further**.

Undoubtedly the current credit crisis requires rapid measures by governments and regulators. However, **fundamental changes** in accounting should be implemented only after due process and the involvement of all stakeholders.

BNP PARIBAS

Submission 25

Ms. Victoria Blackburn
IASB

11 November 2008

Re: Summary of matters raised for the financial crisis roundtable Nov 14, 2008

We are pleased to provide a summary of the matters we wish to raise at the financial crisis roundtable.

The financial crisis has put into question the unintended consequences of the current requirement to measure financial instruments at their market-based fair value, in circumstances of illiquid markets. The dangerous downward spiral created by the sales of assets that certain market participants were obliged to execute, has been intensified by the requirement to continue to mark to market trading positions, although no trading was any longer possible.

We welcome the measures taken in October to allow entities to reclassify such positions out of the trading categories, as well as the guidance initiated by the SEC to help constituents in measuring the fair value of financial instruments when markets are no longer active. However, we believe that :

- Further steps should be taken before year-end, in order to address the outstanding issues identified by the European Commission in consultation with the industry, and which we support.

- The revision of IAS 39 should be accelerated and should address in-depth consideration of the lessons learnt from the crisis, in particular the responses to the procyclicality of the fair market value and its unintended consequences.

    - In our opinion, this should first lead to a limited use of fair market value (exchange based) for instruments traded on active markets, with adequate volumes and reasonable bid-ask spreads. This implies reconsidering applying fair value to illiquid financial instruments, including at inception.
    - Fair market value should be excluded as a measurement to account for retail banking activities, when loans and deposits are managed on a cash-flow based business model, and hedging activities should be given proper accounting treatment reflecting their management.

We look forward to presenting more details on these issues.

Sincerely,

Franck Lafforgue
Group Accounting Policy