14th September 2009

Sue Lloyd,
International Accounting Standard Board
30 Cannon Street
EC4M 6XH
United Kingdom

Re: Comment Letter on Financial Instruments: Classification and Measurement

Dear Sue,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the IASB - *Financial Instruments: Classification and Measurement exposure draft (ED).*

The CFA Institute Centre represents the views of its worldwide members, including portfolio managers, investment analysts, and advisors. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting these goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct.*

EXECUTIVE SUMMARY

In a previous letter dated 30th June 2009**,** we stated our support for the pursuit of a comprehensive overhaul of IAS 39 as long as such actions will result in a high-quality, principles-based standard that is keenly focused on providing users with more decision-useful information than we receive under the current standard. We identified at least four reasons why this project is one of the board's priorities. These include:

- Improving financial reporting
- Reducing complexity for financial instrument accounting
- Progressing through the convergence projects
- Communicating through effective action that the Board is being responsive to the financial crisis.

[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, Brussels and London, CFA Institute is a global, not-for-profit professional association of more than 100,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

We also expressed the risk of an expectation gap being created with all stakeholders, due to pursuit of multiple objectives within a very ambitious and short time frame. The concern of an expectation gap remains and our evaluation of the ED is primarily based on whether it does in fact, reduce overall complexity and improve the quality of financial reporting to investors.

In our comments, we express our concerns about the mixed measurement attribute, where there are multiple measurement basis reflected in the performance statement, becoming a permanent feature for financial instrument accounting. We do not consider the proposed changes to be a sufficiently comprehensive overhaul nor do we believe the ED has achieved its objective of reducing complexity of financial instrument accounting.

The debate about fair value is in part a reflection of concerns about financial statement presentation and the impact of fair value on net income. Hence, we believe that the Board should have focused on presentation in addition to refining the classification as a means to reducing complexity. We are similarly concerned about the criterion of qualification for amortised cost treatment, and that the loose definition of these criteria will leave room for reporting entities to conceal their risk exposures, defer real economic losses and that this will compound the inconsistent accounting across similar financial instruments which is confusing to investors. As an alternative, we propose that one approach to address the different information needs of different stakeholders including users, would be to require both fair value and amortised cost reporting for those financial instruments that are eligible for amortised cost treatment, and thereafter to display with equal prominence the gains and losses on those financial instruments on separate income statement columns. All other financial instruments should be accounted for at fair value.

We believe the exception treatment granted to equity investments sets a precedent that will retain the existing complexity of financial instrument accounting and encourage further allowance of exceptions in the future. Continued posting of items to other comprehensive income (OCI)[3] will continue to distort the performance reported through the income statement.

Finally, we are concerned about the seemingly divergent approaches of FASB and IASB. We are concerned that this will impact on the convergence process and urge both Boards to work together towards a single and highest quality solution. We reiterate that convergence should only be a means to providing high quality financial reporting and should not provide a premise for a race to the bottom between standard setters.

[3] '*The OCI statement has no conceptual basis; it is an artefact of compromise-based standard setting as it has often been used as a repository for items that conceptually belong in the income statement. These include fair value changes associated with so-called available for sale securities, gains and losses on cash flow hedges, foreign currency translation effects and postretirement benefit adjustments. Thus, the OCI bears semblance to a suspense account that, contains key elements of a reporting entity's performance and risk and in essence indicates that reported earnings are perpetually wrong. The implication of the OCI category is that there is a disconnect between the inherent volatility associated with a business and the volatility of its earnings – that is, earnings are being enhanced to artificially appear less volatile than they truly are*.' – CFA Institute letter on Financial Statement Presentation 14th April, 2009

Background and summary of key changes

The G20 leaders in April urged both Boards to expedite their financial instrument projects. During a meeting with ECOFIN ministers, the IASB chairman confirmed the intended response to the financial crisis, including finalizing a classification and measurement standard in time for 2009 annual statements.

The ED, Financial Instruments: Classification and Measurement, is part of the IASB's wider project to replace IAS 39 *Financial Instruments: Recognition and Measurement* over the next year. It is the first of three phases and the standards for impairment and hedge accounting will be issued later in the year. The FASB is expected to release its proposals on a standard dealing with classification, measurement and impairment in the near future. A discussion of the key changes is included below

Classification core principles

Under the existing mixed measurement attribute model, where there are multiple measurement methods including fair value and amortised cost are reflected in the performance statement, the classification of financial instruments determines the corresponding measurement approach. Currently, there are four classification categories, including;

- Held to maturity,
- Loans & receivables,
- Available for sale,
- Fair value through the profit and loss.

The held to maturity and loans & receivables are measured on an amortised cost basis. The ED, aims to reduces the number of categories and has the amortised cost and fair value measurement as its principal categories. However, due to the allowed exceptions, the ED will likely result in three measurement categories for financial assets and financial liabilities, namely:

- Amortised cost,
- Fair value through the profit and loss,
- Fair value through other comprehensive income (OCI)

The ED proposes new criteria for determining eligibility for amortised cost measurement. A financial instrument would be measured at amortised cost if it has only basic loan features and is managed on a contractual yield basis. The Board has justified these criteria as appropriate for instruments that have predictable cash flows and are held for yield purposes. This is premised on the notion of amortised cost, rather than fair value, being appropriate for such type of instruments. The ED describes basic loan features as giving rights to cash flows that are only 'principal and interest', but these terms are loosely defined and the application of these terms across the full spectrum of financial instruments is not very clear. All other financial instruments are proposed to be measured at fair value, with gains and losses going through the profit and loss.

The ED would eliminate the exemption allowing some unquoted equity instruments and related derivatives to be measured at cost.

The existing tainting provisions for disposals before maturity of a financial asset would be eliminated. Tainting provisions were in place to avoid gains trading for items classified as held to maturity and accounted for on an amortised cost measurement basis. In other words, recording instruments at cost can lead to masking losses, but realization of gains. Gains trading conceal downside whilst enabling the realization of financial instrument upside. Tainting the portfolio of financial instruments classified as held to maturity items after they are reclassified was meant to deter this practice.

The classification of an instrument would be determined on initial recognition. No subsequent reclassifications would be permitted or required.

While reclassifications would not be permitted on an ongoing basis, at adoption of the proposed standard an entity would reconsider all classifications and designations including the fair value option.

Exception to core classification principles

If a financial instrument is measured at fair value, all changes in fair value would be recognised in profit or loss, with one exception. For equity investments which are not held for trading an entity can choose to recognise gains and losses in other comprehensive income (OCI) with no recycling of dividend income or gains and losses into profit or loss. Recycling is the accounting process of moving gains and losses that were initially recorded in the OCI category, from the OCI category to the main profit and loss account. Recycling occurs at the point of realisation of the gains and losses. In addition, if an equity instrument is so designated, then dividend income also would be recognised in other comprehensive income. This exception was motivated due to the pressure to retain the current practice from certain jurisdictions, with claims that equity investments sometimes occur for ‘strategic’ purposes.

The ED contains an option to classify financial instruments that meet the amortised cost criteria as at fair value through profit or loss if doing so reduces accounting mismatches. This is also described as the fair value option. This is not a new approach as it is allowed under current accounting standards.

Embedded derivatives

Embedded derivatives with financial host contracts would not be bifurcated; instead the hybrid financial instrument would be assessed as a whole. No change is proposed to accounting for embedded derivatives with non-financial host contracts.

(see appendix for definition, example and current accounting of embedded derivatives)

Transition date

No mandatory effective date is specified but the IASB does not expect it to be before 1 January 2012. The IASB plans to have a final standard for stage 1 of its project available for early voluntary adoption in 2009 year-end financial statements.

Implication for investors

- Mixed measurement accounting model: the continued application of the mixed measurement model will retain the situation of different accounting for identical financial instruments, making it difficult for investors to compare company earnings and net worth.

- Opportunities for structuring may arise due to selective use of the variability of cash flows characteristic, to determine which financial instruments may be reported at amortised cost.
- It is difficult to judge whether more or fewer items will be accounted for on a fair value basis under this proposal.
- There may be a reduction in some financial instruments that are accounted for under the other comprehensive income (OCI) statement (i.e. debt instruments will no longer be accounted for under OCI with the elimination of the available for sale category). However this could be offset by the increase in the equity investment that will be accounted for through OCI.
- Opportunities for structuring may arise due to the exception accounting allowed for equity investment.
- Anticipate varied impact on net income volatility. Firms with large amounts in the available-for-sale category will have higher net income volatility, while others may experience reduced income volatility with more items being eligible for amortised cost accounting.
- There is likely to be reduced transparency of embedded derivatives due to elimination of bifurcation rules.
- The ED will not impact on existing impairment and hedge accounting rules. The existing impairment standards have not provided timely information on financial instruments carried at amortised cost and have never been adequate for equity investments. The proposed amortised cost and Strategic equity investment categories raise questions about whether the IASB will be able to develop better and more decision-useful impairment standards.
- To the extent some companies chose early adoption beginning in 2009 and the standard is not ultimately mandatory until 2012, there will be additional non-comparability between firms caused by voluntary election options.

Summary of CFA Institute positions
Below is a summary of our key positions:

Recommended option for reducing complexity: Classification refinement should not be the primary means of reducing complexity. The focus should be on providing the measurement basis that provides full transparency of financial instruments (i.e. fair value) and resolving the presentation concerns that revolve around different measurement bases. We do not consider tinkering with the existing mixed measurement attribute to be a comprehensive change and strongly urge the Board to see these changes as interim step, with the objective of a more fundamental review that will consider fair value for all financial instruments in the future.

We believe that one approach to reducing complexity and to address the different information needs of different stakeholders including users, would be to require both fair value and amortised cost reporting for those financial instruments with basic loan features and that are managed on a contractual yield basis, and thereafter to display the gains and losses on those financial instruments on separate income statement columns, with equal prominence. This requirement should also apply to "strategic" equity method

investments. All other instruments should be at fair value. Equal prominence will allow fair values to be included in earnings releases on a timely basis to the benefit of investors who require this information.

Three stage amendments: We believe that the Board, in the approach to overhauling IAS 39, has understated the interdependent nature of classification and measurement, impairments and hedge accounting. Under the current approach, it appears that the hedge accounting approach will have to simply fit in with the designated classification approach. However, we believe that the intended hedge accounting approach should have been considered when determining the appropriate classification criteria. For example, the cash flow hedge accounting[4] and impairment approaches, will have a large impact on how effective the classification changes really are.

Amortised cost criterion: Given the choice by the Board to continue to allow a mixed measurement attribute, we would have expected the development of robust criteria for amortised cost classification. However, we have questions about the proposed amortised cost criteria of holding basic loan features and being managed on a contractual yield basis. We believe this 'novelty'criteria and its loose and vague definitions will contribute to the ability of preparers to financially engineer results, obfuscate performance for investors, conceal the economic risk exposures of complex financial instruments, alongside providing inconsistent accounting across financial instruments. This concern is compounded by the elimination of "tainting" note as there is no penalty for trading instruments being held at amortised cost.

The emphasis on basic loan and management of contractual yield overlooks that the biggest source of losses during the credit crisis were the most senior parts of structured investment vehicles. It further overlooks the extent of active management across all financial instruments that occurs within financial institutions and that these instruments are also managed on a total return basis. As noted in the dissenting opinion it is not clear how many trades are needed before one questions the business model. Also, inconsistent application and implementation challenges can arise in situations where there is a dynamic business model. A possible unintended consequence of designating instruments as being managed on a contractual yield basis is that the designated business model definition may end up being shaped by accounting requirements, rather than accounting simply reflecting the underlying business performance.

Equity Investments classification: We do not support the choice to create a category to allow for the recognition of equity investment fair value gains and losses through other comprehensive income. We consider this approach to be an unjustified application of exception accounting principles. The Board does not offer an adequate conceptual justification for this exception and this is an accounting choice clearly aimed at achieving a predefined classification outcome. The genesis of this choice reveals it as being a compromise to overall conceptual principles, initially tailored at preserving the accounting practice of particular jurisdictions, but thereafter morphing into a more liberal exception due to the difficulties in developing solid conceptual principles to justify the category's existence (e.g. difficulty in defining 'strategic' investment).

Whereas this might appear to be an innocuous and limited exception, it overlooks that a single exception is the foundation of multiple future exceptions. This is a key lesson from the genesis of previous standards that the Board should have learnt. In addition, the reclassification prohibition and restriction on dividend classification through profit and loss, do not provide sufficient deterrent from the application of

[4] Will the deferral and recycling through OCI be retained for cash flow hedge accounting?

this category. This will likely end up being a very large category used to include any volatile equity instrument.

Embedded derivatives: We do not support eliminating the bifurcation of embedded derivatives. This would backtrack on transparency requirements for hybrid instruments, where the derivative is not closely and wholly related to the host contract. Conveying the risks and rewards associated with these instruments, is more important than having simpler but misleading accounting. The financial crisis has heightened the need for greater transparency on such complex products.

Recycling and reclassification: We support the prohibition of recycling of items from OCI. We similarly support the prohibition of reclassification across categories and encourage the Board to extend the recycling prohibition to other areas (e.g. cash flow hedge accounting).

Converged solution: We reiterate the need for both Boards to work together to provide a converged and highest quality financial reporting solution so as to provide investors with comparable financial statements. This will stave off the political pressures to level the playing field that focuses on diluting the conceptual quality of standards in a race to the bottom between standard setting boards. We reiterate that convergence should only be a means to providing high quality financial reporting and should not provide a premise for a race to the bottom between standard setters.

GENERAL COMMENTS

Objective of reducing complexity
Financial reporting stakeholders including users have consistently stated that reducing complexity[5] of financial instrument accounting is a high priority and this is a key objective of the ED. We understand that reducing the classification categories from four to effectively three (i.e. including fair value through OCI for equity investments) is one of the means of reducing complexity. However, at an aggregate level the proposed approach falls short of its objective on several levels.

Entrenching the mixed measurement attribute approach
The most crucial and contradictory shortcoming of the proposed approach is in attempting to reduce complexity, it seeks to embed the primary source of complexity (i.e. the mixed attribute approach) as a permanent feature of financial reporting. Unfortunately, the Board in this instance appears not to have learnt from the lessons of development of previous standards, including the standard it is replacing (i.e. IAS 39) where application complexity arises due to a mixed attribute approach and the allowing of exceptions. These exceptions often necessitate a perpetual stream of piecemeal enhancements plus additional implementation guidance. This is in addition to similar financial instruments being accounted for differently across reporting entities.

A key shortcoming of a mixed measurement attribute approach is that it is often characterised by internal inconsistencies. For example, under the proposed model, there could be tension between prohibiting reclassification, while asserting that classification should be based on how instruments are managed. This is not to suggest that we support reclassification under any circumstances, but only to highlight what seem to be unavoidable internal inconsistencies under a mixed measurement attribute approach. These inconsistencies are what leads to subsequent amendments, and maintains the unwieldy set of rules. In other words, we are not convinced that the Board will effectively realise its goal of reducing complexity by preserving elements of a mixed attribute measurement system. Tinkering with the mixed attribute system does not amount to a comprehensive review and we strongly recommend that the Board consider the application of full fair value for all financial instruments in the future.

Under the current politicised environment, these well established shortcomings of the mixed attribute appear to be overlooked, in order to satisfy parties that would either like to defer recognition of losses or place undue emphasis on earnings stability. If the ED's approach is adopted, the mixed attribute feature will continue to plague the quality of financial reporting information. Therefore the Board ought to be

---

[5] '*Despite the appeal of eliminating complexity, there is the danger of complexity being a catch all phrase resulting in different constituencies talking at cross purposes. Everyone is likely to agree with the goal of reducing complexity but there is a danger of such a goal meaning different things to different constituencies. Therefore, in its communication to its key constituencies, the IASB should disaggregate the category of complexity that it aims to resolve. The board and staff need to be clear whether what is being resolved is implementation, investor interpretation or volume complexity. There is also a need to distinguish between avoidable and unavoidable complexity. Complex arrangements and the ongoing innovation of financial instruments are part and parcel of modern finance. Managers need to fully convey the nature and the entire spectrum of risks associated with the complexity that they face. Hence financial reporting should efficiently and precisely convey the complexity. In other words, accounting should shed light on the complexity of financial instruments and it should neither exacerbate nor mask the complexity of such instruments. Overall, we support measures (i.e. fair value and improved disclosures) that reduce user interpretation complexity and provide a more accurate depiction of the economic reality of reporting entities.*'- CFA Institute comment letter on reducing complexity 19th September 2008

bold enough to take this opportunity to improve the application of fair value accounting, especially given that fair value has been in the spotlight during the credit crisis, and the debate presented a chance to address any perceived shortcomings of its application. This would include ensuring the full adoption of the recommendations of the Expert Advisory Panel (EAP) regarding the fair value application for illiquid instruments. In addition, this reinforces the importance of the financial statement project and the disaggregation principles of the income statement. The concerns about classification are a consequence of sub-par, mixed attribute, single-column presentation of performance.

As we have noted in our comment letter on Reducing Complexity for Financial Instruments, the debate around classification categories is really a secondary consequence of a) multiple measurement methods and b) concerns about location of recognized gains and losses. The mixed attribute system is what necessitates an undue preponderance on classification. **In other words, classification should not be the primary issue to resolve complexity.** Hence a more meaningful set of options, that focuses on sources of concerns and complexity, would be whether to;

- Apply full fair value for all financial instruments with everything going through the profit and loss; or
- Apply both full fair value and amortised cost for all financial instruments, but allow a separate column for fair value gains and losses; or
- Apply either amortised cost or fair value for financial instruments, with fair value changes going to OCI, but with fair values disclosed for all investments.

We believe that one approach to reducing complexity and to address the different information needs of different stakeholders including users, would be to require both fair value and amortised cost reporting for those financial instruments with basic loan features and that are managed on a contractual yield basis, and thereafter to display the gains and losses on those financial instruments on separate income statement columns, with equal prominence. This requirement should also apply to “strategic” equity method investments. All other instruments should be at fair value. When amortized cost is presented and fair value is not, bias is introduced into the reporting model that implies that amortised cost is more relevant information. We find fair value information to be more decision-useful information for investors and its recognition will enable the timely inclusion in earnings releases for the benefit of investors who require this information. Fair value recognition and measurement will also incentivize the disclosure of sensitivity analysis and related information.

Inadequate development of amortised cost criterion
Given the choice to continue to allow a mixed attribute approach, while reducing the number of categories, it is essential to develop robust criterion governing how these are recorded in their respective categories. In other words, an operational and easy to comprehend criteria that can lead to a common understanding of how each financial instrument will be measured. The proposed approach of instruments bearing basic loan features and being managed on a contractual yield basis, as a qualification for amortised cost measurement, will likely yield many areas of ambiguity and inconsistency in the accounting across a range of financial instruments. The basic loan feature of a financial instrument is subject to diverse interpretation and clearly this ‘novelty’ criterion will require significant enhancement alongside a lot more extensive education to all stakeholders, than the ED currently provides, notwithstanding that the goal was to reduce complexity within such a short time frame.

The ED provides the example and discussion around securitisation instruments with waterfall structures. This illustration shows the inconsistent accounting treatment across various tranches of the same structured vehicles. This is likely to create opportunities for structuring to meet one measurement basis over the other. For example, it is possible that by inserting an additional special purpose entity into a waterfall structure, a firm could pass the basic loan feature criterion and attain amortised cost status on a greater portion of a securitization. The irony of the proposed approach is that it may lower transparency around structured investment vehicles, notwithstanding that the poor accounting around these instruments, was a key contributory factor to the understatement of the risk of financial institution and ultimately to the credit crisis. A fact being overlooked is that the highest source of losses during the credit crisis were the senior pieces of structured investment vehicles and only an accounting system that provides an early warning system to investors (i.e. fair value), around such complex instruments, can be considered an improvement. The proposed approach will likely expand opportunities for preparers to financially engineer results and obfuscate performance, conceal risk exposures and confuse investors on how financial instruments have been accounted for within the principles and rules.

Given our concerns on reduced transparency due to amortised cost application for structured finance instruments, we urge the Board to, at a minimum, require the fair value disclosure of all securitisation instrument tranches and **not to, under any circumstances, extend the amortised cost** towards the subordinated tranches with protective features.

Accounting based on managerial intent and contractual yield management

We believe the root causes of avoidable complexity include accounting approaches that allow accounting based on management intent due to its inconsistent accounting treatment for similar instruments. The ED states that instruments that will be managed on a contractual yield basis and claims that business model is an observable fact, and thus on the surface, this would appear to prevent the exercise of management intention regarding the classification of individual securities. However, this assertion does not correspond to reality. While this might be presumed to result in an objective classification of the financial instrument, it ignores the fact that the selection of a business model involves management bias and judgment. Thus, the classification is ultimately what management intends it to be, rather than a neutral presentation of the financial instruments' worth. And, unlike IAS 39, there is no constraint in the form of 'tainting' criteria. This aspect of the model has the potential to lead to non-comparable accounting for identical instruments across the universe of companies applying the standards.

Another problem is that the proposed accounting does not take into account any changes in the way a portfolio of financial instruments is used, or the fact that the same financial instruments could be used for more than one purpose. Assume a bank has a portfolio of liquid instruments that it holds ostensibly for the contractual yield earned. If faced with a liquidity crisis, the bank would sell the securities to preserve its ability to meet debts. Should such a portfolio be considered as being "managed on a contractual yield basis"? If their purpose is to be held in reserve for liquidity, it would seem that they'd fail the "managed on a contractual yield basis" criterion.

The interesting question relative to the classification proposal is that preparers have to say that they manage their portfolio on a contractual cash flow basis; that is, they do not evaluate it on a total return basis. It is true that insurance companies (especially life insurance) and many banks attempt to match the duration of assets and liabilities, however it should not be suggested that total returns are not considered as well.

A possible unintended consequence of designating instruments as being managed on a contractual yield basis is that the business model definition may be influenced by the accounting requirements. We maintain that the accounting should simply reflect the underlying business performance. The Board appears to have formally developed a business model rationale that exists for reporting purposes rather than a business model that is a rational outcome of economic verities.

Consequence of amendments
One common question: will this proposal increase the amount of financial instruments presented at fair value by financial institutions? There is no definitive answer because it will depend on two unknowable variables: one, the kinds of financial instruments existing on balance sheets when a classification and measurement standard is adopted, and two, whether or not firms have been able to interpret the principles in the standard so as to *avoid* accounting for financial instruments at fair value. It would also depend on whether hybrid instruments previously accounted on a bifurcated basis, would now be accounted for in their entirety more on one basis or the other.

We understand the argument that the consequences are indeterminate as the Board's primary focus is on the conceptually correct demarcation. However, this remains a key question that most stakeholders will base their evaluation of the amendments. The fact that there is no answer to the consequences across the range of financial instruments is revealing of possible implementation and operational shortcomings of the criterion. A characteristic of a well developed criterion should be the capacity to clearly anticipate and articulate its consequences.

Relevance of amortised cost versus fair value information for users
The Exposure Draft does not make a compelling case for preserving amortised cost as a primary measurement method. The Basis for Conclusions states that the Board believes that both amortised cost and fair value "can provide useful information to users of financial statements for particular types of financial instruments in particular circumstances,"[6] yet it fails to explain how amortised cost provides information that is at least as investor-useful as provided by fair value reporting. The two bases do not present information the same way, with gains and losses in value omitted from reporting under an amortised cost basis. Investors do not benefit when economic information is suppressed or omitted from financial reporting. Through various commentary[7] **we have stated why we believe that fair value measurement is the only appropriate measurement basis for all financial instruments**. We have consistently held this view and the financial crisis has reinforced our support of the appropriateness and utility of fair value measurement for all financial instruments. We once again draw your attention to the member survey evidence backing our support for fair value. The findings of CFA Institute 2007 Financial Reporting and Measurement survey show that;

- 72% of respondents indicated that companies should not have recognition and measurement options for similar items. This is predicated on the belief that a single measurement basis can allow greater comparability between reporting entities and within items reported by the entity.
- 58% of respondents prefer fair value as the single measurement basis for financial assets and liabilities with amortised cost information provided as a note disclosure item

[6] Basis for Conclusions, paragraph 15.
[7] CFA Institute on Reducing Complexity for Financial Instruments- 19th September 2008

Our global and EU member survey results[8] show support for fair value. We reiterate the benefits of fair value that we have severally cited, including to;

- Reduce the complexity of a mixed measurement accounting model
- Reflect active management
- Avoid accounting by management intent
- Improve transparency of assets and liabilities with small historical costs
- Improve comparability across financial instruments by ensuring the consistency of accounting across similar financial instruments
- Reflect information based on current economic conditions and therefore provide better predictive information content

A question sometimes being asked of those who support the application of fair value is how do users attempt to model fair value? It is equally appropriate for the Board to question whether analysts are able to model amortised cost/incurred loss impairments in their valuation models and whether these have any predictive value. As such, a better question would be how can investors forecast balance sheets, cash flows and capital requirements without having audited fair value information? The arguments in favour of amortised cost tend to reflect concerns about financial statement presentation and net income volatility, rather than decision relevance or comparability of information. That is why we propose that the Board's focus should also have been on addressing the presentation issues that are implied in fair value debates. On the other hand, there is academic evidence[9] supporting fair value as being more relevant in the valuation and risk analysis of financial institutions. Not to mention the pervasive evidence that all **capital allocation decisions only occur on a fair value basis**.

We emphasize that the amortized cost of an instrument, though useful has the least relevant information for investors. An investor who is considering a security will not find the valuation of the instrument based on management's intent the relevant measurement because that investor will ultimately be expected to pay a price for the stock that represents the fair value of its holdings. Similarly, when an institution considers the acquisition of another company, it is not its expectation that it will pay the amortised cost value based on the previous management's intent. It will pay a price based on fair value. In both cases, the amortised cost based on a historical valuation before the company or investor acquired a position in the investment simply is not relevant information. For both parties, the amortised cost measure is a historical artifact to be ignored. The only investors who will find the amortised cost relevant are those who are long-term holders of the stock who acquired the instrument before the financial instrument was purchased. If the instrument has a life approaching ten, twenty, or thirty years, this is likely to represent a very small portion of the shareholder base.

---

[8] A 2008 member poll conducted of our 12,000 person EU membership, which shows that 79% were opposed to suspension of fair value and 85% believe that suspending fair value would decrease investor confidence in the banking system. This was consistent with findings of our global membership survey.

[9] Hirst, Hopkins and Wahlen (2004), 'Fair value, Income Measurement, and Bank Analysts' Risk and Valuation judgement', The Accounting Review, Vol 79, no.2, pp 453-472
Hodder, Hopkins and Wahlen (2006), 'Risk Relevance of Fair Value Income Measures for Commercial Banks', The Accounting Review, Vol 81, No.2, pp 337-375

Future improvements to financial instrument accounting

Further to reducing complexity, these changes have resulted from multiple pressures and being enacted under a politicised environment. As stated earlier we are concerned that the Board is becoming further entrenched in a mixed attribute approach which is an acknowledged source of complexity, under the premise of undertaking a comprehensive review. This approach is likely to handicap potential future improvements and embed complex, intractable financial instrument accounting characterized by ongoing piecemeal changes and unwieldy volume of rules to deal with the exceptions that will inevitably arise.

We also believe that the Board, in the approach to overhauling IAS 39, has understated the interdependent nature of classification and measurement, impairments and hedge accounting. Under the current approach, it appears that the hedge accounting approach will have to simply fit in with the designated classification approach. However, the classification criteria should have been driven and defined primarily by the economics of the hedge and focused on the objectives of strengthening the conceptual soundness and simplifying its hedge accounting model. For example, whether the cash flow hedge accounting approach and its deferral and recycling through OCI, is changed, will have a large impact on how effective the classification changes really are.

Implications for convergence

A first reading of the proposals of both the IASB and FASB, gives us concern about the Boards pursuing divergent paths and the impact that this is bound to have on convergence. There seem to be distinct differences on the balance sheet effects as the FASB approach would require the fair value recognition across a broader array of financial instruments.

As a way forward, we would suggest that both Boards should work towards a single solution that yields the highest quality information. A divergent approach between the IASB and FASB is likely to fuel the race to the bottom of financial reporting quality as exemplified by the changes that occurred through the October reclassification amendments and recently through the relaxation of FASB's impairment rules.

In pursuing a converged solution, it is important that both Boards place emphasis on developing the highest quality accounting for the benefit of investors in all their jurisdictions. We reiterate that convergence should only be a means to providing high quality financial reporting and should not provide a premise for a race to the bottom between standard setters.

SPECIFIC COMMENTS

Amortised cost criteria

Basic loan features

The basic loan feature criterion for achieving an amortised cost classification may present significant implementation problems. One criterion for classifying a financial instrument is that it contains "basic loan features" - contractual terms that give rise to cash flows in repayment of principal and interest on the principal outstanding. It appears that the intent of the proposed accounting is to include only basic financial instruments like loans and ordinary bonds in the amortised cost category, and there are numerous examples of basic loan features provided in the ED. It is not hard to conceive of new instruments being developed solely to satisfy the basic loan feature criterion – and it is not hard to conceive of further interpretations being requested by preparers and auditors so as to achieve a desired amortised cost status.

<u>Furthermore, based on seniority of payment, the counter-intuitive possibility exists that the same kind of instrument could be classified in both categories.</u> The ED addresses securitizations with "waterfall-structured" senior tranches and junior tranches, where the junior tranches provide credit protection to holders of the senior tranche securities. The senior securities could be construed as having basic loan features and be classified as amortised cost financial instruments, whereas the junior tranches would be classified as fair value financial instruments – an odd result, given that they are securitisations from the same transaction.

A more serious concern for investors, however, is that the opportunity exists for structuring transactions so as to achieve the amortised cost treatment. It is possible that by inserting an additional special purpose entity into a waterfall structure, a firm could pass the basic loan feature criterion and attain amortised cost status on a greater portion of a securitization. Financial instruments resulting from securitization transactions figured largely into the economic crisis endured in the past few years. It would be ironic if an accounting reform effort gave them less transparency under the cover of amortized cost reporting.

Contractual yield management

The "managed on a contractual yield basis" criteria for achieving an amortised cost classification may be biased by management judgment, resulting in more or less amortised cost presentation – depending on what management wants to show. Financial instruments are managed on a contractual yield basis <u>only</u> if they are managed, with performance evaluated by key management personnel, on the basis of contractual cash flows generated when held or issued. On the surface, this would appear to prevent the exercise of management intention regarding the classification of individual securities.The Board believes that the way a particular unit of a firm is managed, or the entire firm itself, should determine the way a financial instrument is classified.

As discussed in general comments, this approach alongside its loose and vague definition, does not preclude accounting based on managerial intent and the designated business model definition may end up being shaped by accounting requirements, rather than accounting simply being a tool to reflect the underlying business performance.

Equity investments
The ED proposes to allow the recognition of fair value changes of equity investments through the OCI. For equity investments which are not held for trading an entity can choose to recognise gains and losses in OCI with no recycling of gains and losses into profit or loss. If an equity instrument is so designated, then dividend income also would be recognised in OCI.

We believe that all fair value changes in equity instruments should be through profit and loss and do not agree with the exemption of allowing equity investments to recognised through OCI. The Board does not offer an adequate conceptual justification for this exception and this is an accounting choice aimed at achieving a predefined classification outcome. This appears to be a compromise to the overall conceptual principles, initially tailored at preserving the accounting practice of particular jurisdictions, but thereafter morphing into a more liberal exception due to the difficulties in developing solid conceptual principles (e.g. difficulty in defining 'strategic' investment). Whereas this might appear to be an innocuous and limited exception, it overlooks that a single exception is the foundation of multiple future exceptions.

This exception will be a further source of inconsistent accounting and create gaming opportunities. This category has the potential to be a sizeable bucket because companies could simply decide to put anything volatile in this category. We do not believe that the dividend and realized gain restriction is not a substantial barrier to using this category. For example, for a volatile biotech stock, dividend classification restrictions, will not disincentivise managers from seeking to use OCI. Many instruments do not have dividends, and managements can very easily instruct analysts to include gains in OCI when it is to their benefit. At a minimum, should this option be permitted, then it must be an irrevocable election upon initial recognition.

Embedded derivatives
The ED proposes to eliminate the bifurcation of embedded derivatives. Embedded derivatives with financial host contracts would not be bifurcated instead the hybrid instrument would be assessed as a whole. However no change is proposed to accounting for embedded derivatives with non financial host contracts.

The main argument against the bifurcation of embedded derivatives seems to be the practical difficulties in separating these, and the pursuit of simplification. This overlooks the benefit of the bifurcation rules that are most useful towards providing transparency of structured financial instruments. These rules necessitated the identification of embedded derivatives that are not wholly or closely related to the host contract. It is noteworthy that after the previous introduction of IAS 39 bifurcation of embedded derivatives, banks stopped selling structured products to entities that had to comply with IAS 39 and shifted their target markets primarily to audiences that have lower transparency requirements[10].

In addition, the focus of financial reporting reform should only be on eliminating avoidable complexity, while ensuring that financial reporting information still conveys the complexity of the underlying business model, including the application of complex financial instruments.

---

[10] 'Accounting for Financial Instruments'- 2009- Cormac Butler. The author notes that there is little doubt that IAS 39 rules on bifurcation of embedded derivatives changed the landscape of structured product originators

Reclassification and OCI recycling

We support the prohibition of recycling of items from OCI and the reclassification across categories. The October 2008 reclassification amendments highlighted several analytical challenges and the reduced comparability across reporting institutions. We have consistently requested that the Board prohibit recycling and encourage the Board to extend this principle to other aspects of financial instrument accounting (e.g. cash flow hedge accounting).

CLOSING REMARKS

If you, Board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, CFA, by phone at +44.207.531.0763, or by e-mail at vincent.papa@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht
Kurt N. Schacht, CFA
Managing Director
CFA Centre For Financial Market Integrity

/s/ Gerald I. White
Gerald I. White, CFA
Chair, Corporate Disclosure Policy Council

Cc: Corporate Disclosure Policy Council

APPENDIX

Embedded derivatives (definition, example and current accounting)

A derivative may be embedded in a financial instrument in combination with a host contract. A host contract is the part of the combined contract other than the embedded derivative (the contract in which the derivative is embedded). The combination of a host contract and an embedded derivative is known as a hybrid contract.

Examples of embedded derivatives

- A commodity indexed note in which the principal or interest payments are based on the commodity price
- Debt with an option for repayment in fixed amount of foreign currency
- Synthetic CDO (i.e. purchase treasury bonds and enter credit derivative contracts). This allows firms to mimic the risk profile of cash CDOs

Current embedded derivative accounting

As a general principle derivative instruments are accounted for on a fair value basis under IFRS. The same principle is applied to embedded derivatives, in which an embedded derivative shall be separated from the host contract and accounted for as a derivative instrument if all of the following criteria are met:

- If the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract; and,
- If the hybrid contract is not accounted for at fair value with changes in fair value recorded in profit or loss (as defined under IFRS); and
- If a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.

An embedded derivative would be considered closely related to its host contract if its cash flows on a stand-alone basis vary in a manner similar to the cash flows of the combined contract. This is inevitably a subjective determination, since the accounting literature cannot contemplate every potential financial instrument.