Setting the global standard for investment professionals

July 1, 2010

Sir David Tweedie
Chair
International Accounting Standards Board
30 Cannon Street
London, United Kingdom EC4M 6XH

International Accounting Standards Board Exposure Draft,
Financial Instruments: Amortised Cost and Impairment

Dear Sir David,

The CFA Institute,[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the International Accounting Standards Board (IASB or the Board) Exposure Draft, *Financial Instruments: Amortised Cost and Impairment* (the ED or Exposure Draft).

CFA Institute represents the views of its investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

Comments

CFA Institute has long expressed its membership's preference for fair value as the means for measuring financial assets and financial liabilities. This preference was reaffirmed by our members in our survey conducted in November 2009 in response to the issuance of IFRS 9, *Financial Instruments*.[3] Our members' preference for fair value has been articulated in a variety of responses to the IASB, FASB, regulators and others in the form of written commentary, official remarks as participants in roundtables or other forums, regular liaison meetings with both the IASB and FASB, and outreach to various media outlets.

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[1] With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 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 CDPC 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 CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

[3] IFRS Financial Instrument Accounting Survey, November 2009 http://www.cfainstitute.org/Survey/financial_instrument_accounting_report.pdf

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Our fundamental support for recognition and measurement principles based on fair value reflects our view that fair value measurements reflect the most current and complete estimation of the value of assets and liabilities, including the amounts, timing, and riskiness of the future cash flows attributable to such assets and liabilities. Fair values are the premise of all asset and liability exchanges, and as such should be represented in the financial statements. As noted in ED Paragraph IN7, the estimates required by this standard are not necessarily any less difficult, subjective, or complex than fair values. As such, we cannot support any financial reporting standard that departs from, or does not advance wider use of, fair value financial reporting.

Fair value measurements would also reduce the complexity associated with the preparation, audit, and use of financial statements. With fair value as the measurement method, there is no need for the determination of amortised cost or impairment as required by this proposed standard. Accordingly, our remarks on the measurement of amortized costs and impairment proposal outlined in the ED come from the perspective that such an approach does not provide more decision-useful information for investors.

Amortised Cost Definition and Objective (Question #1 & #2)

Definition of Amortised Cost

When reviewing this Exposure Draft we were reminded that the definition of amortised cost has historically been different between U.S. GAAP and IFRS – most significantly that the IASB definition included the allowance account in its definition and the U.S. GAAP definition did not. With the changes proposed in this Exposure Draft, and the changes proposed by the Financial Accounting Standards Board (FASB) in their recently released *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedge Accounting* (FASB FI Exposure Draft) this definition, and the related objective, will further differ in aspects of their definition but also in their underlying objective.

Under the currently proposed IASB definition, amortised cost will continue to include the allowance account but will be modified to include the "write-up" for positive changes in expected losses because the definition includes the allowance account. The IASB definition will now require that all write-offs be taken through the use of an allowance account – a modification we see as an improvement that will promote consistency between IFRS reporting entities. Under the FASB's FI Exposure Draft amortised cost under U.S. GAAP will not include the allowance account, only direct write-offs of principal, and it will include foreign currency adjustments (i.e. not explicitly stated in IASB definition). We believe the inconsistency in the definition defies the objective of convergence and will result in a lack of comparability and confusion by users.

Objective of Amortised Cost

As it relates to the objective of the amortised cost measure, we would observe that the Exposure Draft defines the objective of amortised cost is to provide information about the effective return of a financial instrument. Proponents of retaining amortised cost are supportive of its use, rather than fair value, because they believe it more accurately reflects the financial asset's future cash generating ability. However, the application of the effective return method may result in outcomes where this is not what is represented by the amortised cost measure at a particular measurement date. Use of the effective rate at inception over the life of the instrument may obscure the measurement of the expected cash flows and may not represent the economics of the security on day two. (See discussion of effective interest rate under measurement principles below) As such, we question whether the supporters of amortised cost will achieve the objective sought through this measurement method and we wonder if users will understand the difference.

Further, we would note that the FASB FI Exposure Draft provides a definition for amortised cost but does not provide an objective of amortised cost. The FASB's amortised cost definition would imply that the FASB's objective would be more consistent with the measurement of future cash flows, when considering the value combined with the allowance account. We believe definitions and objectives should be more closely aligned to reduce the complexity for users.

Finally, we would emphasize that though the IASB's defined objective of amortised cost is to provide information about effective return, the Exposure Draft provides insufficient guidance to help constituents understand the IASB's models for determining the effective interest rate.

<u>*Measurement Principles (Question #4)*</u>

Expected Cash Flows

We support the proposed principle requiring the use of an "expected loss" model in place of the current "incurred loss" model. We support the expected loss model because it uses forward-looking estimates of expected credit losses, which we believe is more consistent with the underlying pricing/valuation of such investments – and, therefore, closer to fair value. More specifically, we are supportive of the principle in ED Paragraph 8 that expected (probability weighted) cash flows be used for measurement purposes. An incurred loss model results in delayed recognition of credit losses, which we do not believe results in decision-useful information to investors.

Effective Interest Rate

Recognizing interest revenue in a pattern consistent with expectations of the amount and timing of expected credit losses appears to be a consistent manner of allocating interested earned with expected risk. The use of the effective interest method as computed at the inception of the instrument would appear to align with this revenue recognition objective and reflect the market's pricing of the uncertainty associated with credit risk of the instrument.

At subsequent measurement dates the use of the original effective interest or effective spread method will not, however, reflect the market's perception of the amount or timing of credit risk associated with the financial instrument and, as such, is not our preferred solution. We believe that resetting the effective yield for current market conditions based upon fair value would produce measurements that better reflect the economic characteristics of the instrument.

We have concerns about the ability of the initial effective interest method to represent the underlying economics of the financial instruments being measured. As discussed under implementation guidance below, we believe that additional guidance on the application of the proposed effective interest rate principle, and further illustrations across a variety of instruments and scenarios would help preparers and auditors translate the principle into practice.

Financial Reporting vs. Regulatory Measurement Principles

We recognize that there are those in the financial services industry who support alternative impairment models that serve the needs of prudential regulators. It is our established belief that accounting standards must primarily serve the investors' need for information, thus facilitating informed investment decision-making and allowing for effective capital allocation and stable capital markets. The financial reporting needs of investors should take precedent over those who use the financial reports for regulation, as regulators can use alternative reporting bases if they believe them more suitable for regulatory purposes.[4]

Implementation Guidance and Illustrative Examples (Question #3)

We are concerned about the complexity of the proposed model. Our overall concern is that the complexity of the model may fail to bring much needed transparency to the measurement of financial instruments.

The IASB staff examples rely on simple financial instruments – where the input data are provided rather than required to be obtained – and extensive and detailed explanations, particularly the variable rate illustration. The IASB staff's efforts serve to improve understanding of the proposed standard; however, we believe, an accounting standard should be written in a manner that application of the proposed principles does not require extensive explanation outside of the standard itself. To that end, it is our view that the final standard should include sufficient comprehensive illustrative examples and implementation guidance to provide constituents with a complete understanding of the principles to be employed under the standard and how a variety of instruments would be measured using the proposed guidance.

Specific examples should include financial instruments with fixed rates, variable rates, and adjustable principal (e.g., inflation adjustable) along with examples of complex structured securities where multiple factors change during the same reporting period (e.g., credit, prepayment, interest rates, etc.). Examples should include the complex financial instruments that IFRS 9 allows to be classified at amortised cost, including structure products (CLOs, CDOs, etc.). We draw particular attention to the need for guidance regarding how the effective interest rate is calculated and what it represents across a variety of scenarios. Detailed implementation guidance and illustrative examples would facilitate consistent and accurate application and understanding of the proposed guidance.

[4] We note that tax authorities worldwide and industry regulators in some jurisdictions use non-GAAP information.

Presentation (Question #5 & #6)
We strongly support the gross presentation of interest revenue, expected credit losses, gains and losses from re-estimation of credit losses, and interest expense. Such disaggregation provides transparency about the performance of an entity's financial instruments – relative to an entity's original expectation – and their impact on the reported financial performance of the entity. Furthermore, we support the use of an allowance account to record changes in estimates of the credit losses and direct write-offs. The use of an allowance account, combined with the proposed reconciliation of changes in the allowance account for credit losses reconciling the activity between reporting periods, will provide much needed transparency.

We would; however, note that the treatment of this remeasurement is not consistent with the treatment of other remeasurements as proposed by the Financial Statement Presentation Project. In the case of this remeasurement, it would be presented separately on the face of the statement of comprehensive income while other remeasurements will be disclosed in the notes to the financial statements.

Disclosure (Question #7)
Disclosures of the inputs, assumptions, techniques and methods used in the development of these credit impairment estimates – as well as a disclosure and analysis of their development over time – is essential to demonstrating that the expected loss technique is an enhancement over the incurred loss model. Without these disclosures, the reliability of these management estimates cannot be gauged and the implementation of this standard may simply result in the replacement of one management estimate with another.

We are supportive of the disclosure requirements proposed in the Exposure Draft, most significantly the inclusion of the allowance account rollforward and the allowance account development triangle. These disclosures will permit investors to evaluate management estimates over time and the effects of estimate changes on the reported financial statements.

However, we would encourage the IASB to reconsider the language in Paragraph B21, which would grant an entity significant discretion with regard to how much detail it will provide, the emphasis it places on different aspects of the requirements and how it aggregates information to display it in the financial statements. We agree a proper balance should be struck between excessive detail, which may not assist users of financial statements and obscuring important information by including large amounts of insignificant detail. However, we believe that Paragraph B21 allows too much flexibility on both the emphasis and application of the disclosure requirements, and recommend that certain items be mandatory.

Disclosures such as: 1) estimates and changes in estimates, including relevant inputs and assumptions used in determining credit losses, 2) disaggregated gains/losses for changes due to credit versus other factors, 3) credit allowance development versus write-offs, and 4) stress testing, to name a few, should be required.

We note that one of the required disclosures relates to the amount of non-performing financial assets and a rollforward of non-performing loans. We believe that the definition of non-performing in Appendix A of the ED is incomplete as it can be read to refer only to principal payments. The definition should read as follows:

The status of a financial asset where required principal and/or interest payment is more than 90 days past due or is considered uncollectible.

Effective Date and Transition (Question #8, #9 & #10)

We have traditionally supported an effective date for new standards as soon as is practicable after a final standard is released, particularly if the objective of the standard is to enhance financial reporting. We believe that three years is an excessive amount of time and question why this standard would be more complex to implement than other projects previously issued by the Board or expected to be issued by the Board in the future (e.g. revenue recognition, insurance, financial statement presentation) Our concern is that this extended effective date will establish a pattern for other forthcoming standards. We believe that earlier adoption is preferred in order for users to realize the benefits of the new standard (especially its disclosures) as soon as possible, but we do not support allowing early adoption.[5] We appreciate that there must be some lead-time for entities to prepare for implementation; however, we believe that the effective date should be no later than January 1, 2013.

Furthermore, we support the proposed transition requirement of modified retrospective adoption back to the opening balance sheet of the earliest period presented which will ensure comparability of the income statements. We do not support the alternative transition approach as we believe it will result in a lack of comparability. We have no objective to the proposed transition disclosures.

FASB vs. IASB Approaches

We are currently evaluating the FASB FI Exposure Draft and its amortised cost, effective return and impairment provisions and how they compare to this Exposure Draft. We will provide our more detailed comments on the differences in approach in our response to the FASB's FI Exposure Draft when we have had sufficient time to compare and deliberate the differences. We would, however, like to make one overarching observation.

We question whether the impairment methods proposed by the FASB and IASB in these exposure drafts are less subjective or less complex than the use of fair value and whether they more faithfully represent the underlying economics of the financial instruments to which they will apply. Based upon our preliminary review and comparison of the approaches the standards don't promote comparability and convergence and without further illustration and comparison of the FASB and IASB approaches it is difficult to determine which approach will provide the most decision-usefulness for users.

Differences in the use of past and current information for projecting losses under the FASB approach compared with the more forward-looking approach proposed to project expected losses under IASB approach illustrate that these measures – though similarly named – could produce substantially different values over the life of a financial instrument. This fundamental difference, combined with: a) differences in the definition of amortised cost, b) the highly complex methods of computing impairments, and c) the technical differences in calculating effective returns; will not only result in a lack of comparability between U.S. GAAP and IFRS preparers, but will

[5] When entities are allowed to adopt a new standard early, the ability to compare similar entities is impaired.

likely only be understood by a small percentage of users and investors. To obtain the most meaningful input from users and investors it would be helpful for the FASB and IASB to illustrate the application of their methods on similar instruments across time thereby allowing users to understand analytically the impact of the proposed standards.

Closing Remarks

If you, other members of the IASB or your staff have questions or seek further elaboration of our views, please contact either Matthew M. Waldron by phone at +1.212.705.1733, or by e-mail at matthew.waldron@cfainstitute.org, or Sandra J. Peters by phone at +1.212.754.8350, or by e-mail at sandra.peters@cfainstitute.org.

Sincerely,

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