The Corporate Reporting Users' Forum

By email: director@fasb.org

29th September 2010

Dear Sirs

Re: Exposure Draft, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*

The Corporate Reporting Users' Forum (CRUF) welcomes the opportunity to respond to the Financial Accounting Standards Board's Exposure Draft (ED) on Financial Instruments. This area of accounting is one of the most challenging, and is one where CRUF members believe that global accounting convergence is essential. We are therefore particularly disappointed that the FASB and the IASB have been unable to develop a converged set of proposals so far, and we would strongly urge both Boards to work to achieve this in the coming months.

Like the members of both the FASB and the IASB, users generally have a range of opinions on the merits of using fair value as a measurement approach in the context of financial instruments. It is no surprise therefore to find that, as users, CRUF members have a spectrum of views on this subject, ranging from those who do not believe fair values are useful as the basis for measurement in the majority of situations, to those who believe the opposite.

However, while they may debate the precise mix, most CRUF members believe that a mixed measurement approach rather than a full fair value model is the appropriate basis for accounting for financial instruments. By this we mean that either fair value or amortised cost should be used to account for a particular financial instrument in the Statement of Financial Position and the Statement of Performance, not both.

Fair value and amortised cost information are often both required by users of accounts in many circumstances but a majority of CRUF members do not believe that the proposals in this Exposure Draft for presenting both alternatives on the face of a single set of financial statements are helpful.

Representing the complex range of views of CRUF members in one comment letter in a way that assists the Board in its efforts to improve accounting in this area while providing a sense of this spectrum is a challenge, but there are many areas where there is broad consensus across the CRUF:

1. CRUF members strongly believe that convergence in this area is essential.

2. CRUF members want both fair value and amortised cost <u>information</u>.

3. CRUF members do not regard the credit entry that arises when companies' own liabilities are fair valued downwards as implying an increase in shareholders' wealth.

We have adopted the same approach in this letter that we used when responding to the IASB's Exposure Draft on financial instruments measurement which subsequently became IFRS 9 Financial Instruments, so this letter does not seek to address each of the questions in the FASB Accounting for Financial Instruments Exposure Draft in detail. Instead we have highlighted the key areas where we have concerns with the approach being advocated and/or suggestions for how both Boards can best serve the needs of users in this complex area. Our comments on the Exposure Draft reflect the particular perspective of users of bank financial statements as well as the general corporate user focus on entities with mainstream business models.

Why a converged solution is important

We refer the Board back to the statements issued by the G20 calling for accounting convergence, particularly in relation to financial instruments accounting. We are disappointed that the FASB has chosen to issue proposals in an Exposure Draft that are so far removed from those issued by the IASB and that on the face of it, move further away from a converged solution rather than closer.

Financial institutions obviously have global importance and are integral to the proper functioning of the modern global economy. Investor confidence in these institutions is an essential part of this process, and being able to make comparisons between institutions domiciled in different countries around the world is a key component in building and maintaining this confidence.

The larger, more systemically important, financial institutions operate globally and attract investment from a global universe of investors. As a result they are widely followed by analysts around the world, both on the buy-side and the sell-side. Effective analysis is hampered when companies follow different accounting regimes, and as we have seen over the last few years, uncertainty and lack of comparability breeds fear, and leads to suboptimal investment decisions.

Financial instruments accounting is clearly integral to the way the these institutions represent themselves to the financial markets – a high-quality converged solution is therefore not merely a 'nice to have' but an essential feature if the IASB and the FASB are to be able to say that they have improved accounting in this area.

In many areas of accounting CRUF members would prefer high quality solutions to be proposed by the Boards to their respective constituents rather than simply seeking convergence as an end in itself, but the majority of CRUF members would regard financial instruments accounting as an area where it would be difficult to argue that a non-converged solution was high quality, and believe that the needs of users will not be well served if convergence is not achieved in this area.

Accordingly, **we would strongly urge the FASB to seek the highest quality converged solution with the IASB** that is achievable during the deliberation phase following the closure of the Exposure Draft consultation period.

Users want both amortised cost and fair value information

All too often the "fair value vs. amortised cost" debate is portrayed as a battle between two opposing and irreconcilable viewpoints. The reality is that information prepared using both approaches is useful to users in many circumstances (with the obvious exception of financial instruments held for trading and all derivatives, where current values are much more likely to be relevant than historic ones).

A few CRUF members find the combined approach proposed by the FASB helpful, but the great majority do not. We would prefer both Boards to propose the primary measurement approach to be followed (fair value or amortised cost), based upon an assessment of the business model (see later comments) and the financial instrument.

In other words, **as users of financial accounts, CRUF members are in favour of a mixed measurement approach to financial instruments accounting**.

The new approach required by the IASB under IFRS 9 is one that many CRUF members accept as a reasonable starting point for a converged solution. We refer you to our comment letter to the IASB which was submitted when IFRS 9 was at the Exposure Draft stage, to provide more insight into the range of opinions our members expressed about the IASB's proposals regarding measurement of financial instruments[1].

We note that the Alternative View expressed in the FASB Exposure Draft by two out of the five Board members is closer to the approach required in IFRS 9 and so would provide an easier starting point for a converged solution than the approach endorsed by three out of five Board members. We strongly encourage the FASB to explore ways to achieve closer convergence with the IASB in this area during the post-consultation review period.

Liabilities – fair value should not be the primary measurement approach

The proposals in the Exposure Draft represent a significant extension to the range of situations when financial liabilities would be measured using a fair value approach.

The majority of CRUF members are not in favour of using fair value as the primary approach to measuring liabilities.

Equity holders are entitled to the returns generated by their company after satisfying all liabilities at their contractually agreed rates (not their current fair values), and so for equity investors, the fair value of liabilities (i.e. the value attributed to those liabilities by actual or theoretical buyers in the credit markets) is not usually relevant.

The rationale for taking this stance is most clearly illustrated by the fact that fair valuing a liability when the borrower's credit rating is deteriorating produces the counter-intuitive result that shareholders' equity appears to increase. This is misleading, and unhelpful to investors; in the majority of situations the 'gain' does not bear any relationship to the change in economic wealth that it being experienced by shareholders, nor does it represent a 'profit' that could easily be captured by the company though a debt buy-back for example.

[1] http://www.cruf.co.uk/CRUF_response_ed_financial_instruments_sept09.pdf

Investor scepticism regarding these ‘gains’ is illustrated by the fact that financial institutions are already beginning to exclude this entry from their pro-forma results where it is currently required by GAAP, and investors are doing the same in their analysis.

The obvious exception is where the liability is being held as part of a combined strategy with one or more financial assets so that fair-valuing the liability and the assets together will provide a clearer understanding of the economic risks that the entity is exposed to. On that basis, many CRUF members are supportive of a ‘fair value option’ for liabilities where it prevents or reduces an accounting mismatch, and we would encourage the FASB to work closely with the IASB to produce a converged solution along these lines.

In particular, it is worth highlighting that CRUF members do not believe that attempting to fair value core deposits is a useful exercise. It is not something that investors regularly attempt to do themselves, and the outputs from the model proposed by FASB seem very theoretical, subject to error, and potentially misleading.

Evidence-based standard setting

When we wrote to the Chairs of both Boards in June 2008[2], we urged both Boards to focus on ‘evidence-based standard setting’. These points are worth repeating.

We regard standard setting as very much a political endeavour in the broad sense of the word – in other words it should be a process of discussion and debate whereby the various stakeholders in the process (users, preparers, accountants, regulators and standard setters) determine principles-based but pragmatic solutions to inefficiencies in the process by which companies communicate in financial terms with shareholders and other people providing their capital.

As part of this process, standard setters should demonstrate that:

1) There is evidence of a problem in the capital markets that can be solved or alleviated by a change to the accounting regime.
2) The evidence suggests that the change proposed provides an appropriate solution.

It is incumbent upon standard setters to persuade their constituents that the benefits of their proposed solutions outweigh the costs to all involved (users, as well as preparers), and that users are supportive of the proposed solutions.

Change is not cost-free for users, nor is the process of participating in a consultation exercise such as this one. Debating Board proposals represents a significant drain on our collective resources when these resources continue to be stretched by turbulent markets. Many investment techniques rely upon being able to compare companies with peers in the sector and/or the wider market, either in a particular period or across time (potentially decades). Given this fact, any change in the information that is presented – particularly if it results in the disappearance of line items, subtotals, or totals – is potentially costly to users and needs to have clear benefits for users to outweigh the negative impacts of change.

The approach being proposed by the FASB is a radical departure from the current approach. In itself that is not necessarily a bad thing – standard setters should provide thought

[2] http://www.cruf.co.uk/joint_boards_letter_PE_june5th.pdf

leadership as well as facilitating the continual debate between preparers and users regarding financial reporting – but radical changes impose higher costs than incremental ones, and so require a greater weight of evidence of the potential benefits to be persuasive.

In the context of this Exposure Draft, we would question whether there was any evidence of strong investor demand for some of the more radical proposals, and we are concerned at the proposed expansion of the use of Other Comprehensive Income without any clear conceptual basis.

Reducing complexity

Both the IASB and FASB have expressed a desire to reduce complexity in the context of financial instruments accounting.

Paragraph BC60 of the FASB Exposure Draft states that: 'The Board believes that the proposed classification and measurement model would reduce the overall complexity in accounting for financial instruments because it would simplify the existing mixed-attribute model and also would obviate the need for a fair value option.' The majority of CRUF members disagree that the Exposure Draft proposals reduce complexity - they replace the complexity inherent in a mixed measurement approach with a more complex approach based primarily on fair values and inconsistent treatments between the Statement of Financial Position and the Statement of Performance.

More importantly from a users' perspective, having two divergent approaches to financial instruments accounting under US GAAP and IFRS would be more complex than the situation prior to the issue of IFRS 9 (where IFRS and US GAAP were broadly similar albeit with unhelpful and significant differences in specific areas).

Impairment

In July we responded to the IASB's proposals regarding impairment and the introduction of an 'expected loss' approach[3]. In that letter we said, 'Overall, we do welcome the expected loss model, although we are not fully convinced that the proposals in the ED meet our requirements of accounting for operational assets in a way that reflects our understanding of the underlying transactions.'

In particular there was a consensus among CRUF members that:

1. An expected loss approach was preferable to an incurred loss approach.
2. Methodologies for calculating expected loss need to be made clear and operationally executable.

In essence what users want from an impairment model is an assessment of the impact that would arise if the forward-looking assumptions being used currently by a business in its agreements with customers were applied to financial assets created in the past.

Most CRUF members felt that it was unclear how management would comply with the IASB's proposal for probability weighted average expected losses which were described in paragraph 8 of the IASB's Impairment ED.

[3] http://cruf.com/fi_amortised_cost_and_impairment03.pdf

Similar comments could be made in relation to the impairment model being proposed in this Exposure Draft.

This is obviously an area where a converged approach is essential, and where further work is required by both Boards. Users will not be well-served if the assessment and calculation of impairment on similar instruments, held by similar institutions, in similar circumstances, produce different accounting results under US GAAP and IFRS.

Hedge accounting

The IASB has yet to issue its proposals regarding hedge accounting but the indications are that this will be another area where there is little evidence of convergence.

The approach advocated in the FASB Exposure Draft is similar to that proposed in the FASB's June 2008 'Accounting for Hedging Activities' Exposure Draft. While the changes proposed would appear to remove complexity for preparers it is hard to see the benefits for users, since the basic accounting approach would remain the same.

Users need to be able to understand how a hedging transaction changes the risks that a business is exposed to, and potentially changes future cash flows, sales revenues, and profits.

The accounting applied to the hedge transaction and the hedged item should facilitate this understanding, something that current hedge accounting (including the associated disclosures) fails to do.

We strongly urge the FASB to work together with the IASB to achieve a converged approach to hedge accounting that meets the requirements of users.

The importance of the Business Model in financial reporting

IFRS 9 uses the 'business model' as an essential component in deciding the appropriate measurement basis for financial assets, and requires any change in the business model to be reflected by a change in the measurement approach applied to the affected financial assets.

In our comment letter responding to the IASB's proposals on financial instruments[4] we included some initial thoughts on how the concept of the business model might provide a principles-based framework to resolve a variety of accounting issues, including financial instrument measurement, and in particular, how it might avoid some of the arbitrary judgements involved in a 'management intention' approach.

For your convenience we have repeated these concepts below.

1. The business model concept is based upon the idea that businesses are created for a strategic purpose – they have a raison d'etre which determines how they set about making a profit, the systems they use to manage their business processes, how

[4] http://www.cruf.co.uk/CRUF_response_ed_financial_instruments_sept09.pdf

employees are incentivized, and the risks that equity investors can expect to be exposed to, and the means by which they hope to earn rewards for taking these risks.

2. Management intentions relate to the tactics employed by the business in order to succeed in a competitive market place and so may change, sometimes frequently, and often in response to changes in the external environment. In contrast the business model will not change that often. When it does there will be clear evidence of major change across all aspects of that part of the business and there will be an associated investment of either retained reserves or new capital to achieve this change (perhaps accompanied by the withdrawal by some investors of their capital).
3. Financial reporting should facilitate communication between the business and its investors in the context of its pursuance of this business model. Investors generally categorize businesses by sector and it is likely that businesses within a sector will have broadly similar business models. Given this, investors' requirements for financial information about these businesses and the uses to which that information is subsequently put in terms of analysis and valuation, are likely to have strong common themes. Financial reporting should respond to these themes.
4. As a policy choice, the measurement approach applied to assets and liabilities, and the way in which operating performance and cash flows during a period are reported, should be determined in the context of the business model rather than exclusively by the specific accounting item, but sufficient disclosures should be provided to facilitate proper communication between preparers and the users of the accounts, and to enable users to take alternative views (including challenging management) when appropriate.
5. In the infrequent situations that a business changes its business model in respect of a particular business unit or the whole business, extensive disclosures should be provided explaining the rationale for the change and the consequences in financial reporting terms so that users can identify how things would have been reported without the change.
6. As a policy choice, changing a business model should have mandatory financial reporting effects rather than optional ones.

Conclusion

If the proposals in this Exposure Draft were to be translated into US GAAP, and if the IASB continues down the path that its Board debates suggest is likely, the accounting for financial instruments under US GAAP and IFRS will be more divergent than was the case before both Boards began their projects. Comparing companies accounting for financial instruments under US GAAP and IFRS would be more difficult than it is currently. This outcome would represent a serious failing in the accounting standard setting process.

Although not all aspects of the IASB's proposals for accounting for financial instruments have yet been published, the majority of CRUF members believe that the mixed measurement approach put forward in IFRS 9 and advocated by two out of five FASB members in their Alternative View in the FASB's Exposure Draft, provides a better starting point from which a fully converged basis of accounting for financial instruments can be developed than the approach actually proposed in this Exposure Draft. Accordingly we urge FASB to reconsider its proposals.

The Corporate Reporting Users' Forum

These comments reflect the views of CRUF participants from Australia, Germany, Japan, the UK and the US. We have signed in our individual capacities rather than as representatives of our employer organisations.

Yours faithfully,

Peter Elwin

Norbert Barth
Executive Director
Equity Research
WestLB AG

Jeffrey Bernstein, CPA
Director
Cutwater Asset Management

Terri Campbell, CFA

Elmer Huh, CFA, FRM
Director
Portfolio Valuation and Corporate Finance
Duff & Phelps, LLC

Toshinori Ito, CMA
Managing Director
Senior Analyst
UBS Securities Japan Ltd

Dennis Jullens
European Head
UBS Valuation & Accounting Research

Sei-Ichi Kaneko
Executive Vice President
The Securities Analysts Association of Japan

John Kattar, CFA
President and Chief Investment Officer
Eastern Investment Advisors

Goro Kumagai, CMA
Senior Fellow
Strategic Research Department
Mizuho Securities Co. Ltd
Visiting Professor
Graduate School of Management
Kyoto University

Paul Lee
Director
Hermes Investment Management Ltd

Greg Marks
Senior Portfolio Manager
Wallara Asset Management Pty Ltd

Radha B. Radhakrishna

Peter Reilly
Head of Industrial Research
European Equity Research
Deutsche Bank

Hiroki Sampei
Director of Research
FIL Investments (Japan) Limited

Rick Seto

Crispin Southgate
Institutional Investment Advisors Limited

Pinto Suri

Jed Wrigley
Portfolio Manager
Director – Accounting and Valuations
Fidelity Investments

About the Corporate Reporting Users' Forum
The CRUF was formed in 2005 as a discussion forum with the aim of helping its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of the International Accounting Standards Board and Financial Accounting Standards Board.

The CRUF is a discussion forum. Its participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer organisations. It does not seek to achieve consensus views, though at times some or all of its participants will agree to make joint representations to standard setters or to the media.

CRUF participants include individuals from both buy and sell-side institutions, and from both equity and fixed income markets. The forum includes individuals with global or regional responsibilities and from around the world. The CRUF meets on a regular basis in Australia, France, Germany, Japan, the UK, and the USA with facilities for remote participation from other countries.

More information and copies of previous comment letters can be found at www.cruf.com.