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cc: International Accounting Standards Board
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Dear Mr Golden

FASB ED: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

I am writing to you on behalf of the UK Accounting Standards Board (ASB) to comment on the FASB's Exposure Draft (the ED) *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, published on 26 May 2010.

The ASB sets UK GAAP to be followed by those UK entities that are not required to comply with IFRS. The current UK GAAP financial instruments standards are fully converged with those under IFRS. Further, we seek to influence the development of IFRS on behalf of those UK constituents that use it. As a result, the ASB takes a keen interest in the developments in IFRS and has been closely following the convergence programme undertaken by the IASB and FASB.

The ASB was prompted in writing this comment letter by an IASB request to its constituents on 27 May 2010 to consider the proposals issued by the FASB on financial instruments. The ASB is also aware of the G20 recommendations for accounting standard setters to work urgently to arrive at a single set of high-quality global accounting standards. We understand that the FASB ED was issued as part of the global convergence project between the IASB and the FASB.

The ASB strongly believes that a common international standard for financial instruments is desirable and achievable. As a result, the comments in this letter, together with the detailed considerations included in the Appendix, focus on the points of divergence between the IASB and FASB proposals and recommend the path that should be taken by the two Boards.

1. Although the ASB would like to see a converged standard for financial instruments, we also firmly believe in principles based standards and, as such, would not support approaches that are heavily rules-based or reliant on legal definitions.

2. The ASB believes that businesses hold financial instruments for a variety of different reasons. Whilst some instruments may be held with a view to benefit from the short-term fluctuations in fair values others are held with a view to collect the contractual cash flows over the life of the financial instrument. Other financial instruments, such as derivatives, by their nature lend themselves to only being truly valued at fair value.

3. With this in mind, the ASB firmly believes that classification and subsequent measurement of financial instruments should be based on a mixed measurement model that reflects the entity's business model for managing the financial instruments as well as the specific characteristics of such instruments. The ASB supports the approach to classification and measurement of financial instruments taken by the IASB in IFRS 9 *Financial Instruments.*

4. The ASB disagrees with the FASB model based on full fair value for all financial instruments, and the multiple measurement options provided therein, as it believes that such a measurement model does not reflect the business model of the entity and provides irrelevant information on the face of the financial statement for certain financial instrument that may be complex for users to interpret.

5. The ASB also believes that reclassification for financial instruments after initial recognition should be permitted as long as it is in line with the change in the entity's business model for managing that financial instrument. In the absence of such reclassification, the ASB believes that the resulting measurement attribute would be inappropriate and could undermine the relevance of the financial reporting.

6. The ASB supports the inclusion of forward looking credit loss information in the amortised cost measurement of financial assets. We believe that under such a method the expected credit losses at initial recognition should be spread over the expected life of the financial asset. Subsequent revaluation of such credit losses should take all objective, relevant factors into account regardless of whether they are past, present, or expected to occur in the foreseeable future.

7. The ASB also believes that the interest calculations for financial instruments held at amortised cost should be decoupled from the credit loss calculations and the two amounts should be reported separately on the face of the financial statements.

8. For a financial instrument held at fair value through profit or loss, the ASB does not believe that there is any merit in separately accounting for the interest income or expense as it is incorporated in the fair value of such instruments. Users do not expect this separation and the preparers would have to add extra systems to operationalise this requirement.

9. The ASB believes that for financial liabilities elected to be held at fair value by an entity to eliminate accounting mismatches an entity's own credit risk should not affect the entity's profit or loss. Respondent to the IASB believe that it is misleading to report the effects of changes in own credit risk on liabilities that are not held with a view to profit from short-term fair value fluctuations.

10. The ASB is concerned that the recommended presentation of the FASB's proposals in the ED, together with the different remeasurement options, would lead to complex and potentially misleading information being presented on the face of the financial statements. In particular, presentation of fair value information for financial instruments for which the entity only expects to collect the contractual cash flows can be potentially misleading. Not only does this valuation fail to reflect the entity's business model it is also likely to be a level 3 valuation heavily reliant on non-market inputs based on management judgement. Given that management do not intend to benefit from the short-term fluctuations in the fair values of such financial instruments providing this information on the face of the statement of financial position would give the fair values unmerited prominence.

If you would like to discuss these comments, please contact Seema Jamil-O'Neill on 020 7492 2422 or myself on 020 7492 2434.

Yours sincerely

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APPENDIX TO ASB RESPONSE TO FASB ED ON ACCOUNTING FOR FINANCIAL INSTRUMENTS

Initial Measurement

Questions for All Respondents Number 8, 9, 10, 11

1. The ASB agrees with the FASB that at initial recognition all financial instruments should be measured at their fair value regardless of how these may be classified for subsequent measurement. However, the ASB also believes that at initial recognition, excluding transaction costs, the best indicator of the fair value of a financial instrument is its transaction price. As such, a financial instrument should be valued at initial recognition at this fair value plus/minus the directly attributable transaction costs.

2. The ASB also believes that if there is a significant difference between the transaction price of a financial instrument and its fair value on the transaction date then this difference should only be recognised in net income if there is observable market evidence of that fair value.

Subsequent Measurement

Questions for All Respondents Number 13-21

3. The ASB believes that a mixed measurement model for financial instruments more closely reflects the way financial instruments are managed by entities. As such, we agree with the IASB's model for classification and subsequent measurement of financial instruments presented in IFRS 9 *Financial Instruments* which classifies and measures financial instruments on the basis of the entity's business model and the characteristics of the instrument.

4. The key reasons for our support for the IASB's mixed measurement model over the FASB full fair value model include:

    a. the vast majority of users prefer to receive financial information about the performance and financial position of an entity that is relevant to the way the management manages the business. These users recognise that valuing a financial instrument at fair value on the face of the balance sheet when the management's business strategy is to hold it for the duration of its contractual life is misleading. This is borne out by the independent survey conducted by PricewaterhouseCoopers[1] which indicated that the majority of users interviewed by the surveyors did not support fair value as the default model for measurement of financial instruments;

[1] PricewaterhouseCoopers Survey: *What Investment Professionals Say About Financial Instrument Reporting*, June 2010

   b. the IASB model succeeds in providing a framework which management can use to present the results of the entity in line with the way it manages the financial instruments (i.e. hold to collect contractual cash flows over the contractual life or to realise fair value gains and losses); and

   c. The IASB's measurement model reduces complexity by providing a single, most relevant measurement of a financial instrument on the face of the balance sheet. Other supporting information, including measurement at fair value for financial instruments valued at amortised cost, is presented in the notes to financial statements. The FASB model, by contrast, would require that certain significant classes of financial instruments be presented under two different measurement attributes on the face of balance sheet. The ASB believes that this FASB requirement represents a significant increase in the complexity of accounting for financial instruments. The ASB believes that this extra information on the face of the balance sheet would give mixed messages to users about the most relevant measurement attribute for a particular class of financial instrument.

5. In addition, the ASB also has significant concerns about the FASB proposals for financial instrument accounting in the ED. These include:

   a. the proposed criteria for qualifying for measuring a financial liability at amortised cost contain specific "bright-line" quantitative thresholds. These rules, in essence, restrict the number of financial liabilities that may be classified as at amortised cost for subsequent measurement. The ASB believes that accounting standards should be principles based and should refrain from providing detailed rules. In addition, it is aware that there has been significant debate in recent months on the most appropriate measurement attribute for financial liabilities. The conclusions the ASB has drawn from this debate is that most users would prefer to see the amortised cost of a financial liabilities (other than derivatives and those held for trading) unless measurement at fair value would reduce an accounting mismatch;

   b. the proposals to include the fair value movements on financial instruments held for collection or payment of contractual cash flows in other comprehensive income (OCI) would introduce volatility in comprehensive income that is not relevant to the business strategy that the reporting entity has adopted in relation to the particular financial instruments. The ASB is not clear how this reporting of an irrelevant residual in OCI is improving financial reporting. As such, it believes that a thorough debate is required on the purpose and content of the income statement and OCI as well as the role, if any, of recycling before the use of OCI can be extended in this way.

6. The ASB also disagrees with the proposed approach in the FASB ED to measure core deposit liabilities at the ‘core deposit liabilities remeasurement approach’. The ASB is concerned that introducing such a remeasurement

approach for one specific type of financial liability would lead to additional, unnecessary complexity in the accounting of financial instruments. Additionally, the ASB does not believe that these proposals will enhance comparability as the approach is based on complex calculations that rely on many entity specific inputs, e.g. the entity's alternative funding rate. Instead, we would recommend that the FASB should continue to measure the core deposit liabilities at their amortised cost.

7. Another set of proposals where the ASB disagrees with the FASB those related to reclassification of financial instruments subsequent to initial measurement. The ASB firmly believes that reclassification of financial instruments subsequent to initial measurement should be permitted if an entity's business model changes. In such an event, the ASB would expect the entity to provide adequate explanation for the change together with qualitative information on the effect of the reclassification.

Presentation

Questions for All Respondents Number 32 - 34

8. The ASB agrees with the IASB's tentative decision on financial liabilities measured at fair value under the fair value option i.e. that on such financial liabilities it is more appropriate to recognise the changes in an entity's credit standing (with or without changes in the price of credit) in other comprehensive income. The ASB questions the relevance of the amount that results from isolating the entity's specific credit spread. This view is based on:

    a. feedback from users that a deterioration in an entity's credit spread does not reflect a reduction in an entity's financial liabilities; and

    b. that in times of turbulence changes in credit spreads may also include the market's perception on systemic risk in the market, some element of liquidity risk as well as the entity specific credit risk. Therefore, isolating the changes of price of credit and changes in the entity's specific credit risk would require significant management judgement and would largely be based on non-observable data, making it less comparable.

9. The ASB does not believe that the FASB, as a standard setter, should be prescribing the use of specific methods of measuring changes in an entity's credit standing. This is an area of detail that we believe should be left to market practices to develop.

Credit Impairment

Questions for All Respondents Number 37 - 41

10. The ASB responded on the topic of credit impairment of financial instruments in its 22 June 2010[2] comment letter to the IASB on its ED *Financial Instruments: Amortised Cost and Impairment*. In substance, the ASB's views have not changed from those expressed in the aforementioned comment letter. Below is a summary of its views that are relevant to the FASB proposals.

11. The ASB is supportive of a credit impairment model that is based on estimates of expected future cash flows which include forward looking information on the credit quality of the financial assets. We believe that such a model is superior to the incurred loss model as well as the FASB model due to the following reasons:
    a. the IASB model requires an initial expectation of credit losses to be calculated for the expected life of the financial asset. This initial expectation of credit losses is then spread over the remaining life of the financial asset and compared with changes in expectations over subsequent periods. The FASB model, by contrast, requires upfront recognition of the entity's initial estimate of credit losses in the period in which the financial instrument is originated or acquired. This means that there is an artificial mismatch between the loss recognition and the interest income which was to cover them over subsequent periods.

    b. the IASB model attempts to align the credit losses with income recognition in an attempt to counteract the cliff effect (interest income recognised before the related credit losses) encountered under the incurred loss method. Whilst there are operational problems with the IASB models, a number of which were identified in our response to the IASB[3], we believe these can be resolved by implementing some of the IASB's Expert Advisory Panel's recommendations.

12. The ASB agrees that changes in estimates of cash flows due to prepayments, foreign exchange rates and changes in interest rates should in general be excluded from an assessment of credit impairment as far as they do not trigger credit impairments.

13. The ASB also does not favour the FASB proposals for higher than expected collections on impaired financial assets purchased by an entity. The ED requires that if an entity subsequently expects to collect more cash flows than originally expected for a purchased financial asset, the entity should adjust the effective interest rate so that the additional cash flows are recognized as an increase in interest income over the remaining life of the financial asset.

[2] The ASB response to the IASB can be accessed from the ASB website or the following link: http://www.frc.org.uk/asb/publications/other.cfm?cat=73
[3] The ASB response to the IASB can be accessed from the ASB website or the following link: http://www.frc.org.uk/asb/publications/other.cfm?cat=73

We believe that such a mixing of interest income and credit information would lead to unnecessary complexity and reduce the understandability of the results reported in an entity's financial statements. Instead, the ASB favours the separation of the information on credit impairment and interest income as proposed by the IASB's Expert Advice Panel and would like to see those proposals on decoupling developed further into operational proposals.

Interest Income

Questions for All Respondents Number 48 - 51

14. The ASB is aware that users of financial statements pay particular attention to reported interest margin and credit losses. As such, it believes that there is merit in ensuring that these balances are as objective as possible and there is consistency in their calculation across entities.

15. The ASB does not agree with the FASB on the requirement in the ED to calculate interest income using effective interest rate unadjusted for losses but applied to carrying amount net of allowance for credit losses (for all financial assets carried at amortised cost). There is a similar requirement currently in IAS 39 for impaired loans only. The ASB does not agree with the extension of this requirement to the 'good book' because it believes that:

    a. Combining the credit losses with the interest income calculation would increase the complexity of information reported in the financial statements;
    b. By applying the effective interest rate to the carrying amount net of allowance for credit losses the FASB proposals will introduce a level of subjectivity into the interest income that currently does not exist; and
    c. Reversals of impairment losses will directly impact the interest recognition.

16. The ASB supports an effective return approach to financial instruments held at amortised cost. As such, it believes that, for the 'good book' of a reporting entity interest income recognition and recognition of initially expected credit losses should be separately allocated over the life of the financial asset. We understand that the IASB's EAP has been looking at ways of achieving this result that would not be so operationally onerous for reporting entities. The ASB would recommend that FASB consider the conclusions drawn by the EAP in this area.

17. The ASB does not support the proposals for financial instruments measured at fair value through profit or loss that require a separate presentation of interest income and expense on such instruments. The ASB believes that changes in fair value capture all the relevant information for such financial instruments.

Hedge Accounting

Questions for All Respondents Number 56 - 58

18. As stated in BC212 of the FASB's Basis for Conclusions, the ASB would support simplified accounting for hedging relationship and improvement of the reporting in financial statements so that hedge accounting results are more useful and transparent to investors and other users of financial information. As such, the ASB supports the proposals to adopt qualitative criteria to assess hedge effectiveness as we believe these would reduce the complexity currently inherent in the current quantitative hedge effectiveness requirements.

19. However, the ASB has certain key concerns with the FASB proposals on hedge accounting, including:

    a. Although the FASB has not defined what it means by 'reasonably effective' we believe that the inclusion of a threshold for hedge effectiveness is not in line with principles based standard setting and would not necessarily lead to all economic hedges being granted hedge accounting in the financial statements. We believe that, provided there is a hedge relationship demonstrating the offsetting of risks; hedges are documented at inception; and all ineffectiveness is recorded through the profit or loss, no quantitative reasonable effective threshold for permitting hedge accounting is required;

    b. The ED appears to do away with the requirement to assess ongoing hedge effectiveness, which is only required in the event that changes in circumstances indicate that the hedging relationship may no longer be reasonably effective. This is a principles based approach that the ASB would encourage (together with the recommendations in (a) above). However, other related proposals in the ED (e.g. paragraph 118 which sets out the type of reference instrument to be used for assessing effectiveness as well as defining specific parameters on what might constitute various parameters) may result in a rules-based interpretation of the final standard;

    c. The ASB disagrees with the proposals in paragraph 119 of the ED prohibiting voluntarily dedesignation of a hedging relationship. We believe that it to contradictory to requirements elsewhere in the ED which permit entities to modify an existing hedging relationship by adding a derivative that would not reduce effectiveness of the hedging relationship. The ASB believes that, as long as a change in the hedging relationship is documented and appropriate qualitative and quantitative disclosures made in the financial statements, modifications and dedesignations of hedging relationships in line with a change in an entity's risk management strategy should be permitted; and

d. IAS 39 currently permits macro hedging and we understand that the IASB is considering continued use of portfolio and net position hedging in its current review of hedge accounting under IFRS. The FASB proposals only address hedging at the individual instrument level. The ASB agrees with the IASB that macro hedging, i.e. hedging at the portfolio level rather than at the individual instrument level, should be permitted as this is likely to result in hedge accounting that better reflects the risk management strategies adopted by certain entities and would enable the resulting financial statements to be more understandable to the users.

20. The ASB also believes the hedge accounting relationship needs to be presented in such a way that the linked nature of the relationship between the hedging instrument and the hedged item is clear to users. This can be achieved either on the face of the financial statements or by way of disclosure of qualitative and quantitative information in the notes. If disclosed in the notes then clear references need to be provided on the face of the financial statements directing users to the relevant notes.

Disclosures

Question for All Respondents Number 65

21. The FASB ED includes a number of highly prescriptive disclosures on all the key headings discussed above as well as those on the various exceptions to the ED. This approach is in danger of providing a large quantity of information to users that is uncoordinated at best and not understandable at worst.

22. The ASB believes that a better approach to disclosures is to set out a principle for disclosures that takes into account the most meaningful and understandable way to communicate relevant information to users of financial statements. The resulting disclosures should then ensure that they comply with the overarching principle. We understand that the FASB has added a project to its agenda with the objective of establishing an overarching framework for more effective and coordinated financial statement disclosures. We encourage the FASB to examine the disclosures on financial instruments as part of this project.