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**CESR statement
on the reclassification of financial instruments
and other related issues**

1. Introduction

CESR has closely monitored developments regarding accounting and especially developments regarding the ongoing discussions on financial instruments and fair value accounting.

In October 2008, the IASB approved an amendment to IAS 39 and IFRS 7 concerning the reclassification between some categories of some financial instruments. At the same time the amendments were endorsed to be used in the European Union. CESR has previously expressed its support for this initiative taken by the IASB and by the European Parliament as this initiative avoided a new European carve out¹.

The European Commission requested, in a statement dated 15 October 2008, that the IASB and CESR begin work immediately to find appropriate solutions to the issues associated with the fair value option, embedded derivatives, insurance questions and other problem areas in IAS 39 and IFRS 7, which in CESR's view were of concern to the public interest, taking into account an appropriate level of transparency.

Following this statement by the European Commission and the endorsement of the amendments to IAS 39 and IFRS 7 regarding reclassification, the European Commission has raised additional issues to the IASB regarding fair value accounting for financial instruments in relation to the current financial crisis². The European Commission has stressed the urgency of finding solutions to these issues and has highlighted that they need to be resolved before the end of 2008.

The issue of fair value accounting has been discussed at meetings in the European Council. In the latest contribution to the European Council dated 2 December 2008³, ECOFIN highlighted the following:

“It reminds the IASB of the issues recently raised by the Commission and urges the standard-setter to give urgent consideration to these and, where appropriate, to come forward with the technical solutions as requested in time for the publication of year-end results.”

The IASB has responded to the European Commission on 17 December 2008 commenting on the issues raised⁴. In this letter the IASB explains how it intends to move forward on each of the issues.

2. CESR work

In response to the request from the European Commission, and taking the letter from the European Commission to IASB into consideration, CESR has considered the issues raised by the European Commission which were the following:

- Fair value option
- Embedded derivatives

¹ The joint 3L3 statement http://www.cesr.eu/index.php?page=home_details&id=336

² See the letter from the European Commission to IASB at the website of the European Commission http://ec.europa.eu/internal_market/accounting/docs/letter-iasb-ias39_en.pdf

³ http://www.consiliium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/104457.pdf

⁴ Letter from the IASB to the European Commission dated XX December 2008 [link]



- Impairment of Available for Sale Items

CESR agrees with the European Commission that these issues are important in the context of the current financial crisis. In addition CESR has discussed these issues with the IASB on several occasions including during the roundtables hosted jointly by IASB and FASB in November 2008. CESR considers all three issues as matters of importance which should be solved within a short timeframe by the IASB

CESR summarises its views on these issues below.

Fair value option

According to the amendment to IAS 39 from October 2008 it is possible to reclassify some financial instruments out of the category of financial instruments through profit and loss to other categories. This option does not apply if the financial instruments have been classified into this category using the “fair value option”⁵.

The European Commission has clearly stated that it is important that financial instruments currently classified under the fair value option can be reclassified into other categories that are not, or no longer, measured at fair value. This should be made possible for the same reasons, and under the same conditions, as the assets reclassified out of the held for trading category.

CESR notes that some other parties believe that, in order to avoid earnings management, it should not be possible to reclassify financial instruments recognised under the fair value option, even if the same conditions are met that apply according to the amendment to IAS 39 from October 2008.

CESR concludes that there is a need to examine the effects of the use of the fair value option in more detail within a short timeframe.

According to the letter from IASB to the European Commission the IASB states that they are committed to such an examination as a matter of priority and will also seek the advice of the newly formed Advisory Group on this issue.

Embedded derivatives

In its letter to the IASB, the European Commission addresses the issue of convergence between IFRS and US GAAP in the area of embedded derivatives. Another issue, which is also relevant in the context of embedded derivatives, is whether it is possible to split a host contract and an embedded derivative and then subsequently only reclassify the host contract into the held-to-maturity category. CESR finds this issue also relevant to current discussions and therefore welcomes the publication by the IASB of its ED on amendments to IFRIC 9 and IAS 39 on 22 December.

CESR would encourage the IASB and the FASB to work together to assess whether further clarification is needed on both of the issues described above relating to embedded derivatives. Furthermore, CESR would recommend that the IASB provides guidance on the main types of synthetic structures covered and on which factors are important for issuers in determining whether an embedded derivative exists and if so, whether it should be measured separately. This clarification should also state that embedded financial guarantee-types do not need to be separated out. CESR believes that further guidance on these issues could be useful for issuers and users.

⁵ The “fair value option” according to IAS 39 paragraph 9 is the option to recognise a financial instrument at fair value through profit and loss if this recognition results in more relevant information because it eliminates or significantly reduces a measurement or recognition inconsistency or the financial instrument is managed and its performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy and information about the financial instrument is provided internally on that basis, or if a contract that contains one or more embedded derivatives is designated in its entirety at fair value through profit or loss.



In the response to the European Commission the IASB states that both the IASB and the FASB believe that the standards are consistent, and the FASB has now agreed to issue mandatory implementation guidance to ensure that US GAAP is applied in the same way as IFRS.

Impairment of Available for Sale Items

The issue raised by the European Commission concerns the appropriateness of two requirements currently contained in IAS 39:

- For Available for Sale debt items, as soon as any impairment is identified, all of any unrealised reduction in fair value is treated as impairment (IAS 39 paragraph 67); and
- For Available for Sale equity items, any impairment cannot subsequently be reversed (IAS 39 paragraph 69).

In the case of Available for Sale debt items, the approach taken to measure impairment is to examine whether or not all contractual cash flows are expected to be received (the same approach as for loans). If that analysis suggests that the decline in fair value of an item is only partly due to an impairment of future cash flows, it seems inappropriate to deem all of the fair value reduction to be due to impairment. This is important in current circumstances when fair value reductions are due to a range of factors over and above that of impairment, such as funding and regulatory capital constraints, portfolio rebalancing and much increased risk aversion.

For equity items, the key issue rests on the argument that if entities can identify when an impairment has occurred, then they can presumably also identify reversals of such impairments.

CESR would therefore recommend the IASB examines the issues surrounding impairment for available for sale financial instruments.

In its response to the European Commission the IASB states that this is a complex issue. The IASB will therefore address the broader question of impairment as part of an urgent broader project on financial instruments in 2009. With the desire to provide the most meaningful possible information for this year end, the IASB and the FASB are both proposing a change in disclosure requirements for impairments. The IASB therefore expects to publish an exposure draft before the end of the year and are asking for comments by Mid-January 2009.

CESR believes, as it has previously stated, in arriving at solutions which aim at achieving global high quality accounting standards that establish a good basis for consistent application and enforcement. Especially in the area of financial instruments CESR is of the view that one single set of accounting standards for financial instruments at a global level is a matter of urgency. Such work should therefore be prioritised by the standard setters.

CESR also believes it is important that appropriate and sound technical solutions are identified for all the above issues. Such high quality solutions need to be acceptable to broadest possible range of users of financial statements.

In addition, CESR would recommend that the IASB in rare circumstances should develop due process procedures – including public consultation – that enable it to amend its standards in response to emergency circumstances.

3. The application of the reclassification amendment

In addition to the considerations regarding the technical issues raised by the European Commission CESR has conducted a review of the application of the reclassification amendment by financial companies within the EU in the 3rd quarter interim financial statements and interim management statements. When conducting this exercise CESR bore in mind that issuers were not necessarily required in all member states to publish quarterly financial statements applying the disclosure requirements of IFRS 7.



CESR analysed 22 companies from eight member states in the FTSE Eurotop 100⁶ representing all financial companies in that index. CESR also analysed 78 additional companies representing as many of the remaining financial companies in Europe for which information was available and could be covered in the time available.

The objective of this review by CESR members has been to analyse whether and if so, to what extent, financial companies in Europe have applied the recent amendments to IAS 39 regarding reclassification of some financial instruments. The objective of the review has also been to analyse whether financial companies have disclosed the information that would be in accordance with the amendment to IFRS 7. The results should be read bearing in mind, that issuers were not necessarily required in all member states to publish quarterly financial statements and that the disclosure requirements of IFRS 7 were not applicable to the interim information for the third quarter.

CESR's analysis of interim financial statements showed that:

- More than half of the financial companies concerned did not reclassify any financial instruments in their 3rd quarter 2008 financial statements.
- For the companies in the FTSE Eurotop 100 index almost two thirds of these companies did not reclassify any financial instruments in any of the categories.

Given that there is no requirement on issuers in all member states necessarily to publish quarterly financial statements, issuers that have chosen to reclassify in the third quarter may as a result not have published the corresponding IFRS 7 disclosures.

The analysis conducted by CESR members focused on the reclassification between the following categories:

1. Reclassification from Fair value through profit and loss to loans and receivables
2. Reclassification from Available for Sale to loans and receivables
3. Reclassification from Fair value through profit and loss to Available for sale
4. Reclassification from Fair value through profit and loss to Held to Maturity

In addition, CESR members have also analysed whether the disclosures required by the amendment to IFRS 7 regarding reclassification were in accordance with the requirements bearing in mind that issuers in some member states were not required to publish quarterly financial statements. When reviewing the financial information CESR took into account that financial information compliant with IAS 34 in some member states is only required at the half-year and that IFRS 7 does not apply for interim financial statements and interim management reports.

At the year end CESR would expect to see far more detailed information, compliant with IAS 1 and IFRS 7, explaining the basis on which the accounting policy has been changed, the effect of that change, and any key assumptions that have been made.

CESR would encourage issuers to consider carefully the disclosures they make regarding the reclassification choices they exercise in the year end financial statements. CESR would also like to draw the attention of issuers to the need of providing all the transparency possible regarding the options they have chosen when implementing the reclassification amendment in their year end financial statements as it is very important that users are able to understand the developments for the issuer during the financial crisis when considering the disclosures in the financial statements.

The financial companies analysed originated from various member states. The spread across member states with financial companies analysed is shown in figure 1.

⁶ http://www.ftse.com/Indices/FTSE_European_Index_Series/index.jsp

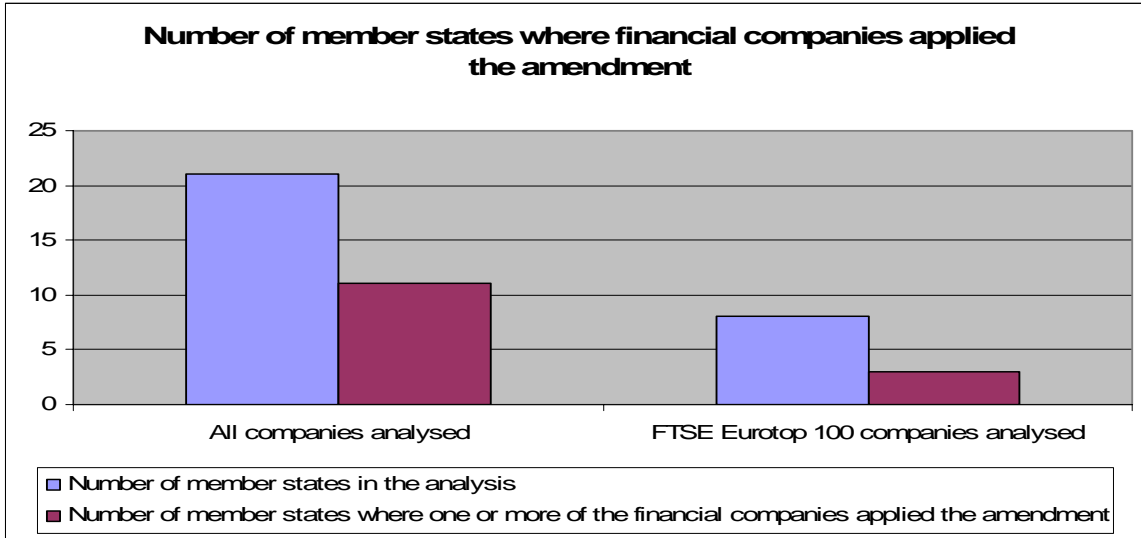


Figure 1

Some of the financial companies applied the options to reclassify to more than one of the categories set out above. Whether and to what extent the analysed financial companies have reclassified financial instruments is set out in figure 2 below:

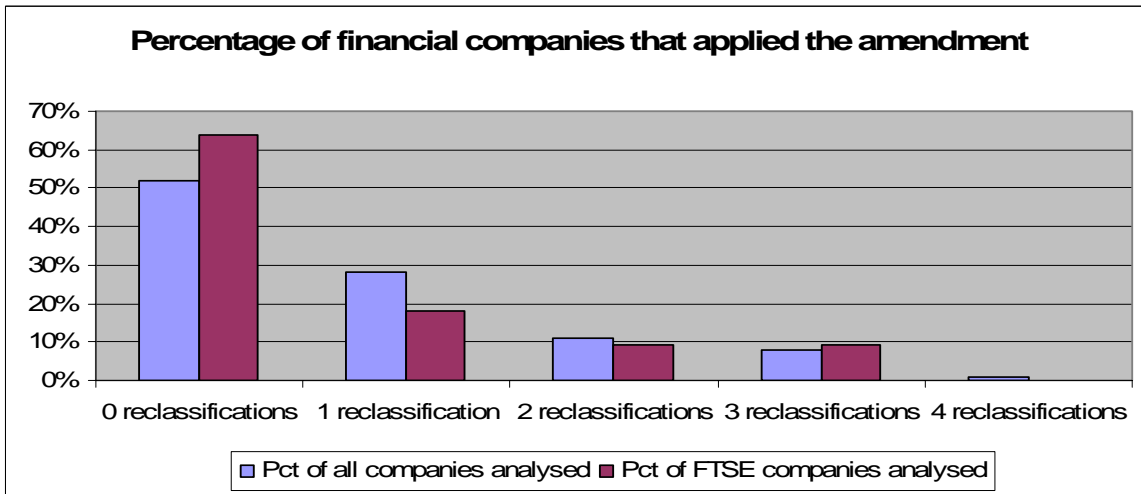


Figure 2

The analysis shows that more than half of the financial companies concerned did not reclassify any financial instruments for the 3rd quarter 2008. For the companies that are part of the FTSE Eurotop 100 index almost two thirds of these companies did not reclassify any financial instruments in any of the categories.

The analysis also shows that 20 % of all financial companies analysed reclassified financial instruments to and from more than one category of financial instruments. 18 % of the companies on FTSE Eurotop 100 reclassified financial instruments to and from more than one category of financial instruments.

The analysis conducted by CESR members focused on which of the categories the financial companies have reclassified to and from. The application of the amendments to IAS 39 and IFRS 7

for the all financial companies in question is shown in figure 3. For the companies analysed that are included in the FTSE Eurotop 100 index the results of the analysis conducted are shown in figure 4 below.

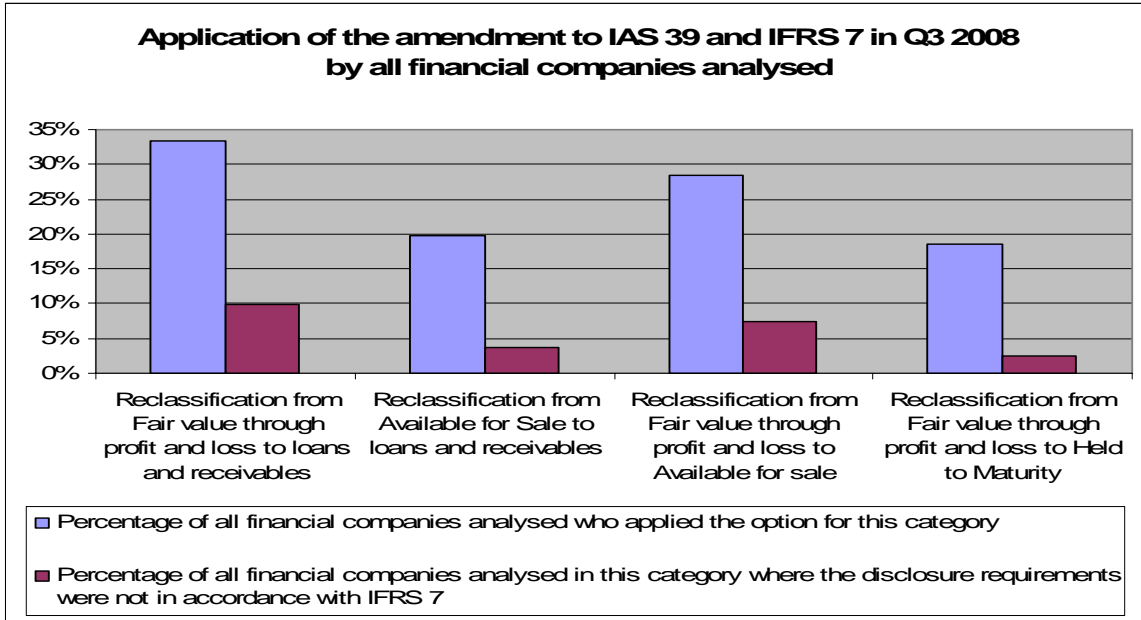


Figure 3

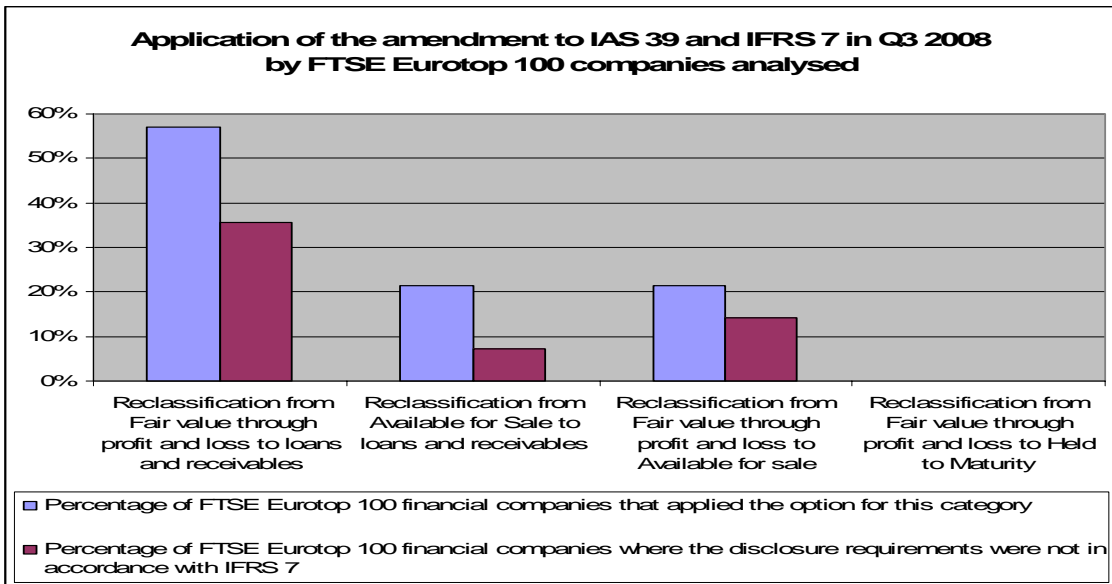


Figure 4

The analysis shows that most of the financial companies concerned used the option to reclassify from the category of fair value through profit and loss to loans and receivables. This is the case both for all financial companies analysed and for financial companies on FTSE Eurotop 100. Only 31 % of all financial companies analysed that had used to option to reclassify in any of the categories (15 % of the total number of companies analysed) had reclassified from the category of fair value through profit and loss to the category of held to maturity. None of the companies analysed that are included



in the FTSE Eurotop 100 had reclassified from the category of fair value through profit and loss to the category of held to maturity.

As the analysis of the application of the amendment is based on the disclosures provided by the financial companies in the interim financial statements and interim management statements for the third quarter 2008 the disclosures are limited, where IFRS 7 will be applicable.

The amendments to IAS 39 and IFRS 7 regarding reclassification in October 2008 have resulted in a number of issues in relation to the application of the requirements. CESR has experienced difficulties especially in relation to one particular issue which is the application of the transitional requirements of the amendment according to IAS 39 paragraph 103G. CESR therefore welcomes the additional clarification of the transitional requirements of the amendment issued by IASB on 27 November 2008 would recommend the option to apply the amendment is made available to issuers in Europe as quickly as possible.

The results of the analysis conducted by CESR members are set out in Appendix 1.

4. Next steps

CESR will continue to closely monitor future developments in the area of financial instruments and fair value accounting. CESR will in particular follow up and review the disclosures required by the amendments to IFRS 7 regarding reclassification in the annual financial statements for 2008 when these financial statements are published during spring 2009. CESR will also consider reviewing other aspects of IFRS 7.

Appendix 1 – Summary of analysis of the application of the amendment to IAS 39 and IFRS 7

Number of member states where financial companies applied the amendment

	All companies analysed	FTSE Eurotop 100 companies analysed
Number of member states in the analysis	21	8
Number of member states where one or more of the financial companies applied the amendment	11	3

Number of financial companies that applied the amendment to IAS 39 and IFRS 7

	Number of financial companies	Pct of all companies analysed	Number of financial companies on FTSE Eurotop 100	Pct of FTSE Eurotop 100 companies
0 reclassifications	52	52%	14	64%
1 reclassification	28	28%	4	18%
2 reclassifications	11	11%	2	9%
3 reclassifications	8	8%	2	9%
4 reclassifications	1	1%	0	0%
Total	100		22	

Reclassifications by categories

	Reclassification from Fair value through profit and loss to loans and receivables	Reclassification from Available for Sale to loans and receivables	Reclassification from Fair value through profit and loss to Available for sale	Reclassification from Fair value through profit and loss to Held to Maturity	Total
Number of financial companies who applied the option for this category	27	16	23	15	81
Percentage of all financial companies analysed who applied the option for this category	33%	20%	28%	19%	100%
Number of financial companies where the disclosure requirements were not in	8	3	6	2	19

accordance with IFRS 7					
Percentage of all financial companies analysed in this category where the disclosure requirements were not in accordance with IFRS 7	15%	6%	12%	4%	37%
Number of FTSE Eurotop 100 companies that applied the option for this category	8	3	3	0	14
Percentage of FTSE Eurotop 100 financial companies that applied the option for this category	57%	21%	21%	0%	100%
Number of FTSE Eurotop 100 financial companies in this category where the disclosure requirements were not in accordance with IFRS 7	5	1	2	0	8
Percentage of FTSE Eurotop 100 financial companies where the disclosure requirements were not in accordance with IFRS 7	36%	7%	14%	0%	57%