Olivier Guersent
Director General, Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Brussels

1 December 2015

Dear Mr Guersent,

EFRAG's assessment on IFRS 9 against the true and fair principle

The purpose of this letter is to explain how EFRAG has reached its conclusion that IFRS 9 *Financial Instruments* is not contrary to the true and fair principle, as stated in its endorsement advice issued on 15 September 2015.

This letter does not purport to provide additional elements of assessment on the subject but only to piece together the elements, contained in Appendices 2 and 3 to EFRAG's endorsement advice to the European Commission, that are relevant for the assessment of true and fair.

Context of EFRAG's assessment

EFRAG assessment as to whether IFRS 9 would not be contrary to the true and fair principle has been performed against the European legal background that is briefly described below.

The IAS Regulation provides that the international accounting standards can only be adopted if they are not contrary to the principle set out in Article 4(3) of Council Directive 2013/34/EU ('The Accounting Directive')[1].

Article 4(3) of the Accounting Directive provides that:

> *The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.*

The IAS Regulation clarifies that '*to adopt an international accounting standard for application in the Community, it is necessary firstly that it meets the basic requirement of the aforementioned Council Directives, that is to say that its application results in a true and fair view of the financial position and performance of an enterprise - this principle being considered in the light of the said Council Directives without implying a strict conformity with each and every provision of this Directive*' (Recital 9 of the IAS Regulation).

[1] References, contained in the IAS Regulation, to the former directives on annual and consolidated accounts (Article 2(3) of Directive 78/660/EEC and Article 16(3) of Directive 83/349/EEC) have been updated with a reference to the 2013 Accounting Directive (Article 4(3) of Council Directive 2013/34/EU).

EFRAG approach in its assessment of the true and fair principle in relation to IFRS 9

To assess whether an IFRS is not contrary to the true and fair view principle, EFRAG refers to Article 4(3) of the Accounting Directive reproduced above and notes that to provide a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, financial statements need the following attributes:

(a) Not to be subject to financial reporting requirements which would lead to unavoidable distortions or significant omissions in the representation of that entity's assets, liabilities, financial position and profit or loss. In concluding that an IFRS provides relevant, reliable, comparable and understandable information and leads to prudent accounting, EFRAG provides the assessment that an IFRS does not impede financial statements from providing a true and fair view. This is assessed on a 'stand-alone' basis, as is explained in full detail in Appendix 2 of the endorsement advice and is summarised below.

(b) All disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss should be included. Generally each IFRS includes specific disclosure requirements. However, a specific standard, IFRS 7 *Financial Instruments: Disclosures,* deals with disclosure requirements related to financial instruments. IFRS 9 *Financial Instruments* has been issued together with amendments to IFRS 7, the whole being referred to as "IFRS 9". Changes in, and additions to, disclosure requirements have been assessed together with the accounting requirements and have been deemed appropriate. These specific requirements are supplemented by the requirements, contained in paragraphs 15 to 17 of IAS 1 Presentation of Financial Statements, to provide additional disclosures so that the financial statements, taken as a whole '*present fairly the financial position, financial performance and cash flows an entity'*. Furthermore the application of the materiality principle, as defined in IAS 1, requires that any supplementary information that can influence the economic decisions that users make on the basis of the financial statements to be provided. In reaching its conclusions EFRAG does not make reference to the above-mentioned disclosure requirements because they apply generally to all financial statements prepared in accordance with IFRS; however EFRAG's assessment implicitly relies upon them.

(c) EFRAG has also identified that the implementation of IFRS 9 in the context of the current application of IFRS 4 *Insurance Contracts* would create or enlarge distortions in the measurement of insurance contract liabilities and financial assets that back them, in particular when insurance contract liabilities are currently measured on a cost basis. However, it was noted that the current IFRS 4 allows entities to change their accounting for insurance contract liabilities to adopt current measurements of those liabilities, and thereby mitigate the effects of the additional distortions that may have arisen otherwise. Entities are therefore not prevented from preparing financial statements that meet the true and fair view principle upon implementation of IFRS 9.

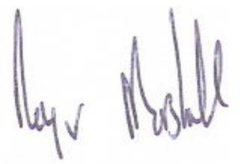
The appendix to this letter presents, in more details, the elements contained in EFRAG's endorsement advice that are relevant to the assessment of the true and fair principle.

Given the positive conclusion on IFRS 9 assessment on a stand-alone basis, the implicit reliance on disclosure requirements applying to financial statements as a whole as stated in IAS 1 and the analysis of the interrelationship between IFRS 9 and IFRS 4 as described above, EFRAG has concluded that IFRS 9 is not contrary to the true and fair principle.

Having reached this conclusion, EFRAG has considered whether the analysis leading to this conclusion, notably in relation to the non-alignment of the effective dates of IFRS 9 and the future insurance contract standard, would be acceptable from a cost/benefit trade-off, in other words whether presenting financial statements that are not contrary to the true and fair view principle would be affordable. As is explained in paragraphs 111 to 128 of Appendix 3 to EFRAG endorsement advice letter, and taking into consideration that the IASB is close to finalising the future insurance contract standard, EFRAG concluded that the efforts necessary to support financial statements presenting a true and fair view would not, in all circumstances, lead to an acceptable cost-benefit trade-off. However, there is such a diversity in the current accounting for insurance contracts, and in the economic circumstances of all entities which carry insurance activities, that any remedy to the non-alignment of effective dates to be found would have to apply on an optional basis.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,



Roger Marshall
Acting President of the EFRAG Board

Appendix 1: EFRAG's assessment of whether IFRS 9 is not contrary to the principle set out in Article 4(3) of the Accounting Directive (the true and fair view principle)

1 The following paragraphs describe the elements in EFRAG's assessment of the qualitative characteristics and prudence, contained it is endorsement advice issued on 15 September 2015, that are relevant to the assessment of the true and fair principle for each of the following topics:

(a) Classification and Measurement;

(b) Impairment; and

(c) Hedging.

Classification and measurement

2 In reaching its conclusion that the classification and measurement requirements contained in IFRS 9 would not be contrary to the true and fair principle, EFRAG considered the following features:

(a) EFRAG assessed that IFRS 9 is built on a single classification and measurement approach for financial assets that reflects the business model in which they are managed and their cash flow characteristics;

(b) IFRS 9 provides for a mixed measurement attribute model: while fair value is an appropriate measurement attribute for financial instruments that are traded, for financial instruments that have basic loan features and that are managed on a contractual yield basis, amortised cost is deemed to provide more relevant, reliable and comparable information;

(c) The application of the contractual cash flow test in IFRS 9 provides a sound and logical basis to distinguish in an entity's financial position between basic lending instruments, measured at amortised cost, from other financial instruments that are measured at fair value;

(d) IFRS 9 contains an option to designate a financial asset as at fair value through profit or loss if it eliminates or significantly reduces accounting mismatches that would otherwise result from measuring economically matched assets or liabilities on different bases; and

(e) On the liability side, EFRAG assessed that IFRS 9 was not substantially changing the existing requirement but for the greater relevance brought by the requirement to account for the own credit risk component in other comprehensive income, as well as by the exception permitting an entity to do so in profit or loss.

3 EFRAG assessed that the use of fair value in IFRS 9 is appropriate and that the Standard would lead to prudent accounting both in terms of measurement of assets and recognition of losses. EFRAG conducted a separate assessment on prudence, which is contained in paragraphs 209 to 218 of Appendix 2 to its Endorsement Advice.

4 The statement that financial statements should be prepared on a prudent basis and give a true and fair view of the entity's assets and liabilities, financial position and profit or loss does not automatically imply that the financial statements exclude unrealised gains and include all foreseeable losses. Recital 19 to the Accounting Directive clarifies that: *'systems of fair value accounting provide information that can be of more relevance to the users of financial statements than purchase price or production cost-based information. Accordingly, Member States should permit the*

adoption of a fair value system of accounting by all undertakings or classes of undertaking'.

5 EFRAG also considered and assessed that IFRS 9 does not extend the use of fair value beyond what is allowed under the Accounting Directive. Under that Directive, extensive options exists, that permit or require fair value accounting for financial instruments and non-financial assets.

6 In its assessment, EFRAG gave due consideration to specific cases where the measurement at fair value would not always result in the most relevant information (see Paragraph 9 to 12 of Appendix 2 to EFRAG's endorsement advice). However, EFRAG assessed that these limitations would not prevent IFRS 9 from meeting the qualitative criteria set up in the IAS Regulation, and lead to prudent accounting.

7 Therefore, EFRAG concluded that the classification and measurement provisions contained in IFRS 9 would not be contrary to the true and fair principle.

Impairment

8 In reaching its conclusion that the guidance on impairment contained in IFRS 9 would not be contrary to the true and fair principle, EFRAG considered the following features:

(a) The IFRS 9 expected loss impairment model is based on a forward-looking approach using unbiased information about past events, current conditions and forecast economic conditions;

(b) IFRS 9 provides for timely recognition of economic losses upon significant credit deterioration when full lifetime expected losses have to be recognised; thus ensuring that the recognition of losses will react to deteriorating economic conditions in a timely manner; and

(c) IFRS 9 significantly improves the disclosures about the way impairment losses are calculated and recognised, including how significant changes in credit quality are taken into account.

9 EFRAG considered that the model can reduce the potential for overstatement of profit or loss; consistent with the objective of prudent accounting that underpins the true and fair principle in the Accounting Directive[2].

10 EFRAG has assessed that the guidance on impairment contained in IFRS 9 would not be contrary to the general principles contained in the Accounting Directive as it leads to the timely recognition of expected losses that have become known in the financial year or earlier years using all reasonable and supportable information available. The Accounting Directive, Article 6(5) allows Member States to permit or require the *'recognition of all foreseeable liabilities and potential losses arising in the course of the financial year concerned or in the course of a previous financial yea*r'.

11 In its assessment, EFRAG also gave due consideration to some of the limitations identified with the IFRS 9 impairment model:

(a) the 12-month expected credit losses allowance had the limitations of a practical expedient that lacks a strong conceptual basis; and

(b) It can be deemed to overstate losses at initial recognition as there is no economic loss if credit risk is reflected in the initial price of the financial

[2] ECJ - October 2013 - State of Belgium vs GIMLE.

instrument. This can be analysed as a limitation to the relevance of the information provided.

12 The true and fair principle is an over-arching concept which involves coming to a judgement balancing the qualitative characteristics and prudence, not looking at them in isolation, and also considering the complexity and applicability of the requirements. In that respect, EFRAG assessed that the model achieved an appropriate balance between faithfully representing the economics and the operational costs and complexity.

13 Conversely, EFRAG assessed that any expected loss model that would require immediate recognition of life time losses at initial recognition would not faithfully represent the underlying economics, or provide information useful for economic decision and, therefore, would be contrary to the true and fair principle. This is because such a model would make no allowance for the fact that financial institutions are compensated for expected credit losses through the interest rate that they charge to borrowers and therefore recognising lifetime credit losses for all instruments in its scope distorts the reporting of the entity's performance.

14 Overall, EFRAG assessed that applying the guidance on impairment contained in IFRS 9, would not be contrary to the principle of true and fair principle.

Hedging

15 In reaching its conclusion that adopting the guidance on hedging contained in IFRS 9 would not be contrary to the true and fair principle, EFRAG considered the following:

(a) IFRS 9 puts the risk management strategy of an entity central to the objective of hedge accounting and better aligns the financial accounting result to the economics of the strategy;

(b) IFRS 9 provides entities with a greater possibility in designating hedge accounting relationships in order to reflect their risk management strategy and practices (including the rebalancing of positions);

(c) IFRS 9 remedies the long-standing criticism that IAS 39 was excessively restrictive and did not allow a proper reflection of risk management practices, whereas the new general hedge accounting model broadly meets this objective and

(d) IFRS 9 provides improved information about those strategies that aim at reflecting in the financial statements how an entity manages its risks;

16 Although the Accounting Directive fully acknowledges the existence of hedge accounting, it does not contain detailed provisions. The Accounting Directive, Article 8(5), allows Member States to permit that '*assets and liabilities which qualify as hedged items under a fair value hedge accounting system, or identified portions of such assets or liabilities, be measured at the specific amount required under that system*'.

17 EFRAG assessed that the proposed guidance on hedging in IFRS 9 would not be contrary to the few principles enunciated in the Accounting Directive.

18 Lastly, EFRAG has also given due consideration, in its assessment, to a few identified restrictions to the application of hedge accounting such as

(a) the non-eligibility, as hedging instruments on a stand-alone basis, of derivatives embedded in financial assets; and

(b) sub-LIBOR exposures not being eligible for hedge accounting.

19 EFRAG nevertheless assessed that these issues would not prevent the guidance on hedging contained in IFRS 9 from meeting the qualitative characteristics of useful information and lead to prudent accounting and therefore that the provisions contained in IFRS 9 are not contrary to the true and fair principle.