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## CESR STATEMENT

### **Application of and disclosures related to the reclassification of financial instruments**

#### **1. Introduction and summary of results**

Developments during 2008 and 2009 in the area of fair value accounting led CESR to monitor closely the various initiatives taken by different authorities. CESR has also participated actively in the debate itself on a number of occasions throughout 2008 and 2009.

CESR carried out an analysis of the application of the amendments to IAS 39 and IFRS 7 regarding reclassification applied in the interim financial statements for the 3<sup>rd</sup> quarter of 2008 which was published in January 2009<sup>1</sup> (CESR ref. 08-937). CESR encouraged issuers to consider carefully the disclosures they would be providing in their year-end financial statements. In this publication, CESR drew the attention of issuers to the need to provide all the transparency possible regarding the options they had chosen when implementing the reclassification amendment in their year end financial statements, as it was very important that users be able to understand developments within the issuer during the financial crisis.

The January 2009 statement also noted that CESR would carry out follow-up work by reviewing the application of the amendments to IAS 39 and IFRS 7 regarding reclassification in the annual financial statements for 2008. The statement also mentioned that CESR would review other aspects of the application of IFRS 7 in light of the financial crisis. CESR has now completed the first part of this analysis regarding reclassification and expects to publish the results of the second part of the analysis later in 2009.

The objectives of the first part of the analysis conducted by CESR members were (a) to consider how financial companies in Europe applied the amendments to IAS 39 and IFRS 7 regarding reclassification of some financial instruments in their 2008 annual financial statements (including an assessment of the quality of their disclosures); and (b) to analyse whether companies have complied with the disclosure requirements set out in IFRS 7 regarding reclassification of financial instruments.

In order to perform this analysis, CESR selected a sample of 100 European financial companies, and European enforcers provided appropriate data on the disclosures made by the companies chosen based on their jurisdictions. The sample consisted of the 22 financial companies included in the FTSE Eurotop 100 index (later “the FTSE Eurotop companies”) and 78 other financial companies across Europe. The aim of the composition of the sample was to ensure that it adequately reflected the distribution of financial companies within the European market.

The balance sheet totals (total assets) for all companies in the sample amounted to 30 trillion euros. For the FTSE Eurotop companies in the sample, the balance sheet totals amounted to 22 trillion euros.

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<sup>1</sup> CESR statement on on the reclassification of financial instruments and other related issues, January 2009 <http://www.cesr.eu/popup2.php?id=5445>



The total market capitalisation of the companies analysed amounted to 503 billion euros. The market capitalisation of the FTSE Eurotop companies analysed and which reclassified in any of the categories amounted to 303 billion euros.

The results of CESR's analysis can be summarised as follows:

- In the sample selected, more financial companies used the option to reclassify in the annual financial statements for 2008 when compared to the interim financial statements for the 3<sup>rd</sup> quarter 2008:
  - o 61% of all the companies analysed used the option to reclassify in the annual financial statements for 2008.
  - o 68% of the FTSE Eurotop companies used the option to reclassify in the annual financial statements for 2008 compared to only 36% in the interim financial statements for the 3<sup>rd</sup> quarter of 2008.
- The level of companies in the whole sample that reclassified financial instruments represent 79% of the balance sheet totals of all companies sampled. Among the FTSE Eurotop companies, the companies that reclassified represented 81% of the balance sheet totals for those companies.
- The impact of the reclassifications was positive on the profit and loss account and on other comprehensive income. If no reclassifications had been made, the total amount reported in the profit and loss account and in other comprehensive income would have been 28 billion euros lower than the figures actually reported. Three quarters of that amount would have been recognised by the FTSE Eurotop companies if they had not reclassified.

For those companies that did apply the option to reclassify:

- 40% of all companies analysed (and around one third of the FTSE Eurotop companies) did not disclose the fair value gain or loss on the reclassified financial asset (whether recognised in profit or loss or in other comprehensive income) prior to the reclassification (IFRS 7.12A (d)).
- Around half of all companies analysed (and around one quarter of the FTSE Eurotop companies) did not disclose the effective interest rate and the estimated amounts of cash flows that they expected to recover (IFRS 7.12A (f)).

As far as these disclosures are concerned, CESR would like to stress that the fulfilment of all requirements in IFRS 7 related to reclassification is particularly relevant for users of financial statements. CESR would have expected companies seeking to benefit from the amendments introduced to IAS 39 also to comply fully with the disclosure requirements that were introduced in October 2008.

## **2. The reclassification amendment to IAS 39 and IFRS 7**

The amendment to IAS 39 issued in October 2008 allows an entity to reclassify certain non-derivative financial assets out of the *fair value through profit or loss* category when specific conditions are met. The amendment also allows an entity to transfer a financial instrument from the *available-for-sale* category to the *loans and receivables* category if the entity has the intention and ability to hold that financial asset for the foreseeable future.

Based on these possibilities made available by the amendment to IAS 39, CESR members have analysed whether the financial companies in the sample have reclassified financial instruments, differentiating between five possible reclassifications:

1. From *fair value through profit and loss* to *loans and receivables*
2. From *available for sale* to *loans and receivables*
3. From *fair value through profit and loss* to *available for sale*
4. From *fair value through profit and loss* to *held to maturity*
5. From *available for sale* to *held to maturity*



In addition, CESR members analysed whether the disclosures complied with the requirements of the amendment to IFRS 7.

### 3. The extent of the application of the amendment

The amendment regarding reclassification was applied as shown in the figure below.

The following graphs give information on the whole sample as compared to the FTSE Eurotop companies in the sample.

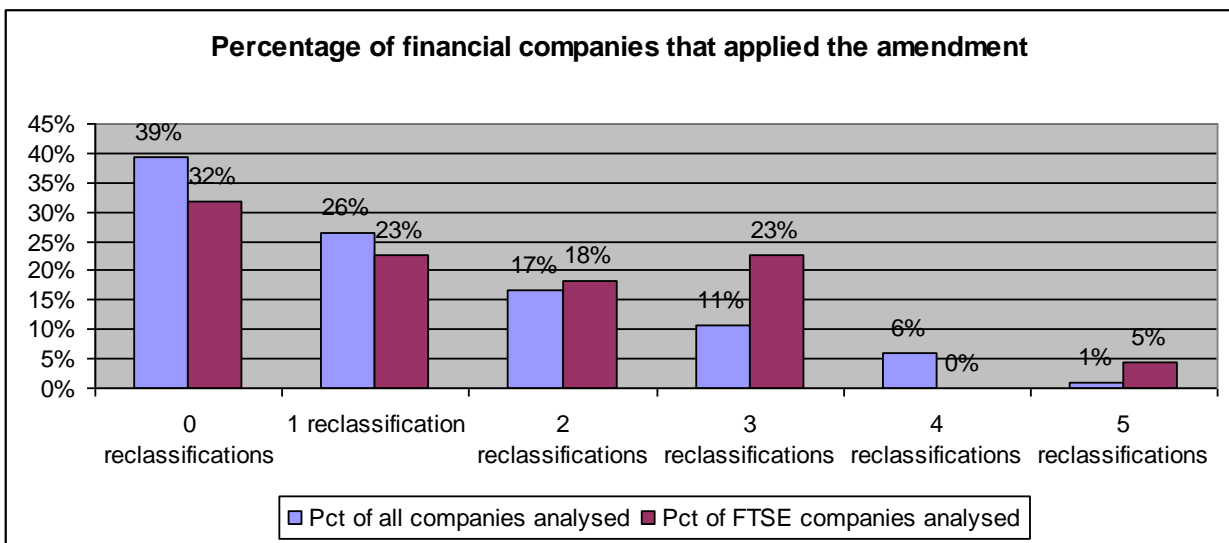


Figure 1

Figure 1 shows that 61% of all the companies analysed used the option to reclassify some financial instruments in their annual financial statements for 2008. This percentage is higher than for the interim financial statements for the 3<sup>rd</sup> quarter 2008 where 48% chose to apply the option.

With regards to the FTSE Eurotop companies, the analysis reveals that 68% of those companies applied the option to reclassify in their annual financial statements for 2008. This amount has clearly increased when it is compared to number of companies choosing to apply the options to reclassify in the interim financial statements for the 3<sup>rd</sup> quarter 2008, where 36% of the FTSE Eurotop companies sampled applied the reclassification option.

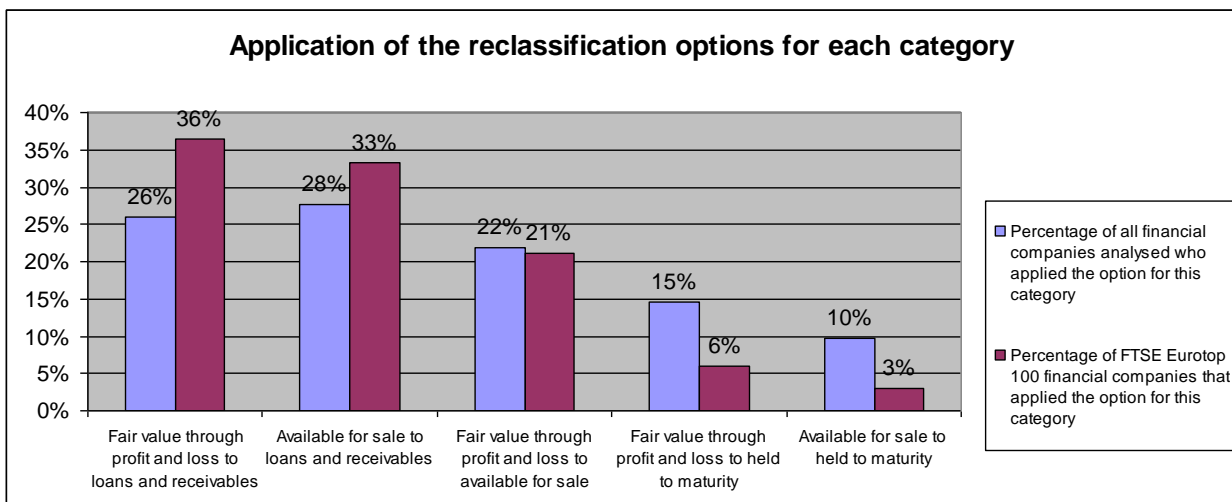




Figure 2

Figure 2 shows that when taking the sample as a whole, the most widely used reclassification option was to transfer from *available for sale* to *loans and receivables*. Reclassification from the *fair value through profit and loss* category to *loans and receivables* was the second most widely chosen option.

However, for the FTSE Eurotop companies, the most widely used reclassification option was to transfer from the *fair value through profit and loss* to *loans and receivables*. The reclassification from the *available for sale* category to *loans and receivables* was the second most widely used option.

CESR also reviewed the application of the option to reclassify for each category and taking into consideration the line of business of the financial company. The sample is composed as follows:

Banks	74
Insurance companies	14
Financial companies with both bank and insurance activities	8
Total number of companies	100

The analysis showed that whilst a majority of the banks sampled used the option to reclassify between the categories of financial statements, very few of the insurance companies analysed used the option to reclassify - only 2 out of 14 insurance companies reclassified in any of the categories.

#### 4. Amounts regarding the reclassification

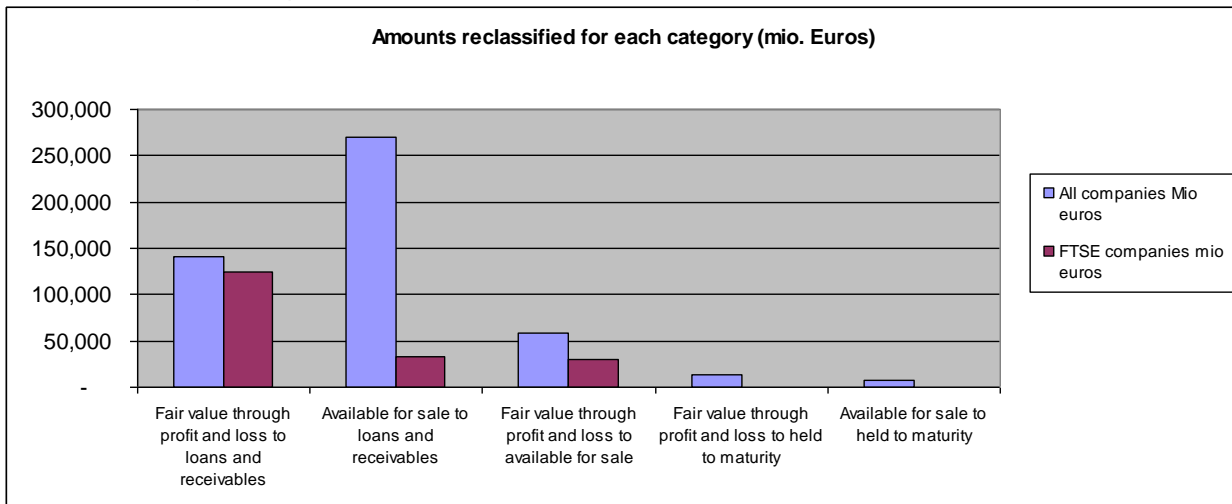


Figure 3

For all the companies sampled, the total amounts reclassified amounted to 550 billion euros<sup>2</sup>. Figure 3 shows that overall the largest amount reclassified (269 billion euros) was from the *available for sale* category to *loans and receivables* which was also the most common type of reclassification.

The total amount reclassified by the FTSE Eurotop companies in all categories was 217 billion euros. For these companies the largest amounts reclassified were from *fair value through profit and loss* to *loans and receivables* (125 billion euros), which was also the most common type of reclassification for this sub-category within the sample.

<sup>2</sup> Including an amount of 60 billion euros for which information regarding the reclassification between different categories was not available, as such disclosures were only included at aggregated level.

Of note in relation to this sub-category is the fact that the amount reclassified from the category of *available for sale to loans and receivables* was only 33 billion euros, which is only about 12% of the amounts reclassified between these two categories in the total sample as a whole.

### 5. Required disclosures regarding reclassification

The disclosures required by the amendments to IFRS 7 on reclassification are set out in IFRS 7.12A. This paragraph requires that an entity shall disclose:

- (a) the amount reclassified into and out of each category;
- (b) for each reporting period until derecognition, the carrying amounts and fair values of all financial assets that have been reclassified in the current and previous reporting periods;
- (c) if a financial asset was reclassified in accordance with paragraph 50B, the rare situation (concerned), and the facts and circumstances indicating that the situation was rare;
- (d) for the reporting period when the financial asset was reclassified, the fair value gain or loss on the financial asset recognised in profit or loss or other comprehensive income in that reporting period and in the previous reporting period;
- (e) for each reporting period following the reclassification (including the reporting period in which the financial asset was reclassified) until derecognition of the financial asset, the fair value gain or loss that would have been recognised in profit or loss or other comprehensive income if the financial asset had not been reclassified, and the gain, loss, income and expense recognised in profit or loss; and
- (f) the effective interest rate and estimated amounts of cash flows the entity expects to recover, as at the date of reclassification of the financial asset.

The analysis shows that some of these disclosures have not been provided. This lack of disclosures is particularly significant in relation to the disclosures required in IFRS 7.12A (d) and (f). The detailed results of the analysis performed on these specific requirements are set out in Figure 4 below.

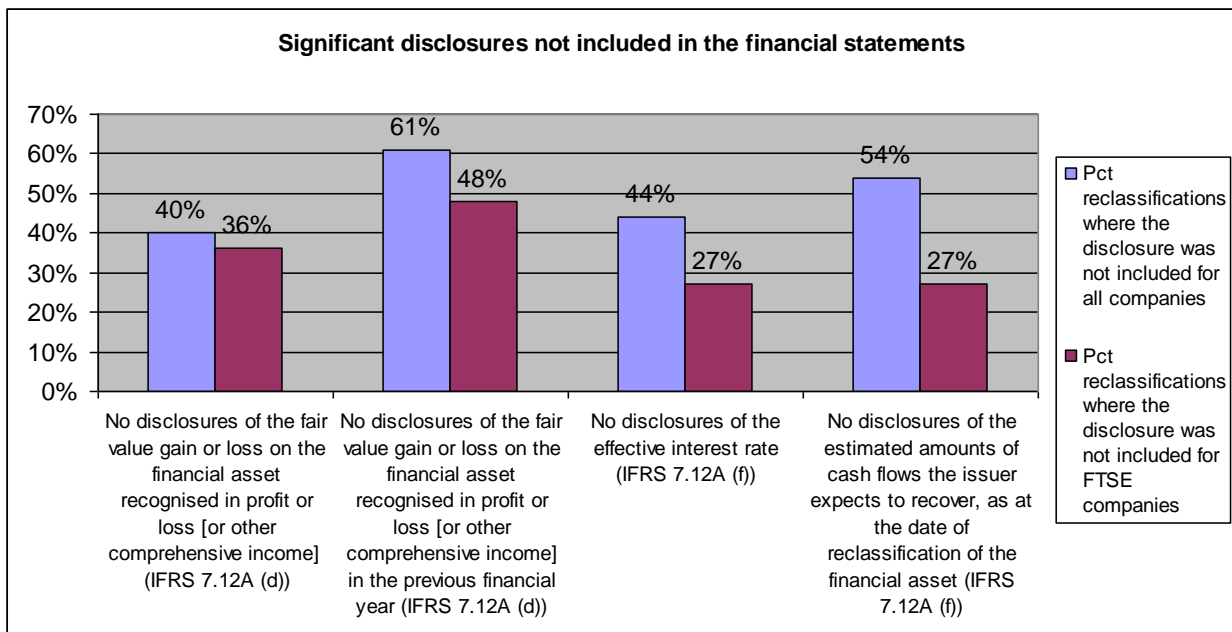


Figure 4

Figure 4 shows that more than 60% of companies that reclassified did not disclose the gain or loss on the financial asset recognised in the profit or loss account or other comprehensive income in the previous financial year, and more than 50% did not disclose the cash flows the entity expected to recover from the asset. As regards the gain or loss on the financial asset recognised in profit or loss

or other comprehensive income prior to the reclassification, and the effective interest rate, more than 40 % of companies that reclassified did not provide these disclosures.

The results for FTSE Eurotop companies in relation to these disclosures are only slightly better than the results of the sample as a whole. Almost 50% of these companies did not disclose the gain or loss on the financial asset recognised in the profit or loss account or other comprehensive income in the previous financial year, and 35% did not disclose this information in the period just prior to the reclassification. As far as the requirements in IFRS 7.12A (f) are concerned, 25% of the companies that did reclassify did not comply with this requirement.

For the impact on the profit and loss account (or other comprehensive income where applicable) the analysis has shown the following:

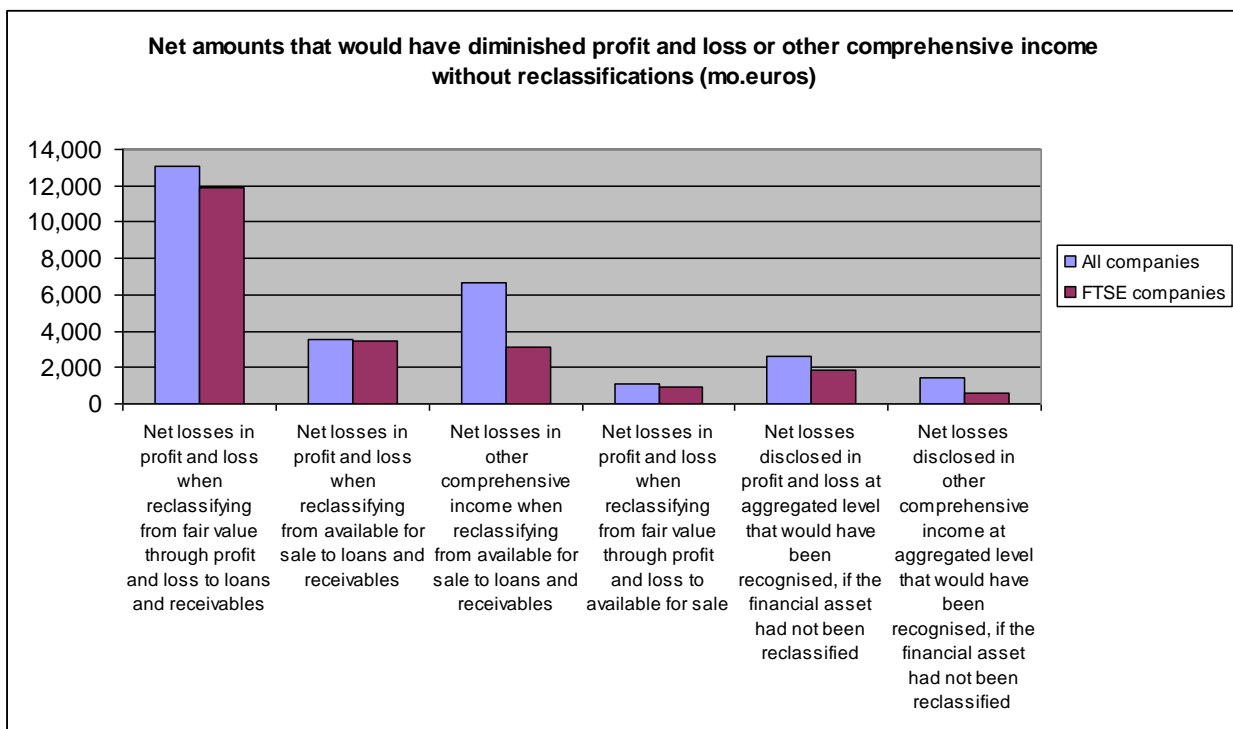


Figure 5

According to IFRS 7.12A (e) the fair value gain or loss that would have been recognised in profit or loss or other comprehensive income if the financial asset had not been reclassified should be disclosed.

Figure 5 shows the types of reclassifications where the amounts for the fair value net losses that would have been recognised if the reclassification had not been carried out were most significant<sup>3</sup>. These figures should be taken as a minimum as not all companies in the sample made the corresponding disclosure under IFRS 7.12A (e). In any case, this specific disclosure was given by almost two thirds of all the companies in the sample.

Without reclassifications, some companies in the sample would have had to recognise lower amounts either in profit and loss or in comprehensive income while others would have recognised higher amounts. In the aggregate, if reclassifications had not been made, the amounts reported in the profit

<sup>3</sup> The application of this disclosure requirement entails that the fair value gains and losses can be disclosed in nine different ways taking the five different reclassifications between categories and the requirement to recognise the gain or loss in either profit and loss or other comprehensive income into consideration.



and loss and the other comprehensive income would have been 28 billion euros lower. Around three quarters of this net loss would have been recognised by FTSE Eurotop companies.

Figure 5 shows that for both the categories of all companies in the sample and of those in the FTSE Eurotop 100 the highest amounts that would have been recognised came from the option to reclassify from *fair value through profit and loss* to *loans and receivables*.

## **6. The companies analysed**

The sample consisted of 100 companies which were selected to appropriately reflect the distribution of financial companies within the European market. The sample was composed of the 22 financial companies which are included in the FTSE Eurotop 100 index and 78 other financial companies across Europe. An analysis of the FTSE Eurotop 100 companies was chosen because CESR was of the view that these companies, being the largest financial companies in Europe, have their financial statements subjected to the highest level of market scrutiny in comparison to the sample taken as a whole.

In this analysis the sample of financial companies included in FTSE Eurotop 100 index is unchanged compared to the analysis in the CESR statement on reclassification of financial instruments and other related issues, which was published in January 2009. For the other companies the sample of companies has been slightly amended in order to better reflect the distribution of financial companies within the European market. CESR is of the view that the results of the analysis for the interim financial statements for the 3<sup>rd</sup> quarter 2008 and for the annual financial statements are comparable.

## **7. Next steps**

CESR will continue to monitor closely future developments in the area of financial instruments and fair value accounting. CESR will further analyse the application of the remaining requirements in IFRS 7 regarding disclosures on financial instruments and expects to publish the results of this analysis later in 2009.