CPA
Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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23 September 2008

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Discussion Paper on *Reducing Complexity in Reporting Financial Instruments*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Discussion Paper. Our responses to the questions raised in your Discussion Paper are set out in the Appendix for your consideration.

Overall, we support the IASB's initiative to simplify the reporting of financial instruments and believe that in the long-term the best way to achieve this is to develop financial instruments standards that are more principles-based.

However, the Board's preliminary views expressed in the Discussion Paper appear to suggest that the debate concerning whether the best way to reduce complexity is to impose a general fair value measurement requirement for all financial instruments has been settled. While we agree that many of the complexities in the current requirements stem from the mixed measurement attributes and that some of the measurement mismatches can be eliminated without much controversy, in our view the Board has yet to put forward a convincing case supporting a general fair value measurement requirement for all financial instruments. In particular, we question whether imposing a single measurement attribute for all financial instruments is the really most appropriate long-term goal, when there are still fundamental concerns among the constituents about the objectivity of fair values estimated using non-observable inputs and the counter-intuitive outcomes arising from measuring financial liabilities at fair value, which undermine the relevance and reliability of financial statements from the users' perspective.

Therefore, while we support some of the proposals for simplifying the current IAS 39 *Financial Instruments: Recognition and Measurement,* we view this as a welcome evolutionary step in the development of IAS 39, rather than necessarily seeing this as an intermediate step towards a full fair value model.

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If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

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Comments on the IASB Discussion Paper on *Reducing Complexity in Reporting Financial Instruments*

Section 1 Problems related to measurement

Question 1

Do current requirements for reporting financial instruments, derivative instruments and similar items require significant change to meet the concerns of preparers and their auditors and the needs of users of financial statements? If not, how should the IASB respond to assertions that the current requirements are too complex?

We agree that some complexities in the current requirements are unnecessary and could be simplified. In particular, we agree with the IASB's identification of the sources of complexities in the current requirements as set out in paragraph BD16 of the Discussion Paper and note that only the first two items on this list are addressed by the proposals in the Discussion Paper. We would welcome initiatives by the Board to address the other identified issues as well.

However, while we acknowledge that the mixed measurement attribute and hedge accounting requirements are two sources of complexity in the current IAS 39, we do not believe that the only appropriate solution is to impose a single measurement attribute and to remove hedge accounting altogether. The litmus test for any proposed changes should be appropriateness rather than simplification. As explained more fully below, we would support some simplification of the requirements of IAS 39 as an evolutionary development in that standard, whilst not necessarily viewing this as an intermediate step on the way to an end goal of fair value for all financial instruments.

Section 2 Intermediate approaches to measurement and related problems

Question 2

(a) **Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that the IASB should not make any intermediate changes, please answer questions 5 and 6, and the questions set out in Section 3.**

The suggestions for "intermediate" approaches are premised on the assumption that there exists one single most appropriate measurement attribute for all financial instruments and that this attribute is fair value. As we further explain in our responses to Questions 8 to 10 below, we consider that the Board has yet to put forward a convincing case that the full fair value model is the way to go – we are not convinced that fair value is "the" measurement attribute suitable for all financial instruments. Indeed, the concept of "fair value" is elusive, difficult to apply, and not without its own problems. The subjectivity of fair value based on unobservable inputs may create its own complexities and impair the relevance of financial information. Furthermore, fair valuing an entity's own liabilities creates counter-intuitive outcomes when the entity is in financial difficulties, again reducing the relevance of the information for users.

Having said that, we agree that the current requirements of IAS 39 could be improved and simplified. However, the changes should focus on improvements to IAS 39 which are not necessarily intermediate steps towards the goal of full fair value. In other words, changes should be evolutionary; being neither necessarily temporary nor revolutionary.

(b) Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?

We agree with the criteria set out in paragraph 2.2(a), (c) and (d).

We do not agree with the criteria in paragraph 2.2(b). As we explained in (a) above, in our view the debate as to whether the full fair value model is the appropriate long-term goal has not yet been completed and imposing this criteria in the consideration of any simplifications may pre-empt the conclusions of the debate.

Question 3

Approach 1 is to amend the existing measurement requirements. How would you suggest existing measurement requirements should be amended? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph 2.2?

We support approach 1 and believe that this is the preferred short-term approach among those suggested to reduce complexity, particularly if the amendments take the form of deleting existing guidance or requirements that are determined to be unduly complicated.

Specifically, we support the elimination of both the “held-to-maturity” and “available-for-sale” categories in IAS 39, such that financial assets in either of these categories would be measured at fair value through profit or loss, where their fair value can be reliably measured (otherwise, as at present, they would be carried at cost less impairment as per IAS 39.46(c)). Judged against the proposed criteria for any intermediate changes:

- These changes would likely bring about substantial simplification without introducing new requirements: the change would eliminate the need for “tainting” rules and the need for guidance on impairment and reclassification adjustments from the AFS reserve to income, which can be subjective and difficult to apply consistently.

- The change is also anticipated to improve comparability across entities as measurement would become independent of management intention and hence similar instruments would be accounted for in similar ways. In addition, reporting changes in the fair value of these investments in the income statement will bring the reporting in line with that already adopted for investment property carried at fair value under IAS 40 *Investment property*.

- From an implementation perspective, as the change would involve striking through substantial portions of IAS 39, rather than re-writing them, the impact of the change in the text of IAS 39 would be relatively straightforward to understand. Also, the costs to preparers in terms of deriving the relevant financial information should not be significant as “available-for-sale” assets are already carried at fair value under the current requirements, and “held-to-maturity” assets are, by definition, quoted in active markets and thus fair values for these instruments should be readily available.

If the Board decides not to proceed with the elimination of the “available-for-sale” category, we recommend that

(a) the impairment requirements concerning available-for-sale debt instruments be improved, such that they deal with the creation and reversal of impairments consistently on an amortised cost basis i.e. using an effective interest rate such that fair value changes arising from interest rate changes do not impact the amount of impairment recognised. This would be similar to the recognition of interest income and foreign exchange differences, rather than the current requirements which take a mixed approach; and

(b) the words "significant or" in the phrase "a significant or prolonged decline in the fair value of an investment in an equity security below cost is also objective evidence of impairment" found in the last sentence of IAS 39.61 be deleted. The reasons for this request are that:

   (i) currently, the statement that a "significant" decline, even though not prolonged, "is also" objective evidence of impairment is causing confusion and diversity in practice as to whether this is intended to override the qualitative factors discussed in the first part of paragraph 61 which relate to determining whether cost of an equity instrument will be recovered. That is, there are diverse opinions about whether or not the last sentence of IAS 39.61 requires significant temporary deficits identified on a strict quantitative basis at the reporting date to be characterised as "impairment", even when management is confident that cost will be recovered before the deficit becomes “prolonged” (or indeed the fair value may have actually recovered prior to approval of the financial statements); and

   (ii) if this wording is intended by the IASB to be applied strictly on a quantitative basis at the reporting date and therefore to override the qualitative discussion in the rest of paragraph 61, there is further concern that this rule is inconsistent with (a) the rest of the guidance in IAS 39.61 which focuses on whether the cost is expected to be recovered and (b) with the general concept under the AFS category of there being a qualitative difference between “deficit” and “impairment”.

   In short, we consider that the words "significant or" in the last sentence of IAS 39.61 are either redundant (for those that take a qualitative approach consistent with the rest of IAS 39.58-62) or result in inappropriate labelling of deficits as impairments by those that interpret the last sentence of IAS 39.61 as requiring them to take a narrow quantitative approach. To reduce confusion and diversity in practice, we therefore ask for the words "significant or" to be deleted.

Both of these proposed limited amendments to the requirements would reduce considerably the areas of uncertainty and debate concerning the appropriate application of the principles of the AFS category, and would therefore be welcome, if the AFS category is retained. We also propose that the IASB removes IAS 39.69, which prohibits the reversal of impairment losses on AFS equity instruments through profit or loss. This prohibition is inconsistent with the treatment of AFS debt instruments and ignores the fact that the circumstances originally giving rise to impairment often themselves reverse.

Question 4

Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions.

(a) What restrictions would you suggest on the instruments eligible to be measured at something other than fair value? How are your suggestions consistent with the criteria set out in paragraph 2.2?

(b) How should instruments that are not measured at fair value be measured?

(c) When should impairment losses be recognised and how should the amount of impairment losses be measured?

(d) Where should unrealised gains and losses be recognised on instruments measured at fair value? Why? How are your suggestions consistent with the criteria set out in paragraph 2.2?

(e) Should reclassifications be permitted? What types of reclassifications should be permitted and how should they be accounted for? How are your suggestions consistent with the criteria set out in paragraph 2.2?

We do not support approach 2.

We consider that the current requirements in their present format, although complicated to apply in practice, are familiar and have been applied for years. If the text of IAS 39 is re-written, then this adds considerably to the burden of preparers and auditors in analysing whether or not the revised text has the same meaning as the previous text, irrespective of whether the final outcome of all this effort is a significant change in accounting policies or in practice no change at all from the current approach. In addition, approach 2 has the potential to introduce additional complexity (in particular the potential new requirements on the eligibility for opt-outs).

Furthermore, this approach assumes that the long-term “goal”, of there being a general fair value measurement requirement for all financial instruments, has already been accepted by constituents, which as mentioned elsewhere in this response, we do not accept.

Question 5

Approach 3 sets out possible simplifications of hedge accounting.

(a) Should hedge accounting be eliminated? Why or why not?

No. Unless the Board has developed a better replacement or alternative to hedge accounting, we do not support the elimination of hedge accounting altogether. Experience has shown that although hedge accounting is voluntary, some preparers are willing to follow the stringent hedge accounting requirements because they consider that the resulting accounting provides relevant information.

Having said that, we agree that certain aspects of the current requirements on hedge accounting are unnecessarily complex and can be simplified (see our response to Question 6 below).

(b) Should fair value hedge accounting be replaced? Approach 3 sets out three possible approaches to replacing fair value hedge accounting.

(i) Which method(s) should the IASB consider, and why?

(ii) Are there any other methods not discussed that should be considered by the IASB? If so, what are they and how are they consistent with the criteria set out in paragraph 2.2? If you suggest changing measurement requirements under approach 1 or approach 2, please ensure your comments are consistent with your suggested approach to changing measurement requirements.

No, we do not think that fair value hedge accounting should be replaced, as this only amounts to replacing one set of complexity with another. Any change may also lead to corporate treasury functions needing to amend existing systems with no apparent benefit.

Question 6

Section 2 also discusses how the existing hedge accounting models might be simplified. At present, there are several restrictions in the existing hedge accounting models to maintain discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings. This section also explains why those restrictions are required.

(a) What suggestions would you make to the IASB regarding how the existing hedge accounting models could be simplified?

Although we appreciate that much of the detail in the current hedge accounting requirements are anti-avoidance in nature, we consider that overall the requirements could be simplified by making them more principles-based. “Bright-line” details should be removed and the requirements should be flexible enough to reflect (rather than restrict) entities’ ever-evolving hedging strategies.

In particular, we support the proposal in paragraph 2.86 of the Discussion Paper. We consider that the existing retrospective effectiveness test (the "80:125" corridor) is arbitrary, rules-based and costly to implement – indeed much of the burden and cost associated with hedge accounting arises from the effectiveness testing requirements. By eliminating the retrospective effectiveness test and requiring only a prospective qualitative effectiveness test (plus continued recognition of any ineffectiveness in profit or loss), hedge accounting, and the associated documentation, can be significantly simplified.

We believe that the requirement for effectiveness testing should be set out in the form of a principle that, before designating a hedging relationship, the entity should document an assessment of the economic relationship between the hedged item and the hedging instrument which demonstrates that the hedge is likely to prove effective, with the extent of further quantitative analysis at this stage being dependent on how "obvious" the correlation between the hedged risk and the hedging instrument is (that is, the less obvious the correlation, the greater the need for quantitative analysis to demonstrate that the correlation in practice exists). The entity should also document how this hedge is consistent with their overall risk management strategy.

(b) Would your suggestions include restrictions that exist today? If not, why are those restrictions unnecessary?

See our response to (a) above. In addition, we recommend that the IASB should remove the restriction preventing the hedging of a portion of non-financial instruments.

(c) Existing hedge accounting requirements could be simplified if partial hedges were not permitted. Should partial hedges be permitted and, if so, why? Please also explain why you believe the benefits of allowing partial hedges justify the complexity.

As we stated in (a), we believe that hedge accounting requirements should not limit an entity's flexibility in carrying out their hedging activities. The accounting should reflect management's intention in financial risk management and economic reality. Prohibiting partial hedges for the sake of simplicity alone may actually restrict the usefulness of hedge accounting and impair the relevance of the resulting financial information. We therefore do not support this.

(d) What other comments or suggestions do you have with regard to how hedge accounting might be simplified while maintaining discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings?

We do not have any other comments or suggestions on hedge accounting.

Question 7

Do you have any other intermediate approaches for the IASB to consider other than those set out in Section 2? If so, what are they and why should the IASB consider them?

We consider that the "own use exemption" as set out in paragraphs 5 to 7 of IAS 39 should be improved and simplified. The general requirement in paragraph 5 has in our view adequately covered the objective of the scope exclusion.

Consequently, we suggest that paragraph 7 of IAS 39 concerning written options should be removed. Such a "bright-line" override is too strict and catches within IAS 39's scope contracts that are entered into primarily for the purposes of an entity's "normal usage requirements". For example, a "volumetric flexibility" clause that allows a buyer to purchase units in addition to the contracted number in a contract to sell non-financial items may render the whole supply contract as a written option even though the contract may have been entered into for the purpose of "normal usage requirements".

We also suggest that the exceptions to the "own use exemption" as set out in paragraphs 6(b) and (c) of IAS 39 should be removed. These are "tainting"-type provisions that we believe are inappropriate and rules-based.

<u>Section 3 A long-term solution—a single measurement method for all types of financial instruments</u>

Question 8

To reduce today's measurement-related problems, Section 3 suggests that the long-term solution is to use a single method to measure all types of financial instruments within the scope of a standard for financial instruments.

Do you believe that using a single method to measure all types of financial instruments within the scope of a standard for financial instruments is appropriate? Why or why not? If you do not believe that all types of financial instruments should be measured using only one method in the long term, is there another approach to address measurement-related problems in the long term? If so, what is it?

No. We do not believe that there necessarily exists one single measurement attribute (whether fair value or not) that is appropriate for all financial instruments. We acknowledge that certain of the complexities in the current requirements stem from the mixed measurement attributes for different instruments; however, this does not mean that imposing a single measurement attribute would be appropriate. In particular, as we further explain in our response to Question 9, we do not think it is always appropriate to measure both financial assets and financial liabilities using the same measurement attribute.

Therefore, while the "one-measurement-fits-all" approach has the potential to simplify IAS 39 by eliminating issues arising from mixed measurement attributes, we urge caution about the risk of over-simplification. Some complications are necessary and indeed provide relevant information for users – they should not be removed in the pursuit of simplification.

Question 9

Part A of Section 3 suggests that fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments.

(a) Do you believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?

(b) If not, what measurement attribute other than fair value is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Why do you think that measurement attribute is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Does that measurement attribute reduce today's measurement-related complexity and provide users with information that is necessary to assess the cash flow prospects for all types of financial instruments?

No. In our response to Question 8 we question the premise that there is one single measurement attribute that is appropriate for all financial instruments. Even if one accepts that such a measurement attribute exists in practice, we still have difficulty in agreeing that fair value is that "golden" attribute.

To begin with, the Board's fair value measurement project has made it evident that the concept of "fair value" is an elusive one: on the one hand, "fair value" is not actually a single measurement and can mean the entry price in some cases and the exit price in other cases; on the other hand, the concept is predicated on assumptions that are not always valid in reality (e.g. the assumption that there always exists a "willing buyer/seller" for a particular financial instrument and that in the absence of observable inputs different entities can come to a reasonably close consensus about the fair value of a particular instrument at any given time). In addition, even if a hypothetical buyer can be imagined, the relevance of "exit" values for instruments which are rarely traded by any entity before maturity (for example, trade debtors or insurance liabilities) is questionable. For these reasons, even if one ignores the resulting accounting volatility, a general "fair value" measurement requirement for all financial instruments may in fact give users of financial statements a false sense of comparability across entities.

Further, simplifying the reporting of financial instruments by imposing a single fair value measurement requirement may indeed give a false sense of simplicity. Despite the developments in financial markets, fair valuing financial instruments remains a daunting task in practice, particularly for those instruments with highly variable cash flows and/or which are thinly traded or not traded at all. While we agree with paragraph 3.63 that an imprecise estimate of a relevant amount can be more useful than a precise estimate of a less relevant amount, we are concerned about the practical difficulties in estimating fair values and the significant subjectivity of some fair values (see also our response to Question 10 below) and consider that these concerns may outweigh any usefulness of imprecise estimates.

In particular, we question whether fair value is the appropriate measurement attribute for financial liabilities. Fair valuing an entity's own liabilities brings about accounting volatility as a result of changes in market factors and the entity's own credit risk. The resulting "noise" is not only counter-intuitive (for reasons quoted in paragraph 3.75 of the Discussion Paper) but will mislead those users who do not understand the significance of the reported "gains" and "losses" and may therefore in general undermine users' faith in earnings reported in accordance with IFRSs. Consequently, we agree with paragraph 3.76 of the Discussion Paper that the needs of the users of financial statements are indeed better served by a measurement that focuses on the obligation – both for a creditor interested in assessing the repayment ability of an entity, and also for an investor interested in assessing the earnings performance of an entity.

Overall, we consider that the Discussion Paper has not yet made a convincing case for a general fair value measurement requirement. While we acknowledge that the amortised cost approach is inappropriate for valuing complex financial instruments with variable cash flows as it does not reflect adequately the risk involved, for financial instruments with fixed or slightly variable cash flows the amortised cost regime is not an overly complex measurement attribute and is well understood. Furthermore, interest income is an important measure for users, particularly in respect of entities in the financial services industries. Use of fair value for measurement, while retaining amortised cost for income recognition, would not appear to represent a simplification.

Question 10

Part B of Section 3 sets out concerns about fair value measurement of financial instruments. Are there any significant concerns about fair value measurement of financial instruments other than those identified in Section 3? If so, what are they and why are they matters for concern?

In addition to the concerns expressed in our comments to Question 9 above and those set out in section 3 of the Discussion Paper, we are also concerned about the recognition of any resulting gains and losses upon the re-measurement of a financial instrument whose fair value is estimated based on a valuation methodology using unobservable inputs (e.g. fair values estimated using information available to or developed by the entity).

Fair valuing complex financial instruments is itself a complicated task; doing so for instruments that are not traded or traded in illiquid markets (for which observable prices are not available) is even more daunting and prone to errors and manipulations. While in principle there exists only one fair value for a particular instrument at a particular time, in practice entities can come up with vastly different "fair values" for an otherwise equivalent instrument.

Take an example of a financial liability of an entity whose debts are not rated. By imposing a fair value measurement requirement for the liability the entity is effectively asked to perform a credit analysis on its own debt. The entity has to develop its own assumptions, such as those concerning its own credit risk, when fair valuing its own liability. Even without management bias, because of the subjectivity involved it is unlikely that two entities with the same credit standing would come up with a similar estimate of an equivalent obligation in practice. Taking into account the potential for management manipulation, how relevant and reliable is the "fair value" to users of financial statements?

Question 11

Part C of Section 3 identifies four issues that the IASB needs to resolve before proposing fair value measurement as a general requirement for all types of financial instruments within the scope of a standard for financial instruments.

(a) Are there other issues that you believe the IASB should address before proposing a general fair value measurement requirement for financial instruments? If so, what are they? How should the IASB address them?

We believe our reservations over the adoption of fair value as the single measurement attribute would necessitate the consideration of issues concerning day one recognition of profit or loss.

(b) Are there any issues identified in part C of Section 3 that do not have to be resolved before proposing a general fair value measurement requirement? If so, what are they and why do they not need to be resolved before proposing fair value as a general measurement requirement?

We agree that all the issues identified in part C of section 3 are pre-requisites that needs to be resolved before putting forward the debate as to whether fair value should be adopted as a general measurement requirement for all financial instruments.

We emphasise, however, that in our view having dealt with these "pre-requisites" does not automatically clear the way to the general fair value measurement objective. As we highlighted in our response to Questions 8 to 10, we do not think it is necessarily appropriate to apply a single measurement attribute to all financial instruments and the concept of fair value is also fraught with its own problems.

Question 12

Do you have any other comments for the IASB on how it could improve and simplify the accounting for financial instruments?

We find that part of the complexity of the current requirements arises from the way the standard is worded, in particular the way that rules are based on terminology which is not defined or explained. For example, as mentioned above, the word "significant" is used in a rule in the last sentence of IAS 39.61 concerning the treatment of "significant" deficits on equity securities which has little to do with the principle of impairment of AFS securities as set out elsewhere in IAS 39.

The introduction of such rules (rather than principles), without any indication as to the meaning of key terms such as "significant", makes it difficult for auditors and preparers to ensure that these rules are being applied as intended. Either rules which are disguised as guidance should be deleted or their meaning should be made less ambiguous, so as to minimise the lengthy arguments which otherwise arise on “what the standard means”.