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Mr. Steve Ong
Director, Standard Setting
Hong Kong Institute of Certified Public Accountants
37/F., Wu Chung House
213 Queen's Road East
Wanchai, Hong Kong

Dear Steve,

IASB Exposure Draft on Financial Instruments: Amortised Cost and Impairment ("Exposure Draft")

We have completed our review of the Exposure Draft and our views are set out below.

General

The Exposure Draft sets out fundamental changes to the impairment guidance for financial instruments accounted for at amortised cost. IASB proposes to replace the current incurred loss model with an expected loss model which will be incorporated into the determination of amortised cost. Under the proposed model, expected losses will be recognised throughout the life the financial assets are held rather than being recognised when a loss event has been triggered.

We support an "expected loss model" which is in line with the prudence concept referred to in paragraph 37 of the Conceptual Framework Statement but note that the proposed model is unduly complex. We believe recognising the time value of money is not a major concern for most business enterprises as it has been taken into account in the pricing of transactions. To require all enterprises to adopt valuation techniques which are more relevant to financial institutions such as banks imposes upon them an unwarranted burden and cost. Moreover, the IASB's proposal of incorporating expected losses into the amortised cost model has substantially changed the current meaning of amortised cost and has created a new hybrid amortised cost model. Our concerns on the amortised cost model, even prior to the IASB's proposal to incorporate expected losses into the computation, include the following: -

- The accounting and reliability of the model given the need for management to make very subjective judgements in estimating the amount of future cash flows and especially their timing, including the timing of possible early repayments of principal

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which will have a significant impact on the reported figures. Cash inflows are not under the lender's control.

- The need for management to create hypothetical models and develop systems to compute estimates of future cash flows over the full life of a financial asset or group of financial assets.
- The need to determine a hypothetical effective interest rate which will be applied throughout the asset's life. The final actual return or cash flows may not be the expected return.
- The amortised cost model acts as a smoothing mechanism to spread the premium or discount arising on the creation or acquisition of the financial asset over the life of the asset. However, the premium or discount may not be realized. The profit and loss account does not reflect the actual cash flows or the real returns on the asset when they arise.
- The amortised cost model arguably is not a cost model. The general meaning of cost to a layman means that the amount is fixed. However, under the amortised cost model the carrying value of the asset is in substance revalued regularly at each period end.
- The amortised cost model does not normally take into account changes in the inflation rate, although we would accept that in determining the contracted interest rate it may have been considered. The asset's amortised cost does not necessarily equate to its fair value.

We believe that the concept of amortised cost measurement should be reconsidered at a conceptual level to consider whether it produces useful, relevant and reliable information and whether it is an appropriate basis of measurement for assets or liabilities in financial statements. This is discussed further below under the heading "Need to reconsider appropriateness of amortised cost measurement". Because of the above and as we believe the proposed model will be costly to implement, we do not agree with the proposals as presented.

Our detailed comments are discussed below which are given in the context of where the financial asset being considered is in the nature of a loan or debt for which the amortised cost method is proposed to be applicable.

Need to reconsider appropriateness of amortised cost measurement

(a) Integrating expected credit losses

We are concerned with the IASB's proposal to incorporate expected losses into the amortised cost model for measuring financial instruments. We believe the Exposure

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Draft has not clearly and adequately explained the objective of amortised cost measurement including the concept, and its relevance in measuring financial instruments. We also believe relevant considerations are different depending on whether a financial instrument is an asset or a liability. For example, in implementing the prudence concept, a unilateral decision can be made by a company for impairing the value of a financial asset, but for a financial liability a variation in the amount payable requires agreement from the creditor. The prudence concept also allows provisions to be made for expected future liabilities.

We believe the current definitions under IAS 39, as well as the proposed definitions in the Exposure Draft, are not clear and easy to understand to lay readers. They are both extracted below for easy reference.

Extract of paragraph 9 of IAS 39

“The definitions relating to recognition and measurement

The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

[Refer: Implementation Guidance Questions B.24-B.27]

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18 Revenue), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

[Refer: paragraphs AG5–AG8, Basis for Conclusions paragraphs BC30–BC36]”

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Proposed new definitions included in the Exposure draft

<i>“amortised cost</i>	<i>A cost-based measurement of a financial instrument that uses amortisation to allocate interest revenue or interest expense.</i>
<i>effective interest method</i>	<i>A method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) that uses the effective interest rate.</i>
<i>effective interest rate</i>	<i>The rate that (or spread that, in combination with the interest rate components that are reset in accordance with the contract,) exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or financial liability.”</i>

The inclusion of expected losses in the amortised cost model under the proposals will substantially change the meaning of the effective interest method and what it is supposed to represent. The current definition in IAS 39 specifically states that when calculating the effective interest rate an entity “*shall not consider future credit losses*” but under the proposals in the Exposure Draft such losses will be included.

(b) Concept of amortised cost

At a conceptual level, we are concerned with the adoption of the amortised cost model and would question its relevance for financial statements of companies that are not financial institutions, such as banks which normally finance their long-term loans through short-term deposits or borrowings. We agree with the dissenting views of the IASB board members and believe that the cost of implementing the proposals will be substantial but will fail to provide sufficient benefits and useful information to readers of financial statements.

We illustrate our concerns below. An example of how amortised cost is supposed to work is included in the implementation guidance on IAS 39 which appears below for easy reference. We would first point out that the example is for one very simple financial asset and does not take into account credit losses as proposed under the Exposure Draft. We believe the complexity of record keeping required under IASB’s proposals would be substantially greater in practice for companies that have a number of contracts with

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different parties initiated at different times and with different terms (including variable interest rates and repayment periods) and maturity dates.

Extract from IAS 39.IG.B.26

“Example of calculating amortised cost: financial asset

Under IAS 39, amortised cost is calculated using the effective interest method. The effective interest rate inherent in a financial instrument is the rate that exactly discounts the estimated cash flows associated with the financial instrument through the expected life of the instrument or, where appropriate, a shorter period to the net carrying amount at initial recognition. The computation includes all fees and points paid or received that are an integral part of the effective interest rate, directly attributable transaction costs and all other premiums or discounts.

The following example illustrates how amortised cost is calculated using the effective interest method. Entity A purchases a debt instrument with five years remaining to maturity for its fair value of CU1,000 (including transaction costs). The instrument has a principal amount of CU1,250 and carries fixed interest of 4.7 per cent that is paid annually (CU1,250 x 4.7 per cent = CU59 per year). The contract also specifies that the borrower has an option to prepay the instrument and that no penalty will be charged for prepayment. At inception, the entity expects the borrower not to prepay.

It can be shown that in order to allocate interest receipts and the initial discount over the term of the debt instrument at a constant rate on the carrying amount, they must be accrued at the rate of 10 per cent annually. The table below provides information about the amortised cost, interest income and cash flows of the debt instrument in each reporting period.

<i>Year</i>	<i>(a) Amortised cost at the beginning of the year</i>	<i>(b = a x 10%) Interest income</i>	<i>(c) Cash flows</i>	<i>(d = a + b - c) Amortised cost at end of the year</i>
20X0	1,000	100	59	1,041
20X1	1,041	104	59	1,086
20X2	1,086	109	59	1,136
20X3	1,136	113	59	1,190
20X4	1,190	119	1,250+59	--

Total 545 Total 1545
 (1250 principal plus 295 interest)

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The example shows an initial discount on purchase of CU250 which results in a discount rate of 10% which is regarded as the market interest rate based on the purchase cost of the financial asset at CU1,000. If the entity only reports annually, we understand that the journal entries for the transaction would be:-

<u>At initial recognition in 20X0</u>	
Dr. Debt instrument	1,000
Cr. Cash	1,000
<u>At end of the year 20X0</u>	
Dr. Cash	59
Dr. Debt instrument	41
Cr. Interest income	100
<u>At end of the year 20X1</u>	
Dr. Cash	59
Dr. Debt instrument	45
Cr. Interest income	104
<u>At end of the year 20X2</u>	
Dr. Cash	59
Dr. Debt instrument	50
Cr. Interest income	109
<u>At end of the year 20X3</u>	
Dr. Cash	59
Dr. Debt instrument	54
Cr. Interest income	113
<u>At end of the year 20X4</u>	
Dr. Cash – Interest	59
Cash – Repayment of loan	1,250
Cr. Interest income	119
Cr. Debt instrument	1,190

We understand that under the above example the company's financial statements would present the following results and financial position. The last column shows the face value of CU1,250 for the receivable acquired but this amount is not disclosed as an asset as its cost was CU1,000.

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Period	Results for the year	Financial position – debt instrument	Contracted receivable amount
At initial recognition in 20X0		1,000	1,250
At end of 20X0	100 (interest income)	1,041	1,250
At end of 20X1	104 (interest income)	1,086	1,250
At end of 20X2	109 (interest income)	1,136	1,250
At end 20X3	113 (interest income)	1,190	1,250
At end of 20X4	<u>119</u> (interest income)	-	-

Net result for 5 years **545 (interest income)**

It can be seen from the above example that the adoption of amortised cost is in substance a form of “revaluing” the debt instrument each year to recognise the discount on acquisition of CU250. Interest income is recognised based on a hypothetical total interest rate of 10% “expected” to be earned over the life of the asset rather than the contracted interest rate of 4.7%. This however is based on the assumption that the full amount of CU1,250 will be paid in 20X4. The reported annual interest income is the hypothetical interest that includes a share of the discount on purchase of CU250 (CU1,250 – CU1,000).

The amortised cost model therefore effectively smoothes the expected gain of CU250 over the life of the asset as follows:-

	Contracted interest	Allocation of initial discount (CU1,250-CU1,000)	Total “interest” recognised
20 X 0	59	41	100
20 X 1	59	45	104
20 X 2	59	50	109
20 X 3	59	54	113
20 X 4	<u>59</u>	<u>60</u>	<u>119</u>
	<u>295</u>	<u>250</u>	<u>545</u>

However, the gain of CU250 will only be realised if the debtor repays in full the principal of CU1,250 in 20X4. In substance, the amortised cost model allows the early recognition of an unrealised but expected CU250 gain in 20X4, yet doubts on its recovery or any part

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of the principal of CU1,250 may have also been a reason why the financial asset could be purchased at a discount in 20X0 in the first place.

The above example shows that the carrying value of the receivable at each balance sheet date does not reflect the contracted amount due from the borrower of CU1,250. Moreover, the interest income recognised of CU545 differs significantly from the true interest income cash flows of CU295 received during the period of the loan.

In summary, it can be seen from the above illustration that the adoption of amortised cost measurement leads to accounting for “hypothetical interest” that does not reflect contractual interest and actual cash flows. The hypothetical interest includes a portion of the expected gain of CU250 that will be made if, and only if, the debt is paid in full in 20X4. If any part of the principal is not repaid, the gain recognised would need to be reversed. Introducing expected losses into the amortised cost equation as proposed by the IASB will add further complexity and companies in effect will be required to maintain three sets of data to meet the proposed requirements; amortised cost data excluding expected losses, amortised cost data including expected credit losses, and data on contracted and actual cash flows. We agree with the dissenting IASB board members that adoption of the proposals will be unauditible or at best, difficult and costly to audit.

We believe that the original intent of the effective interest rate method was to account for the gross return on the assumption that the amounts would be settled in full. The purpose was to show the effective interest rate return which takes into account the present value of money, but not credit losses. Paragraphs B1 and B2 of the Exposure Draft are not clear as to whether the effective interest rate needs to be recomputed at each balance sheet date but it appears from paragraph BC41 in the Basis for Conclusions Paper that at least in respect of variable interest rate instruments, the effective interest rate is not reset. We believe that using the original effective interest rate set at initial recognition together with incorporating expected losses changes the concept of the amortised cost model. The need to take into account credit losses means that the original effective interest rate determined when the asset was initially recognised is in fact not the effective interest rate. The credit losses recognised reduce the effective return but this fact is not recognised in a reduced effective interest rate. We also note that paragraph BC75 recognises that if the proposed new approach is adopted there is a change in the effective interest rate from the effective interest rate determined under the existing IAS 39.

As a matter of principle we believe that accounting for “interest” or income recognition should be dealt with separately from accounting for loan principal. Accounting for interest is concerned with the concept of revenue recognition, whereas accounting for loan principal is concerned with accounting for the underlying revenue generating asset. Moreover, if the intention of the proposed amortised cost model incorporating impairment losses is to show the “total net return” on the loan, we believe other considerations may be relevant, such as the cost of funds borrowed to finance the loan.

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We believe that as a general conceptual principle accounting for recognition in the profit and loss account and the statement of financial position should reflect transactions at their contracted terms as agreed between two contracting parties. The purpose of contract negotiation is to arrive at agreement as to terms for the transaction. Financial statements should not reflect hypothetical transactions which in substance means that the information presented is merely pro-forma or “as if” information.

Expected cash flows incorporating expected credit losses

We understand the proposed approach involves estimating forward-looking cash flows that incorporate expected future credit losses throughout the term of a single financial asset or a portfolio of similar financial assets. The proposed model, unlike the current incurred loss model, would not require a triggering event to occur for the recognition of credit losses. Under the proposals, an entity would be required to revise its estimates of expected cash flows including credit losses at each balance sheet date. The requirements will therefore apply in the preparation of annual, half-yearly, quarterly and other periodic financial reports.

We believe that in principle an expected loss model in contrast to an incurred loss model is appropriate as it is an application of the fundamental concept of prudence, which is to avoid the overstatement of assets and earnings by recognising expected losses in a timely manner. However, we do not agree with the proposed accounting and integration of expected impairment losses into the concept of amortised cost measurement.

“Probability-weighted outcome” versus “most likely outcome”

Under the proposed model, the amounts and timing of cash flows are proposed to be based on a probability-weighted possible outcome model rather than the most likely outcome model. We expressed our concerns on the probability-weighted possible outcome model in our letter to you dated 31 March 2010 on the issue concerning accounting for provisions for future liabilities, and we have similar concerns on its adoption here when accounting for impairment losses.

We believe that the most likely outcome model is more easily understood, relevant and simple to apply and suggest that it be adopted. We would also suggest that IASB provide clear guidance to encourage consistency. To prevent entities from managing earnings by revising key assumptions, adequate disclosure of the reasons for any change in the assumptions used and an estimate of their financial impact should be made.

“Individual basis” versus “portfolio basis”

The IASB proposes to allow entities to estimate expected losses either on a collective or an individual basis. This basis may be changed during the life of a financial asset (e.g.

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after default). The IASB proposes that entities should use the approach that provides the best estimate and which does not result in double-counting of credit losses. We believe the objective of identifying the best estimate is consistent with the most likely outcome model which we recommend above.

We agree that an expected loss model should be allowed and applied on a portfolio basis as this would be a pragmatic solution for companies that have transactions that are individually of low value but high in volume. However, it should only be permitted if the financial instruments have the same or similar characteristics and credit risks.

Financial assets marked to market under amortised cost

The IASB believes that its proposed amortised cost model would not lead to more financial assets being marked to market. However, we believe that the model in substance is moving towards a marked to market model in the sense that it attempts to reflect financial instruments at their value based on present value concepts.

Allowance account

The Exposure Draft requires the maintenance of an “Allowance Account” and to show movements in the allowance for credit losses. We agree with the need for such an account but the current proposals are confusing and it is not entirely clear how the account can be easily understood. Paragraph B22 (a) on page 30 of the Exposure Draft indicates that credit losses will be shown as a reduction of gross interest revenue. We believe that losses of loan principal will normally be substantially larger than the losses on the related interest and a loss of principal will result in negative interest returns. We believe that credit losses that relate to interest should be separated from credit losses that relate to loan principal and this is a reason why we believe there is a need to reconsider the appropriateness of using the amortised cost basis of measurement which incorporates credit losses.

Other observations

Below are some other miscellaneous observations and comments on the Exposure Draft and the Basis for Conclusions Paper.

Exposure Draft Page /Paragraph	Comment
Page 22 / Appendix A	<i>Amortised cost</i> The use of the word “cost” in the term “amortised cost” is confusing to a lay reader. The IASB should consider an alternative term. Moreover, the proposal to include credit losses introduces a new hybrid term.

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Exposure Draft Page /Paragraph	Comment
Page 22 / Appendix A	<p><u>Definition of “non-performing”</u></p> <p>The proposed definition refers to a “financial asset that is more than 90 days past due <u>or is considered uncollectible</u>”.</p> <p>We believe that reference to “uncollectible” is inappropriate as this would mean the asset was in fact a bad debt which would mean that it should be written off.</p> <p>We would suggest that the word “uncollectible” be replaced with “doubtful of collection”.</p>
Page 22 / Appendix A	<p><u>Definition of “write-off”</u></p> <p>We would suggest deletion of the word “direct” as it is inconsistent with paragraph B23 on page 30 of the Basis for Conclusions Paper which states that direct reduction of the carrying amount will be prohibited.</p>
Page 19 / Paragraph 20	<p>We note that disclosures on stress testing will be required but only if stress testing is used for internal management purposes. We believe this will discourage stress testing to be done. We believe that stress testing disclosures recognises the subjectivity of the assumptions and expectations in arriving at the provisions made. As an alternative, we would suggest more qualitative disclosures on the accuracy of the company’s estimation of expected losses including a comparative table of past estimates of impairment allowances and actual usage of the allowances.</p>
Page 28 / B17	<p>This paragraph includes discussion of the use of “practical expedients” and we believe by doing so IASB recognises that its proposals will be operationally costly and difficult to implement.</p>

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Basis for Conclusions Paper Page / Paragraph	Comment
Page 9 / BC 22	<p>We believe that the “through-the-cycle approach”, whereby an entity estimates impairment on a portfolio of financial assets using statistical parameters derived from historical credit loss data that cover a full economic cycle or several economic cycles, is appropriate, simple to apply and will be less costly to implement.</p> <p>To overcome the concerns of the IASB on the “through-the-cycle approach” which we prefer and discuss further below under “An alternative approach”, the provisioning should not be based solely on historical events but should take into account all information known up to the date the financial statements are approved by the board of directors.</p>
Page 9 and 10 / BC 21 and BC 25	<p>We note an inconsistency in IASB’s Basis for Conclusions Paper. Paragraph BC 24 states that through-the-cycle approach was rejected because it would result in recognising an impairment loss on initial recognition of a financial asset. However, in paragraph BC25 in support of IASB’s proposed approach it states that the “<i>an entity would include the initial estimate of expected credit losses for a financial asset in determining the effective interest rate.</i>”</p> <p>We believe that as the effective interest rate is used to determine the initial carrying value of the financial asset; in effect, this means that there has been recognition of impairment on initial recognition.</p>

We believe that the amortised cost method, by use of a subjective effective interest rate in lieu of the actual contracted interest rate, in substance attempts to account for a hypothetical and an alternative choice of return and therefore its adoption is inappropriate. We believe present value calculations are more relevant prior to making decisions on alternative investments but once a decision and a transaction has been made present values of the asset are of less relevance unless the intention is to dispose of the asset. The alternative return may not be received by the entity as a choice has already been made by agreeing to the contracted interest rate. We believe that financial reporting should reflect

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the actual consequences of the choices that have been made and actual returns, and not the consequences of hypothetical alternatives.

An alternative approach

We believe that a more simple, meaningful and less costly approach to accounting for financial assets would be to value them at their contracted values at the date of the transaction. Only in circumstances where at the date of exchange there is no monetary amount specified for the transaction should they be valued at their fair value similar to other non-monetary transactions. Amortised cost should not be adopted. To keep accounting simple, interest should be recognised based on the contracted interest rates applicable for the relevant period. This may be supplemented by disclosures of past and expected future interest rates.

In respect of impairment charges, we believe that taking into account expected losses is appropriate as this is implementation of the prudence concept. However, instead of using the probability-weighted possible outcome approach, a simple model of making provisions for expected losses based on past experience and information available up to the reporting date should be adopted. We recommend a return to what was previously called “general provisions for doubtful debts” but where the general provision would also cover specific provisions for known individual assets for which recovery is considered doubtful. To prevent abuse of using such provisions as a means to manage earnings, the IASB should require disclosures of the impairment rates or percentages used including comparatives for the last 3 years together with qualitative disclosures on how they were determined. If the rates are changed, the facts and circumstances for the change and the financial impact of the change should be disclosed.

We believe an Allowance Account should be disclosed and linked to each class of financial asset showing separately those amounts that relate to “loan principal” and those that relate to “interest” in order to:

- track the development of the losses in loan principal for that class over time;
- provide transparency on the accuracy of management’s estimates; and
- provide information on why loss estimates are changed over time, including information on recoveries.

Credit risk is normally focused on the loss of loan principal rather than interest income. Where recovery of the principal debt is in doubt accruals for interest should cease pursuant to the requirements of IAS 18 and provisions for losses for non collection of previously accrued interest should be made.

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Financial Accounting Standards Board (“FASB”) proposals

We note that the US FASB has recently issued its own exposure draft on financial instruments and more financial assets, including loans, will be measured at fair value. The FASB’s proposed approach is significantly different from the IASB’s approach.

Although the IASB has not proposed fair value measurement for financial assets such as loans, we wish to take the opportunity to comment on fair value measurement as we understand the IASB may adopt it as a basis of measurement for a wider range of financial instruments. Although fair value information is useful, we have concerns on the move to fair value.

We believe the conceptual basis for re-measurement as well as fair value re-measurement gains/losses being recognised in the profit and loss account/ other comprehensive income account, rather than being disclosed needs to be reconsidered. Re-measurements to fair value in substance represent, and have the same effect, as the sale and repurchase of the relevant asset/liability. However, the prescribed accounting treatment of recognising in full the gains/losses arising from fair value re-measurements through profit and loss is different from principles in other current accounting standards. For example, paragraph 14 of IAS 18 requires that for a sale and therefore a gain to be recognised there must not be retention of ownership and control of the relevant asset. However, where fair value re-measurements are made, ownership and control of the relevant asset or liability is retained but a gain/loss is recognised.

A similar principle of non recognition of gains/losses is included in IAS 17. Under IAS 17, in a sale and leaseback, gains or losses on the sale must be deferred as the gain is not earned. Moreover, the rules in IAS 17 on sale and lease backs deal with actual or real sales to an independent third party whereas fair value re-measurement gains/losses arise from hypothetical transactions with hypothetical parties determined unilaterally by the reporting entity.

The issue on fair value re-measurements leads to the fundamental question of what is the meaning of “profit” and how it should be determined. This then leads to additional fundamental conceptual questions of what definition and meaning we should attach to “gains and losses” and how they should be treated. There are conceptual questions of what assets and liabilities should be re-measured and why and how the resulting “holding” gains/ losses should be dealt with either through disclosure or recognition.

We believe accounting standards should provide guidance on how to account for actual transactions made between a company and other parties as this would reflect the company’s true cash and economic inflows and outflows. In contrast, recognising fair value re-measurements through profit and loss, which are based on hypothetical transactions with hypothetical parties facilitates the manipulation of earnings. Re-measurement to fair values represent recognition of unrealised and hypothetical

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gains/losses and do not reflect the business purpose for which the assets and liabilities were acquired or used and therefore the reporting entity's true position. Once fair value information is embedded into a company's accounting system it makes it difficult to determine what are "actual costs", "actual realised profits and losses" and "distributable profits", which are relevant to investors. Incorporating fair value re-measurement impacts on the culture of an enterprise and may unduly influence management to make untimely decisions that may jeopardise its short-term liquidity position and the long-term strategy and prospects of the company.

We hope that the above comments are helpful.

Yours sincerely,
For and on behalf of
The Stock Exchange of Hong Kong Limited



Colin Chau
Senior Vice President
Listing Division

CC/el

c.c. Mr. Mark Dickens – Head of Listing