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

Dear Steve,

FASB Exposure Draft on Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities ("Exposure Draft")

I refer to your letter to our Mr. Mark Dickens dated 8 June 2010 on the above which has been passed to me for my attention.

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

General

The Exposure Draft proposes a comprehensive new model of accounting for financial instruments, including classification and measurement of financial assets and financial liabilities, impairment and hedging. However, we note that the proposals are significantly different from the IFRS requirements and proposals. Page 2 of the Exposure Draft notes that *"Ideally, this proposal would have been issued jointly with the IASB and contain converged guidance. ... However, each Board has faced different imperatives that have resulted in different approaches for accounting for certain types of financial instruments ..."*.

We respect FASB's right to propose a different model for accounting for financial instruments. However, we consider that both the IASB and FASB should have worked more closely together to develop a single converged financial reporting standard so that it could be applied internationally to reduce compliance costs for multinational companies. This would have avoided the need for the production of separate exposure drafts by the IASB and FASB and the resulting need for interested stakeholders to spend time to review both. The comments in this letter are therefore confined to comments on the Exposure Draft on fundamental concepts and principles.

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Fundamental conceptual issue

Under the FASB's proposals, most financial assets and liabilities would be reported at fair value, with changes in fair value being recognised either through net income or other comprehensive income, if certain criteria are met.

However, it is not clear from the Exposure Draft why certain items are recognised in "net income" and others are to be recognised in "other comprehensive income". The purpose of recognising certain items under "other comprehensive income" ("OCI") is not clear, given that both OCI and "net income" items result in a change in the net equity of an entity. The Exposure Draft does not explain the underlying concept and principles that drive the different treatment and we also note that the FASB approach sometimes allows an entity to elect that fair value changes to be recognised in OCI. As discussed in our letter to you dated 20 August 2010 in response to the IASB's exposure draft on "Presentation of Items of Other Comprehensive Income (Proposed amendments to IAS 1)", we raised similar concerns and in particular the need for a conceptual basis for determining why and what type of gains/losses should be included in "net income" vis-a-vis "other comprehensive income". We believe that further detailed discussion on and resolution of this conceptual issue is needed by both FASB and IASB and this should be done before the Exposure Draft is finalised and released as a standard.

Principle-based accounting standards

We believe that the Exposure Draft indicates that the FASB is in substance adopting a "rule-based" rather than a principle-based approach in developing the accounting standard.

The Exposure Draft proposes that an entity would have an option to irrevocably classify a financial instrument as a financial instrument with qualifying changes in fair value recognised in other comprehensive income rather than in "net income" if it meets the criteria as set out in paragraph 21 on page 35 of the Exposure Draft; or subsequently measure a financial liability at amortised cost if it meets the criteria as set out in paragraph 28 on page 38 of the Exposure Draft.

Paragraphs 28 to 34 of the Exposure Draft allows exceptions from subsequent remeasurement at fair value and includes specific measurement guidance for some financial instruments, namely, "core deposit liabilities" will be stated at their "present values", "short-term receivables and payables" will be stated at amortised cost, and "investments that can be redeemed only for a specific amount" will be stated at their redemption values.

We believe that accounting standards should be principle-based. Therefore we consider that FASB should explain the conceptual principle that drives classification and the resulting accounting treatment rather than proposing different measurement guidance depending on whether:-

(a) certain criteria is met;

(b) requiring certain income/expenses and gains/losses on the same financial instrument to be recognised in "net income" but requiring others to be recognised in OCI;

(c) allowing an entity to elect whether fair value changes are to be recognised in OCI.; and

(d) providing for a variety of measurement bases such as fair value, transaction price and present value, amortised cost and redemption values as mentioned above.

In particular, we do not believe that the new remeasurement concept developed for "core deposit liabilities" is conceptually sound and believe that it will not be operational and applied consistently in practice.

Paragraph 31 of the Exposure Draft requires the following and the terms in bold have specifically defined meanings:-

> *"An entity shall measure its **core deposit liabilities** at the present value of the average core deposit amount during the period discounted at the difference between the **alternative funds rate** and the **all-in-cost-to-service rate** over the **implied maturity** of the deposits (the core deposit liabilities remeasurement approach). An entity shall determine that remeasurement amount separately for each major type of demand deposit, such as noninterest-bearing checking, savings, and money market accounts."*

It is unclear what the resulting present value computed for core deposit balances is intended to represent or portray as the <u>difference</u> between the "alternative funds rate" and the "all-in-cost-to-service rate" is used. Moreover, what constitutes "core deposits" is very subjective and can easily be manipulated as these are simply defined as *"deposits without contractual maturity that management <u>considers</u> to be a stable source of funds, which excludes transient and surge balances"*. The "all-in-cost-to-service rate" includes not only interest costs but is defined to include *"the expenses of maintaining a branch network"* and will therefore include both direct and other indirect expenses as the entity deems fit.

In paragraphs BC 123 to BC 127 on pages 143 to 144 of the Exposure Draft, the rationale justifying the proposed different accounting treatment for non-core deposit liabilities (which are to be stated at fair value) and the proposed accounting treatment for core deposit liabilities is made. However, we would comment that the arguments put forth appear inconsistent and illogical. The FASB also admits that the proposed measurement approach for core deposit liabilities would be an exception to its Concepts Statement 7.

Fair value

We believe that the primary focus of financial statements should be to record *"actual transactions"* at their agreed contracted transaction price and subsequent settlements which will reflect the entity's true cash and economic inflows and outflows. In our letter to you dated 7 June 2010 in respect of the IASB exposure draft on "Financial Instruments: Amortised Cost and Impairment", we expressed our concerns on the use of fair value as basis of measurement and the recognition of resulting unrealised gains and losses. Fair value accounting is in substance mark-to-market accounting, that is, hypothetical future value accounting assuming a hypothetical transaction will take place at a hypothetical price with a hypothetical party. We believe that measuring financial assets and liabilities at their fair value has the same effect as the sale and immediate repurchase of the relevant asset/liability and recognising the fair values changes in net income does not result in a true reflection of the actual cash flows and financial performance and position of an entity. Although we agree that information on *"potential unrealised"* gains and losses arising from fair valuing account balances at the year end date (being the value that might be realised if they were sold at that date) is useful, we believe such information is best dealt with through disclosure rather than by recognition.

Amortised cost

In our letter to you dated 7 June 2010 as mentioned above, we expressed our concerns on the use of "amortised cost" as a basis of measurement. Although the FASB also intends to allow the use of "amortised cost" as a measurement basis, we note that its definition is not the same as that adopted by the IASB. In particular, the FASB definition is not linked to the use of the "effective interest method" which we understand is fundamental to the term adopted by the IASB. The effective interest rate is a key element in determining the carrying value of the financial asset or liability at each reporting date.

We also note that the definition of the "effective interest rate" adopted by FASB and how it is computed is also different to that adopted by the IASB.

Reclassifications

Although we understand that the objective is to prevent abuse and manipulation of reported results which may be made by some unethical preparers of financial statements, we consider that disallowing reclassification of financial instruments is unrealistic and would produce undesired effects. An entity may have good and legitimate reasons to change its business strategy or model and hence its intention for its financial assets. This should be reflected in a change in the classification of financial instruments and possibly the measurement method adopted, and appropriate disclosures explaining the reason for the change should be made. If reclassification is not allowed, the continued use of an inappropriate classification and measurement would make financial statements less relevant as they would not reflect the intention and actual use of the financial assets and how they are managed, and well as their related risks.

Presentation of both amortised cost and fair value information on the face of the statement of financial position

The Exposure Draft proposes to require entities to present both fair value and amortised cost information on financial instruments on the face of the statement of financial position. First, this proposal would require preparers of financial statements to maintain details on at least three separate sets of financial information on the relevant financial instruments, that is, original legally contracted transaction terms and actual cost, amortised cost and fair value. This will substantially increase costs to preparers. Second, we are also concerned that presenting both fair value and amortised cost information on the face of financial statements would add complexity and would cause confusion to users of financial statements.

In closing, we believe that the observations of Mr. Malcolm Gladwell, the author of "Blink" and "The Tipping Point", in his latest 2009 book "What the dog saw", are interesting and should be considered in developing future financial reporting standards. The chapter "Open secrets – Enron, intelligence and the perils of too much information" includes thought-provoking views and raises the question – *"Had we taken the lessons of Enron more seriously, would we have had the financial crisis of 2008?"*. We believe that the two key underlying messages are first, the need for a reassessment of mark-to-market accounting and second, how disclosures in financial reports can be made more useful and meaningful to provide a better and clearer understanding of the performance and financial position of companies.

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

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