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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 Fair Value Option for Financial Liabilities ("Exposure Draft")

I refer to your letter dated 8 June 2010 on the above to our Mr. Mark Dickens 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.

We note the IASB's decision to propose limited changes and retain almost all of existing requirements for classifying and measuring financial liabilities as the benefits of the proposed changes are not expected to outweigh the costs. The Exposure Draft sets out proposals on how gains and losses on liabilities designated under the fair value option should be presented in the profit and loss statement ("P&L") or other comprehensive income ("OCI").

<u>Fair value option of a financial liability</u>

We believe the IASB should reconsider the conceptual basis for permitting an entity to elect to re-measure financial liabilities at fair value and also the principles and concepts of including the resulting gains/losses in either the P&L or OCI.

We do not believe that financial liabilities should be re-measured at their fair values after their initial recognition, as the fundamental concept of *"going concern"*, which is used in the preparation of financial statements, assumes that the entity will continue in operation in the foreseeable future which means that it will honor its legal obligations and pay contractual amounts when due. The Exposure Draft recognises this in paragraph BC39 which states that *"..... if the entity repays the contractual amount, the cumulative effect over the life of the instrument of any changes in the liability's credit risk will net to zero because its fair value will equal the contractual amount"*.

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As explained in our letter to you dated 31 March 2010, we believe that liabilities are *"present obligations"*, that is, a liability only arises when there is an agreement between the two contracting parties on the amount due. Once agreed, a liability or the amount payable by an entity cannot be unilaterally altered without the agreement of the other party.

We believe that re-measurement of liabilities does not provide useful information and in fact results in the production of misleading information. Therefore, we urge the IASB to reconsider the conceptual principle for fair value re-measurement of liabilities including the eligibility conditions for designation of financial liabilities at fair value through P&L.

We are not convinced by the argument of accounting mismatch of assets and liabilities to support re-measurement of liabilities and in particular, those that relate to the entity's own credit risk. We consider that a change in the credit risk of an entity's liabilities does not justify re-measurement of the liability to mirror adjustments made for credit risk in measuring the carrying value of holders of such assets.

We believe that the primary focus of financial statements should be to record *"actual transactions"*, which reflect the entity's true cash and economic inflows and outflows. To recognise fair values changes for liabilities, including changes in an entity's own credit risk, is misleading and does not result in the true reflection of the financial performance and position of the entity. The recognition of a gain from a decline in the credit quality of an entity's own liabilities is counter-intuitive and unrealistic. Recognition of a gain would only represent the true picture if, and only if, the entity is not obliged to settle its obligation in full when it falls due. In any event, the gain should not be recognised until the creditor has agreed to waive his right to receive payment and not based solely on a unilateral decision made by the reporting entity.

The issue on fair value re-measurement of liabilities 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. We agree that information on *"unrealised"* holding gains and losses from fair value changes may be useful. However we believe such information is best dealt with through disclosure rather than by recognition.

Presenting the effects of changes in an entity's credit risk in OCI

We understand the Exposure Draft proposes a *"two-step approach"* in recognising the effects of changes in its liabilities due to changes to its own credit risk. As a first step, it is proposed that an entity is required to present the *"full"* change in fair value in P&L for financial liabilities designated at fair value through P&L. In the second step, the *"portion"* relating to changes in an entity's own credit risk would be deducted and separately presented in OCI. We believe the proposed approach lacks simplicity in conveying relevant information and instead adds complexity. We believe it raises a legitimate question of what in fact is the accounting policy adopted for accounting for financial liabilities – Is it to P&L or only <u>partially</u> to P&L? We believe the proposed approach suggested by the Exposure Draft is the latter which creates a hybrid that is both confusing and misleading. We believe financial reporting standards should be principle-based and the current proposal is not.

Another fundamental conceptual issue arising from the Exposure Draft is *"which"* items should be presented in the OCI rather than the P&L. We understand the IASB has recently issued an exposure draft on *"Presentation of Items of Other Comprehensive Income"* which appears to recognise the need to improve consistency of what and where items should be presented in the income statement. We therefore believe it is premature to proceed with the proposed change in the Exposure Draft before the exposure draft on *"Presentation of Items of Other Comprehensive Income"* is also fully considered.

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