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

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.iasb.org)

14 September 2009

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

Dear Sirs,

IASB Exposure Draft on *Financial Instruments: Classification and Measurement*

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 Exposure Draft. Our responses to the questions raised in your Exposure Draft are set out in the Appendix for your consideration.

We welcome the IASB giving priority to the project of improving financial reporting for financial instruments in response to the recent recommendations made by the G20 and the Financial Stability Forum. Current guidance under IFRS is considered to be complex because it contains a number of rules and exceptions to the underlying principles. We believe that in the long-term the best way to achieve simplification of IAS 39 is to develop financial instruments standards that are more principles-based.

Mixed Measurement Model

We agree with the Exposure Draft that a mixed measurement model should be retained as we agree that some instruments are best measured at amortised cost, in accordance with the way that the business is managed, and others that should be measured at fair value. We agree with the broad thrust of the IASB's proposals that the business model employed by a reporting entity should determine whether particular instruments are eligible to be measured at amortised cost. We also agree that it is important for instruments that will be measured at amortised cost to have basic loan features. However, we have concerns that the principles underpinning these two criteria in the Exposure Draft are not defined with sufficient clarity to produce consistent application in practice. We are also concerned about the examples of instruments ineligible for amortised cost measurement in B8 regarding subordinated interests, and B13(b) regarding assets acquired at a discount that reflects incurred credit losses. We do not believe that these examples are consistent with the underlying principles.

In addition, we have the following concerns regarding the Exposure Draft:

- We do not agree with the proposals for prohibiting reclassification of financial instruments after initial recognition. We suggest that reclassification should be permitted in the circumstance of a change in business model with adequate disclosure by the entity giving reasons for the change.

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- We consider that the IASB should retain a reliability-based exemption as provided under current IAS 39 by allowing certain unquoted equity investments (and all derivatives on such instruments) to be stated at a cost-based measurement.

- We agree with the proposal of providing a presentation choice for investments in equity instruments that are not held for trading to present fair value changes in other comprehensive income (OCI). However, we do not support the inclusion of dividend income in OCI. An accounting mismatch will result if the investment is funded by debt financing on which the related interest expense would be charged against profit or loss.

Convergence of US accounting standards

The Exposure Draft reiterates the IASB's commitment to working jointly with the FASB to develop a comprehensive standard on financial instruments. As noted, the FASB and the IASB are at different stages in developing proposals on this issue. We therefore urge the IASB to continue to work with the FASB and consider the implications for its own standard based on comments received at the joint round tables and in respect of the FASB's exposure draft.

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

Yours faithfully,

Steve Ong

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SO/WC/ac

Encl.

Hong Kong Institute of CPAs

Comments on the IASB Exposure Draft on *Financial Instruments: Classification and Measurement*

<u>Question 1</u>

Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

We agree that amortised cost provides decision-useful information for a financial asset or financial liability that has basic loan features and is held predominantly for the collection or payment of contractual cash flows, as this best reflects the entity's business model. As noted in our response to Question 2, we believe that there is a need for greater clarity in the development of these criteria.

<u>Question 2</u>

Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a contractual yield basis'? If not, why? What additional guidance would you propose and why?

We are concerned that the guidance the ED proposes is not sufficiently robust enough to produce consistent and meaningful results in practice. There is no clearly-defined principle regarding what constitutes a basic loan feature, nor is the term "managed on a contractual yield basis" commonly-used or well understood. Furthermore, as set out in more detail below, we believe that certain of the examples provided in Appendix B are inconsistent with our understanding of the proposed criteria.

Basic loan features

- We generally agree that an instrument has "basic loan features" if its contractual cash flows represent principal and interest on that principal, where interest is compensation for the time value of money and credit risk, and is not leveraged.

- The Basis for Conclusions indicates that "leverage" would not be a basic loan feature as it amplifies the variability of cash flows. However, the principle of "leverage" is not clearly defined in the proposed standard. Guidance should be provided on how to differentiate whether the contractual cash flows are leveraged.

- The ED does not intend entities to look through structured entities when applying the basic loan features test. Although we recognize that it is a rather simple approach to apply, we are concerned that it might provide structuring opportunities for special purpose vehicles to create instruments with basic loan features out of instruments that do not have such features (e.g. due to leverage of credit risk) that the basic loan features test might not be able to fulfill its objective.

- Under the proposal an entity is required to consider the effects of subordination on the cash flows of the instrument as certain types of subordination are not considered to be basic loan features. Our concerns at this proposal are set out in more detail in our response to Question 4.

Managed on a contractual yield basis

- We agree that the primary driver for the classification of financial instruments should be the entity's business model. However, we do not believe that the term "managed on a contractual yield basis" is commonly-used or well understood.

- In particular, certain financial instruments are not "managed", but instead are held for the collection of cash flows (e.g. those assets held to maturity), or the payment of cash flows (e.g. borrowings). Accordingly, we do not believe that 'management' on a contractual yield basis is a necessary condition. Instead, we believe that the business model could be better considered in light of an assessment of whether the financial instrument is "held predominantly for the collection or payment of contractual cash flows".

- Paragraph B13(b) states that an example of a financial asset that is not managed on a contractual yield basis is a financial asset that is acquired at a discount that reflects incurred credit losses. We have concerns about the reasoning given in BC 29. We are not convinced that the incurrence of credit losses changes the nature of an instrument's features. We believe that an assessment of the acquirer's business model should be sufficient in determining whether or not the instrument is being acquired for the collection of contractual cash flows through active credit management, and hence whether the use of amortised cost is appropriate. We therefore recommend that the Board delete both paragraph B13(b) as well as BC 29 in the final standard.

<u>Question 3</u>

Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost? If so,

(a) what alternative conditions would you propose? Why are those conditions more appropriate?

(b) if additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in information that is more decision-useful than measurement at fair value?

(c) if financial assets or financial liabilities that the exposure draft would measure at amortised cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?

Broadly speaking, we agree with the two proposed criteria except for some concerns about the detail as noted in Question 2.

Question 4

(a) Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

(b) Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (ie tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision-usefulness of information about contractually subordinated interests?

(a) We share the IASB's comments in the ED that the existing embedded derivative requirements are rule based and are complex to implement and agree that the proposal to eliminate bifurcation and require hybrid instruments to be assessed together for classification purposes can simplify the accounting requirements. However, we are concerned that under the proposal, more financial instruments will be required to be measured at fair value through profit and loss (e.g. an equity-linked note). It is not always easy to determine fair values of financial instruments when no market-based information is available. In addition, on the basis of the current thinking on fair value measurement, fair valuing an entity's own financial liability brings about volatility as a result of changes in the entity's own credit risk. In other words, own credit risk having a much greater impact on the numbers in the primary statement if more financial liabilities have to be fair valued. We recognize that the IASB has recently issued another discussion paper *Credit Risk in Liability Measurement* where we have expressed our view that we disagree with including credit risk in measuring many liabilities that the entity intends to settle on a contractual cash flow basis, instead preferring a current measurement model that excludes changes in the price of own credit.

(b) We do not support the proposals, which are rule-based rather than being derived from a robust definition of a basic loan feature. Furthermore, we believe that amortised cost is likely to be a more appropriate measure for many subordinated tranches that are held predominantly for the collection of contractual cash flows.

We acknowledge that it is a difficult task in determining when to "look through" structured investment vehicles, but believe that the Board should explore using a more precise definition of leverage to establish a principle regarding the credit quality of the underlying assets when determining the classification of investments in waterfall structures.

Question 5

Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch?
If not, why?

We agree that entities should continue to be permitted to designate any financial asset or financial liability within the scope of financial instruments standard at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch.

Question 6

Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

No. We believe that the proposed fair value option is sufficient.

Question 7

Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

We do not support the proposed prohibition on reclassification. In our view, an instrument should be reclassified if it no longer meets the criteria for its current classification. We believe that when there is a change in the entity's business model, such that a portfolio that was previously being held predominantly for the collection or payment of contractual cash flows is no longer so held (or vice versa), reclassification should be required. That will ensure that the items that are measured at amortised cost are those that met the criteria for the amortised cost category at the time the financial statements were prepared. We recognize that the Board may be concerned about abuse, but do not believe that would be the case as changes in business model should be infrequent. Comprehensive disclosures accompanied with any reclassification can enhance transparency and understandability of financial statements.

Questions 8 and 9

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

Whilst we agree that fair value is the most appropriate measurement for all equity investments, we are concerned that the proposal to remove the exemption from fair value for instruments that are not reliably measurable will result in practical difficulties for emerging economies, where the valuation profession is not as widely developed, as well as those circumstances in which the reporting entity cannot obtain sufficient information to input into a valuation model. For example, certain strategic or relationship-driven investments entered into in our region (including China) may be made with minimal quantitative information at the time of investment or subsequently which would establish the fair value of the equity investment. We therefore believe that the IASB should retain a reliability-based exemption as provided under current IAS 39 by allowing certain unquoted equity investments (and all derivatives on such instruments) to be stated at a cost-based measurement.

Where the fair value of an equity instrument cannot be reliably measured, there may also be difficulty in measuring any impairment loss. Accordingly, we recommend that the entity should be required to perform an annual review for impairment indicators; where such an indicator is identified the instrument should be written down to the lowest value in the range of values identified for the instrument, which in the absence of quantitative information for the instrument may be zero.

Question 10

Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

We support the basic premise of the proposal of providing a presentation choice for investments in equity instruments to present fair value changes in other comprehensive income (OCI). However, we do not support the inclusion of dividend income in OCI. The major reason is that entities which invest in equity instruments for long term or strategic purposes may desire to capture dividend income as a return on the investment to match the associated funding costs. An accounting mismatch will result if the investment is funded by debt financing on which the related interest expense would be charged against profit or loss.

<u>Question 11</u>

Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not,

(a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?

(b) should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

We agree with the proposal to make the presentation choice available for all equity investment other than those that are held for trading. We believe that the proposal is more principles-based and can avoid the need to define what "strategic investments" are. We also agree that this election should only be available on initial recognition.

<u>Question 12</u>

Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

While agreeing conceptually with the additional disclosure requirements, we recommend the Board to take due consideration into whether the Board intends to encourage or discourage early adoption. The proposed disclosure requirements, while sound logical conceptually, can be unduly burdensome in practice. We are not sure whether the disclosure would serve to offer great value to users of financial statements because it would not reflect the business model and classification decisions at the time of transition.

<u>Question 13</u>

Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

We agree in principle with applying the proposals retrospectively. However, we recognize that retrospectively application would in many cases inevitably involve the use of hindsight which might not reflect the decisions made at the time, thereby hindering the decision-usefulness of the restated comparatives. We consider that an approach similar to that set out in IFRS 1 would be more appropriate. We also recommend that the IASB should clearly define what is meant by "date of initial application" in the final standard.

Question 14

Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortised cost, specifically:

(a) in the statement of financial position?

(b) in the statement of comprehensive income?

If so, why?

We do not believe that the alternative approach provides more decision useful information than the approach proposed in the ED. In our view the amortised cost category under the alternative approach would be too narrow. While this would result in more financial instruments being measured at fair value, this would not necessarily mean the information provided would be more decision-useful if the instruments were not managed on this basis.

Question 15

Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

We do not believe that either of the possible variants of the alternative approach provides more decision-useful information as they would add complexity to the proposed model in the ED. In particular, we are not in favour of the introduction of a full fair value measurement model for financial instruments. As noted in our cover letter, we support the use of a mixed measurement model for reporting of financial instruments.