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.ifrs.org)

19 April 2013

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

Dear Sirs,

IASB Exposure Draft of *Classification and Measurement: Limited Amendments to IFRS 9*

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 this Exposure Draft (ED). Our responses to the questions raised in your Invitation to Comment are set out in the Appendix for your consideration.

We welcome the IASB's decision to broaden the notion of what is "solely payments of principal and interest on principal". However, we consider that the drafting of the proposed standard in this area may not be sufficiently robust. The meaning of the term "insignificantly different" is not clear. The difference between the application of "immaterial" and "insignificantly different" cannot be found in the ED. In addition, the proposals remain unclear as to what "benchmark" means, for example, in a regulated market where the interest rate of a local currency floating rate interest loan is reset based on the original tenor rather than the remaining term of the loan as dictated by the regulator. In such circumstances where a benchmark instrument is not available in the market, it would only be possible to try to compare the actual instrument to a hypothetical instrument, which by definition does not exist and may not even be legally possible in the relevant jurisdiction. We believe that such a comparison is neither a valid basis on which to classify the instrument nor one which will result in consistent application in practice and across jurisdictions.

Though we have concerns that the extension of the use of the OCI category brings further complexity into the standard when one of the aims of the IAS 39 replacement project was to reduce complexity in relation to the financial reporting for financial instruments, on balance we can see the reason for the proposal to introduce a mandatory FVOCI measurement category for debt investments that are held within a business model in which assets are managed both to collect contractual cash flows and for sale (subject to the contractual cash flow characteristics assessment). However, we are concerned that a) the determination of the appropriate business model could involve a high degree of subjectivity and b) the proposed amendments have not articulated well the dividing lines between the different types of measurement categories (i.e. the dividing line between FVOCI, FVTPL and amortised cost, and which measurement category would be considered as a "default" category). In particular, we found the notion of "managed both in order to collect contractual cash flows ***and*** to sell" is unclear (despite of the illustrative examples provided in the ED). Should the IASB decide to

proceed with this proposal, we believe that the IASB should develop more robust principles and application guidance to differentiate the different types of business models and measurement categories.

In addition, we believe the Board should consider introducing a practical exception for equity investments without readily determinable fair values to be measured at cost less impairment adjusted for observable market transactions, with changes to cost being recognised in profit or loss or in OCI if the unquoted equities are designated as FVOCI. This exception is based on that proposed in the FASB classification and measurement ED. Whilst we believe that in many cases the fair value of such instruments can be determined reliably using well-developed models, we acknowledge that entities in developing countries continue to encounter challenges in determining fair value. For this reason, we support relief from having to measure fair value in limited cases where fair value is not readily determinable.

Finally, we believe that the IASB should carefully consider the interaction of the proposals with the other phases of IFRS 9 which are yet to be completed, that is, hedge accounting and impairment, to prevent any unintended consequences arising from introducing a mandatory FVOCI category.

If you have any questions regarding the matters raised in our submission, please contact Winnie Chan, our Manager of Standard Setting at winniechan@hkicpa.org.hk.

Yours faithfully,

Simon Riley
Director, Standard Setting

SR/WC

Encl.

Comments on IASB Exposure Draft of Classification and Measurement: Limited Amendments to IFRS 9

Contractual cash flows – modified economic relationship

Question 1

Do you agree that a financial asset with a modified economic relationship between principal and consideration for the time value of money and the credit risk could be considered, for the purposes of IFRS 9, to contain cash flows that are solely payments of principal and interest? Do you agree that this should be the case if, and only if, the contractual cash flows could not be more than insignificantly different from the benchmark cash flows? If not, why and what would you propose instead?

Question 2

Do you believe that this Exposure Draft proposes sufficient, operational application guidance on assessing a modified economic relationship? If not, why? What additional guidance would you propose and why?

Question 3

Do you believe that this proposed amendment to IFRS 9 will achieve the IASB's objective of clarifying the application of the contractual cash flow characteristics assessment to financial assets that contain interest rate mismatch features? Will it result in more appropriate identification of financial assets with contractual cash flows that should be considered solely payments of principal and interest? If not, why and what would you propose instead?

Responses to Q1 to Q3.

We support the Board's objective to clarify that those financial assets with a modified economic relationship between principal and interest may still represent cash flows that are solely payments of principal and interest (SPPI). However, we are concerned that the proposed guidance is not sufficiently clear and does not cover all situations where we believe instruments contain cash flows that are solely payments of principal and interest and hence will potentially lead to divergence in practice.

We recommend that the principle for making the assessment should be more clearly stated. We believe the phase "more than insignificantly different" is inherently complex and lacking in meaning. It is difficult to understand the difference between the application of "immaterial" and "insignificantly different". We suggest that the threshold should be that a modification does not materially alter the nature of the payments when taken as a whole as the sum of principal and interest. The purpose of the assessment is to determine the correct classification and measurement of a financial asset in its entirety. It would not be meaningful to classify and measure one financial instrument at amortized cost while another similar financial instrument is measured at fair value due solely to cash flow streams that, for one instrument, may not meet a narrow theoretical

definition of interest, particularly when the cash flow stream in question would not otherwise meet the definition of a derivative.

We also recommend that the IASB should apply a more principle-based approach to the notion of interest. The ED defines interest as consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time. We believe that this definition is too narrow and does not reflect other components of interest that represent compensation for liquidity risk. We believe the definition should be revised to clarify whether it includes other components that are inherent in any theoretical definition of interest and to state explicitly in the body of the standard that liquidity risk is one of those components. We note that paragraph BC4.22 in IFRS 9 (2010) acknowledges a broader interpretation of the definition of interest and indicates that credit risk may include a premium for liquidity risk.

In addition, we acknowledge by our constituents of their concerns that the modified economic relationship test may be problematic for instruments in jurisdictions where the mechanism of resetting the interest rate is the same for all instruments regardless of the remaining maturity of the instrument. Specifically, we understand that the contractual interest rates on retail and corporate loans denominated in local currency in the Mainland China are reset according to the original maturity of the loans when the official interest rates regulated by the central bank are reset. For example, a 3-year loan with a remaining maturity of 1-year will re-price to the new 3-year rate. While there is an interest rate mismatch feature based on the principles in the ED, the contractual cash flows of the loan are economically solely payments of principal and interest and the cash flows do not have the element of leverage.

We believe that the IASB should clarify in the standard whether its intention is that such regulated constant maturity loans should be measured at amortised cost. Under the current proposal, these constant maturity loans may not pass the contractual cash flow characteristic assessment, as the use of a market-oriented benchmark interest rates may result in a conclusion of "more than insignificant difference in cash flows". For example, interest rates are generally higher for loans with longer tenor (e.g. three years) compared to those with a shorter tenor (e.g. one year). Accordingly, the difference in contractual cash flows of a three-year loan with a remaining one-year maturity may be considered as more than insignificant.

With regard to the proposed benchmark test, we have significant concerns on how to determine the appropriate benchmark for regulated assets: especially in cases where a benchmark instrument does not exist and as a result a hypothetical benchmark instrument might have to be created. For example, an instrument originated in Mainland China with a 5-year maturity that resets from time to time to a 5-year rate (mandated by regulation) must be compared against a "benchmark" rate. Since there is no appropriate benchmark or unmodified rate to use from a comparable instrument that does not contain the modification (as all other instruments of these types in the jurisdiction are reset in the same manner), a hypothetical instrument with an interest reset period of 6 months is devised. However, the implementation issue concerns the appropriate interest rate – whether, for example, it is a rate on the same yield curve that the actual lending rate is derived from, or an inter bank lending rate. In this case, the actual instrument reflects a People's Bank of China (PBOC) rate that is an interest rate published by the PBOC specifically for consumer and commercial lending. SHIBOR (Shanghai Inter-Bank Offered Rates) are rates on inter-bank market and bond markets that act as a reference for short term rates (less than 3 months but not beyond 3

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

months). The SHIBOR-6M rate is also available and could be used as a hypothetical "benchmark" rate; however, in practice the SHIBOR has a limited liquidity for more than 3-month funding and therefore it would be inappropriate to use as an unmodified rate. Whether the 6-month PBOC or SHIBOR rate is used, the resulting hypothetical instrument would likely bear no resemblance to any instrument that is actually available in the market.

If the Board proceeds with this approach, there is the very real possibility that the classification and measurement of financial assets will simply be differentiated among reporting entities by the geographical location of the originator of the financial asset rather than any real difference in the nature of the underlying cash flows. Potentially local currency retail and corporate loans in Mainland China with a vanilla lending business model would be measured at fair value through profit or loss under the ED.

We believe that the IASB should justify why the proposals, if they result in debt instruments issued in a regulated environment (that is held within a business model whose business objective is merely to collect the contractual cash flows) being required to be measured at fair value, would provide more useful information to users of financial statements.

We suggest that benchmark cash flows should be determined using the benchmark interest rate in the originating jurisdiction. We agree with the suggestion in the IASB Staff Paper that would allow a scope exception to permit classification of a financial asset at other than fair value through profit or loss (subject to business model) if the base interest rate is consistent with and required by a stated interest rate structure that is set by the government or central bank and that represents the legal pricing basis for domestic currency transactions available in the jurisdiction.

Finally, we suggest that the scope of modified economic relationship test should not be limited to instruments with leverage and interest rate features. We believe the board should also provide clarity around whether financial assets acquired at a discount or premium that include a prepayment option can meet the SPPI criteria, since the amount funded may be different than the contractual amount to be repaid. For example, financial assets that have an embedded prepayment option are frequently purchased on the secondary market at premiums or discounts to face value. In some cases, the premium or discount reflects the interest rate and credit environments at the date of purchase, not necessarily anticipated compensation for the early termination of a contract, therefore the instrument should not be in conflict with the SPPI test.

Business model for fair value through other comprehensive income (FVOCI)

Question 4

Do you agree that financial assets that are held within a business model in which assets are managed both in order to collect contractual cash flows and for sale should be required to be measured at fair value through OCI (subject to the contractual cash flow characteristics assessment) such that:

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

a) **interest revenue, credit impairment and any gain or loss on derecognition are recognised in profit or loss in the same manner as for financial assets measured at amortised cost;**

b) **and all other gains and losses are recognised in OCI? If not, why? What do you propose instead and why?**

If not, why? What do you propose instead and why?

Question 5

Do you believe that the Exposure Draft proposes sufficient, operational application guidance on how to distinguish between the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the guidance provided to describe those business models? If not, why? What additional guidance would you propose and why?

Responses to Q4 to Q5.

On balance we can see the reason to have a proposal to introduce a mandatory FVOCI measurement category for financial assets that are held within a business model in which assets are managed both in order to collect contractual cash flows and for sale (subject to the contractual cash flow characteristics assessment) though some constituents are concerned that the IASB's original aim of simplifying financial instrument accounting is being undermined by the proposals.

We have received feedback from constituents suggesting that having only two measurement categories, that is, amortised cost and fair value through profit or loss (FVPL), for debt assets is too limiting. Introducing the FVOCI category would address some of the concerns about the amortised cost category being too narrow and FVPL not being the most useful category for some financial assets, particularly where entities hold some financial assets in a portfolio either to collect contractual cash flows and/or to sell and realise fair value changes. In addition, we believe that it would address some of the concerns raised by insurers when considered in conjunction with the IASB's tentative decision to present in OCI the changes in insurance liabilities arising from changes in the discount rate. However, we share the dissenting view of the IASB members that some accounting mismatches would still remain because not all the financial assets backing insurance liabilities would be measured at FVOCI and the expected duration of insurance contracts and financial assets do not coincide. We recommend that the IASB clarify whether insurers would qualify for the "accounting mismatch" and be eligible to use the fair value option for both financial assets that would otherwise be mandatorily measured at FVOCI and insurance liabilities (in their entirety).

Some of our constituents expressed concerns about the lack of a conceptual rationale for (1) allowing the cumulative gain or loss previously recognised in OCI to be recycled to profit or loss on derecognition of debt assets measured at FVOCI under the proposal as compared with (2) prohibiting the recycling of amounts previously recognised in OCI to profit or loss on derecognition for equity instruments designated at FVOCI in the current IFRS 9. We recommend the IASB provide a clear rationale on such different accounting treatments when the standard is finalised.

Furthermore, we are concerned that the determination of the appropriate business model would involve a high degree of judgement and subjectivity. We recommend that should the IASB proceed with this proposal, more robust application guidance on identifying the appropriate business model should be provided in the standard. The notion of "managed both in order to collect contractual cash flows and to sell" is unclear even though examples have been provided in the ED. This could lead to diversity in practice. For example, there is no clear way in the ED to distinguish between managing assets with the objective of maximising total return (which is mentioned in the ED as a "hold to collect and for sale" business model) and managing assets on a fair value basis. (Please refer to our further comments on the illustrative examples in the ED in our response in "other comments" below.)

In addition, under the ED, when an entity reclassifies a financial asset out of the fair value through profit or loss measurement category, the new carrying amount of the financial asset would be its fair value at the reclassification date. The effective interest rate is determined based on that carrying amount. However, when an entity reclassifies a financial asset out of the fair value through other comprehensive income measurement category, because the cumulative gain or loss previously recognised in other comprehensive income is removed from equity and adjusted against the fair value of the financial asset at the reclassification date according to paragraph 5.6.5, the new carrying amount of the financial asset at reclassification date would be its amortised cost as if it was measured at amortised cost initially. There is no change in effective interest rate as a result of the reclassification.

In order to eliminate this discrepancy so that fair value for an asset previously measured at fair value on the balance sheet becomes the new amortized cost basis regardless of the prior measurement category, we suggest that the existing approach under IAS 39 for assets reclassified from AFS to loans and receivables be adopted. This would require that fair value become the new amortized cost basis, with any difference fair value and the maturity amount recognized as an adjustment to EIR. Gains and losses previously recognized in OCI would not be reclassified but would be amortized to profit or loss on an EIR basis.

Question 6

Do you agree that the existing fair value option in IFRS 9 should be extended to financial assets that would otherwise be mandatorily measured at fair value through OCI? If not, why and what would you propose instead?

We support allowing a fair value option for financial assets that would otherwise be mandatorily measured at fair value through OCI. This is consistent with the existing option under IFRS 9 for financial assets carried at amortized cost.

Early application

Question 7

Do you agree that an entity that chooses to early apply IFRS 9 after the completed version of IFRS 9 is issued should be required to apply the completed version of IFRS 9 (ie including all chapters)? If not, why? Do you believe that the proposed

six-month period between the issuance of the completed version of IFRS 9 and when the prohibition on newly applying previous versions of IFRS 9 becomes effective is sufficient? If not, what would be an appropriate period and why?

In the interest of maintaining comparability between entities, we agree with the proposal in the ED that after IFRS 9 is finalised, an entity early applying IFRS 9 should be required to apply IFRS 9 in its entirety. We consider the six-month transition period proposed by the ED appears reasonable.

For some entities, such as insurance ones, reflecting the economic linkage between assets and liabilities is fundamental to how the business is managed, as well as analysed by users. On application of the final insurance contracts standard, it is highly likely that the linkage between the assets and liabilities, which is so intertwined, will need to be revised As it appears that there will be a lag between the effective date of IFRS 9 and the application date of the insurance contracts standard, we suggest that entities that issue insurance contracts should be given a second opportunity to revisit the decisions on adoption of IFRS 9 when they subsequently apply the final insurance contracts standard. This will allow for a more holistic view of how the entity issuing insurance contracts manages it business and provide enhanced information to users of the financial statements.

Question 8

Do you agree that entities should be permitted to choose to early apply only the "own credit" provisions in IFRS 9 once the completed version of IFRS 9 is issued? If not, why and what do you propose instead?

We agree that entities should be permitted to choose to early apply only the "own credit" provisions in IFRS 9 before the completed version of IFRS 9 is issued. We recommend the Board consider the most expeditious way for entities to adopt these provisions. For example, the board may consider amending IAS 39 to reflect the own credit risk provisioning of IFRS 9 with a mandatory effective date within 12 months of amendment. This would have the effect of immediately addressing an issue for which there is wide agreement.

Question 9

Do you believe there are considerations unique to first-time adopters that the IASB should consider for the transition to IFRS 9? If so, what are those considerations?

An entity may be required to transition to IFRS after the six-month window (referred to in question 7) has lapsed but before the standard is effective. This may not give its management sufficient time to prepare comparatives under IFRS 9. In addition, its management would not want to adopt IAS 39 knowing it will be subsequently changing to IFRS 9 shortly thereafter. IFRS 9 currently provides relief from restating comparatives for early adopters depending on the date of adoption before the effective date. Given amendments to the effective date are being proposed, we believe the relief from presenting comparatives should be carried forward to the new effective date.

Other comments:

1. Para 4.1.4 - the last sentence of this para states "However, an entity may make an irrevocable election for particular financial assets in this measurement category to present in other comprehensive income subsequent changes in fair value (refer to paragraph 5.7.5)". We believe this sentence is not only cumbersome but it is also unclear. We observe that at the first sentence of paragraph 4.1.4, three measurement categories (i.e. FVPL, amortised cost and FVOCI) are being mentioned; it is uncertain as to which measurement category the term "this measurement category" in the last sentence is intended to refer to. In addition there is a reference to "particular financial assets" when in fact we believe this reference is appropriately made to "equity instruments", which relates to para 5.7.5. This sentence might be more understandable if it amended to "However, an entity may make an irrevocable election in accordance with paragraph 5.75 to present subsequent changes in fair value of equity instruments in other comprehensive income".

2. It is noted that a double negative form of expression is sometimes being used in the ED, for example, in para B4.1.9D, line 6, the double negative form is used "... a semi-annual rate is not more than insignificant, ...". We are concerned that double negatives might reduce the understandability of the requirement and hence lead to diversity in practice. We recommend that a positive form of the expression should always be used such as in para B4.1.9C "..... could result in cash flows that are more than insignificantly different ....".. Otherwise the double negative could be interpreted as meaning "significantly different", which we believe is not the intention of the IASB.

3. Example 1 under para B4.1.4B (page 22) – The nature of the financial asset(s) is not specified in this example, and it is not clear why they meet the conditions in para 4.1.2A and qualify for the new "hold to collect and to sell" category. Secondly, a reference is made to the objective of the business model being "to maximise the return". We are unclear as to the difference between "maximising the return" and "maximising the cash flows", as referred to in para B4.1.5, when illustrating an example of financial assets measured in FVPL. The distinction may be key to the determination as to whether the asset is in FVOCI or FVPL.

4. Example 1 under para B4.1.5 – The example describes a switching strategy where an entity invests excess cash in financial assets in order to fund capital expenditure when the need arises. We are unsure as to whether there should be any change in the classification of the financial asset if the entity decides not to re-invest. It is not clear what is the main driver for the conclusion that such a portfolio fails the amortized cost criteria: whether it is the contemplation to sell or the level of sales the entity is considering to reach.

~ **End** ~