



Our Ref.: C/FRSC

Sent by email (ajvaneperen@fasb.org)

3 April 2009

Financial Crisis Advisory Group
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

[Financial Crisis Advisory Group – Input from Constituents](#)

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 note your request for comment from constituents published on 10 March 2009 and our responses to the questions are set out in the Appendix for your consideration.

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

Yours faithfully,

Steve Ong, FCA, FCPA
Director, Standard Setting Department

SOMC/ac



Hong Kong Institute of CPAs

Question 1

From your perspective, where has general purpose financial reporting helped identify issues of concern during the financial crisis? Where has it not helped, or even possibly created unnecessary concerns? Please be as specific as possible in your answers.

We believe that the application of fair value accounting has been instrumental in identifying issues of concern during the financial crisis. The financial crisis was precipitated by a rapid deterioration in the sub-prime mortgage market, leading to declining values on structured investments. The use of fair values brought transparency of these declines to investors, and hence enhanced focus on deteriorating economics, more quickly than would have been the case under a cost-based model. If fair values had not been reported, management and counterparties to transactions would have known the real values, but investors would have been unaware of the decline. In addition, we believe that the need to consider impairment provisions and the disclosures relating to management judgement and risk analysis has helped.

The current financial crisis has brought to light difficulties in applying fair value in illiquid markets, leading to questions over whether the application of fair value should be amended. While we are pleased that the IASB will shortly be issuing an ED of a proposed standard on Fair Value Measurement guidance, we believe that apart from establishing a framework for *how* fair value is measured, the above questions will require the IASB to also address the question of *when* fair value should be adopted as the appropriate measurement attribute for any given asset or liability. We also note that the IASB recently enhanced its guidance on the use of fair values in illiquid markets; we believe that this should be given authoritative status.

Hong Kong is relatively unique in that we have a very large retail investor base who find the length of detail in general purpose financial statements somewhat lengthy and difficult to understand. This has raised concern that the fundamental warning signs are not spelt out clearly enough in the current format of disclosures.

Another concern has been that the inconsistent treatment of impairment losses (or rather the inconsistency in when we can reverse them) may have led certain preparers to defer recognizing such losses sufficiently early as impairment charges. Having such a mix of tests creates application and interpretation problems for both preparers and users.



Question 2

If prudential regulators were to require 'through-the-cycle' or 'dynamic' loan provisions that differ from the current IFRS or US GAAP requirements, how should general purpose financial statements best reflect the difference: (1) recognition in profit or loss (earnings); (2) recognition in other comprehensive income; (3) appropriation of equity outside of comprehensive income; (4) footnote disclosure only; (5) some other means; or (6) not at all? Please explain how your answer would promote transparency for investors and other resource providers.

Regulatory reporting and general purpose financial reporting have different objectives. Regulators are concerned about financial stability which results in the incentive to keep the necessary capital within the financial institutions whereas accounting standard setters stress the importance of the information in general purpose financial statements, prepared for the benefit of investors, being neutral, that is, free from bias.

If regulators allow entities to set up a dynamic provision for regulatory purposes, we would not support approaches (1) or (2) i.e. recognizing the dynamic provision in profit or loss or in other comprehensive income as they are not consistent with the objectives of general purpose financial reporting. We are of the view that transparency of the financial performance is the key objective of financial reporting. Dynamic provisioning would fly in the face of transparency and make it unclear to the user what provisions were being made by a company in its financial statements, when and why. Indeed, 'through the cycle' provisions are calculated using a formula, yet there is no universally-agreed formula that can be applied consistently. If the formula is established by individual regulators, it would be difficult to compare banks subject to different regulators.

Moreover, from a conceptual perspective, average loan maturities are shorter than economic cycles, and hence it is probable that provisions established in the growth part of the cycle will be used to meet losses on loans that have not been originated at the balance sheet date. The accounting profession fought for a long time to improve transparency by ending the use of hidden reserves to serve a similar purpose.

We think approach (3) is the most practical, and in fact this has been used in Hong Kong by the Banking Regulator in recent years in dealing with loan loss provisions. This approach has the benefit of staying true to the principles of financial reporting, permitting regulators to insist on prudential capital and providing transparency to the investors as to the level of retained capital and distributable earnings. We could accommodate approach (4) but it is not as good an approach as approach (3).



Question 3

Some FCAG members have indicated that they believe issues surrounding accounting for off-balance items such as securitisations and other structured entities have been far more contributory to the financial crisis than issues surrounding fair value (including mark-to-market) accounting. Do you agree, and how can we best improve IFRS and US GAAP in that area?

The crisis did not originate from financial reporting; inappropriate lending practices, deregulation, creation of complex investment structure that investors did not understand and inadequate risk management decisions are widely viewed as the prime catalysts.

We acknowledge that the IASB has recently issued some proposed amendments to its consolidation standards that seek to address concerns that have arisen. In our comment letter, we support the development of a principle-based standard based on control and applicable to all types of entities. However, we are of the view that the proposals will not necessarily result in an increase in consolidation of financial structures under IFRS as in our opinion SIC-12 has already served IFRS well, as the majority of securitisation vehicles were on balance sheet, although disclosures regarding risks associated with those off-balance sheet were not always comprehensive.

We consider that another topic that is closely related is derecognition for assets transferred into structured entities, which should be addressed together with the consolidation project.

We recommend that the FASB accelerate their efforts to achieve a converged approach with the IASB regarding consolidation and derecognition.

Question 4

Most constituents agree that the current mixed attributes model for accounting and reporting of financial instruments under IFRS and US GAAP is overly complex and otherwise suboptimal. Some constituents (mainly investors) support reporting all financial instruments at fair value. Others support a refined mixed attributes model. Which approach do you support and why? If you support a refined mixed attributes model, what should that look like, and why, and do you view that as an interim step toward full fair value or as an end goal? Whichever approach you support, what improvements, if any, to fair value accounting do you believe are essential prerequisites to your end goal?

In the recent IASB Discussion Paper *Reducing Complexity in Reporting Financial Instruments*, we argue that although we acknowledge that certain of the complexities in the current requirements of financial instruments stem from the mixed measurement attributes for different instruments, this does not mean that imposing a single measurement attribute (whether fair value or not) would be appropriate.

To begin with, the IASB's fair value measurement project has made it evident that the concept of "fair value" is not clear. Fair value is not actually a single measurement and



can mean the entry price in some cases, the exit price in other cases, or a consensus of the two in some cases.

Further, despite the developments in financial markets, fair valuing financial instruments remains a daunting task in practice, particularly for those instruments with highly variable cash flows and/or which are thinly traded or not traded at all. Some have questioned whether fair value is the appropriate measurement attribute for financial liabilities. Fair valuing an entity's own liabilities brings about accounting volatility as a result of changes in market factors and the entity's own credit risk. There is a risk that investors may not understand the significance of the reported "gains" and "losses", which appear counter-intuitive.

For the time being, we urge the IASB to expedite the finalization of the Fair Value Measurement project to establish a single source of guidance for determining fair value.

Question 5

What criteria should accounting standard-setters consider in balancing the need for resolving an 'emergency issue' on a timely basis and the need for active engagement from constituents through due process to help ensure high quality standards that are broadly accepted?

We consider that under no circumstances should the due process procedures be overridden. We believe that it is important that an appropriate due process is followed (albeit on a shortened timetable) in order to allow constituents to consider and comment on the proposed changes.

We support the notion of a separate "fast track" procedure for dealing with changes to IFRSs in cases of great urgency, which should happen only in rare circumstances and where there is a clear justification. We suggest that in agreeing to take an item onto its agenda, the Board should determine at the outset whether this is an "emergency issue" or not. We suggest that "political" pressure of itself is not a sufficient criterion. Examples of criteria could include:

- A recognition that current circumstances have changed the underlying thought process.
- Evidence that there could be confusion in preparers or readers' minds over the item in question.
- Timing of the issue in relation to reporting season.
- Public interest criteria



Question 6

Are there financial crisis-related issues that the IASB or the FASB have indicated they will be addressing that you believe are better addressed in combination with, or alternatively by, other organisations? If so, which issues and why, and which organisations?

We believe that the FASB and the IASB should be responsible for everything within the scope of financial reporting. However, we believe it is important for the Boards to draw on the expertise of others and to work in close cooperation with relevant other organizations (such as experts, regulators and national standard setters) when that is necessary to enable the Boards to gain a better understanding of implications of its proposed financial reporting requirements in practice. For example, in the current difficult economic conditions, the application of IAS 36 Impairment of Assets has proved challenging, particularly in establishing the value in use of cash generating units. In this regard it would be useful if the Boards could work closely with the business valuations profession to enhance IAS 36 and provide useful practical guidance on its application in such circumstances i.e. following the approach taken when the IASB's expert advisory panel provided guidance on fair valuing financial instruments in an inactive market.

Question 7

Is there any other input that you'd like to convey to the FCAG?

While not strictly an accounting issue, we believe the IASB should engage more with regulators and other bodies to understand how accounting standards and general purpose reporting can be co-ordinated to become more holistic. Examples of this include:

- Providing input on business reviews by management
- Understanding views of IAASB (and others) on the practical effects in audit reporting of measures rolled out.