香港會計師公會
HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)
香港金鐘道八十九號力寶中心二座四樓
4th Floor, Tower Two, Lippo Centre, 89 Queensway, Hong Kong.
Tel: 2287 7228 Fax: 2865 6603 / 2865 6776 Website: http://www.hksa.org.hk E-mail: hksa@hksa.org.hk

By air-mail and e-mail <CommentLetters@iasb.org.uk>

Our. Ref.: C/FASC 23 October 2002

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

Dear Sir/Madam,

Exposure Draft of Proposed Amendments to
IAS 32 Financial Instruments: Disclosure and Presentation
IAS 39 Financial Instruments: Recognition and Measurement

The Hong Kong Society of Accountants (HKSA) welcomes the opportunity to provide you with our comments on the exposure draft of Proposed Amendments to International Accounting Standards on Financial Instruments ("exposure draft").

We set out in the attachment our response to the questions raised in your Invitation to Comment together with our comments on additional matters identified.

We express our strong overall concern about the heavy bias towards a rules based approach taken in the exposure draft as opposed to a concepts based approach. In a number of areas, the exposure draft is particularly prescriptive in considering specific situations instead of providing concepts. From our experience, handling abuses with rules just means that the abusers need to advance their technology, it rarely leads to the "correct" or desired economic outcome in the long run, whereas in the implementation of a conceptual approach gives the reviewer (say management or auditor) the chance to question the legitimacy of accounting from a strong fundamental base and allow for the "right" answer to prevail irrespective of the legal form of what is being executed.

The HKSA has a policy of converging its Statements of Standard Accounting Practice with the International Accounting Standards Board's Standards. The standard setting due process applied in Hong Kong (details of which are available on the HKSA's website) acts to support this policy. The HKSA's Financial Accounting Standards Committee (FASC) issued an Invitation to Comment on the exposure draft with a comment period concurrent with that set by the IASB. In the Invitation to Comment, constituents are informed that they have an opportunity not only to comment on the proposed adoption of the exposure draft in Hong Kong but also to have their comments reflected in the HKSA's comment letter. Accordingly, the accompanying comments reflect the views not only of members of the FASC but of constituents in Hong Kong who provided comments to the HKSA.

The FASC received a comment letter from the Hong Kong Association of Banks (HKAB). To an extent, the HKAB's comments offer an alternative view on a number of proposals contained in the exposure draft. The FASC has considered, but does not necessarily endorse, these comments. But in order to be fair to our constituent, we have included their comments in toto as an appendix to our comment letter.

If you have any questions on our comments, please contact our Deputy Director - Accounting, Mr. Simon Riley, in the first instance.

Yours sincerely,

WINNIE C.W. CHEUNG
SENIOR DIRECTOR
PROFESSIONAL & TECHNICAL DEVELOPMENT
HONG KONG SOCIETY OF ACCOUNTANTS

WCC/SR/al

<u>Invitation to Comment (IAS 32)</u>

Question 1 - Probabilities of different manners of settlement (paragraphs 19, 22, and 22A)

Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).

We disagree with the proposed change.

We support retention of the principles contained in SIC-5 and also recommend that probability of settlement shall be taken into account in determining the classification of other financial instruments, including derivatives on own equity. It is inconsistent to argue that the substance of a financial instrument, rather than its legal form, should govern its classification on the issuer's balance sheet without taking the probability of settlement into account.

We are also particularly concerned by the effect that changing this text could have on the application of IAS elsewhere. To have in an important standard a principle that transactions should be evaluated without regard to the probabilities of the various outcomes will lead to a substantial swing towards form-based accounting.

Paragraph 22 – proposed deletion of guidance on economic compulsion. We do not support the deletion of the text on economic compulsion. Indeed, we believe that greater guidance should be given to determine when it should be applied.

In practice, this text has provided guidance on the appropriate treatment as a liability of instruments that are designed to be accounted for as equity, yet are priced as liabilities by investment banks and investors. Generally the substance of these instruments is very clear: almost all behave like debt instruments, except on liquidation of the entity.

Additionally, this paragraph should also explicitly identify other examples of situations where a contractual obligation to redeem can be established indirectly through the terms of and conditions of the preferred share. For example, an instrument that entitles the holder to liquidate the issuer in certain circumstances may effectively establish such an obligation.

Question 2 - Separation of liability and equity elements (paragraphs 28 and 29)

Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?

We would agree that asset and liability elements should be separated and measured first with any residual assigned to the equity element. We believe the proposed change would fix the 'loop hole' previously appearing in IAS 32 and, in treating the equity element as the residual or balancing item, require what we believe to be a common sense approach to compound financial instruments.

Even though IAS 32 always purported to be a disclosure and presentation standard, we note that this issue was one of a number that touched on matters to do with measurement. By reference to question 4 below, both IAS 32 and IAS 39 individually have requirements dealing with the recognition, measurement, presentation and disclosure. If the IASB is convinced that a robust, principle-driven, standard on financial instruments arises on project completion, and that there are no conflicts or overlaps between IAS 32 and IAS 39 we see no reason why the content of IAS 32 cannot simply be subsumed into IAS 39.

If IAS 32 and IAS 39 continue to exist as separate standards, given that this matter is addressed in IAS 32 but impacts on measurement, we would suggest that:
(a) A reference be included to the applicable paragraphs of IAS 39 on how to determine the carrying amount of the liability component; and
(b) It be clarified in this section that embedded derivatives in compound instruments are subject to the normal principles in IAS 39 and may need to be bifurcated.

Question 3 - Classification of derivatives that relate to an entity's own shares (paragraphs 29C -- 29G)

Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?

We understand that the proposals attempt to correct an area of abuse and, to that extent; we believe the proposals should give rise to a more 'correct' result. However, we express our concern that the proposed correction of past abuse is made through prescriptive means. The remedy should be founded on a clear statement of principle.

Paragraph 29F requires a liability to be established at the present value of the redemption amount of a written put option on own shares. This does not fairly present the real economics of these transactions. The valuation of the liability should take account of the probability of a call being made and we would therefore recommend that the liability should be valued on this basis both at initial inception and subsequently, with changes in the value recognised in equity. This approach would be more consistent with the principles underlying IAS 39 and would give a better reflection of the substance of the instrument.

Further, we do not agree with the proposals in paragraph 29E. As a matter of principle we do not believe that accounting conclusions should be dependent upon past behaviour. In our view, if an entity has the right to settle a fixed obligation by issuing a fixed number of its own shares and it is highly probable that it will settle on that basis, then the instrument should be treated as equity. We recommend that, if it is highly probable that it will be settled gross, this should be documented at the outset and the contract treated as equity. If gross settlement is no longer likely to occur, then the instrument should be reclassified as a derivative at fair value and the backlog gain/loss should be reported immediately in income. This approach would be consistent with the approach adopted in IAS 39 in respect of cash flow hedges of highly probable future transactions.

If the IASB believes that an anti abuse provision is necessary, such as in paragraph 29E, then it should deal with this in a consistent manner to the rules on held to maturity assets.

Paragraph 29C – consideration received on derivative contracts classified as equity: To be consistent with paragraph 31A addressing transaction costs of equity instruments, this paragraph should recognise that the amount of consideration recognised in equity should be net of current or deferred tax.

Question 4 - Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard

Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)

We would support such a proposal. Further comment on this matter appears in our response on question 2 above.

Other comments on IAS 32

Paragraph 1 (a) - scope - interests in subsidiaries The scope needs amendment to make clear whether this standard applies to all interests in subsidiaries, joint ventures and associates or just to direct equity investments in those entities. We believe that the text should be extended to make clear that all interests, including those arising from derivatives on the equity interests held by the entity in subsidiary companies should be exempt from IAS 32. IAS 27 then needs to make clear how such interests are treated.

Paragraph 1 (a) - scope - insurance contracts The definition of an insurance contract needs amendment to bring it into line with the thinking that the IASB has developed in the insurance project. If the IASB decides not to adopt this approach then additional guidance is necessary to clarify the meaning of "principally" when used to determine the boundary between financial instruments and insurance contracts. For example, guidance should be included to confirm that a contract that has an insurance element and also gives rise to a fixed accretion of the premiums should be treated as insurance, since there is no variability in cash flows arising from the investment element.

Liabilities and equity
Paragraph 17: This paragraph explains that any instrument classified as equity of a subsidiary would be presented as minority interest or equity in the consolidated financial statements of the group. In practice there are financing structures where this is not necessarily the case. In those instances at the level of the subsidiary, which is generally a special purpose vehicle issuing preferred shares, treatment of the shares as equity seemed appropriate. However, at the group level the presentation of the transaction as liability rather than minority interest in our view would be correct, if the parent provides a guarantee or an in-substance guarantee to the counterparties to the transaction. We recommend that this issue be addressed in this paragraph.

Offsetting
Paragraph 33: We believe that additional explanation in the Basis for Conclusions is necessary as to why offset is not permitted in respect of transferred financial assets and the related liabilities, since the contractual terms of the transfer could very well meet all of the criteria for offsetting under IAS 32.

Paragraph 34: We believe specific requirements and guidance are necessary on income statement presentation of items in respect of offsetting. We believe that income, expenses, gains and losses from items that have been offset in the balance sheet under paragraph 34 should be offset in the income statement too. But IAS 1 does not allow income statement offset of these items in the absence of a specific requirement in IAS 32 (or another IAS).

<u>Invitation to Comment (IAS 39)</u>

Question 1 - Scope: loan commitments (paragraph 1(i))

Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?

We agree with this proposal. The treatment of financial liability commitments and contingencies should be consistent with the requirements applying under IAS 37.

The previous solution in Question 30-1 of IAS 39 Implementation Guidance under which such commitments could sometimes be excluded as "regular way" transactions was unsatisfactory. However we note that the impact of not recognising a derivative for the loan commitment is that loans will be issued at less than market interest rates.

The standard should clarify whether it is intended that a loss should be recognised on initial measurement of loans arising from unrecognised loan commitments in accordance with paragraph 67. For example a fixed rate loan commitment will result in a loss on issuance of the loan if interest rates increase during the commitment period. This would effectively reverse the effect of the scope exclusion for loan commitments. We expect the intent is the cost of the loan on initial recognition will be taken as being the fair value at the date of commitment, so that no loss would be recognised.

Question 2 - Derecognition: continuing involvement approach (paragraphs 35-57)

Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?

In principle, we believe that the extent of an entity's continuing involvement with a financial arrangement should determine the extent to which a financial asset or liability should be derecognised.

The proposals include rules about "pass-through" arrangements and the conditions that must be satisfied in order for this to not be considered continuing involvement. The proposal will generally be applicable for situations of securitisations through a special purposes entity (SPE) where either the transferor or the SPE performs servicing of the assets. We do not agree that an issue as fundamental as consolidation of SPEs, as interpreted in SIC-12, should be circumvented by including these new derecognition proposals in IAS 39. This applies especially to situations where various classes of instruments are issued and most of the interest-holders do not take risks other than those of lenders.

Also, there is still a basic question of how to determine if a transaction is merely providing financing or if it is "creating" a beneficial interest (as per IAS 39.42). We feel this issue should be addressed as part of this project, otherwise the result will be an inconsistent application of these rules.

Question 3 - Derecognition: pass-through arrangements (paragraph 41)

Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?

We agree with this approach in a true pass-through arrangement where the reporting entity is essentially acting on an agency basis.

However there are cases where the arrangement is not an immediate pass through of cash. For instance, in a securitisation of financial assets via an SPE, often there is a specified priority of cash distributions to the beneficial interest holders based on the tranche of securities issued to them by the SPE. The result is that only certain beneficial interest holders receive cash distributions when the SPE collects and distributes cash. Also the SPE may have to hold back cash in reserve accounts to be used against future defaults on repayment of the underlying financial assets. In our view this very typical sort of arrangement would fail the criteria set out in paragraph 41 of the revised standard. Consideration should be given as to whether the criteria in paragraph 41 produce the intended result in these circumstances.

Question 4 - Measurement: fair value designation (paragraph 10)

Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?

We recognise that such an approach is necessary to solve some particularly difficult inconsistencies in the model where derivative gains and losses go to income and other gains and losses go to equity. On that basis, we would support the proposal but we are concerned that it is more of a 'rules-based' solution than a 'principles-based' solution and therefore we are concerned that, in solving one issue, other accounting problems as yet unforeseen may arise in the future.

The proposed amendment also enables companies to avoid the need for complex hedging documentation in many circumstances where there is a natural hedge. However, this does little to achieve consistency and comparability between companies and between the results of different accounting periods from the same entity. We therefore support the restriction on transferring financial assets and liabilities into or out of the trading category after initial designation at inception.

The requirement for designation at initial recognition means that this does not resolve the problem experienced by the issuers of exchangeable bonds who are not permitted to designate the embedded written option as a hedge of the underlying security, even where the bond is mandatorily exchangeable into that security. The resulting income statement volatility does not reflect the true economics of the situation. The IASB needs to consider how this issue can be addressed in the standard.

We feel that describing all fair value through income financial instruments as "trading" (as per paragraph 10 and many times subsequently in the standard) even if they are not held for that purpose is inappropriate. Paragraph 18A deals with this by suggesting a label other than "trading" be used for the non-trading fair value through income category. However, this seems to contradict the wording in paragraph 10.
We suggest instead using the following names to refer to the categories to be measured at fair value on the basis of designation: "fair value through income" and "fair value through equity". The fair value through income category would include "instruments held-for-trading", "derivatives" and "financial instruments designated for accounting at fair value through income". The fair value through equity category will include financial assets that are not classified as loans and receivables originated by the entity, held-to-maturity investments, or financial assets designated to be measured at fair value through income. This would require consequential changes throughout IAS 39, for example to 17A, 68, 89A, 103 and 171A.

If the proposal is adopted, it should be supported by additional disclosure requirements in IAS 32 to ensure that users understand the rationale for optional designation of assets and liabilities in this category and have sufficient information to compare the financial statements of different entities. In particular, the disclosure requirements relating to the methodology used to determine fair value in the absence of market prices (in paragraph 77B) should be strengthened. Furthermore, disclosure should also be required on the face of the income statement of the effect of movements in the entity's own credit rating on the fair value of liabilities designated as held for trading.

Question 5 - Fair value measurement considerations (paragraphs 95-100D)

Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95-100D of the Exposure Draft? Additional guidance is included in paragraphs A32-A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?

We support the guidance that appears in paragraphs 95-100D.

However, we do not support the proposed deletion of the guidance in paragraph 98 relating to the need to take into account the current circumstances of the entity in determining fair value. In circumstances where the value of an asset is likely to be affected by a decision to dispose of the asset in the immediate future, we believe it is appropriate to reflect the impact of that decision in the valuation methodology. Similarly, it is not clear whether the deletion of the guidance in paragraph 100 relating to large holdings and illiquid markets, and the retention of paragraph 99, is intended to remove any possibility of recognising illiquidity discounts in the valuation of large holdings of securities. This would be inconsistent with current market practice. We do not support the elimination of the practice of making such valuation allowances.

Question 6 - Collective evaluation of impairment (paragraphs 112 and 113A--113D)

Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A-113D?

In principle we support a portfolio approach to evaluating impairment of financial assets. We agree that a non-impaired financial asset should be allowed to be included within a portfolio of similar assets that are collectively evaluated for impairment. Further, we agree with a proposal that would allow setting up an impairment provision for inherent risks in a portfolio of assets.

However there needs to be clarification of what is deemed to be a "portfolio" as otherwise this may lead to inappropriate groupings of financial assets for impairment testing purposes. This clarification should provide enough guidance for an entity to determine what is an appropriate portfolio, including deciding when a financial asset should not be included in any portfolio but rather assessed individually.

We note that the discussion of portfolio assessment is included only in the section dealing with financial assets carried at amortised cost, which presumably means impairment testing of other instruments must be done on an individual asset basis. We do not support this and feel that a portfolio assessment should also apply to available for sale securities.

Question 7 - Impairment of investments in available-for-sale financial assets (paragraphs 117--119)

Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?

We strongly disagree with the proposal. We do not support the rationale appearing in C93 on page 297 of the Exposure Draft to suggest that impairment losses should not be reversed because of difficulties in determining objectively when such impairment losses have reversed. Such a suggestion is not founded on principle and is not consistent with the treatment for impairment as found elsewhere, for example, in IAS 36 and IAS 2.

If the reversal of an impairment loss can be supported by reference to the factors that caused recognition of the impairment originally, we believe that the reversal should be recognised. To do otherwise would allow entities the potential to create hidden reserves in good years that can be released in not so good years.

Question 8 - Hedges of firm commitments (paragraphs 137 and 140)

Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?

We agree with the proposal. The change in fair value of a hedging instrument that is designated and is effective as the hedge of a fair value exposure in an unrecognised firm commitment should be matched in the balance sheet by the change in fair value of the hedged item, so that net assets are not distorted.

When an entity enters into derivatives and designates a hedge of expected currency exposure prior to a firmly committed agreement it could only use a cash flow hedge accounting model. It is not clear from Q&A 137-10 that the designation made at the initiation of the hedge in these circumstances should not be changed when the cash flows become firm commitments and we would suggest that this is clarified. Requiring a forecast foreign currency cash flow to be redesignated as a fair value hedge when it becomes a firm commitment would create a significant accounting burden for entities hedging such cash flows with no apparent benefit.

Paragraph 139 has been changed in accordance with the proposed change to the accounting treatment of firm commitments. However, we believe the paragraph should still include an example of a cash flow hedge for forecast transactions, for example hedges of forecast sales, since in our view this is a very common type of cash flow hedge. It would also be helpful to include an explanation of the different effect in practice on the balance sheet and the income statement between choosing to account for a hedge of foreign currency receivable or payable as a fair value hedge and choosing to account for it as a cash flow hedge.

Question 9 - 'Basis adjustments' (paragraph 160)

Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?

On balance we do not fully agree with the proposed changes and would prefer that companies be given an *option* as to how to present the fair value changes of the hedging instrument i.e. record basis adjustments or leave in equity.

The proposed treatment creates inconsistencies between the accounting treatment of forecasted transactions and firm commitments. Under the proposed amendment, firm commitments will be treated as a fair value hedge, which effectively means that basis adjustments will be recorded for those transactions. The arguments in the Basis for Conclusions for eliminating basis adjustments apply also to firm commitments so we do not find these to be strong arguments to prohibit basis adjustments in cash flow hedges. In addition we note that the overall issue only relates to presentation of the fair value changes of hedging instruments in the balance sheet and is not a measurement issue.

We note that the distinction between firm commitments and forecast transactions is not always clear in practice. The proposed changes to hedge accounting will make it even more important for companies to correctly distinguish between the two types of hedges. As a result we expect that more interpretative guidance will be needed relating to the effect on firm commitments of delayed transactions, termination of hedges and other issues.

We believe it is much simpler to make the adjustment directly to the asset concerned (for example, to carry the effects of currency hedges as part of the cost of the underlying asset on acquisition) thus retaining basis adjustments for fair value hedges but not for cash flow hedges.

Question 10 - Prior derecognition transactions (paragraph 171B)

Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (i.e. that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?

For those entities that had previously applied IAS 39, and had appropriately derecognised a financial asset or liability under the conditions existing at that time, we believe it is appropriate on a practical basis to *permit* that entity to continue derecognising that specific asset or liability regardless of whether derecognition continues to be appropriate under the new rules. For those assets and liabilities recognised at the point when the revised rules come into effect, derecognition should occur in accordance with the new rules.

Other comments on IAS 39

Embedded Derivatives

Paragraph 22: A comment has been added stating that the presentation of embedded derivatives is not addressed here. We do not find this statement helpful. Generally, IAS 39 does not refer to presentation. We believe that the comment should be deleted and specific guidance on the presentation of embedded derivatives should be added to IAS 32.

Derecognition

Paragraph 46: The calculation of the amount of profit or loss on disposal does not include an adjustment for the fair value of the new assets or new liabilities (the requirement to adjust the profit or loss for the fair value of new assets or liabilities previously included in paragraph 51 has been deleted). We believe that this requirement is necessary to correctly calculate the profit or loss on disposal, unless the proceeds are adjusted for the fair value of new assets or liabilities. If the latter is the IASB’s intention then this should be specified in paragraph 46(b)(i).

Paragraph 47: The section on derecognition of a portion of a financial asset does not mention how to treat new assets or liabilities. Unless this section is redrafted, we recommend repeating in these paragraphs the principles on recognition of new assets and liabilities so that it is clear that the requirements related to new assets and liabilities apply in all derecognition situations, rather than only to situations where an *entire* asset is derecognised. (Currently it only is included in the section on derecognition of an asset in its entirety i.e. in paragraph 44.) In paragraph 47, the previous requirement to consider the fair value of new assets or liabilities in calculating profit or loss on derecognition has been deleted. We believe that new assets and liabilities must be included to calculate the correct profit or loss on disposal.

Subsequent measurement

Paragraph 83: It is not clear whether “for example, less than three months” and “for example, 90 per cent” are meant to be definitive thresholds or just examples. If the intention is to provide definitive thresholds then “for example” should be deleted. If not, then it would more appropriate to move the examples to the appendix and provide more guidance on how to determine the thresholds in the text of the standard.

Paragraph 99: The description of an active market introduced here is not consistent with the definition of an active market in IAS 36 “Impairment of assets”, IAS 38 “Intangible assets” and IAS 41 “Agriculture” (a market where willing buyers and sellers can be found at any time, the items traded in the market are homogeneous and prices are available to the public). It might create confusion using terminology defined in other standards but with a different meaning. We recommend either addressing this inconsistency or using different terminology.

Paragraph 103B: The added words are unclear and seem to conflict with IAS 21. The proposal suggests that exchange differences on the amortised cost component of an available-for-sale instrument be recognised in income and exchange differences on fair value changes be recognised in equity. IAS 21 on the other hand requires all exchange differences on monetary items (including exchange differences on revaluation components) be recognised in the income statement, as does Q&A Other-6. Therefore, we suggest to retain guidance in Q&A Other-6 and include it in this paragraph and as an appendix.

Impairment

Paragraph 109: The criteria for recognition of impairment losses of the various types of assets for which impairment has to be assessed, could be clarified and brought more in line with each other: paragraph 109 mentions as a criterion objective evidence; 111 states in addition it is probable that an entity will not be able to collect all amounts due; 116 provides only for the objective evidence criterion and 117 mentions apart from objective evidence, a decline in fair value recognised in equity.

We recommend that the following steps (in the order stated) are included as a common basis for recognising impairment, rather than making distinctions between the types and measurements of financial instruments:

- ✓ Objective evidence that the asset is impaired.
- ✓ Probability that the entity will not be able to collect all amounts due or that the fair value will not be recovered (cash flow expectations of the acquirer when entering into the transaction are assessed to have to be adjusted downward).

Paragraph 113: The proposals regarding modification or renegotiations of a loan refer to those in situations of financial difficulties of the borrower or issuer. This seems to indicate that if the renegotiations are not the result of financial difficulties (objective evidence of impairment) then another interest rate would be used. IAS 39 does not provide guidance on how in the historical cost model such modification in terms not arising from an impairment should be accounted for, while it does provide guidance on the accounting for a modification of a financial liability (paragraph 64). Also the guidance on the objective evidence for loans is not consistent with the recognition of impairment on equity instruments. When fair value of an equity instrument is for a longer term below cost, which could result from market circumstances changes from the moment when entering into the transaction, on equity instruments this would lead to an impairment loss (as per paragraph 110A), without the loss necessarily being based on the situation of the issuer of the equity and irrespective of expected future cash flows.

Paragraph 115: The word ‘individual’ has been added in this paragraph. However, discounting is as much part of individually impaired instruments as it is of recognising impairment in portfolios. Guidance is needed on how the interest accrual on recoverable amounts under a portfolio approach would be calculated.

Hedge accounting

Paragraphs 122 and 126: The changes to paragraph 122 and 126 seem to imply that non derivative financial assets carried at fair value through income can be hedging instruments (because in this case there are no differences in the basis for measurement). However, it is our understanding that an equity security may never be designated as the hedging instrument. Furthermore, paragraph 10 (and also the rest of paragraph 122) prohibits non-derivative financial assets being designated as the hedging instrument except as hedges of foreign currency risk. We suggest deleting paragraph 126 and clarifying 122.

Paragraph 126C: There are other cases where the components of a derivative are separately measurable – for example the interest and foreign exchange components of a cross currency and interest rate swap. We do not agree with the prohibition in those cases – for example if a held-to-maturity instrument is fully hedged with a cross currency and interest rate swap, hedge accounting is not allowed for the transaction in its entirety because of the prohibition on hedge accounting for hedges of interest rate risk on held-to-maturity instruments combined with this exclusion on treating components of the instrument as the hedging instrument. The identical result can be achieved with an interest rate swap and a separate currency forward contract and in these cases the forward contract would be eligible for hedge accounting.

Paragraph 127: Hedge accounting for held-to-maturity instruments in respect of interest rate risk is not allowed. The reason provided in the standard is that instruments classified as such are not exposed to interest rate risk since they will be held to maturity. However IAS 32 and 39 define risk exposure in terms of fair value risk as well as cash flow risk. If exposure was only defined as a risk of changes in fair values, we would understand the rationale. Given however that the standard allows for a change in risk profile for all other instruments by either applying cash flow hedge accounting or fair value hedge accounting, do not prescribe risk reduction in terms of one type of exposure and given that generally (especially in financial institutions) all instruments, including held-to-maturity instruments will be part of a risk exposure analysis of the total balance sheet, we feel that the exclusion of held-to-maturity instruments is not appropriate. We recommend that the requirements in this respect be reconsidered.

Paragraph 129-130: These paragraphs state that non-financial assets and liabilities can only be hedged in their entirety or separately with respect to foreign exchange risk. The reason given is that other risk components generally do not have a predictable, separately measurable effect on the price of the item and therefore should not be allowed as hedged item by themselves.

We believe that in some circumstances other risk components than foreign currency risk may be separately measurable and as a result should be eligible for hedge accounting. Examples include: a basis price risk inherent in certain commodity contracts, and interest rate risk in operating leases.

We believe it would be appropriate to permit a component of a non-financial asset or liability to be designated as a hedged item when the appropriate element of fair value or cash flow within the hedged item as a whole can be clearly identified and measured by reference to a price in an active market.

Paragraph 137: The definition of a fair value hedge only includes firm commitments to buy or sell an asset at a fixed price. We believe the definition should also include firm commitments under leases or service contracts. This can be achieved by changing the wording to refer to firm commitments at a fixed price. Moreover, as explained in our response to question 8 and 9 above we believe the distinction between firm commitments and forecast transactions is not always clear in practice. We recommend that more guidance and/or examples to clearly identify firm commitments be included.

Paragraph 147: The revised wording continues to suggest that the application of a "short cut" method is appropriate, without actually saying so. Given the requirements in 142(a) and 142(e), whether or not such a method is allowable should be clarified in paragraph 147.

Paragraph 164(b)(ii): The hedging instrument for a net investment hedge would normally be a foreign currency liability, which would be carried at amortised cost. Therefore the reference here to paragraph 103 and “limited circumstances” is confusing/incorrect.

Paragraph 165: If the hedged item is not a financial instrument, paragraph 103 is not relevant. Also, even if it is a financial instrument, if it is a monetary item exchange gains and losses must be reported in the income statement under IAS 21. We suggest instead to state that if a hedge does not qualify for special hedge accounting, it is accounted for under the measurement rules applicable if it had not been hedged.

Appendix – Comments received from the Hong Kong Association of Banks

IAS 32

Definition of insurance contract
We note the different definitions for insurance contracts in IAS 32 and the Draft Statement of Position for insurance contracts:

IAS 32 paragraph 3: "For the purposes of this Standard, an insurance contract is a contract that exposes the insurer to identified risks or loss from events or circumstances occurring or discovered within a specified period, including death (in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others and business interruption. However, the provisions of this Standard apply when a financial instrument takes the form of an insurance contract but principally involves the transfer of financial risks (see paragraph 43), for example, some types of financial reinsurance and guaranteed investment contracts issued by insurance and other entities. Entities that have obligations under insurance contracts are encouraged to consider the appropriateness of applying the provisions of this Standard in presenting and disclosing information about such obligations."

DSOP 1.19: "An insurance contract is a contract under which one party (the insurer) accepts an insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary (other than an event that is only a change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable)."

We favour the definition in DSOP 1.19.

Offsetting of a financial asset and a financial liability
Paragraph 33 states that a financial asset and financial liability shall be offset when and only when an entity intends either to settle on a net basis or to realise the asset and settle the liability simultaneously. This requirement is unduly stringent and may hinder certain businesses. Legally enforceable set-off provisions will be included in transaction documentation in order to limit risk. In practice, settlement is not necessarily on a net basis. We suggest that the word "intends" is replaced by "the ability to insist".

Disclosures
Paragraph 77B(d) states that if a fair value estimated using a valuation technique is sensitive to valuation assumptions that are not supported by observable market prices, a statement of this fact and the effect on the fair value of using a range of reasonably possible alternative assumptions should be given. We do not believe the notes to the financial statements is an appropriate place for such sensitivity analysis. We believe there is a danger that such analysis would undermine the validity of the figures in the financial statements that represent management's best estimate.

Consolidation
We agree with the current proposal of the IASB that the disclosure requirements in IAS 30 'Disclosures in the financial statements of banks and similar financial institutions' should be moved into IAS 32, thereby creating a single standard for disclosure and presentation of financial instruments.

IAS 39

We believe that IAS 39 remains a complex and controversial rules-based standard and requires further changes in addition to the amendments currently proposed. In particular, the provisions may unduly influence the risk management activities of an entity rather than presenting a true and fair view of its economic performance and financial position.

Risk management

Non-derivative hedges: paragraph 122 determines that a non-derivative financial asset or liability may only be designated as a hedging instrument in respect of foreign currency risk. The reason given for this limitation is the different bases for measuring derivatives and non-derivatives. We do not see the logic behind the restriction on hedging by instruments other than derivatives.

Internal transactions: paragraph 126B states that for hedge accounting purposes only derivatives that involve a third party can be designated as hedging in nature and concludes that intra-group or intra-company transactions cannot qualify for hedge accounting in consolidation. Consequently, IAS 39 obliges banks to enter into contracts with third parties to eliminate or reduce risk where they could have utilised positions within the group to achieve much the same effect. By requiring the bank to enter the marketplace, further credit risk and cost is incurred, thereby increasing the cost of capital. In our view, the effective prohibition of internal contracts impedes effective risk management.

Held-to-maturity assets: paragraph 127 determines that the interest rate risk element of held-to-maturity investments cannot be hedged. We see no economic or accounting reason for this limitation. (This is also commented on below in the context of loan accounting).

Hedge accounting: the hedging relationships permitted under paragraphs 127 and 137 create significant operating difficulties and introduce restrictions on risk management for which there appears to be no logical reason. The standard was not drafted with portfolio risk management in mind and is unsuited to the circumstances of a complex financial institution seeking to mitigate risk. Banks may be able to devise systems that qualify them for cash flow hedging but the process involved will be complex and alien to the way in which most banking groups operate.

We believe that IAS 39's hedging provisions should enable, rather than hinder, risk management conducted according to sound business practice and that it is appropriate for such rules to include designation, documentation and effectiveness testing. However, IAS 39 should build on existing approaches to enterprise-wide risk management and not work against them. Therefore, each of the issues raised above should be addressed and a better appreciation of Asset and Liability Management gained. The IASB has been made aware of the reasons why banks manage risk as they do but appear to have taken little notice; the hedging rules place arbitrary restrictions on hedging activities instead of determining a basis for reliable measurement and effectiveness testing.

Loan accounting

Under the section 'Subsequent Measurement of Financial Assets' (paragraphs 68 to 76), only loans and receivables originated by an entity and not classified as held for trading or available-for-sale are measured at amortised cost without regard to the entity's intention to hold them to maturity. As we see it, this would include participations funded on the date that a loan is originated by another lender in lead capacity, loans acquired through syndication and loans acquired in a business combination that was classified as originated loans by the acquired entity. Our understanding, however, is that it excludes securitisations, purchases of loans originated by other lenders (after origination), loans that are in substance purchases of loans previously originated, such as loans to a special purpose vehicle investing in a securitisation issue, and loans acquired in a business combination that were not classified as originated loans by the acquired entity.

Under paragraph 20 of IAS 39, loans and receivables purchased by an entity after origination cannot be classified as originated loans and receivables but should be classified as held-to-maturity, available-for-sale or held for trading as appropriate. Loans and receivables classified as held-to-maturity should be measured at amortised cost whereas loans and receivables classified as held for trading or available-for-sale should be measured at fair value. In practice, this means that loans acquired with the intention of being held to maturity cannot be assimilated into the acquirer's mainstream originated loan book, because of the need to apply the held-to-maturity criteria to the acquired holding. This creates a situation in which loans can be fully assimilated where a bank purchases a business outright but not if it buys only its mortgage book. We see no reason for assimilation not to be permitted.

Under paragraph 127, it is not permitted to hedge held-to-maturity assets in respect of interest rate risk on the grounds that for a held-to-maturity asset interest rate risk is not relevant. We do not agree entirely with this view. For example, consider the case of a loan purchased after origination that may only be classified as held-to-maturity (amortised cost), available-for-sale (marked to market) or trading (marked to market) as opposed to an own originated loan (amortised cost). Under IAS 39 as it stands, a bank may hedge an own originated loan which is measured at amortised cost but may not hedge a purchased loan which is measured at amortised cost. Either purchased loans should be permitted in the own originated portfolio or the hedging of held-to-maturity assets should be permitted.

Impairment and uncollectability of financial assets

The sections on impairment and uncollectability of financial assets seek to introduce a complex methodology for estimating potential losses on impaired loans. Compliance with these rules would require banks to invest significantly in systems developments. However, we do not consider that these would result in more accurate estimates of potential loan losses than those produced by existing methodologies.

Paragraph 115 states that interest should continue to be accrued on an impaired financial asset. Consequently, a bank would generally have to raise an additional provision against a non-performing loan, equal to the amount of interest accrued, to reflect the fact that the borrower is not expected to meet the interest payment. This accounting treatment appears far less meaningful than the current practice of suspending the interest.

Furthermore, paragraph 115 implies that interest income on an impaired loan should be accrued at a rate other than the contractual rate. This would result in a bank reporting a gross loan balance at a value that neither the lender nor borrower would recognise as the amount outstanding. This position would be exacerbated by paragraph 153(b) that would require the carrying value of a hedged loan to be adjusted for any gain or loss on the hedged risk. These requirements would cause considerable difficulties with the reconciliation of loan balances and may result in increased operational risk for banks.

Strategic investments

Strategic investments in equity securities have no fixed maturity date and will, therefore, be classified as available-for-sale under IAS 39. As a result, they will be measured at fair value with gains and losses recognised in the Statement of Changes in Equity during the period. However, investments of this nature are usually held for continuing use in the business as part of a longer-term strategy. It would, therefore, be more appropriate for them to be measured at cost less provision for any permanent impairment in value.

In addition, strategic investments are frequently illiquid and it may not be possible to obtain reliable market values for them. IAS 39 does recognise the difficulty in obtaining a reliable estimate of fair value for some financial instruments and paragraph 69 permits investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured to be measured at cost. We consider cost to be a more appropriate measurement base for strategic investments irrespective of whether the reliability of market price is brought into question.

Perfect hedge effectiveness
In the US standard SFAS 133, paragraph 68 details the 'shortcut' method to ease the operational burden for those companies that manage risk utilising interest rate swaps. Under this scenario, if a number of criteria are met, a company may assume no ineffectiveness in a hedge strategy where the interest rate risk of an interest-bearing asset or liability is hedged perfectly by an interest rate swap. Assuming no ineffectiveness has several benefits, for example, periodic calculations of hedge effectiveness are not required.

Paragraph 147 of IAS 39 does not mention the shortcut method. Instead it recognises that an entity may adopt different risk strategies. One such strategy is to match exactly the principal terms of the hedged item and the hedging instrument, such as amounts, maturities and repricing dates. IAS 39 implies but does not actually state that a company following such a strategy could assume perfect hedge effectiveness. Our view is that paragraph 147 of IAS 39 be conformed to the wording of SFAS 133.

Basis adjustments
We do not support the proposal to revise the rule in IAS 39 that the gain or loss on a hedge should be removed from equity at the time the hedged item gives rise to an asset or liability and should be included in the measurement of the asset or liability. Such treatment is simple to record and present. The proposed treatment of recycling the gain or loss from equity, period-by-period, in line with the depreciation on the asset or other recognition in profit or loss of consumption of the asset or reduction of the liability is cumbersome and would make the effects of the hedge more difficult to understand. We believe the current treatment provides better information for users of the accounts to assess the success or failure of the hedge connected to a hedged item.

Derecognition
Whilst the continuing involvement approach has a number of attractive features, we consider the measurement aspects as described in the exposure draft of amendments to IAS 39 to be flawed, as they result in the recognition of assets and liabilities that do not meet the definitions of those elements in the Framework.

For example, a transaction with a credit guarantee for default of 10% of the principal amount of transferred receivables, while the expectation is that default losses will not exceed 5%. Under the proposed continuing involvement approach, this example will be considered as if the transferor has transferred 90% of the receivables unconditionally (90% to be derecognised) while retaining a continuing involvement in 10% through the guarantee for which the consideration is accounted for as a collateralised borrowing. We believe that where compensation based on the performance of the transferred asset can be reliably estimated (for example, based on historical loss data in the case of a guarantee), the asset should be derecognised in full while recognising a provision for the guarantee. This approach reflects the new assets and liabilities generated by the transaction and avoid the unnecessary recognition of a fictitious asset and liability.

Measurement
Fair value designation: we regard the proposed amendment to allow entities to designate irrevocably any financial instrument at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in the profit and loss account as an important change which is welcomed in so far as it simplifies the application of IAS 39 and facilitates the use of hedges.

However, we do not think that such designation should be irrevocable. Items carried at fair value should be allowed to be subsequently redesignated as instruments that are measured at cost (fair value at the moment of change in the designation would be the deemed cost) since the same effect can currently be obtained by sale of the instrument at fair value in the market and purchase of another instrument with similar terms which is intended to be held to maturity. We believe that entities should not be forced into market transactions that generate transaction costs when an internal transfer at market value would have the same effect without the transaction costs. We accept, however, that it should not be possible to make further reclassifications once an instrument has been redesignated from a fair value instrument to an amortised cost-based instrument.

Impairment of available-for-sale assets: we do not support the proposed amendment for impairment losses in respect of available-for-sale financial instruments not to be reversed. We fail to see the distinction between this situation as those as explained in IAS 2 'Inventories' paragraph 31 (reversal of write-downs of inventories), IAS 8 'Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies' paragraph 27 (recognition of the effect of a change in accounting estimate in profit or loss), IAS 16 'Property, Plant and Equipment' paragraph 37 (the reversal of a revaluation decrease of an asset previously recognised as an expense is recognised as income) and IAS 38 'Intangible Assets' paragraph 76 (an intangible asset should be recognised as income to the extent it reverses a revaluation decrease of the same asset which was previously recognised as an expense). All of these situations require a consistent treatment of reversals through income when the initial revaluation decrease was previously recognised as an expense.