By Electronic Mail and Post

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Sir David Tweedie
Chairman,
International Accounting Standards Board,
1st Floor, 30 Cannon Street,
London EC4M 6XH,
United Kingdom.

Dear Sirs,

Financial Instruments Joint Working Group of Standard Setters -
Draft Standard and Basis for Conclusions,
Financial Instruments and Similar Items

We have considered the Draft Standard and Basis for Conclusions, Financial Instruments and Similar Items issued for comment by the Financial Instruments Joint Working Group of Standard Setters. Our responses to individual questions are set out in Annex 1 for your consideration.

Although it seems that the concept of fair value is the right way forward, we do see a lot of problems and difficulties in applying this in the short term. We also understand that it would take some time to resolve the related issues. Nevertheless, we believe that the fair value project is very important and should be given high priority in the work plan of the International Accounting Standards Board.

The body of this letter contains our views on the basic logic of the draft standard, the practical application of the draft standard and expresses our concerns with some of the detailed proposals.

In summary we consider that any move to full fair value accounting for assets and liabilities needs to be done slowly. It will involve significant education of preparers and users of financial statements as to methods of preparation and to the best ways to interpret the results. The first move to full fair value accounting should be restricted to separate disclosure in footnotes or accompanying reports not in the main financial statements.

1. Basic logic of the draft standard

We believe that fair value accounting for all financial instruments has some theoretical attraction. It provides a single basis for the measurement of financial assets and liabilities and removes the artificial differences in IAS 39 between the "trading book", "held to maturity" and "other securities". It also extends fair value accounting to all financial assets and liabilities. However, we note, in general, a growing divergence between market capitalisation and book value, particularly for financial institutions, including those that have been reporting fair values of all financial instruments under IAS 32 and US GAAP. We are not aware of research that demonstrates that such divergence would diminish under a full-fair-value/no-hedge-accounting model.

For a financial institution, this provides a single common approach to the measurement of the majority, but not all, of its assets and liabilities. We are concerned about whether there are substantial unrecognised non-financial assets (such as core deposit intangibles) that could also result in asymmetry if only financial assets and liabilities are measured at fair value.

Many non-financial institutions have financial assets and liabilities that would fall within the scope of the draft standard. We believe that application of the draft standard to such non-financial institutions would result in significant asymmetry. Any such application of the draft standard to non-financial institutions would have to be part of a general move to applying fair values to all assets and liabilities. We recognise that applying fair values to all assets and liabilities is outside the scope of a standard on financial instruments. However, without considering whether and how fair value accounting should be applied to all assets and liabilities, we do not consider it appropriate to apply fair value accounting to financial assets and liabilities of non-financial institutions.

2. Practical concerns

We are concerned that the lack of market liquidity and transparent market information in South East Asia will make it difficult to determine the appropriate discount rates for credit risks and market risks needed to calculate fair values. This is true even for the most developed economies in the region because of very sizeable cross-border loans and investments.

There are significant problems in measuring financial instruments that the Joint Working Group proposal acknowledges but seems to dismiss. These problems are particularly acute in emerging economies but are prevalent for many financial instruments in developed economies as well. IAS 39 recognises this by providing a “reliability exception”.

We believe that IASB must resolve how financial performance is to be reported before proceeding with the Joint Working Group proposal, which calls for fair valuation of all financial instruments with all value changes reported in net profit or loss. Issues include one performance statement or two, a single measure of comprehensive income, and recycling.

We also believe that enterprises do manage risks of anticipated transactions by entering into anticipatory hedging contracts. The Joint Working Group proposal concludes that this management reality should not affect the reporting of subsequent changes in the value of these contracts. We disagree.

Also, before any fair value standard can be introduced, a considerable period will be necessary to educate both preparers and users of financial statements. In general, the calculations required by the draft standard are outside the expertise of most companies in South East Asia. Few banks have the accounting expertise needed to prepare full fair value financial statements. Loan portfolios are not managed on a fair value basis. We are concerned that introduction of the standard would be far beyond the capability of many companies in South East Asia.

We also consider that South East Asian users of financial statements, investors and other businesses, in general, do not fully understand fair value financial statements. One of the largest groups of users of financial statements of banks is other banks for credit control purposes. Credit control departments of banks, in general, do not understand fair value financial statements of banks and will need some time to learn how to make appropriate decisions based on fair value financial statements.

As well as education of accounting staff, successful introduction of the draft standard would depend on education of senior management. Even within banks management only adopt fair value accounting for a limited part of their business. If fair values are applied to all financial assets and liabilities in financial statements, management are unlikely to be able to provide an informed commentary on an entity's performance or financial position. This will greatly reduce the usefulness of the management discussion and analysis. We consider that the management discussion and analysis is an important part of any annual report. Changes to financial reporting must not go faster than general management can absorb.

We believe it is essential that IASB takes time to learn lessons from applying IAS 39 before trying to reach any conclusions as to the best way to account for financial assets and liabilities. We consider that it is too soon to reach any conclusion on how to extend fair value accounting beyond that required in IAS 39 or if indeed IAS 39 goes too far. As IAS 39 is only effective for financial years beginning after 1 January 2001, only in 2003, when December 2002 financial statements are finished, will the financial reporting community be in a position to draw meaningful conclusions from applying IAS 39.

3. Detailed proposals

The draft standard includes a requirement for fair values to be applied to an entity's own debt. It envisages that an entity with quoted debt will value the debt at its market value, even when that value represents a significant discount to the face value. We consider that any reduction in the value of debt beyond that justified by interest rate changes is a partial derecognition of a liability and is not purely a question of valuation. As such it is incorrect to recognise such changes in the value of liabilities; it is also inconsistent with the parts of the standard dealing with derecognition of assets and liabilities.

The draft standard proposes that loans should be valued based on interest rates charged for similar loans at the measurement date. If interest for loans is calculated at base plus 3% when a loan is issued, and at the period end loans with a similar credit risk and maturity are granted at base plus 4%, the loans are valued using a discount factor of base plus 4%. We are concerned that this approach may result in significant asset volatility due to factors other than market movements. A financial institution that changes its market strategy, for example by reducing the interest rate for new loans from base plus 3% to base plus 2%, will see a significant adjustment to the value of existing assets. We do not consider it correct for the fair value of assets to depend on an institution's marketing strategy. We are also concerned that this approach provides significant scope for profit manipulation by adjusting interest charged on new loans.

The draft standard provides for financial instruments to be valued at exit prices. Thus, any purchase of a financial instrument will result in an immediate loss as generally exit prices for financial assets are less than purchase price and exit prices for financial liabilities are higher than the initial price.

Whilst we are in general agreement with the derecognition principles proposed by the Joint Working Group we believe that the JWG proposal fails to address the related "SIC 12" issue (consolidation of SPEs). We do not think the Joint Working Group proposal can be adopted in isolation.

If you have any questions on our comments, please do not hesitate to contact Ms. Elsa Ho, Assistant Director (Accounting) at the Society, in the first instance.

Yours faithfully,

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

WCC/EH/al
Encl.

Annex 1

Q.1 The Draft Standard would apply to all enterprises (see Draft Standard paragraph 1 and Basis for Conclusions paragraphs 2.1-2.12). Do you agree? If not, please specify which enterprises you believe should be excluded from the scope (and why), and the basis on which you would distinguish those enterprises that should apply the Draft Standard from those that need or should not.

A1 We do not agree.

Conceptually the Draft Standard may be more relevant to financial institutions than non-financial entities. For financial institutions it is likely that fair valuing liabilities may lead to higher levels of accounting symmetry as most items in their balance sheets are financial instruments. For non-financial entities the situation is reversed; applying fair value techniques is likely to lead to significant asymmetry.

If you introduce this standard it should only cover financial institutions. Non-financial entities should only be obliged to adopt this standard if the level of financial assets reaches a certain threshold. We suggest that a non-financial entity should adopt this standard if its financial assets (excluding cash and cash equivalents and, accounts receivable arising from trading transactions) account for more than 20% of its total assets. This could be in the form of a general (but rebutable) assumption that companies with more than 20% of their gross assets in financial assets earn a significant portion of their income from financial assets.

There are significant problems in measuring financial instruments that the JWG proposal acknowledges but seems to dismiss. These problems are particularly acute in emerging economies. Many Hong Kong enterprises have substantial holdings in financial instruments issued in other South East Asian countries that fall in the “emerging economies” category and/or are part of a group that includes enterprises located in the South East Asian countries. We also believe that developed economies may have these problems too.

Q.2 ***The definition of a financial instrument would differ somewhat from the present IASC definition (see Draft Standard paragraph 7 and Basis for Conclusions paragraphs 2.13 and 2.14). Do you agree with the definition in the Draft Standard? If not, what changes would you make, and why?***

A2 No specific comments.

Q.3 ***The Draft Standard would apply to all financial instruments except for those referred to in paragraph 1 (see also Basis for Conclusions paragraphs 2.20-2.36).***

a) Do you agree with the proposed scope exclusions and the manner in which they are defined? If not, why not?
b) Are there other items that should be excluded from the scope of the Draft Standard? If so, why, and how should those items be defined?

A3 If hybrid equity instruments are issued, these might be bifurcated (as in the case of IAS 39 where in the hands of the purchaser), and accounted accordingly. Otherwise there would be large incentives to disguise anything as equity to achieve a potentially more beneficial accounting treatment. If fair values were applied to all elements of the balance sheet there would appear no real need to fair value the equity (as this should occur by default as the residual of the assets and liabilities), but any other elements disguised within an equity instrument would seem to cause asymmetry.

If the intent of the standard setter is to remove categories which are "too difficult" to fair value, then special consideration needs to be given to the large number of emerging market assets that might in reality be far more troublesome to fair value.

Q4. ***The definition of an insurance contract used in the IASC Insurance Steering Committee's, Issues Paper: Insurance, November 1999, is used as the basis to exclude insurance contracts from the scope of the Draft Standard. However, financial guarantees and certain contracts that require payment based on the occurrence of uncertain future climatic, geological or other physical events would not be excluded (see Draft Standard paragraphs 1(d), 17-19 and Basis for Conclusions paragraphs 2.23-2.30)? Do you agree with this approach and definition? If not, what approach and definition would you propose?***

A4 See A3 above.

Q5. ***The scope of the Draft Standard would include certain additional items, including certain contracts to buy or sell a non-financial item and servicing assets and servicing liabilities (see Draft Standard paragraphs 2 and 3, Application Supplement paragraphs 197-210, and Basis for Conclusions paragraphs 2.37-2.47).***

(a) Do you agree that these additional items should be included in the scope? If not, why not?
(b) Are the additional items included defined in a manner that can be clearly applied? If not, how would you amend the requirements?
(c) Are there other items that should be included in the scope of the Draft Standard and, if there are, how should they be defined?

A5 No specific comments (see A3 above).

Q6. ***The Draft Standard would require an enterprise, with certain exceptions, to separately account for sets of contractual rights and contractual obligations in a hybrid contract that, if they were separated, would fall within the scope of the Draft Standard (see Draft Standard paragraphs 4-6 and 25 and Basis for Conclusions paragraphs 2.48-2.52). Do you agree with this proposal? Is the definition of a hybrid contract clear and operational? If you disagree with either of these two questions, what alternative would you suggest?***

A6 No specific comments.

Recognition and Derecognition

Q7. ***The basic recognition principle is that an enterprise should recognise a financial asset or financial liability on its balance sheet when, and only when, it has contractual rights or contractual obligations under a financial instrument that result in an asset or liability (see Draft Standard paragraphs 31-34, Application Supplement paragraphs 214-220, and Basis for Conclusions paragraphs 3.1-3.8). Do you agree? If not, why not? How would you amend the principle?***

A7 The area of anticipatory hedges again becomes problematic. Such a definition would recognize the hedge but often not the underlying risk being hedged (i.e. a non financial asset or liability in a corporation).

This is an ongoing difficult problem for accounting to which the recognition of the risk underlying may be a future solution, though this paradoxically in itself introduces circumstantial asymmetry.

Q8. ***The Draft Standard would require that a transfer that does not have substance not affect the assets and liabilities recognised. It proposes that a transfer has substance only if either the transferee conducts substantial business, other than being a transferee of financial assets, with parties other than the transferor, or the components transferred have been isolated from the transferor (see Draft Standard paragraphs 35 and 36, Application Supplement paragraphs 222 and 223, and Basis for Conclusions paragraphs 3.72-3.80). Do you agree? If not, how would you propose to limit the potential for non-substantive transactions that might occur without such a test?***

A8 We doubt whether such a test is necessary. Though often the purpose of a transaction may be other than trading, if it is in substance a transaction which leads to a different risk profile being faced by the organisation, then that alone should lead to new appropriate (and often different) accounting being necessitated.

Q9 ***The basic derecognition principle is that an enterprise should derecognise a financial asset or financial liability or a component thereof when, and only when, it no longer has the contractual rights or the contractual obligations that resulted in that asset, liability or component (see Draft Standard paragraphs 37-40, Application Supplement paragraphs 224-231, and Basis for Conclusions paragraphs 3.1-3.8 and 3.15-3.30). Do you agree? If not, why not? How would you amend the principle?***

A9 In general we agree with the derecognition principles proposed by the JWG. However the proposal fails to address the related SIC 12 issue on consolidation of special purpose entities. We do not think the JWG proposal can be adopted in isolation.

Q10 ***The Draft Standard would require that, in certain circumstances, when cash flows are passed through one enterprise to another, the assumption of a contractual obligation to make payments that fully reflect the amount of the cash flows being received from another enterprise would qualify as a transfer of the contractual right to receive the cash flows (see Draft Standard paragraphs 41-48, Application Supplement paragraphs 309-314, and Basis for Conclusions paragraphs 3.32-3.37).***

(a) Do you agree? If not, why not? How would you amend the requirement?
(b) Is the requirement and implementation material workable? If not, what changes do you believe are necessary to make them workable?

A10 The nature of the receipts are important, and once again the understanding of where the risks reside should be the fundamental driver of the accounting.

In certain countries, legal issues require the use of “pass-through” vehicles as conduits for transactions but in substance these vehicles are not designed to hold risk. If these vehicles were to be made an encumbrance on the process, the real business transactors (and hence the real risk management and liquidity often generated by such transactions) may be deterred, from executing the deals.

Q11. ***The JWG has developed criteria to be used to determine whether a financial asset (or a component thereof) should be derecognised by the transferor when a transfer of substance involving a financial asset takes place. In particular, the Draft Standard would require the whole of the financial asset previously recognised by the transferor to be derecognised if either the transferor no longer has a continuing involvement in that asset or the transferee has the practical ability, which it can exercise unilaterally and without imposing additional restrictions, to transfer the whole of that asset to a third party (see Draft Standard paragraphs 51-62, Application Supplement paragraphs 236, 237 and 242-250, and Basis for Conclusions paragraphs 3.50 and 3.81-3.92).***

(a) Do you agree? If not why not? How would you amend the requirement?

(b) The JWG has developed some material to determine whether the transferee has the practical ability described above (see paragraphs 56-61 and 244-249). Is this material appropriate, clear and operational? If not, how would you amend it?

A11 See A10 above.

Q12. ***The Draft Standard also would require, in the case of a transfer that does not result in the transferee having the practical ability described in Q11, if the transferor is left with either (a) an obligation that could or will involve the repayment of consideration received or (b) a call option over a transferred component that the transferee does not have the practical ability to transfer to a third party, some or all of the transaction to be treated as a loan secured by the transferred component (see Draft Standard paragraphs 63-67, Application Supplement paragraphs 251-258, and Basis for Conclusions paragraphs 3.38-3.71 and 3.93-3.102).***

(a) Do you agree? If not, why not? How would you amend the requirement? In particular, if you believe that some transfers involving financial assets are loans secured by the transferred asset, how would you differentiate between those transfers and transfers that are, in effect, sales of the transferred asset? If you do not believe that some transfers involving financial assets are loans secured by the transferred asset, or do not believe that some transfers are sales of the transferred asset, please explain your reasoning.

(b) The Draft Standard would require the liability to be recognised in such circumstances to be measured initially at the maximum amount that might need to be repaid under the obligation or the amount of the consideration received in respect of the transferred component over which the transferor has the call option. To the extent that the obligation and call option overlap, only the larger of the two liabilities would be recognised (see Draft Standard paragraph 64 and Basis for Conclusions paragraphs 3.93-3.98). Do

you agree with this approach to determining the amount of the liability? If not, how would you change the approach?

(c) The Draft Standard would require, in the case of transfers that the Draft Standard would require the transferor to treat in part or entirely as loans secured on the transferred asset, the transferee not to adopt accounting that is the mirror-image of the transferor's (see Application Supplement paragraphs 238-241 and Basis for Conclusions paragraphs 3.64-3.68). Do you agree with this approach? If not, why not? How would you amend the Draft Standard?

A12 See A10 above. In reality the amount recognised should reflect the risks that the business still carries. If "fair values" are to be applied, then they should be consistently applied here.

If the risks are operational ones, then again suitable estimates should be made of such risks and costs and provision or asset liability recognition made as suitable.

We agree to the proposal in 12(c) if the company has valid reasons to support the accounting treatment.

Q13. The Draft Standard would require the basic recognition and derecognition principles set out in paragraphs 31 and 37 to be applied to all transfers not falling within paragraphs 51-67 (see Draft Standard paragraph 68 and Basis for Conclusions paragraph 3.62). Do you agree with this proposal? If not, why not? How would you amend the Draft Standard?

A13 See A12 above.

Measurement

Q14. The Draft Standard would require an enterprise to measure all financial instruments at fair value when recognised initially and to re-measure them at fair value at each subsequent measurement date, with one exception (see Draft Standard paragraph 69, Application Supplement paragraphs 315-317, and Basis for Conclusions paragraphs 1.6-1.26). Do you agree? If not, what other approach would you suggest and why?

A14 This raises the whole fundamental issue of the application of fair values. This has a number of practical detractors in the emerging markets arena.

(a) The limited amount of information in order to calculate fair values.
(b) The corresponding volatility arising from the lack of transparency above.
(c) The common issue of credit quality and its impact.
(d) The higher level of transaction costs.
(e) The political nature of markets and pricing.
(f) The assumption of replacement by like instrument rather than best substitute in calculating fair values.

It appears that there is no clear rationale for excluding the category described as "private equity". We suggest that the standard should:

(a) either include the real private equity to stimulate investment. Practically the costs of keeping fair value books for these investors are almost prohibitively high.
(b) or exclude all categories.

The concept of fair valuing liabilities (or assets for that matter) without taking into account liquidity and other transactional factors appears irrational.

If further moves are made to increase the costs on the producers of accounts, there seems to be increasing needs to segregate to what size of organisations such requirements should be applied, with effectively ever rising minimum requirements.

Q15. The Draft Standard would require the fair value of a financial instrument to be an estimate of its market exit price determined by interactions between unrelated enterprises that have the objective of achieving the maximum benefit or minimum sacrifice from the transaction (see Draft Standard paragraphs 28, 70 and 71 and Basis for Conclusions paragraphs 4.1- 4.10). The JWG also proposes that any expected costs that would be incurred to exit a financial instrument at that market exit price should not be taken into account in arriving at fair value (see Draft Standard paragraphs 72 and 73 and Basis for Conclusions paragraph 4.11).

(a) Do you agree with the market exit price objective? If not, how would you amend it and why?
(b) Do you agree with the proposed treatment of direct costs to sell or obtain relief from a financial instrument? If not, how would you amend it?

A15 We disagree with the exit price approach in fair valuing financial instruments. We also do not believe it is conceptually appropriate to ignore direct costs to sell or close out a financial asset or liability in measuring the fair value of that asset or liability. In particularly in an emerging markets situation the costs of closing out a transaction, in particular with liquidity issues, can be very large (particularly on derivative style transactions that are not vanilla in nature and are on credit sensitive companies or products).

Similarly when considering the fair values of liabilities this cannot be practical as the close out value on the liability should be its replacement cost, not its market value per se as it is unlikely that they could repurchase the whole of an (their) issue at market prices, and even less likely in the case that it is pricing down because of short term or long term credit quality concerns.

The financial markets in emerging market countries tend to have;

i) Larger transaction costs due to relative execution illiquidity and other ongoing operational costs.
ii) Often substantial price variations due to liquidity and other related issues. To actually sell a block of securities substantially larger or smaller than

market size can practically be difficult and will result in noticeable pricing differences.

iii) In some situations the market volumes are not large enough to sell even relatively small percentages of an issue, hence one day's price is only indicative and not really meaningful as it may take many days if not months to sell the position.

Pricing mathematics in theoretical situations (i.e. when no valid executable market price which has both depth and liquidity), generally rely on opportunity cost approaches (for example Black - Scholes looks at hedging costs in attributing a price). It would seem sensible to consider applying similar considerations here, particularly on the liability side of the balance sheet or some assessment of the more prudent of;

i) opportunity cost
ii) market price
iii) market price as adjusted for costs and liquidity

Such adjustments from what is proposed in the standard could be booked as provisions, though in reality there are situations where to separate the two may not give a fair reflection of the true position of the business.

Q16. The Draft Standard would require an enterprise to measure a part of a hybrid contract that is to be separately accounted for as if it were a free-standing financial instrument, except if the enterprise determines that it cannot reliably identify and measure the separate sets of financial instrument rights and obligations in the hybrid contract. In the latter case the enterprise would account for the entire contract in the same manner as a financial instrument falling within the scope of the Draft Standard (see Draft Standard paragraphs 74-76 and Basis for Conclusions paragraphs 4.12-4.16). Do you agree with this proposal? If not, what alternative would you suggest?

A16 In paragraph 318, it said that "the reported amount of the remaining non-financial portion of the hybrid contract will be the difference between the fair value of the hybrid instrument as a whole and the fair value of the financial instrument as a free-standing financial instrument." In paragraph 319 it said, "if an enterprise cannot reliably identify and measure the separate sets of financial instrument rights and obligations, it should account for the entire contract as if it were a financial instrument". We do not have any problem with the previous statements. But it went on to say " an enterprise would, however, always separately identify any component of a hybrid contract that comprises equity of the enterprise and exclude it from being accounted for in accordance with the draft standard". We could not figure out how one could separately identify the equity component of a hybrid contract if one could not reliably identify and measure the financial instrument components of the same.

Q17. ***The Draft Standard sets out principles for estimating the fair value of financial instruments within a hierarchy. First, observable market exit prices for identical instruments are to be used if available. If such prices are not available, market exit prices for similar financial instruments are to be used with appropriate adjustment for differences. Finally, if the fair value of a financial instrument cannot be based on observable market prices, it should be estimated using a valuation technique that is consistent with accepted economic pricing methodologies (see Draft Standard paragraphs 77-86 and 104-117, Application Supplement paragraphs 320-327 and 344-369, and Basis for Conclusions paragraphs 4.17 and 4.36- 4.47). Do you agree with this hierarchy? If not, how would you amend the proposals, and why?***

A17 Conceptually we agree with the hierarchy, however further consideration needs to be considered for abnormal market conditions such as those which exist in emerging markets. The methodology assumes liquid substitutes for using theoretical methods and also implicitly the existence of reliable information, this is often not the case and is a major inhibition in making reliable, and auditable estimates of fair values.

A recognition of such situations and also that the use of more adjustments to theoretical values to cover such issues, would appear appropriate.

Q18. ***The Draft Standard addresses a number of circumstances requiring special consideration in using observed market prices to determine fair value (see Draft Standard paragraphs 87-103, Application Supplement paragraphs 328-343, and Basis for Conclusions paragraphs 4.18-4.35).***

(a) Do you agree with the Draft Standard's conclusions in these circumstances? Are there additional circumstances that should be addressed (please specify)?

A18 (a) See A17 above.

(b) Is the conclusion that value that is not directly attributable to a financial instrument should not enter into the determination of the fair value of a financial instrument (see Draft Standard paragraphs 92-94, Application Supplement paragraphs 331-339, and Basis for Conclusions paragraphs 4.18-4.32) appropriate and operational, in particular as it applies to demand deposit and credit card relationships? If not, why not?

A18 (b) We agree. We do not favour recognition of values that are not attributable to a financial instrument such as credit card relationships.

Practically, without the evidence of external market data (i.e. a sale), the value of such relationships is troublesome to estimate.

We believe that this area will remain difficult to address in the short term without an overriding change in accounting premise to fair values / replacement cost as oppose to the hybrid accounting framework into which these proposals would place us (if for example fixed assets stay at cost less diminution except certain investment property).

(c) Do you agree with the conclusion that, if an enterprise holds a large block of financial instruments and market exit prices are available only for individual instruments or small blocks, the available price should not be adjusted for the potential effect of selling the large block (see Draft Standard paragraphs 102 and 103 and Basis for Conclusions paragraphs 4.34 and 4.35)? If not, in what circumstances would you require adjustment, and how would you ensure consistency of the amount of adjustments that would be made?

A18 (c) The basis for fair valuing a large block of financial instruments as proposed in paragraph 102 is different from that proposed in paragraph 88. In paragraph 88 the fact that the observed price is recognised as not necessarily being a fair market price (for example, it is between two related parties) is taken as being grounds for ignoring the price other than as a reference to check prices determined by other methods. We consider that a market price based on sales of one or two items is just as irrelevant for the valuation of a large block. Rather than just accept that price as suggested by paragraph 102 we suggest following the other approach and use alternative measures and use the market price as a reference.

Also see A17 above.

Q19. The Draft Standard would require an enterprise that cannot estimate fair value using observable market exit prices of identical or similar financial instruments to estimate fair value by using a valuation technique. The Application Supplement includes material explaining how valuation techniques would be used in a number of situations (see Draft Standard paragraphs 104-117, Application Supplement paragraphs 344-369, and Basis for Conclusions paragraphs 4.36-4.47).

(a) Is this material clear and operational? If not, how would you modify it?
(b) Is this material sufficient, or do you believe that more detailed material is necessary? Please specify what additional material you believe to be necessary.
(c) Are there other significant circumstances (please specify) on which guidance should be provided?
(d) Is the proposed material consistent with market pricing practices? If not, how should it be modified?

A19 We do not agree with the guidance on fair valuing loan assets of financial institutions. If a bank reduces its spread charged on mortgages in order to attract more business from Base plus 400 points to Base plus 300, it would now discount its long term mortgage assets at Base plus 300. The impact would be an immediate significant gain on all the old mortgages at Base plus 400. As this is not from any change in the value of the loans (there has been no change in Base), there can be no justification for saying there is any change in the fair value of the existing mortgages. The only thing that has changed is the bank's own pricing policy. This provides a massive scope for profit manipulation.

In addition, the prescribed guidance is a significant move away from the previous approach of effectively, in tandem with the audit process, placing the valuation decision in the hands of the directors of the business.

In the simple situations identified the techniques appear in line with common best practices and hence would appear appropriate if such an approach is to be taken.

However, as we have found often in implementing the often more prescriptive FASB derived standards, when the situation does not fit into normal G7 market conditions, the applicability of the guidance may be difficult and also if the person applying the guidance does not have the experience to understand why it may need modification to achieve the appropriate result, may end in inappropriate values being ascribed.

Conceptually such approaches will never be able to address all situations unless markets are standardised and product ranges cease to proliferate. In emerging markets situations this therefore may lead to higher duties of care in application often in situations where conversely such skill sets and resources are less common.

A preferred approach may be one of suggesting the initial premise of market best practice ahead of defined techniques.

Q20. The JWG believes that fair values are, generally, reliably determinable, at reasonable cost, for all financial instruments except certain investments in private equity instruments (see Draft Standard paragraphs 122-125 and Basis for Conclusions paragraphs 1.14-1.21 and 4.64-4.67). Do you agree? If not, why not? If you believe that other items are not capable of reliable fair valuation, what are they, what factors cause their fair values not to be reliably determinable, and how should these items be measured?

A20 See A19 above.

Values can be attributed for most things, however the questions or challenge will always be the trade off between trying to apply fair values and the reliability / audibility of such values.

It must also be stated that practically speaking, if an organisation has diverse product ranges, the amount of effort involved to either automate such processes or manually attribute values may be substantial / prohibitive.

Q21. ***The Draft Standard would require the reported value of an enterprise's financial liabilities to reflect the enterprise's own creditworthiness and changes in it (see Draft Standard paragraphs 118-121, Application Supplement paragraphs 370-372, and Basis for Conclusions paragraphs 4.50-4.62).***

(a) ***Do you agree? If not, why not? How do you propose that the effect of changes in the enterprise's own credit worthiness could be excluded without giving rise to the difficulties noted in Basis for Conclusions paragraph 4.59?***

(b) ***Is the material in paragraph 370 of the Application Supplement, explaining how an enterprise can establish whether there has been a change in its own creditworthiness affecting its financial liabilities when there is no observable market exit price, appropriate and operational? If not, why not? How could it be improved?***

A21 We do not agree in fair valuing financial liabilities of a company. In the extreme case where a company is on the verge of winding up, an observed market valuation is not the result of the market demanding a high interest rate but the result of the market factoring in a "forgiveness" element. It is clear that part of the gain comes from "forgiveness" of the financial liabilities by the creditor. How would the 'forgiveness" element be separated from the credit risk element? To allow a company to effectively derecognise part of the loan under the guise of a measurement calculation is WRONG. We consider that either all changes relating to changes of credit status should be eliminated or a limit should be fixed that only allow changes up to the levels for normal junk bonds but do not see how we could distinguish the stage when the market is applying purely a risk element to a loan and when it is factoring in a "forgiveness" element.

There is no guidance in fair valuing deposits held by financial institutions.

This issue is also highly problematical in developing economies. Credit pricing is made up of a number of factors, which include;

i) Sovereign or political risk factors
ii) Countrywide economic factors
iii) Industry and business specific issues
iv) Investors short-term sentiment

They are often also heavily influenced by market liquidity issues. For example if a credit is expected to downgrade there are likely to be many more sellers then buyers, and in an illiquid market, a price equilibrium may not be easily found at a realistic level.

A number of these factors above are exogenous to the company itself, and may not hamper the company in maintaining an ongoing and vibrant business. For example consider the situation of a strong domestic market corporation whose credit rating is capped at the sovereign limit but in another country might achieve a higher rating. If the "credit cost" of that country declines, the price of the individual credit may change as well, though the fundamentals of the business have not moved.

They remain as equally able to tap the non-traded debt (loan and other credit substitutes) market both domestically and often internationally at the same levels as previously. Though under these proposals such market price swings would be factored into the balance sheet.

Again liquidity will have a major impact here. If only 10% of a bond is traded and the market has large selling pressure, the price may drop excessively. The issuer would unlikely be able to move into the market to repurchase its own issue in entity without forcing the price back up. To assume otherwise in emerging markets is difficult. If the "gain", due to credit decline cannot be realised by the business, it again appears illogical to attribute this value to the whole issue.

It would appear again sensible to allow the issue of liquidity to be adjusted for in the fair value of such items.

Q22. The Draft Standard would require an enterprise to establish appropriate policies and procedures for estimating fair value of financial instruments (see Draft Standard paragraphs 129 and 130, Application Supplement paragraphs 376-379, and Basis for Conclusions paragraphs 4.68 and 4.69). Do you agree with this proposal? If not, how would you change it in a manner that provides reasonable assurance of reliable and consistent fair value estimates?

A22 It is common practice in financial institutions to have such policies. Again they often have the same conceptual issues as described in the answer to Q19, and often best when defining conceptual approaches and practices to resolving issues rather than a heavily prescriptive approach.

Balance Sheet Presentation

Q23. The Draft Standard would require that minimum categories of financial assets and financial liabilities be distinguished on the face of the balance sheet and in the notes to the financial statements (see Draft Standard paragraphs 131-135 and Basis for Conclusions paragraphs 5.1-5.5). Do you agree with the categories proposed? Are the categories clear and useful? If not, how would you amend them and why?

A23 A drafting error was noted. Paragraph 135(a) does not fall into the "other significant financial assets and liabilities" as stated in paragraph 134(c).

Income Statement Presentation

Q24. ***The Draft Standard would require an enterprise to recognise all changes in the fair value of financial instruments, after adjustment for receipts and payments, in the income statement in the reporting periods in which they arise, with one exception (see Draft Standard paragraph 136, Application Supplement paragraphs 380 and 381, and Basis for Conclusions paragraphs 6.1-6.29) Do you agree? If not, how should such gains and losses be treated, and why?***

A24 Again the issue of anticipatory hedges needs to be resolved. This remains a difficult issue to overcome in the framework as described.

It would seem to make sense also to consider for financial institutions, reducing the distinction between realised and unrealised gains and losses, but to do so would require that the fair values attributed are ones that could be "realised", i.e. after adjustment for taking into account market circumstances such as liquidity.

Q25. ***The Draft Standard would require an enterprise to separately disclose the income statement effects of certain changes in fair value (see Draft Standard paragraphs 137-152, Application Supplement paragraphs 382-390, and Basis for Conclusions paragraphs 6.30- 6.84).***

(a) Do you agree with the proposed disaggregation? If not, why not? What other basis of disaggregation would you propose to provide information about the components of changes in fair value of financial instruments?
(b) Do you believe that any other gains and losses arising on fair value measurement of financial assets and financial liabilities should be separately presented in the income statement or notes thereto? If so, which gains and losses, and why do you believe that they should be shown separately? On what basis should such gains and losses be distinguished?

A25 (a) The fair valuing of interest appears meaningless as the level of interest to be recovered by the business is based on a previous decision (which may have been either beneficial or detrimental with hindsight) which has occurred. To try to attribute an analysis of the performance of that decision against present market circumstances appears strange, unnecessary and highly likely to confuse the layman.

Similarly the outcome may also be unusual as markets move. It is quite common to find situations in emerging markets where due to exogenous factors or economic market turmoil, rates may fluctuate widely, though the final price to the customer may be more stable. This volatility measure is relatively meaningless.

The computational processes necessary to calculate this, particularly for retail or commercial banks appears over-burdensome if not impossible, in any way which will provide values with any quality.

(b) These issues should be dealt with by the single earnings statement process. We believe that net gain or loss on interest-bearing financial assets should be shown separately from net gain or loss on interest-bearing financial liabilities in the income statement. It is not clear from the current drafting of paragraph 137(e) that they mean this.

Q26. The Draft Standard would require that interest revenue and interest expense be determined on the fair value basis, using the current yield to maturity basis, except that an enterprise may use the current market expectations basis if the chief operating decision maker relies primarily on that basis for assessing the performance of its significant interest-bearing financial instruments and it is consistent with the enterprise's basis for managing interest rate risk (see Draft Standard paragraphs 139 and 140, Application Supplement paragraphs 382-390, and Basis for Conclusions paragraphs 6.46-6.77).

(a) Do you agree that interest income and expense should be separately presented?
(b) Do you agree with the proposed method of determination? If not, how would you propose that interest revenue and interest expense be determined in a fair value model?
(c) Is the guidance clear and operational? If not, what additional guidance is necessary?

A26 See A25 above.

i) Hedges

Q27. The Draft Standard would not permit any special accounting for financial instruments entered into as part of risk management activities (see Draft Standard paragraph 153 and Basis for Conclusions paragraphs 7.1-7.22). Do you agree? If not, why not? How would you address the issues raised in paragraphs 7.1-7.22 of the Basis for Conclusions?

A27 Conceptually, specific exceptions for hedges appears unnecessary, as if markets are functioning appropriately and in an efficient manner, the fair values derived from the "hedging" contracts should offset the fair value movements in the "hedge underlying".

However, as mentioned above, the issue of anticipatory hedges still remains problematic, as the "hedge underlying" in such situations would not be recorded, where as fair value fluctuations in the hedge would be.

In addition we are concerned about fair valuing financial liabilities that are used to finance non-financial assets that are accounted for on a cost basis.

As we move further towards a full fair value model, we may need to consider the recognition of situations where it is probabilistically valid that assets and liabilities will be purchased and/or sold in the future, as these are inherent parts of the business's value creation process. If anticipatory hedges are being used to mitigate fair value volatility in these assets, it would seem more appropriate to recognize the underlying anticipatory contracts than not. This is in itself problematic (as it again raises issues about accounting asymmetry) but conceptually would appear more vigorous, as a transition towards full fair value recognition (and hence changes in goodwill arising from believed future transactions and relationships may need to be incorporated).

Disclosure

Q28. The Draft Standard would require disclosure of an enterprise's significant financial risks and of the enterprise's financial risk management objectives and policies (see Draft Standard paragraphs 154-163, Application Supplement paragraphs 393 and 394, and Basis for Conclusions paragraphs 8.5-8.12). Do you agree that this information is necessary to provide the context for understanding and evaluating information about the enterprise's actual financial risks and performance of its financial instruments? If not, how would you change these disclosures?

A28 The suggested levels of disclosure would in reality be only possible to be achieved, by only a few if any, financial institutions in the world of any relative size.

The disclosures would also heavily blur the distinction between management internal information to support decision makers, and externally reported matters. There is a high risk of such information disclosure becoming non-commercial, particularly for financial institutions were it would place organizations complying in a competitively disadvantageous position as they reveal too much about their strategy or positioning.

The average reader of accounts, and even the substantially above average accountant might find the interpretation of such information problematic, potentially leading to the drawing of the wrong conclusions, unless such disclosures are linked to substantial explanatory notes or market education. Questions have to be asked about the value in producing such information that, particularly in emerging markets, is unlikely to be either read or understood (in reality by both the reader and more troublingly by the producer).

Q29. The Draft Standard would require disclosures about financial instruments used to manage risks associated with transactions expected to occur in future reporting periods only when an enterprise separately discloses gains or losses on those financial instruments (see Draft Standard paragraphs 181 and 182 and Basis for Conclusions paragraphs 8.36-8.43). Do you agree with this approach? If not, how would you change it?

A29 See A28 above.

Q30. The Draft Standard encourages, but does not require, disclosures about the extent to which fair values of financial instruments and income and cash flows could change as a result of changes in underlying financial risk conditions (see Draft Standard paragraphs 179 and 180, Application Supplement paragraphs 409-411, and Basis for Conclusions paragraphs 8.30-8.35). Do you agree that these disclosures should be encouraged? If not, why not, and what alternative would you propose?

A30 See A28 above.

Q31. Do you agree with the other disclosures proposed in Draft Standard paragraphs 164-178 and 183-189 (see also Application Supplement paragraphs 391 and 392 and 395-408 and Basis for Conclusions paragraphs 8.13-8.29 and 8.44-8.56)? If not, how should the disclosures be amended, while maintaining a balance between the need to inform users about an enterprise's financial risk position and the concern of causing competitive harm to the enterprise or unnecessary burden for preparers?

A31 See A28 above.

Implementation Recommendations

Q32. The JWG proposes that about two years is a suitable period of time between issuance of a final standard and the effective date to balance preparation time with the need for standards (see Basis for Conclusions 9.1-9.4). Do you agree? Do you believe that certain enterprises need additional time to prepare for implementation? If so, please specify which enterprises and how they should be differentiated from those that apply a final standard initially. Also, please specify why these enterprises may need more time and the length of time that may be required.

A32 Given the timetable for the implementation of both FASB 133 and IAS 39, it is unlikely that many organisations would be able to meet a 2 year time line, especially if left open to all commercial enterprises, not just financial institutions.

It will take some time to amend the technical knowledge of practitioners, both in industry and public practice, to make available the width of skills necessary in order to apply these concepts appropriately and effectively.

Q33. ***Some suggest that a comprehensive fair value model for financial instruments should be first introduced in supplemental financial statements, presented in parallel with financial statements prepared in accordance with existing practices. Only after a period of time would such financial statements replace financial statements prepared in accordance with existing practices (see Basis for Conclusions paragraphs 9.5-9.7). Do you believe that supplemental financial statements should be introduced before replacing financial statements prepared in accordance with existing practices? If so, how would you overcome the disadvantages of such an approach, which are identified in Basis for Conclusions paragraph 9.6?***

A33 See A32 above.

Some form of informational process may be appropriate though again to mandate such a process will lead to the same issues as above.

Q34. ***The Draft Standard includes a number of transitional provisions to be taken into account in adopting it (see Draft Standard paragraphs 192-195 and Basis for Conclusions paragraphs 9.8-9.21). Do you agree with these provisions? If not, why not? How would you amend them?***

A34 See A32 above.

Q35. ***What steps need to be taken to assist in implementing a comprehensive fair value model for financial instruments? Please comment on any significant legal or other obstacles to implementing a final standard based on this Draft Standard and on how they might be best addressed.***

A35 Outside the standard G7 markets a number of economic environment issues would hamper application as written for example

a) Government intervention in the market place:
    - Rate fixing for interest
    - Rate fixing for foreign exchange
    - Market manipulation
b) Legal barriers to transferring assets
c) Legal barriers for all participants to access the market either directly or indirectly.
d) Taxation regime's that might influence market behaviour.

Q36. ***Are there other issues that must be resolved before the Draft Standard could be implemented? If so, what are they and what steps should be taken to resolve them?***

A36. No specific comments.