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Gavin Francis
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Dear Gavin

Discussion Paper 'Reducing Complexity in Reporting Financial Instruments'

This letter sets out the UK Accounting Standards Board's (ASB) comments on the above IASB Discussion Paper (DP).

The ASB welcomes the publication of this discussion paper, which we believe addresses issues of major importance to a large number of entities and users of financial statements. Our answers to the questions in the DP are set out in the appendix to this letter. We have a number of concerns with the proposals and the main points we would like to make are as follows:

- We agree that the current standard is complex, but we consider that this is to a large extent a result of the inherent complexity of financial instruments themselves. The mixed measurement model is one way of addressing the wide range of financial instruments and their uses in different businesses. However, IAS 39 then adds unnecessary complexity by its rules-based approach to implementing the mixed measurement model, and by failing to separate the simple principles that deal with most common financial instruments from the complex requirements that apply to only a few highly specialised financial institutions.
- We do not think that the IASB should adopt its proposed 'long term solution' without considerable further consultation and analysis – to do so is to prejudge the outcome of the debate. It is far from clear to us that a single measurement attribute is appropriate for all financial instruments, given the vast range of such instruments and the manner in which they are used by different entities in their businesses – we think that some types of business are more readily understood if financial instruments are measured at amortised cost. We also think that cash flow hedge accounting will continue to be necessary in a full fair value model.

- Furthermore, although we think that a current value measurement attribute is most likely to be appropriate for many financial instruments in a long term solution, we are not convinced that 'fair value' as defined in FAS 157 is necessarily the most appropriate current value in all cases.
- We also consider that the presentation in the performance statement of gains and losses arising from fair value (or current value) measurement is of critical importance, including the disaggregation of changes in value. Proposals on presentation need to be developed more fully before conclusions can be reached on whether complexity can be reduced by adopting a single measurement attribute.
- We therefore think that any long-term solution is many years away. Furthermore, we do not think that any of the intermediate proposals, with the exception of the simplification of hedge accounting, are likely to provide improvements in the foreseeable future. We therefore believe that a standard based on IAS 39 will remain current for a good number of years to come, and that the IASB should focus attention on improving the current standard, where we think there are several areas that could be revised to achieve simplification. We consider that this provides the opportunity for major improvements that would reduce costs for the many entities adopting IFRS for the first time over the next few years.

If you would like to discuss these comments, please contact Simon Peerless (020 7492 2424) or myself (020 7492 2434).

Yours sincerely



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Appendix

Response to the Invitation to Comment

Section 1 Problems related to measurement

Question 1

Do current requirements for reporting financial instruments, derivative instruments and similar items require significant change to meet the concerns of preparers and their auditors and the needs of users of financial statements? If not, how should the IASB respond to assertions that the current requirements are too complex?

There is no doubt that the current requirements of IAS 39 are complex and difficult to apply. Much of this derives from the wide range of financial instruments currently used, and the varying roles such instruments play in different businesses. Much of the complexity of the standard results from trying to differentiate between these roles, and to apply accounting that is appropriate to each role.

Users need to be given information that helps them understand three aspects of the financial instruments used by the entity:

- differences in the type of instrument
- differences in the role that the instrument plays in the entity's business
- differences in the reliability of valuations

Users need to be able to understand each of these aspects, and separate gains and losses in accordance with the type of business employing the financial instruments. Some types of business are essentially an investment business, and the value of the business is no more than the value of the portfolio of investments held. For other businesses (for example retail banking) the value of the business is not only the value of the net assets currently held, but in the ability to enter into future business that generates a profit margin. Fair values can distort information (such as net interest margin in retail banking, or for an industrial company that finances a project by fixed rate borrowings, the margin between cashflows generated by the project and the interest costs on the funding) that is useful in projecting future business cashflows.

The current standards seek to provide this information by applying different accounting treatments, including different measurement bases, to these different categories. The resulting complexity is one way of presenting users with information that cannot be distilled more simply without loss of valuable analysis. If this complexity is not present in the measurement and accounting for the financial instruments, it will be needed in the presentation of the resulting gains and losses in the performance statement.

However, IAS 39 then builds on this necessary complexity by the further complexity of a very rules-based approach to classification and measurement of financial instruments. For example:

- the arbitrary 'anti-avoidance' tainting rules for held-to-maturity instruments
- complex criteria for the fair value option
- complex and unclear hedge accounting rules
- rule-based definition of 'effective interest rate'
- lack of clarity on when impairments are to be recognised for instruments held at amortised cost
- embedded derivatives are also a major source of complexity, especially for non-financial businesses
- the scope of the standard, and definition of financial instruments, are difficult to understand, particularly for those whose business is not primarily in financial instruments.

For short-term improvements, we consider that the IASB should consider first removing this additional layer of complexity as well as trying to find a new intermediate approach.

We also consider that much of the application guidance was developed in response to particular questions raised by constituents; whilst this was helpful when the standard was first issued, it has reinforced the rules-based image of the standard and would be better replaced by a systematic explanation of the principles underlying the standard. In addition, much of the more complex material in the standard is of relevance only to specialised financial institutions. Other entities with relatively few simple financial instruments can find it difficult to identify the parts of the standard that relate to them. A redrafting that separated the general principles from detailed requirements for more specialised businesses would greatly enhance the usability of the standard.

We generally take the view that redrafting existing standards is rarely cost-effective, since the changes are not usually substantial enough to justify the costs of the change. However, we think this may be one case where there is scope for significant improvements that would provide benefits that exceed the costs – particularly as there are expected to be many first-time adopters of IFRS over the next few years who would benefit from these improvements.

Section 2 Intermediate approaches to measurement and related problems

Question 2

(a) Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that the IASB should not make any intermediate changes, please answer questions 5 and 6, and the questions set out in Section 3.

(b) Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?

(a) We agree that intermediate solutions should be considered. In our view, the IASB is prejudging the issue by concluding at this stage, without extensive further consultation and analysis, that a long-term solution is to move to 'full fair value' accounting. As discussed in our answers to questions 8 and 9, it is far from clear that a single measurement attribute is appropriate for all financial instruments, and although we think that a *current value* measurement attribute is most likely to be appropriate for most, if not all, financial instruments in a long term solution, we are not convinced that *fair value* as defined in FAS 157 is necessarily the most appropriate current value in all cases.

As a consequence, the IASB should be looking at intermediate approaches that are based on the current mixed measurement model. In particular, and as outlined below, we believe that significant improvements and simplifications can be made to the existing hedge accounting requirements.

(b) We agree with the criteria in paragraphs 2.2 (a), (c) and (d).

In relation to (d), we would emphasise the need to consider not only the costs to those entities that have already adopted IAS 39 and would need to change their accounting policies, but also the reduced costs of a simpler standard for those entities that will be moving to adopt IAS 39 over the next few years.

We disagree with the criterion in paragraph 2.2(b), that the intermediate solution must be a move towards full fair value; this effectively prejudices the eventual outcome.

Question 3

Approach 1 is to amend the existing measurement requirements. How would you suggest existing measurement requirements should be amended? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph 2.2?

We think there is considerable scope for improvement of the existing requirements of IAS 39. However, as we do not think that the IASB should conclude that full fair value is the long-term solution, these should not be regarded as intermediate steps but as simplifications to the current standard. In our view the following areas would merit further research:

(a) The classification of financial instruments reflects to some extent the presentation of gains and losses in performance statements. For example, the purpose of the available-for-sale category is to distinguish realised from unrealised gains and losses, so that the latter are reported in OCI. We think that as the presentation project develops further, it should provide the framework for reporting these separate aspects of gains and losses and enable the requirements in IAS 39 to be simplified.

(b) We believe that the held-to-maturity category could be simplified. Although the boards have previously rejected the proposal to eliminate this category, further development of the proposals in the presentation project might mean this decision can be reconsidered. If the category is to be retained, the anti-avoidance 'tainting' rules should be revisited; these are currently perceived as inhibiting entities from making the best business decisions, and can lead to lack of comparability if one entity uses the held-to-maturity category and a similar entity, either through choice or because it has made sales of investments in earlier years, does not. A better alternative would be to require full disclosure of sales from held-to-maturity portfolios, together with an explanation of why the classification remains appropriate for the remainder of the portfolio.

(c) We think that the requirements for embedded derivatives, and in particular the distinction between 'closely related' embedded derivatives and others, could be substantially improved and clarified by replacing the existing lists of embedded derivatives that meet, or do not meet, the 'closely related' concept with a general principle that expresses what that concept is intended to be, and which can be applied to determine the status of any embedded derivative.

(d) The current requirements for recognising impairments on instruments measured at amortised cost are unclear, in particular the distinction between incurred loss and expected loss.

(e) We consider that requirements of the 'effective interest rate' method of calculating amortised cost are unnecessarily complicated and 'rules-based'. It is often difficult to understand what is required for more complex instruments. Redrafting of these requirements based on a general objective of what effective interest rate is intended to achieve, that can be applied to any interest-bearing instrument, would simplify adoption of the standard by those entities not currently using it, although might impose additional costs on those entities that are already applying the standard.

(f) The scope of the standard is unclear and unnecessarily complex, and for some instruments it is necessary to go through a chain of complicated definitions to determine whether an item is in or out of the scope.

Although these changes (and in particular the last three) might increase costs for those entities that have already adopted IAS 39, and therefore implemented accounting systems that meet the existing requirements, they could produce significant cost savings for those entities that are yet to adopt IFRS. Furthermore, by removing distortions and inconsistencies caused by the existing standard, these simplifications are likely to provide improved information for users.

Although paragraph 2.14 points out that experience has shown that amending existing requirements can take considerable time and resources compared with the benefits, we think that this concern can be alleviated by careful project management (and in particular clearly specified project objectives and scope); and that similar criticisms can be applied to 'blank sheet of paper' projects that are not well managed.

Question 4

Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions.

(a) What restrictions would you suggest on the instruments eligible to be measured at something other than fair value? How are your suggestions consistent with the criteria set out in paragraph 2.2?

(b) How should instruments that are not measured at fair value be measured?

(c) When should impairment losses be recognised and how should the amount of impairment losses be measured?

(d) Where should unrealised gains and losses be recognised on instruments measured at fair value? Why? How are your suggestions consistent with the criteria set out in paragraph 2.2?

(e) Should reclassifications be permitted? What types of reclassifications should be permitted and how should they be accounted for? How are your suggestions consistent with the criteria set out in paragraph 2.2?

We believe that this approach would result in proposals similar to the modified IAS 39 suggested in our answer to question 3, with the disadvantage of starting from scratch rather than building on the existing structure of the standard. It is unclear how this approach will result in a standard that is significantly less complex. Furthermore, as noted above we do not agree that the IASB should assume that full fair value is the long-term solution, and an intermediate solution based on full fair value with exceptions can be seen as prejudging that outcome. For these reasons we do not support this approach. In response to the specific issues raised:

(a) We do not think that a criterion for eligibility for cash-based measurement that is based on the variability of cash flows is any less complex than the current IAS 39 definition of loans and receivables (and will certainly lead to the question of where the line is to be drawn between high variability and low variability).

(b) Instruments not at fair value should be at amortised cost less impairment.

(c) As noted in our answer to question 3, we consider that the IAS 39 impairment requirements need clarification, in particular the distinction between incurred and expected loss models. If the IASB follow Approach 2, a similar debate and clarification will be needed.

(d) We see little point in changing the current IAS 39 basis before the IASB has developed more fully its proposals on presentation.

(e) We consider that reclassifications should be allowed under this approach to enable entities to reflect changes in the purpose for which an instrument is held; for example if an asset is held in a loan portfolio at amortised cost and then transferred within the business to a trading portfolio, it would be misleading to continue to report it at other than fair value.

Question 5

Approach 3 sets out possible simplifications of hedge accounting.

(a) Should hedge accounting be eliminated? Why or why not?

(b) Should fair value hedge accounting be replaced? Approach 3 sets out three possible approaches to replacing fair value hedge accounting.

(i) Which method(s) should the IASB consider, and why?

(ii) Are there any other methods not discussed that should be considered by the IASB? If so, what are they and how are they consistent with the criteria set out in paragraph 2.2? If you suggest changing measurement requirements under approach 1 or approach 2, please ensure your comments are consistent with your suggested approach to changing measurement requirements.

(a) We do not support the proposal to eliminate hedge accounting entirely; hedging is carried out by many types of entity as a way of bringing greater certainty to future cashflows inherent in their business, and users are very interested in understanding the extent to which this has been done. We think that reporting financial instruments would be more complex from the users' point of view if the financial statements did not allow hedge accounting, so that the effects of risk management were explained only in management commentaries. Elimination of hedge accounting would also lead to management devising their own hedge accounting adjustments for non-GAAP or management commentary figures, that would be unconstrained by any hedge accounting rules in the standard.

We consider that, at present, the rules for hedge accounting are so complex that it is difficult to understand when risk management can be reflected in the accounts by hedge accounting and when it may not. We also understand that many entities find the requirements so complex that they prefer to ignore the possibility of hedge accounting. This leads to a lack of comparability between entities, and a lower level of understanding by users of the hedging carried out by those entities. In contrast, what users need is greater transparency in the way that entities have used hedges in the management of business, including information on the extent to which total exposures have been hedged and how far into the future costs and other hedged cashflows have been hedged.

(b)(i) We therefore support the IASB's intention to consider ways of modifying or replacing the current hedge accounting requirements.

However, we do not support any of the suggestions for replacing fair value hedge accounting set out in paragraph 2.35 of the Discussion Paper. Our views on each of these are as follows:

A fair value option

Although we would welcome some reduction in the current restrictions on using the fair value option (and would also like to see it extended to certain non-financial assets and liabilities that have characteristics similar to financial instruments), we do not consider that this should be seen as a replacement for fair value hedge accounting. We believe that the fair value option should be simply an unfettered way of using fair value measurement for financial instruments that the entity's management consider are best reported on a fair value basis, irrespective of whether these are subject to hedging or other risk management. In contrast, fair value hedge accounting should be restricted to risks that are actually being offset in hedging arrangements, and subject to some designation and effectiveness testing. To try to use the fair value option to meet both these purposes would add confusion and complexity.

Furthermore, if the fair value option was to be used to replace hedge accounting, it would be necessary to modify it (as suggested in paragraph 2.40 of the discussion paper) to permit its application to specific portions of the designated item, and for specific periods only (for which the hedge was maintained). However, if this flexibility were to be added to the fair value option, it would be necessary to add restrictions similar to those applying to fair value hedge accounting.

Recognition outside earnings of gains and losses on hedging instruments

This approach would have the merit of treating both cash flow hedging and fair value hedging in the same way. However, we are concerned that this approach would still depend on detailed requirements for hedge designation, identification of hedged portions, and effectiveness, and would therefore be no less complex than the existing fair value hedging. It would also depend on developing requirements for the presentation of these gains and losses in the performance statement, which are likely to be no less complex than the existing hedge accounting requirements. We also have fundamental objections to the extension of 'recycling' that would be the result of this approach.

Recognition outside earnings of gains and losses on hedged items

This approach presupposes that hedged items are measured at fair value, and that changes in fair value attributable to specified risks are recognised in OCI rather than earnings. We do not see this as a viable suggestion as an intermediate solution, replacing fair value hedge accounting in the existing standard, but one possible approach to performance reporting within a full fair value model.

(b)(ii) Other suggestions

We note that two further approaches to dealing with the gain or loss on the hedged item under a fair value hedge could be considered by the IASB:

- to offset the gain or loss on the hedged item against the value of the hedging derivative (with clear disclosure of the amount offset)
- to defer the gains and losses on the hedged item as separate assets or liabilities on the balance sheet.

Whilst neither of these approaches is conceptually pure, they each provide a clearer picture of the effects of hedging than the current fair value hedge accounting model or the IASB's second approach referred to above (in particular, under the second suggestion the total accumulated hedge gains and losses that are deferred are immediately apparent to the user). However, they share with the IASB's second approach the criticism that detailed designation and effectiveness requirements are necessary. One of the advantages of the current IAS 39 fair value hedge model is that ineffectiveness is automatically recognised in profit and loss as it occurs; this is not the case with any of the alternative approaches.

We therefore do not consider that the alternatives to fair value hedge accounting proposed by the IASB are likely to result in a method that reduces complexity, either for preparers or users of financial statements. Instead, the IASB should concentrate on improvements to the current model, as discussed in question 6 below.

Question 6

Section 2 also discusses how the existing hedge accounting models might be simplified. At present, there are several restrictions in the existing hedge accounting models to maintain discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings. This section also explains why those restrictions are required.

(a) What suggestions would you make to the IASB regarding how the existing hedge accounting models could be simplified?

(b) Would your suggestions include restrictions that exist today? If not, why are those restrictions unnecessary?

(c) Existing hedge accounting requirements could be simplified if partial hedges were not permitted. Should partial hedges be permitted and, if so, why? Please also explain why you believe the benefits of allowing partial hedges justify the complexity.

(d) What other comments or suggestions do you have with regard to how hedge accounting might be simplified while maintaining discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings?

(a) & (b) We consider that the IAS 39 hedging models could be simplified very significantly by:

- removal of some of the ineffectiveness requirements, and
- more generally, by redrafting the requirements so as to be based on clear principles.

One of the advantages of the IAS 39 fair value hedge model is that by recognising both the change in value of the hedging instrument and the change in value of the hedged risk in profit and loss as they occur, all ineffectiveness is automatically recognised as it arises. We therefore see little need for complex prospective ineffectiveness tests; and retrospective tests need do no more than ensure that ineffectiveness is, indeed, fully recognised. We consider that provided this is done, little harm is done by using hedge accounting for a transaction where there is a high degree of ineffectiveness, although we would suggest there is a general 'reasonableness' test that the hedging transaction is entered into with a hedging purpose (which might take into account the entity's risk management strategy and the alternatives available for hedging a particular risk).

More fundamentally, we consider that much less complex requirements for hedge accounting could be developed based on three principles:

- that the hedging relationship is designated as such at the time it is established, without retrospective designation;
- the hedge must be consistent with the entity's risk management strategy, that the entity has a risk of loss arising from changes in financial variables, that the hedging transaction is an effective way of mitigating that risk without introducing further risks, and that the strategy of risk mitigation is consistently followed;
- all actual ineffectiveness is measurable and recognised in profit and loss immediately it arises.

This approach would enable hedge accounting to move away from the highly transaction-driven model of IAS 39 to recognising that entities use hedging for managing risks arising over a portfolio, not simply offsetting individual transactions.

We believe that, under this approach, most of the IAS 39 requirements would effectively remain as consequences of the principles, although more in the nature of implementation guidance than rules applying to all circumstances.

We also consider that the proposals for reduced effectiveness testing in the recent FASB exposure draft *Accounting for Hedging Activities* (issued in June 2008) might form a starting point for simplification of hedge accounting (although we have concerns over other aspects of the FASB proposals, in particular the limitation of hedging of portions).

(c) We consider that partial hedges should be retained, since the purpose of a significant proportion of hedges in practice is to offset just one of a number of risks inherent in the hedged position. To preclude hedge accounting for partial hedges would mean that hedge accounting under the standard would be even further removed from actual hedging transactions carried out by businesses.

(d) See above.

Question 7

Do you have any other intermediate approaches for the IASB to consider other than those set out in Section 2? If so, what are they and why should the IASB consider them?

We have no further suggestions other than those referred to above.

Section 3 A long-term solution – a single measurement method for all types of financial instruments

Question 8

To reduce today's measurement-related problems, Section 3 suggests that the long-term solution is to use a single method to measure all types of financial instruments within the scope of a standard for financial instruments. Do you believe that using a single method to measure all types of financial instruments within the scope of a standard for financial instruments is appropriate? Why or why not? If you do not believe that all types of financial instruments should be measured using only one method in the long term, is there another approach to address measurement-related problems in the long term? If so, what is it?

Although the use of a single measurement attribute is appealing, we do not believe that this conclusion should be reached without first considering the related question of presentation in the performance statement. The different types of financial instruments – and the different uses to which financial instruments are put in different businesses – mean that users do not need the same information for all financial instruments. For example, understanding the business of a retail bank and forecasting its future profitability involves knowing details of interest margins and impairments, rather than just changes in fair value. If this information is not provided by the measurement basis – as IAS 39 attempts to do – it must be provided by the way the gains are presented in the performance statement. We therefore believe that this question cannot be addressed without also considering the presentation, which will give rise to its own complexities.

In developing its views on presentation, the IASB should keep in mind the need for management to be able to present a simple picture of a complex business organisation – market reactions to results announcements are often driven by headline presentation rather than detailed analysis of note disclosures.

Question 9

Part A of Section 3 suggests that fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments.

(a) Do you believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?

(b) If not, what measurement attribute other than fair value is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Why do you think that measurement attribute is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Does that measurement attribute reduce today's measurement-related complexity and provide users with information that is necessary to assess the cash flow prospects for all types of financial instruments?

We agree that some form of *current* value is the only measurement attribute that might be appropriate for all financial instruments (although as explained in Q8 we do not necessarily accept that any single attribute is appropriate). However, we do not believe that fair value, as prescribed in FAS 157, is necessarily the most appropriate current value to use. Where instruments are not traded in active markets, it is necessary to devise some form of valuation model, but to characterise this as an exit value in a transaction between hypothetical market participants can lead, in our view, to distortions from trying to force a model onto a purely hypothetical transaction, and unrealistic interpretations of what the value actually means. For example, the current market turmoil has raised the question of how liquidity premium should be dealt with and whether changes in the premium should be reflected in the appropriate current value of financial instruments in stressed markets.

We propose that before a long-term objective based on current value is adopted, a project to consider the objectives and principles of current value measurement, and how this relates to fair value or other current measurement attributes, should be undertaken.

Question 10

Part B of Section 3 sets out concerns about fair value measurement of financial instruments. Are there any significant concerns about fair value measurement of financial instruments other than those identified in Section 3? If so, what are they and why are they matters for concern?

Although we cannot suggest any further areas of concern, we question whether the DP's analysis of these concerns is sufficiently detailed. In particular:

- presentation of unrealised gains and losses (paragraphs 3.48-50) – simple separation between market price changes and cash flow changes is unlikely to be sufficient; the problem really is that the move to fair value for all financial instruments shifts the complexity from the categorisation of instruments for measurement purposes to the categorisation of gains and losses in the performance statement;
- changes in credit risk (paragraphs 3.73 to 3.77) – this is a difficult area on which we have yet to reach a conclusion (although in the case of pensions liabilities our preliminary view is that these factors should not be taken into account), but we do not find the analysis and conclusions in the DP full and convincing;
- difficulty in estimating fair values (paragraphs 3.78 to 3.80) – this is a very significant issue that the DP dismisses in three short paragraphs; in particular, IASB must take account of the lessons that arise from the work it is planning to undertake in response to the current credit crisis and market turmoil.

Question 11

Part C of Section 3 identifies four issues that the IASB needs to resolve before proposing fair value measurement as a general requirement for all types of financial instruments within the scope of a standard for financial instruments.

(a) Are there other issues that you believe the IASB should address before proposing a general fair value measurement requirement for financial instruments? If so, what are they? How should the IASB address them?

(b) Are there any issues identified in part C of Section 3 that do not have to be resolved before proposing a general fair value measurement requirement?

If so, what are they and why do they not need to be resolved before proposing fair value as a general measurement requirement?

As noted above, we consider that a fuller consideration of different current value attributes as alternatives to the FAS 157 fair value needs to be carried out.

Question 12

Do you have any other comments for the IASB on how it could improve and simplify the accounting for financial instruments?

We have no further comments.