THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

23 September 2008

Our ref: ICAEW Rep 100/08

Your ref:

Sir David Tweedie
International Accounting Standards Board
1st Floor
30 Cannon Street
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By email: commentletters@iasb.org

Dear David

REDUCING COMPLEXITY IN REPORTING FINANCIAL INSTRUMENTS

The Institute of Chartered Accountants in England and Wales (the Institute) is pleased to respond to your request for comments on the Discussion Paper *Reducing Complexity in Reporting Financial Instruments*, published in March 2008.

Please contact me if you would like to discuss any of the points raised in the attached response.

Yours sincerely

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW Representation

ICAEW REP 100/08

REDUCING COMPLEXITY IN REPORTING FINANCIAL INSTRUMENTS

Memorandum of comment submitted in September 2008 by The Institute of Chartered Accountants in England and Wales, in response to International Accounting Standards Board Discussion Paper *Reducing Complexity in Reporting Financial Instruments*, published in March 2008.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the Discussion Paper *Reducing Complexity in Reporting Financial Instruments*, published by the International Accounting Standards Board in March 2008.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

4. Our members occupy a wide range of roles throughout the economy. This response was developed by the Financial Reporting Committee of the Institute, which includes preparers, analysts, standard-setters and academics as well as senior members of accounting firms.

MAJOR POINTS

Major concerns in relation to the long-term project

5. We welcome the Discussion Paper as a first step in meeting the commitment in the Memorandum of Understanding to issue one or more due process documents on financial instruments. However, the long-term proposals in the Paper do not present a viable way forward. It is very clear that there are significant issues such as how to define fair value, how to define financial instruments and how to disclose and present information on a fair value basis that would need to be resolved before the long-term proposal can even be contemplated. In addition, other IASB projects such as financial statement presentation and distinguishing between liabilities and equity will need to have made considerable progress before the full implications of the proposal can be assessed. Even if all these issues could be resolved, it is clear that there is a substantial body of opinion that does not agree with the proposals on a conceptual level. In this respect, the Discussion Paper is unlikely to change the views established in the late 1990s when the issues were last debated.

Fair values

6. At the moment, there is no clear agreement on the meaning of fair value. Until it is clear what fair value is in terms of entry price, exit price and how illiquid markets should be addressed - issues currently being addressed both in developing the FAS 157 discussion paper and the recommendations in

Report the Financial Stability Forum on Enhancing Market and Institutional Resilience - it seems inappropriate for the IASB to suggest a long-term solution mandating the use of fair value.

7. The determination of what is meant by fair value will need to be made in light of experience gained in current market conditions. The use of fair values has not contributed to current market conditions (as some have claimed) but the relevance of fair values in extreme market conditions has been questioned and this should be at least examined within a longer term project about fair value. The examination should consider financial liabilities as well as assets since the measurement and presentation of the impact of own credit on financial liabilities is being questioned by users, including analysts, and the meaning of fair value for some liabilities, such as bank deposits, is not clear.

8. As a result of these projects and other more practical considerations, there may be deemed to be no benefit in measuring at fair value those financial instruments for which there is no liquid market and where the business model is to originate and retain them for the longer term. In other words, if items are not managed on a fair value basis, then there must be a question over usefulness of this measurement basis for reporting in the primary financial statements on conceptual, practical *and* cost-benefit grounds.

Mixed model

9. We believe that at the current stage of development of financial reporting the mixed measurement model is the most appropriate model for financial instruments, in the same way as it is for non-financial items. This approach best reflects the use of assets and liabilities in the business which drives how future cash flows will emerge. We share the commonly held view that basing the income statement on how financial instruments are used in the business, reflects different business models better than a single measurement basis, and, coupled with disclosing fair values for all financial instruments, provides the most useful information.

Danger of focusing on the balance sheet

10. The proposed long-term solution seems overly focused on the balance sheet. While having fewer categories for financial instruments in the balance sheet might arguably reduce complexity in this statement, the problem simply resurrects itself in the performance statement in terms of reporting and recycling fair value movements. Financial instrument measurement cannot be addressed in isolation from financial statement presentation, definitions of equity and liabilities and other cross cutting projects in the conceptual framework.

11. Furthermore, increasing the use of fair value for instruments which are not held for trading or managed on a fair value basis, particularly where there is no market or an illiquid market, is likely to increase significantly the extent and volume of disclosure necessary to explain the determinations of fair value, where in many cases amortised cost coupled with fair value disclosures already gives all relevant information. This may detract from the usefulness and understandability of financial reporting.

12. Moreover, even if all financial instruments were measured at fair value, similar categories to those that already exist would almost certainly be required to differentiate gains and losses on instruments that are used in the business in different ways in the performance statement. For example, we understand from bank analysts that, they need to understand interest margins and impairment losses. Therefore, users are likely to find that they need the total fair value movement in a period analysed into different components such as interest income and credit movements to be able to understand the business performance, which is likely to be difficult and subjective. Users are also likely to need a greater understanding of the methodologies for determining fair values for instruments that are not traded on liquid markets and the assumptions underlying the models and their sensitivities. This increased volume of disclosure will add considerably to the difficulties of preparing and understanding the financial statements. Even if it could be argued that full fair value results in better reporting (and we are unconvinced in this respect), it cannot be said to be less complex.

No need for major short-term change

13. While we accept that IAS 39 contains some widely-accepted problems, we do not believe that significant short-tem change is required. If the IASB wish to make changes to the existing standard rather than embarking on a medium term project to replace IAS 39, stringent cost/benefit criteria must be applied. Preparers, auditors and users have devoted considerable effort to understanding and implementing the requirements of IAS 39 to date, and we believe that this standard is finally, after several years of experience, largely operational for larger entities (although it may still cause problems for smaller, private entities - which can be dealt with through the IFRS for private entities project). And, in resource terms, there are simply more important issues that deserve priority in the IASB work plan, such as the recommendations in the Financial Stability Forum report (see paragraph 29 below).

14. Nevertheless, we agree that it is useful to explore the potential for simplifying the accounting for financial instruments as a medium term project rather than as a step along a process to a long-term proposal that would prove difficult to implement and unhelpful to both users and preparers.

Complexity

15. As we have stated in other submissions (for example, in our response to the Discussion Paper 'Financial instruments with characteristics of equity'), complex instruments necessarily involve complex accounting. We do not regard it as appropriate to reject accounting models purely on the grounds of complexity. Conversely, the model judged to be the simplest is not necessarily the best, particularly if the resulting information is not relevant or understandable. Of course, accounting standards themselves should set out clear principles and not create additional, unnecessary complexity, and wherever possible unnecessary complexity should be removed from accounting standards. However, the aim must be to create meaningful financial reporting that meets users' needs at a reasonable cost. Financial reporting is about accommodating practical concerns within a conceptually sound framework.

16. The implication of the Paper is that using different measurement bases leads to complexity, which can therefore be reduced by reducing the number of

available bases. However, we question whether the measurement bases themselves are the source of the problem. Some of the bases are applied in accordance with the framework and are consistent with the reporting of non-financial items. Most of the criticisms of the standard probably derive from the lack of clear principles in the standards, some poor drafting and voluminous rules in the standard and implementation guidance, rather than the outcomes (see paragraph 25 below). We do not regard the categories themselves as a major source of complexity, and we believe that categories should be retained as they are probably more straightforward to understand and apply than alternative approaches. While we believe that the categories could be restated with clear underlying principles based on how the instrument is used in the business rather than the nature of the instrument itself, we do not recommend such changes are made as a quick fix. It may be appropriate to consider such changes as part of a medium term project to replace IAS 39, rather than as an intermediate step to a longer term aim.

17. Perhaps the most complex area where it may be appropriate to consider short term changes is hedge accounting. We believe hedge accounting should be retained for the present, but we would support a re-examination of how it is dealt with in the standard where it may be possible to clarify principles and remove unnecessary rules. It may be that the requirements for companies to meet the very detailed and specific rules in the standard to achieve hedge accounting results in the accounting diverging from the economics of the actual hedging strategy. This would make it difficult for companies to explain their hedging strategy in terms of the accounting result and for users to understand how the hedge accounting result relates to the underlying economics. Easing the detailed rules could achieve more understandable hedge accounting. We put forward some ideas in paragraph 54 et seq below.

18. The whole issue of hedge accounting should be examined on a fundamental basis in both the longer term part of the Financial Statements Presentation project and particularly in the Conceptual Framework Project, when the use of hedge accounting would need to be reconciled to the definitions of income and expenses (gains and losses) and to the requirements for financial reporting to produce useful and understandable performance reporting.

19. We note that other areas of complexity are not addressed, such as derecognition, embedded derivatives (particularly those in non-financial instruments), impairment (particularly for AFS instruments) and effective interest, and IFRS 7 disclosures, for example, for wholly-owned subsidiaries. If the driver for this project is truly to reduce complexity as much as possible, it is hard to see how this could be done without also tackling these issues.

Presentation and disclosure

20. The Paper 'acknowledges the importance of presentation and disclosure', but goes on to state that 'this paper is not about presentation and disclosure'. We believe that this is disappointing because, as also acknowledged, 'disclosure is critical because no single number, regardless of the measurement attribute used, provides all the information users need to understand financial instruments' (paragraph BD19).

21. In our view, clear and informative narrative disclosure is essential to support financial disclosure - whatever basis of measurement is used - in order to reduce complexity for the user of accounts. Preparers of financial statements

should explain why a particular measurement base is appropriate for a particular financial instrument or class of financial instruments.

22. The Paper notes that 'neither IFRS 7 nor SFAS 157 was intended to produce a package of information that would be most relevant if nearly all financial instruments were measured at fair value'. Before requiring fair value measurement for all types of financial instruments, the IASB will need to undertake such a project. As stated above, we do not believe that the long term proposals are viable. However, if they were to be pursued, we would include consideration of how narrative reporting could be used to reduce complexity in reporting financial instruments in the list of issues to be resolved.

SPECIFIC QUESTIONS

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?

23. No. While it may be possible to improve IAS 39 in the medium term, we do not think that significant change is required at present.

24. Complexity in reporting arises in many instances from the complex nature of some financial instruments. Financial reporting should faithfully reflect this complexity within the bounds of understandability and cost/benefit considerations. Complexity also arises from the different business models of entities and accounting standards should reflect this complexity rather than try and simplify it. We are not concerned that different entities measure financial instruments in different ways if they are used differently in the business nor are we concerned that the same entity can report the same financial instrument differently if used differently in the business. This reflects the underlying business model and financial reporting would provide less relevant and understandable information if these differences were suppressed by the use of a single measurement basis.

25. Some assertions that the current requirements are too complex are no doubt a result of the lack of clear principles in the standards, some poor drafting and the sheer volume of implementation guidance that has been seen to be necessary. Some complexity is a result of the requirements of the standards themselves, particularly in terms of anti-avoidance provisions and detailed rules. We note that the derecognition requirements and the debt/equity distinction, to which some of the criticisms above apply, are outside the scope of this paper.

26. Certainly the current requirements could be better drafted and they could be simplified in terms of the removal of unnecessary rules and we support the IASB in making efforts in these areas. However, it seems to us that the complexity of the standards is somewhat overstated and the benefits of familiarity from use over some time should not be discarded lightly.

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.

27. Our answers to the detailed suggestions for changes to measurement and hedge accounting are set out in paragraph 54 et seq below.

28. While we agree that the IASB should consider addressing the unnecessary complexity that arises from measurement and hedge accounting, we would also point out that IAS 39 as revised in 2004 has now been used by a large number of companies for three years and IFRS 7 has just been implemented. Rather than starting with a premise that the standards are complex because there are a lot of categories for measurement and two kinds of hedge accounting, it may be useful to conduct some credible research into what preparers find difficult in operating IAS 39/IFRS 7 and what users find difficult to understand and interpret. Indeed the challenges of complying with the standards and understanding the results in the current market conditions should be fully understood and addressed by the IASB before drawing any final conclusions on the appropriate way forward both in the longer term and in what improvements should be made to the existing requirements. As recommended in the Financial Stability Forum report, it may be that addressing fair value measurement and disclosure, derecognition and consolidation are a more appropriate use of IASB resources in the short term than relatively minor improvements to IAS 39.

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

29. We support genuine improvements being made to the existing standards where there are clear cost/benefits in making changes. We do not support changes being made to facilitate a journey to a destination that has yet to receive proper consideration and where the measurement bases are not agreed, particularly given that the IASB is still considering the SFAS 157 discussion paper and issues of performance reporting have yet to be addressed. Therefore we do not agree with criterion 2.2b, which appears prejudicial in making an intermediate approach dependent on a criterion that is still subject to debate. We do accept that improvements to the existing standard are unlikely to reduce the number of financial instruments measured at fair value, but we would not accept this as an objective.

30. We note that criterion 2.2a makes no reference to the change providing more reliable information (or more faithfully representative information) as well as more relevant and more easily understandable information and we recommend that providing more reliable information is also included in the criteria. We fully support criterion 2.2d.

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?

31. Four approaches to either reduce the number of measurement categories and/or simplify or eliminate some of the requirements or restrictions of the existing categories are identified in the paper, and discussed below.

- *The elimination of the held-to-maturity category in IAS 39 and SFAS 115.*

32. Since the category is little used due to the tainting rules, eliminating the category is unlikely to have sufficient impact on accounting to make the change worthwhile.

- *Alternatively, or cumulatively, the elimination of the available-for-sale category and simply require measurement at fair value through the P&L (IAS) or trading (US)*

33. Many instruments that entities consider are held for the long term are reported as available for sale. These instruments are not held for trading and gains and losses on them would need to be distinguished from trading in the income statement to allow users to properly understand their nature. Therefore we think that a category identical or similar to available for sale would be necessary for financial statement presentation so there can be little benefit in eliminating the category, although consideration could be given to the detail of its measurement requirements, for example, the determination and reporting of impairment.

34. In the current market conditions there has been a significant divergence in the value of available-for-sale portfolios measured on an expected future cash flow basis from 'fair value' based on observable market exit prices. The fact that the available-for-sale category allows management to reflect that it expects the fall in fair value to be temporary has enabled the provision of additional, useful information to users.

- *Alternatively, all instruments traded in active markets (however defined) could be measured at fair value. Instruments already measured at fair value, eg derivatives, would continue to be measured at fair value; while the remainder would continue to be measured on the basis of other existing requirements.*

35. This alternative seems more likely to introduce additional complexity in defining an active market and determining what happens if a market changes status. There are merits in the markets' view of the future cash flows of a financial instrument but there are also merits in a valuation of a financial instrument and its reporting through the income statement in a way that reflects how future cash flows are expected to arise through the business model. The virtue of the current mixed measurement model is that fair values are disclosed for all financial instruments but they are reported in the income statement based on how they are used in the business. This alternative may or may not result in a significant change in existing practice, but it is not an appropriate restatement of the mixed measurement model, which is based on how the instrument is used in the business rather than the nature of the instrument itself.

36. It may be more fruitful to relabel the categories and restate them along the lines of trading and held for the longer term (to encompass both the existing held to maturity and loans and receivables based on having both an intent and ability to hold) An available for sale type category may also be needed as a bridge for those instruments that are not part of the trading portfolio and that the entity cannot demonstrate a reasonable commitment to hold. Transfers

between categories could be permitted or required where intent and ability changes provided the transfers are at fair value and fully disclosed. We note that, while the tainting rules result in the held to maturity category not being much used, an entity could transfer out of the category and meet the disclosure requirements.

- *The removal of the tainting rules applying to the held-to-maturity category is given as an example of how existing requirements or restrictions could be simplified or eliminated; these rules were put in place for anti-abuse reasons and could be replaced with disclosure requirements.*

37. We agree that the tainting rules could be removed and replaced with disclosure requirements. This is the sort of practical improvement that could be made to IAS 39 in the short term. We note that this may result in reporting that better reflects the business model for many of the instruments that are currently reported as available for sale where, for example, they are held in the business for the long term but could be sold to meet liquidity needs.

Question 4 Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions.

38. This approach seems the least attractive and likely to increase rather than reduce complexity. The use of the option would no doubt be circumscribed in order to achieve the result of ensuring equity instruments with readily available market prices and derivatives are at fair value. Additional guidance would be required to describe what is meant by 'slightly variable cash flows' and 'highly variable cash flows' and the consequences of an instrument moving between these categories would need to be addressed. If, as noted in paragraph 2.22, exceptions would enable the practical effect to be less significant than the effect on the standards, there seems little benefit in such an approach which would result in time taken by the standard setters and the rest of the constituency in making the changes only for a similar result. If the practical effect is to be significant, then the proposal would need to be thought through, including the implications for financial statement presentation and disclosure requirements. It seems likely that any proposal that focuses on the nature of the instrument itself rather than how it is used in the business will result in additional complications for income statement presentation and disclosure that could well be more complex than the categorisation currently in use.

(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?

39. Given our preference for a mixed measurement model, the restrictions we would place on instruments eligible to be measured at other than fair value through profit or loss would be based on how the instrument is used in the business and would end up with a result similar to the existing categorisation. The existing categorisations could be restated into fair value with exceptions, but we are not convinced that any small notional improvement would be worth the time and trouble involved. Therefore it may meet some of the criteria set out in paragraph 2.2, but not the cost/benefit test. Another suggestion for

restating the categories on a more principled basis is set out in our answer to question 3 (see paragraph 32 et seq above).

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

40. Amortised cost seems a sensible basic rule, although this will depend on whether fair value hedge accounting is applied.

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

41. Impairment loss is a concept that applies to assets held for use in a business where the present value of the expected future cash flows from the use or sale of the asset are less than the current carrying amount. As such, the concept does not apply to items held for trading where it is appropriate to recognise gains as well as losses based on market values. If amortised cost is the measurement basis for instruments to which an optional exception to a fair value measurement principle applies then it is not clear why the requirements for impairment testing and recognition of impairment should necessarily change.

(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?

42. If the income statement is to present a meaningful picture of how the business has performed in the period, gains and losses on instruments that are not held for trading or managed on a fair value basis, whether realised or unrealised, will need to be reported in a way that provides an indication of the expected future cash flows from the instruments based on how these cash flows will appear. If the exception is drafted in a way that permits a mixed model similar to the current position, then there should be few if any issues with presentation of fair value gains and losses. If the exception results in instruments that are intended to be held for the longer term in the business being carried at fair value through profit or loss, then we expect many users and preparers to wish to present amortised cost results separately from other fair value movements in order to provide similar information as is currently presented in the income statement. This could result in many more instruments being treated essentially as available for sale in so far as performance reporting is concerned but with the increased complexity of maintaining double entry book keeping on both an amortised cost and fair value basis.

43. This issue will need to be addressed in Financial Statements Presentation project and the Conceptual Framework Project. Meanwhile, depending on how the exception is drafted, it seems either that it would be a poor use of the IASB's resources for little change in practice and so would fail to meet the cost/benefit test, or it would significantly increase complexity for an uncertain improvement in reporting.

(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?

44. Reclassification is an added complexity to the approach. On its own logic, reclassification should be permitted or required when instruments move from having 'slightly variable cash flows' to 'highly variable cash flows' and vice versa, however that is to be assessed.

Question 5 Approach 3 sets out possible simplifications of hedge accounting.
(a) Should hedge accounting be eliminated? Why or why not?

45. No. The paper notes that some preparers would object to eliminating hedge accounting because the resulting volatility in earnings does not reflect the economic consequences of hedging activities. We concur with this statement and consider it is likely to reflect the opinion of most users of financial statements as well as preparers.

46. The paper also suggests that the effects of hedging activities could be disclosed rather than reflected in the primary financial statements to provide more useful information. Even if this were the case, it is not clear how complexity would be reduced since we assume that accounting standards would end up containing hedge disclosure requirements similar to hedge accounting requirements, to ensure that the disclosure of the effects of hedging activities would be on a comparable basis between entities and over time. If this rigour were not provided by standard setters, presumably local listing rules requirements would be introduced to regulate this 'non GAAP' information. Companies would be likely to end up keeping one set of financial information with hedge disclosures and one set without, which seems more complex than having sensible hedge accounting requirements which can be used for all forms of reporting.

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

47. No. On balance fair value hedge accounting should be retained. The three approaches set out in the paper are considered below.

- *A fair value option could be substituted for instruments that would otherwise be hedged items.*

48. A fair value option is not a substitute for hedge accounting since hedge accounting can be targeted at specific risks and can be designated and dedesignated at any time to match the risk management practices. We believe that the fair value option could usefully be expanded by, for example, removing restrictions on post-day-one designations and removing restrictions on being able to use the option. This would enable firms who wish to adopt fair value measurement more broadly to do so.

- *Recognition outside earnings of gains and losses on financial instruments designated as hedging instruments could be permitted, similar to cash flow hedge accounting.*

49. Without a greater understanding of how financial statement presentation will ultimately progress, it is difficult to assess the viability of the proposal.

However, it seems no less complex than the current requirements so we agree that it may not result in a significant reduction in complexity.

- *Recognition outside earnings of gains and losses on financial instruments.*

50. This suggestion would appear likely to result in accounting similar to available for sale accounting for many more instruments, particularly loans and receivables where hedge accounting is currently applied. This would result in increased complexity, whether or not restrictions comparable to existing hedge accounting requirements were added. Both amortised cost interest and foreign exchange movements would have to be calculated and separated from fair value movements in order to report earnings. It is also not clear how the proposal would deal with impairment. We also agree that the proposal is likely to be too complex for users to understand. These disadvantages, particularly in terms of the criteria in paragraph 2.2, make this suggestion not worth pursuing.

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

51. We do not consider any of the methods suggested are worth further consideration.

(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.

52. We do not think a fundamental change to hedge accounting is necessary at this time. Suggestions for improvements that can be made to the existing requirements are set out in the answer to the next question.

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?

53. We do not support eliminating the ability to hedge portions, specific risks and the ability to designate and dedesignate hedge relationships since this flexibility is necessary to reflect how risk is managed. We think the understandability of hedge accounting could be improved by better presentation and disclosure of the hedging results, for example by separately disclosing fair value movements attributable to the hedged risk. The main problem with hedge accounting is the volume of detailed rules which are not obvious from any underlying principles. For example:

- why shouldn't a written option be a hedging instrument if it otherwise meets the criteria?

- why shouldn't hedge accounting be possible if the hedge is not anticipated to be effective within the 80/125 range?

54. We do not support the overall direction of the FASB exposure draft, *Accounting for Hedging Activities an amendment to SFAS 133*. As noted above, we do not favour the elimination of hedge accounting and note that the dissenting opinions of the FASB members which indicate that the proposals are so restrictive that hedge accounting would be much reduced or completely curtailed for some companies, notably banks, in some circumstances. However, we consider that the idea of a qualitative rather than quantitative assessment of the effectiveness of the hedge relationship based on an economic relationship is worth considering. We would not include even an anticipation of reasonable effectiveness for financial instruments because we do not see why value hedge accounting should not be recognised even if the effectiveness is outside the 80/125 range provided all ineffectiveness is recorded in profit or loss. In addition, the IASB may wish to consider whether the disclosures in that paper would represent an improvement over IFRS 7. Making such improvements to hedge accounting would reduce complexity for preparers and users without changing the number of financial instruments currently measured at fair value.

55. Other areas worthy of investigation include the following.

Hedging non-financial items. We believe it should be possible to hedge non-financial items for specifically identifiable risks. I.e. it should be possible, in certain circumstances, to hedge portions of non-financial items. For example, it is currently possible to hedge inflation linked cash flows relating to finance leases (as finance leases are financial items), but it is not possible to hedge inflation linked cash flows relating to operating leases (as operating leases are not financial items). Provided the risk is identifiable and measurable, we believe it should be possible to hedge that risk, regardless of whether it lies within a financial or non-financial contract.

Hedging net positions. Currently, it is not possible to hedge net positions. Instead, an entity can hedge a portion of a gross position. This results in the designated hedged item being different from the true economics behind the hedge which creates complications for the entity and for users in trying to understand the hedging strategy and disclosures. We believe that hedges of net positions should be allowed.

Measuring hedge effectiveness. As noted above, we see the 80/125 effectiveness range as arbitrary and unnecessary. However, in addition to this, we believe that the rules about how effectiveness is measured could be relaxed. For example, if a hedge is terminated simply because its effectiveness falls outside of the 80/125 range, in order to resume hedge accounting, a new hedge relationship must be documented. For cash flow hedges, this means that the hypothetically perfect derivative will also change, and so the new hedge relationship is likely to be ineffective. This could be resolved by allowing the hypothetical derivative to remain unchanged.

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

56. Restrictions around hedge effectiveness and what can be a hedging instrument are not necessary provided ineffectiveness is taken to income. It may also be possible to remove some of the detailed rules and application guidance although this may not be worth doing as existing practice is unlikely to change.

(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.

57. If hedge accounting is going to be a proper reflection of the risk management techniques undertaken by the company, then partial hedges should continue to be permitted.

(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?

58. See our answer to part (a) of this question in paragraph 54 et seq 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?

59. Please see our comments in paragraph 28 et seq above.

60. For fair value hedge accounting, the revaluation of the asset could be presented in a separate balance sheet account rather than by adjusting the carrying value of the asset. This has two advantages. Firstly, it removes the problem of having assets in the balance at hybrid values where only part of the asset is hedged (nearly always the case as most FV hedging is just for interest rate exposure and ignores other risks); and secondly it provides an indicative measure of the extent to which the asset's cash flows have been altered by hedging activities.

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?

61. No. We continue to believe that the mixed measurement model is the most appropriate model for financial instruments, as it is for non-financial instruments, because it best reflects how assets and liabilities are used in businesses in the earnings generation process.

62. We are not convinced that introducing a single measurement method would address measurement-related problems in the long term. Firstly, the IASB has not completed its work on the FAS 157 discussion paper so it is not clear what is meant by fair value. Secondly, as is demonstrated by current market conditions, it may be possible to require a single measurement basis, say market exit price, but there will be many different methods to determine it which may change as circumstances change. This results in significant additional disclosure requirements to explain how the values are determined and how they may change if circumstances change. This introduces additional complexity and may impair the relevance and understandability of the information, particularly where the financial instruments are not held for trading or otherwise managed on a fair value basis. Thirdly, in these circumstances, an income statement recognising a single fair value movement in the period may not provide useful information and there may be demands for the fair value movement to be disaggregated into interest, credit, etc components. This disaggregation is likely to be complex and fairly subjective or arbitrary.

63. Therefore it seems likely that a single method to measure financial instruments will introduce much greater complexity into financial reporting than the mixed measurement model (with fair value disclosures) based on a relatively simple categorisation approach. The IASB may believe that the greater complexity is worthwhile because the information provided is superior to the mixed measurement model. However, the IASB has not yet made the case that this is so. To do so would require the issue to be tackled on a comprehensive basis, including how gains and losses are reported in the income statement. In the interim, we believe the current overall approach in IAS 39 best meets the needs of users and preparers of financial information.

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?

64. While we agree that fair value information is useful for all types of financial instruments, since it provides one view of the expected future cash flows, we do not agree that it is the *only* appropriate measurement attribute. Where instruments are not held for trading or otherwise managed on a fair value basis, amortised cost provides more useful information for performance reporting and this information is lost if only one measurement attribute is used.

(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?

65. We do not think a single measurement attribute is appropriate for all types of financial instruments since we support the mixed measurement model.

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?

66. The concerns identified are significant and encompass all aspects of financial reporting, ie what fair value is, what would be fair valued, how it would be presented and how it would be disclosed as well as associated issues such as the unit of account to which fair value is applied.

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?

67. Unit of account is important. In addition, the IASB should conduct proper research to demonstrate the usefulness and understandability of the resulting information. Consideration of the impact on narrative reporting would also be necessary.

(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?

68. No.

Question 12 Do you have any other comments for the IASB on how it could improve and simplify the accounting for financial instruments?

69. Please see our comments above, particularly in reference to hedge accounting.

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