COMMENTS

19 September 2008

DISCUSSION PAPER REDUCING COMPLEXITY IN REPORTING FINANCIAL INSTRUMENTS

General remarks

BUSINESSEUROPE agrees that there is a need to simplify the existing financial instruments reporting requirements from both preparers and users perspective and therefore welcomes the paper as part of the memorandum of understanding to have a due process document out on financial instruments. In light of the mentioned memorandum of understanding it should be noted, however, that the activities of the US FASB in the area of financial instruments and hedging seem to be more advanced. We would recommend aligning the activities of both standard setters.

BUSINESSEUROPE does not believe increasing the use of fair value as a single measurement method is a criterion that must be met for reducing complexity. Moving to a full fair value model would introduce its own complexities in presentation and disclosure as well as the difficulties of determining fair values in some circumstances. Therefore some of the proposed changes should be made for the sake of reducing complexity permanently not only as an interim objective.

BUSINESSEUROPE furthermore supports the mixed measurement model as it often provides more useful information that reflects the underlying business and the economics of transactions. Additionally, in light of recent economic events, we question whether this is an appropriate long-term goal. Moreover, the measurement basis for all financial instruments is not yet agreed since the IASB is still considering the SFAS 157 discussion paper. This work as well as the work on the conceptual framework and financial statement presentation is critical to progress before any fundamental change to financial instruments can be contemplated.

Answers to questions

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?

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BUSINESSEUROPE supports a mixed measurement model for financial instruments and consider this is consistent with the appropriate measurement model for non financial instruments. Only a mixed measurement model results in financial reporting that reflects the economics of the underlying transactions and the business model of the entity.

Therefore, we are not convinced that the reporting for financial instruments requires radical change. On the other hand, IAS 39 contains many anti-abuse provisions and excessively detailed rules and requirements that could be usefully simplified, although care would need to be taken to ensure that any benefits from simplification are worth the time and effort of all involved in the process to make the changes.

IAS 39 is considered complex for a variety of reasons and has been subject to much criticism, including from the IASB. Many transactions involving financial instruments are complex. Financial reporting should properly communicate these transactions but the reporting requirements themselves should not add unnecessary complexity. IAS 39 seems to add unnecessary complexity as it lacks clearly stated principles, is not well drafted and has been subject to an excessive amount of implementation guidance. Financial instrument standards also include requirements for derecognition and the debt/equity distinction that can be difficult to apply and understand but are outside the scope of the DP. It may be that growing familiarity with the requirements will reduce the number and volume of assertions that the current requirements are too complex.

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.

BUSINESSEUROPE does not agree with the proposed long term solution of using a single measurement method. Improvements that could be made to measurement and hedge accounting in order to reduce complexity are long term solutions in our point of view anyway.

We would support improvements being made to the standard if the benefits of making changes outweigh the costs. We are not convinced that the measurement categories in themselves create unnecessary complexity and it may be that the disclosure requirements in IFRS 7 have clarified the presentation of the different categories. We are also concerned that significant change to the IAS 39 measurement categories is likely to have knock on impacts on the presentation of financial statements, particularly performance reporting. While we would not preclude such changes, it may be more fruitful for the IASB to explore simplifications that can be made to hedge accounting that do not change the basic hedge accounting model.

We also suggest that other areas of financial instruments such as completing the work to understand what is meant by "fair value", providing any additional guidance considered necessary for determining fair value in the absence of a liquid market, reviewing disclosures provided on assumptions and uncertainties of fair values and projects on derecognition and consolidation should be given a higher priority.

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

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 which has yet to receive wide spread support and where the measurement bases is not yet agreed since the IASB is still considering the SFAS 157 discussion paper. Therefore we do not agree with criteria 2.2b We note that criteria 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 recommend that providing more reliable information is also included in the criteria. This seems more important than simplifying the requirements. We fully support criteria 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?

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:

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

  Since the category is little used due to the tainting rules, the category could be eliminated, although this is unlikely to have much effect in practice.

- 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).

  We do not think that eliminating the AFS category would result in simplification since gains and losses on AFS would need to be distinguished in the income statement from trading gains and losses. 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 aligning the accounting for debt and equity instruments in this category.

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

  This alternative seems more likely to introduce additional complexity in defining an active market and determining what happens if a market changes status. It would also introduce the complexity into the presentation of the income statement since fair value gains and losses on instruments used in the business in different ways would still need to be distinguished to provide meaningful performance reporting. A requirement to fair value based on the nature of the instrument (traded on an active market) rather than how the instrument is being used in the business is likely to create more complexity than the relatively simple categorization currently in place.

We do not think any change should be made to the Loans and receivables category (other than to increase its use) since the category is an appropriate reflection of the activities of both industrial and commercial companies for their receivables portfolios and retail banks for their main banking activities.

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?

BUSINESSEUROPE does not support this approach. Any distinction between instruments which are measured on a fair value basis and those measured at amortized cost with impairment should be based on how the instruments are used in the business rather than the type of instrument or whether it is traded on an active market. As drafted, the proposal is likely to create its own complexities, i.e. what is meant by low variability. The paper seems oblivious to current market conditions which are raising concerns about when markets are active and whether values determined using inactive or dysfunctional markets provide relevant, reliable and understandable information for reporting.

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

Amortised cost, including appropriate impairment allowance is the sensible way to measure financial instruments that are not derivatives and that are not held for trading.

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

There seems no pressing need to change the current impairment requirements. However, the measurement rules for impairments should be consistent for all categories.

(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?

We prefer the existing treatment of unrealized gains and losses being maintained with the recognition in the income statement based on the categorization of the instruments concerned and whether or not cash flow hedge accounting has been applied. Any change to a model based on fair value with some exceptions would need to result in similar income statement presentation as is currently the case which is likely to increase complexity as similar categories to the existing ones would need to be maintained for income statement presentation.

(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?

Reclassification is an added complexity to the approach, but it reflects the dynamics of modern business. Assuming adequate disclosures, reclassification, therefore, should be permitted or required depending on the management's intended use of instruments. For this is reason we do not advocate the approach suggesting an assessment of changes from “slightly variable cash flows” to “highly variable cash flows" and vice versa, which we believe will add complexity.

Question 5

Approach 3 sets out possible simplifications of hedge accounting.

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

No, we think hedge accounting provides relevant information by reflecting risk management techniques in the financial statements.

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

Corporate entities most commonly address both foreign currency risk and interest rate risk in their hedging strategies.

Foreign currency risk arises most commonly from ongoing operations or group structure and is predominantly hedged using either cash flow hedges or net investment hedges. In the case of balance sheet hedges of monetary items denominated in a foreign currency hedge accounting is often not applied due to the natural offset from applying IAS 21. Consequently the abolition of fair value hedges is unlikely to have a significant impact on treasury strategy in this area.

A large proportion of the more complex hedging strategies of corporates relates to interest rate hedging of funding. Most corporates do not manage interest rate exposure on the basis of reducing either cash flow interest rate risk or fair value interest rate risk. Rather they manage their funding to reflect the interest rate risk profile of the underlying business.

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

The three approaches set out in the paper are:

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

The current option to take all fair value movements on financial assets and financial liabilities to the income statement should be retained as it could be a substitute for hedge accounting in many cases. Since fair value hedge accounting can be targeted at specific risks and can be designated and dedesignated at any time to match the risk management practices it should be retained as well.

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

Without a greater understanding of how financial statement presentation will ultimately progress, it is difficult to assess the viability of the proposal which has some attractions provided the basis adjustment is maintained.

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

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 required are were added since both amortised cost interest and foreign exchange movements would have to be calculated and separated from fair value movements. It is also not clear how the proposal would deal with impairment. We also agree that the proposal is likely to be complex for users to understand. These disadvantages, particularly in terms of the criteria in paragraph 2.2 make this suggestion not worth pursuing.

(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.

None – we do not think a fundamental change in the approach to hedge accounting is necessary.

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?

One of the most significant complexities in the current hedge accounting model is the requirement for retrospective assessment of hedge effectiveness to be within the 80-125 % effectiveness range. The 80-125% threshold drives entities to complex hedge designation and effectiveness testing methods in order to stay within the range, as the consequences of failing the retrospective test (e.g. having just 79 % effectiveness) will have and disproportionate impact on the reported profit or loss.
Retrospective effectiveness measurement is nevertheless critical to ensure that the right amount of ineffectiveness is recorded in profit or loss. Hedge accounting should flow naturally from the risk management strategy of the entity, provided it is a risk reducing strategy. With clearer guidance on how to measure the fair value of the hedged risk in a cash flow hedge all ineffectiveness will be readily identifiable and can be taken to the income statement. Consequently, the 80-125% threshold in the retrospective effectiveness test has limited benefit. To achieve greater clarity the measurement of ineffectiveness should be consistent with the hedged risk.

The change to the prospective effectiveness test will put greater emphasis on the need to demonstrate the way in which the hedging strategy reduces risk within the entity's overall risk management strategy. Entities should ensure at inception that the hedge is linked to a specific (risk-reducing) strategy and should be able to demonstrate that the strategy reduces the specified risk. Retesting should only be necessary in case of material changes of the underlying business or risk structure. The test could be qualitative if the risk reduction is clear with little or no analysis.

Documentation requirements should be more principal based and should rather require documentation based on the managements hedging strategy than based on single transactions.

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

Restrictions around hedge effectiveness are not necessary, provided ineffectiveness is taken to income

(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.

We strongly support retention of partial hedges, as despite all complexities, the enhanced reporting enabled by this hedging technique outweighs its hedge accounting compliance costs. The elimination of partial hedges is contrary to the relevance and fair presentation principles.

(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?

We disagree with the following three alternatives, which risk being counterproductive given the change criteria:

- *Designations and redesignations*: Requirement of irrevocable designation, per 2.64. Proper and documented designation and de-designation are sufficient, as long as these are within the framework of the entity's risk management policies and satisfy the adopted methods of effectiveness testing; and
- *Reclassification to earnings of deferred gains and losses (for cash flow hedge accounting only)*: Use of forecast transaction timing, foreseen and/or estimated at inception, for the reclassification of deferred gains and losses, as per 2.94.
- We also disagree that the elimination of the basis adjustment is a simplification as suggested in § 2.96 ss. The basis adjustment is necessary for the hedging of the price risk (currency and/or commodity) of non financial items such as future purchases of PP&E and inventories in commercial and industrial enterprises.

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?

No.

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?

In our view, it is not feasible to use a single basis for measuring all financial instruments within the scope of the financial instruments' standard. Even if you consider a single measurement basis to be a simplification (which we do not since it will move the complexity from classification to measurement, presentation and disclosure) such "simplification" does not justifying fair value in all circumstances, especially when fair value is not relevant to economics of the transactions. An exception from fair value measurement is necessary where the estimates of fair value would remain subjective, e.g. as in the case of untraded equity instruments, and where the economics are better reflected by an amortized cost measurement, e.g., in the case of loans and receivables.

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?

No. We believe the mixed measurement model provides more useful information that properly reflects the economics of transactions. In particular, loans and receivables should be measured at amortised cost in line with their nature and the economics of the transaction. We are also concerned that the use of fair value for items that are not held for trading or otherwise managed on a fair value basis would lead to subjective and non-transparent reporting of financial instruments.

We, therefore, suggest that, where fair value is the appropriate measurement basis, specifying that mark-to-market fair value measurement is the benchmark treatment for all financial instruments with quoted liquid market prices (including traded derivatives). In the meantime, the mark-to-model valuations supported with acquisition costs/disposal proceeds set at an arm's length deal (including OTC derivatives) should serve as an allowed alternative when the market prices are not available.]

We disagree with your argument that "the range of possible differences in judgment is not especially wide if the credit risk is not especially high". Recent events have shown that there are discrepancies in valuations of more than 200bp on AA rated instruments which is clearly significant.

(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?

Considering the heterogeneity of financial instruments, we don't think that there is one single valuation method that could be applied to all financial instruments. We strongly believe that there is no "one size fits all" fair value solution that is superior to the current mixed measurement model. Our reasoning and respective arguments were set out in earlier paragraphs and without repeating these, we would like to refer to the point on cash flows. While cash flows underlie most of quoted market prices and mark-to-model estimates, the use of projected future cash flows could be of limited predictive value in case of instruments with fixed or slight variability of cash flows (such as loans and receivables).

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?

The concerns identified are significant and encompass all aspects of financial reporting, i.e. what fair value is, what would be fair valued, how it would be presented and how it would be disclosed as well as associates issues such as the unit of account to which fair value is applied. We are particularly concerned with financial statement presentation and suggest that any change in financial instrument measurement should be within the context of the current distinction between the income statement and OCI with gains and losses on instruments held for trading or otherwise managed on a fair value basis being included in income and other gains and losses being included in OCI.

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?

Given the breadth and scope of the issues that need to be addressed, we have no further ones to add.

(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?

No, all the issues need to be resolved.

Question 12

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

No. Providing relevant and reliable information is more important than simplification for its own sake.

Appendix A on Scope

In general terms we oppose to the rules based structure of this Appendix as this will increase complexity for the users of the reporting from companies if scoping is carried out in this fashion. We would rather that there is a general principle e.g. stating that if there are derivatives included in non-financial agreements these are to be reported separately if not in-line with the underlying transaction.

- Contrary to doubts expressed under A.27, we do not think that rights to require payment for using non-financial items (e.g. license fees and royalties) are financial instruments. We, therefore, believe that a better way to address the accounting treatment of such rights would be to include these in the scope of the new standard on revenue recognition.

- We will not support the inclusion of service contracts into the scope of the standard on financial instruments, as discussed under A.34-39, should such a proposal be made. We accordingly think that the accounting treatment of service contracts should not be included in the scope of this paper, but the new standard on revenue recognition.

- We find the discussion of derivatives embedded in non-financial contracts with reference to foreign currency element incomplete. We strongly believe that the discussion paper should clearly state the absence of embedded currency derivative for currencies of trade/denomination of exchange traded non-financial items. For example if the only currency in which the oil is traded is the US dollar, there can't be an embedded derivative irrespective of the functional currency of such a commodity buyer by default. However, should it not have been the case (i.e. the oil was traded in all of the world currencies) then the line of thinking per this discussion could have been sustained.

- We think that the requirement to measure the entire non-financial contract that contains an embedded derivative at fair value is indeed a simplification, contrary to the reasoning per A.47(b).

Appendix B on Measurement

- We do not support the analogy between the features of an option and those of a credit contract, as per B.6, provides sufficient support for a measurement conclusion. We think that a freedom to act commercially (i.e. in one's interest) should not be automatically treated as optional as applicable to a financial instrument. Furthermore, the option economics are non-linear and depend on several variables, which will certainly not simplify the measurement task for credit contracts, should these be treated as options.

- Based on the same reasoning (per the above point), we disagree with the conclusion on similarities between the right to make a deposit and a call option to purchase a liability.

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