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19 September 2008

Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Dear Sir David,

Discussion Paper – Reducing Complexity in Reporting Financial Instruments

Deloitte Touche Tohmatsu is pleased to respond to the IASB's Discussion Paper on Reducing Complexity in Reporting Financial Instruments ("the DP").

We welcome the IASB's efforts to improve financial reporting for financial instruments. We believe that current guidance under IFRS is complex and requires significant improvements to reduce the inherent complexity.

However, to meet the goal of improving reporting for financial instruments by reducing complexity it is important that complexity is properly defined and that any change made to existing Standards should not result in a mere shift of complexity from one constituent to another.

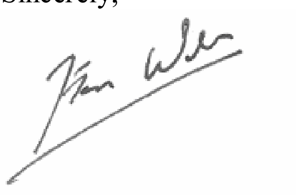
In addition, the DP fails to address important areas, notably scope and derecognition, of financial instruments accounting that also fall outside the IASB's other concurrent projects or, where they are within existing projects, these would be completed only with a significant time lag to the financial instruments project. We believe that guidance on these issues influences the assessments made on the proposals of the DP.

Furthermore, we do not agree with the implicit assumption of the DP that full fair value accounting would be the ultimate improvement to financial instruments accounting. We believe such a conclusion would be premature at this point. We believe that at the moment, amending existing Standards, possibly over a longer period, would be a feasible way to improve financial instruments accounting significantly for all constituents without undue costs or efforts. Below we set out an approach that, whilst still incorporating a mixed measurement attribute model, we believe would represent a significant improvement over the current guidance in IFRS. Our approach also includes a proposal for improving hedge accounting that we consider superior to the existing model in IAS 39 *Financial Instruments: Recognition and Measurement*.

Our detailed responses to the invitation to comment questions are included in the Appendix to this letter.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907, Andrew Spooner in London at +44 (0) 207 007 0204, or Robert Uhl in Wilton, the United States, at +1 (203) 761-3152.

Sincerely,



Ken Wild
Global IFRS Leader

Appendix:

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?

We agree that the current requirements for reporting financial instruments are too complex for all constituents and warrant significant improvement. We support an approach that looks broadly at financial instrument accounting and therefore welcome the DP. However, we believe that the Board should analyse the issue of complexity and weigh competing projects before proceeding with any related project.

We believe that complexity cannot be eliminated and what may appear to be a reduction in complexity on closer analysis may merely transfer complexity from one constituent to another. For example, removing a mixed measurement model through comprehensive use of fair value may reduce complexity for users as it reduces the number of options for classification and thereby improves comparability, but will increase the complexity for preparers and their auditors, particularly when valuing financial instruments that are not actively traded due to the associated subjectivity. Similarly, removing cash flow hedge accounting may appear to reduce complexity for preparers as all derivatives will be fair valued through profit or loss and entities will avoid the burden of designating and monitoring hedge effectiveness, however it would increase complexity as financial results will be less understood as gains/losses on derivatives will be recognised in a different period to the forecasted transaction that is being hedged. In addition, reducing complexity in one area of the financial statements, e.g. decreasing the number of measurement attributes, will increase complexity in another, e.g. fair value measurement and disclosures for instruments that are derived using valuation models. Therefore, in deliberating which approach to pursue the Board must ensure their analysis of complexity is broad.

We note there are competing demands which require the IASB to prioritise its projects. Pursuit of the Memorandum of Understanding with the FASB, response to the credit crisis, and other long-term projects where standards are still required in areas where there is no existing literature, e.g. accounting for insurance contracts, mean that allocation of the Board and staff resources is key. Financial instruments accounting is just one major subject area among many others. Within this subject area the Board has to further address the balance of resources assigned to this project and other pressing issues that are causing genuine application problems today. We acknowledge that the DP excludes derecognition, but this subject is of significant diversity and complexity which has not been alleviated by the IFRIC's and the Board's inability to provide clarification on a series of derecognition issues that were raised with the IFRIC and the Board in 2006. We acknowledge that there is a separate derecognition project but this will not be finalised for some years to come. Similarly, scope is a significant practical issue which is also not part of this project. Determining whether contracts over non-financial items are 'own-use' and therefore are outside the scope of the standards is particularly complex and is of a critical importance to resource intensive industries. We would not want to see scarce resources dedicated to a project on classification and hedge accounting at the expense of these other important issues that ultimately will not be resolved by this project.

The IASB must complete or run concurrently the project on financial statement presentation before implementing a new financial instruments recognition and measurement standard. It would be unreasonable to force an increased use of fair value for financial instruments (and/or removal of the available for sale category) without constituents understanding how performance will be reported under the new presentation model. Equally, the fair value measurement project must also be resolved so constituents know what definition of fair value will be applied. We consider this of particular importance to liabilities where there is concern as to whether it is more appropriate to assume a transfer notion or a settlement notion when determining an exit price fair value.

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.

Given a choice of full fair value accounting or an "intermediate approach" for financial instruments we favour the latter. We appreciate the term "intermediate approach" is consistent with the IASB's ultimate ambition for full fair value accounting for financial instruments, but, as noted in our response to Question 8 we do not believe that support of this long-term goal is a precondition to supporting what the IASB refers to as an intermediate approach. Successful application of an intermediate approach, in conjunction with successful application of standards on fair value measurement and financial statement presentation, may best meet the needs of users where a full fair value accounting approach may not. Therefore, our recommendation is to pursue an intermediate approach (our preferred approach is detailed in our response to Question 7) that includes completed standards on fair value measurement and financial statement presentation. After there has been a sustained period of application of these standards that allows the IASB to look back on the standards' successes and failures, the IASB should then review the long-term ambition of full fair value accounting. Only then do we believe the IASB can fairly judge whether full fair value accounting for financial instruments would provide an improvement to financial reporting and whether that approach is feasible.

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

We agree with the criteria set out in the DP with the one reservation: paragraph 2.2(b) requires that any future intermediate proposal must not result in an item currently at fair value to be recognised other than fair value. We do not support this criterion as this presumes that fair value for all financial instruments is the only long-term objective and we question this assumption. As described in our response to Question 7, our preferred approach may result in some held long-term debt instruments being classified at amortised cost that currently are classified as available for sale assets.

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 are supportive of certain aspects of Approach 1. Our preferred approach is detailed in our response to Question 7.

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 are not supportive of a full fair value approach. Our preferred approach is detailed in our response to Question 7.

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.***

We are supportive of certain aspects of Approach 3. Our preferred approach is detailed in our response to Question 7.

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?***

Our proposals for simplifying hedge accounting form part of our overall preferred approach as detailed in our response to Question 7.

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?

Our preferred approach is set out below:

Initial recognition

All financial instruments are initially recognised at fair value. We appreciate that the definition of fair value remains outstanding as it is subject to resolution as part of the IASB's fair value measurement project which, as already stated, we consider must be resolved at the latest before the next stage of this project is effective. A key area to be resolved in the fair value measurement project is whether initial recognition is an entry or exit price and the potential for recognising upfront gains/losses ('day 1 profit or loss'). Our views on these aspects are detailed in our response to the IASB DP on Fair Value Measurement dated 4th May 2007 and therefore are not repeated in this letter.

Classification and subsequent measurement

Only two primary measurement bases for recognised financial assets and financial liabilities are retained: fair value through profit or loss[1] and amortised cost.

Fair value through profit or loss is required for all financial instruments that are *held at fair value*. Held at fair value includes:

[1] As discussed later in more detail 'cost' may be appropriate for unquoted equity investments and therefore can be considered a secondary measurement basis to be potentially applied in certain limited circumstances.

- all derivatives (all changes recognised in profit or loss, except if designated in a cash flow or net investment hedge accounting relationship where the effective portion of the gains or losses must initially be recognised in equity as part of other comprehensive income);
- all equity instruments (subject to a potential cost based exemption for unquoted equity instruments discussed later in this latter); and
- all debt instruments that are not *held at amortised cost.*

Amortised cost is *required* for debt instrument financial *assets* where:
- the cash flows are determinable and variations are due solely to interest rate risk (including non-leveraged inflation) and the issuer's own credit risk[2],
- the activities of the reporting entity with respect to those instruments is to realise its return through receipt of contractual cash flows, i.e. a return is generated through continuing investment and not return through sale; and
- the debt instrument is not managed on a fair value basis.

Amortised cost is *required* for debt instrument financial *liabilities* that are not held at fair value, where cash flows are derived solely by interest rate risk (include non-leveraged inflation) and the issuer's own credit risk and are not managed on a fair value basis.

If an instrument meets the criterion for amortised cost the entity can choose to apply a fair value option at initial recognition if there is an accounting mismatch that would result from measuring at amortised cost that can be overcome by applying a fair value option (assume a similar criterion to IAS 39.9).

For debt instruments held at amortised cost an effective interest rate based on expected cash flows will apply (as in the current Standard). Guidance will be required, similar to that contained in IAS 39.AG6/7, to determine over what period cash flows should be discounted in the case where cash flows are derived from a floating interest rate and there is a reset to market rates at specified dates. Similar guidance contained in IAS 39.AG8 would be required for fixed rate debt instruments that are subject to changes in the timing of cash flows due to the existence of prepayment options. Where the effect of discounting is immaterial discounting would not be required as currently permitted by IAS 39. The impairment guidance for debt instruments held for investment (held at amortised cost) would continue to be based on an incurred loss model. We propose that where loan commitments are not in the scope of IAS 39, the impairment should be determined in accordance with IAS 39, not IAS 37 as currently required, so that the determination and measurement of impairment for a loan commitment is consistent with the loan that will be originated from it.

Contracts that may result in the entity buying back own equity by delivering cash or other financial assets for the gross physical receipt of its own equity are currently recognised as a financial liability for the present value of the amount the entity could be required to pay with a corresponding debit in equity. Consistent with our proposal to have only two measurement attributes for financial instruments, amortised cost and fair value, we do not believe it is appropriate to continue with the current treatment in IAS 32 where forward purchase contracts and written puts are effectively split into two, the amount payable, and the shares that may be received under the contract. Assuming there are no other amendments to IAS 32 (i.e. the financial liabilities and equity project is not completed before the completion of an intermediate approach), if the arrangement is a derivative that will be settled by delivering a fixed amount of cash or other financial asset for a fixed number of shares ('fixed-for-fixed'),

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[2] If an instrument is asset-backed with a debt instrument then amortised cost is appropriate only if the debt instrument to which the asset-backed instrument was linked would have been required to be measured at amortised cost had the instrument been held directly by the entity.

the instrument should wholly be classified as an equity instrument, or if not, should be wholly fair valued through profit or loss.[3]

A comparison of the impact of our proposed approach described above compared to the existing requirements for subsequent measurement is summarised below:

Instrument	Existing treatment	Proposed treatment
Derivatives not in a qualifying hedge accounting relationship and derivatives in a qualifying fair value hedge accounting relationship	FVTPL	FVTPL
Derivatives in a qualifying cash flow or net investment hedging relationship (effective portion)	FV through OCI	FV through OCI
Held for trading (derivatives and non-derivatives) instruments	FVTPL	FVTPL
Non-traded equity investments (quoted in an active market)	FV through OCI (AFS)	FVTPL
Non-traded equity instruments (not quoted in an active market)	FV through OCI (AFS)/Cost	FVTPL/Cost[4]
Short-term/Long-term receivables/payables (not traded, not subject to the fair value option)	Amortised cost	Amortised cost
Non-derivative assets and liabilities managed on a fair value basis but not traded (without use of the existing IAS 39 fair value option)	FV through OCI (AFS)/Amortised cost (L&R, HTM, Other financial liabilities)	FVTPL
Non-derivative assets and liabilities managed on a fair value basis but not traded (use of the existing IAS 39 fair value option)	FVTPL	FVTPL
Debt instruments held quoted in an active market (not traded and not subject to the fair value option)	FV through OCI (AFS), HTM	Amortised cost
Debt instruments issued (not structured – i.e. not linked to say commodity or equity prices, not traded and not subject to the fair value option)	Amortised cost	Amortised cost
Structured notes, issued or acquired, linked to say commodity prices or equity prices (not traded and not subject to the existing IAS 39 fair value option)	Embedded derivative + debt host contract at amortised cost	FVTPL
Acquired convertible debt (not traded and not subject to the fair	Embedded derivative + debt host contract at amortised	FVTPL

[3] We note that in our response to the IASB's Discussion Paper *Financial Instruments with Characteristics of Equity*, we proposed to measure all equity derivatives at fair value through profit or loss (see our letter dated 4th September 2008). However, our proposal is based on the fact that the principles in IAS 32 Financial Instruments: Presentation remain as they are at the moment.

[4] We believe further assessment is needed to determine whether fair value can be universally applied to unquoted equity instruments and whether the benefits accruing to users will be offset by the lack of reliability and cost to preparers and auditors.

Instrument	Existing treatment	Proposed treatment
value option)	cost	
Held to maturity debt instruments	HTM in entirety or HTM for the debt host contract (plus FVTPL for the embedded derivative)	Will depend. Amortised cost if cash flows are derived from interest rate risk and credit risk and not managed on a fair value basis, otherwise FVTPL
Issued convertible debt that is convertible into own equity instruments (assuming IAS 32 remains unchanged and debt host is not traded or subject to the fair value option)	Debt host at amortised cost plus equity instrument	Debt host at amortised cost plus equity instrument
Derivative that may result in the receipt of a fixed number of equity instruments for the payment of a fixed amount of cash or another financial asset (assuming IAS 32 is retained)	Gross obligation recognised at present value of strike price under option or forward price under forward	Equity
Derivative that will not result in the receipt of a fixed number of equity instruments for the payment of a fixed amount of cash or another financial asset (assuming IAS 32 is retained)	Gross obligation recognised at present value of strike price under option or forward price under forward	FVTPL

We agree with the DP that the most appropriate measurement attribute for all derivatives is fair value. Fair value is the most meaningful attribute as it conveys the potential large variability in contractual cash flows relative to the instrument's little investment.

We believe fair value is the most meaningful measurement attribute for investments in equity investments where the measurement is reliable. Fair value most faithfully reflects the potential variability in expected cash flows that a cost based measurement attribute does not.

We would favour eliminating the available for sale category in conjunction with the completion of a comprehensive financial statement presentation standard as we support gains/losses being recognised in a single performance statement and therefore aim to reduce the amount of items that are currently subject to recycling. This would remove the arbitrary recycling that results for impairment of equity investments when the cumulative decline in fair value is deemed 'significant or prolonged'. This approach can result in significant volatility in income in the period even though the decline in fair value in the period is small relative to the cumulative decline. In addition, different entities apply different thresholds in determining what is significant or prolonged which hinders comparability.

We recognise that as equity instruments have no contractual cash flows the determination of fair value for such instruments may be subject to significant judgement. Where the instrument is quoted in an active market the entity is not required to use its judgement as the collective judgement of the market is used instead. Therefore, in the case where the equity instrument is quoted in an active market fair value is the most meaningful measurement attribute. We believe further work needs to be undertaken by the IASB to determine whether fair value for *all* equity instruments is feasible due to the inherent judgement and greater subjectivity required in determining fair value for equity instruments not traded in active markets where there is a lack of reliability. The IASB should establish whether a cost measurement attribute with disclosure of why fair value is not reliable is more meaningful to users as opposed to requiring fair value with disclosure as to the potential inadequacies and judgements of the fair value measurement.

We are not supportive of retaining the held to maturity category as currently defined in IAS 39 due to the restrictions placed on initial classification and the prohibition on sale and tainting provisions that arise if there is disposal of more than a significant amount of held to maturity assets. Reclassifying all held to maturity investments due to a sale of some financial assets within the category is an overly disproportionate response. We are also not supportive of retaining the available for sale classification for debt instruments for the same reasons described above for equity instruments as this would further reduce items that would be subject to recycling. In addition to those arguments, removing the category will remove the complexity that arises in requiring separation of the effective interest rate and foreign currency translation on debt instruments classified as available for sale. Also, an existing inconsistency will be removed where impairment amounts on debt instruments held at amortised cost and available for sale differ even though they are based on the same impairment triggers. This inconsistency is exacerbated when comparing different entities as any loan and receivable can be designated under the current standard as available for sale and therefore different entities have different impairment amounts for the same instrument.

Our preference is for certain held debt instruments to be measured at amortised cost if the entity's business model is earning a return on the instrument through passive investments as opposed to trading or purchasing and selling. This may be the case in many financial institutions that originate mortgages and other long-term loans where the intention is to earn a return through the contractual cash flows of the instrument. To the extent a financial institution's intention is to hold to sell, e.g. through securitisation that achieve partial or full derecognition, then the instruments could not be classified as held at amortised cost.

By limiting amortised cost measurement to debt instruments where cash flows are derived from interest rates and the issuer's credit risk the vast majority of guidance on embedded derivatives in financial hybrid arrangements will be removed. We recognise that some guidance will be required on what is a reasonable interest rate and credit risk but we believe this would be relatively simple in comparison to existing embedded derivative guidance. Guidance will still be required on embedded derivatives in non-financial hybrid arrangements under our preferred approach (but also in the case of a full fair value accounting approach) unless the scope of this project was extended to measurement of executory contracts.

We are supportive of retaining a fair value option. IAS 39 currently permits any financial instrument to be designated at fair value through profit or loss at initial recognition if it will substantially reduce an accounting mismatch, is managed on a fair value basis, or includes an embedded derivative that substantially modifies cash flows. Our preferred approach limits the fair value option only to the former because our preferred approach *requires* fair value through profit or loss in the case where financial instruments are managed on a fair value basis and most embedded derivatives in financial instruments that substantially modify cash flows would require the entire financial instrument to be fair valued through profit or loss. We considered whether an entity should be permitted to apply the fair value option after initial recognition and came to the conclusion that in most cases where an entity would wish to apply the election they would also be able to elect for fair value hedge accounting instead. The most prevalent example would be a hedge of interest rate risk of issued or acquired fixed rate debt after initial recognition with an interest rate swap. As our preferred approach also reduces the burden of hedge effectiveness testing (see below) we considered it unlikely that the fair value option would be chosen if fair value hedge accounting was available and achieved a more preferable accounting outcome. In addition, we noted that permitting a fair value option after initial recognition would potentially allow abuse by allowing an entity to enter into an offsetting instrument to accelerate a gain/loss prior to its disposal but would not be compelled to retain the offsetting instrument. On balance, therefore, we decided to limit the fair value option to initial recognition only.

Reclassifications

Our preference is to limit any opportunities for reclassification. Reclassifying financial instruments into and out of measurement categories after initial recognition creates complexity because of the rules that are needed to limit potential abuse, i.e. cherry-picking.

Applying the *held at fair value* and *held at amortised cost* classification categories at initial recognition will require judgement. Standards should allow the use of judgement to ensure the entity has the ability to provide the most meaningful information to financial statement users. However, it would be detrimental if entities were able to reclassify based on changes in intent which are inherently subjective and may increase complexity and the risk of abuse. In addition, because the criterion for meeting amortised cost measurement is relatively simple, based either on an assessment of the underlying cash flows of the instrument, or based on the entity's business model, we considered it preferable not to create rules on what is or is not deemed an acceptable reclassification.

We are not supportive of allowing an entity that has previously classified a financial instrument as held at fair value to later classify it as held at amortised cost. This will generally only ever be the case for fixed rate debt instruments only as the amortised cost and fair value of floating rate debt instruments is substantially the same (except due to significant changes in credit risk). Measuring fixed rate debt at amortised cost has greatest benefit when applied at initial recognition as that date determines the effective interest rate that will be applied for determining income in future periods. Permitting reclassification of a portfolio of fixed rate debt instruments from held at fair value to held at amortised cost would result in all future income being determined at the date of designation as this will be the date that determines the effective interest rate. We question the relevance of this income measure as well as being concerned that allowing reclassification in such cases may create opportunities for abuse. As an alternative to reclassification an entity may choose to start to disclose the effective interest rate separately from other fair value gains/losses. In addition, an entity may wish to isolate the carrying value of the portfolio on the face of the balance sheet from other held at fair value assets and disclose that it has changed to a hold, rather than a sale strategy.

We are not supportive of allowing an entity that has previously applied held at amortised cost to later unilaterally apply held at fair value. Even if the entity's business model has changed significantly to warrant new assets to be classified as held at fair value going forward we do not consider it appropriate that all existing assets should be reclassified to fair value with the cumulative gain/loss recognised in current period income. Our preference is to not permit reclassification and instead let those assets be derecognised through sale over the passage of time so the proportion of assets measured at amortised cost will fall and be replaced by assets that at initial recognition will be subsequently measured at fair value. An entity may wish to provide supplementary disclosure in this case to explain that initial classification for new assets will differ to past classification due to a change in the business model of the entity.

Financial statement presentation

As previously stated we consider the conclusion of the financial statement presentation project essential before the output of this project is effective. As the success of one standard is dependent on the other we would hope both could be concluded concurrently. In light of our proposed approach we believe the following proposals may enhance financial statement presentation:

- Consistent with the balance sheet classification the performance statement should distinguish between debt instruments that are held at fair value and those held at amortised cost. This will demonstrate clearly the extent to which earnings are derived from items that are held for investment purposes, i.e. including the earnings effect due to the effective interest rate, foreign currency translation and impairment, and those that are not.
- To the extent an entity wished to separately present the effective interest rate on a debt instrument that is held at fair value (or dividends on an equity instrument held for sale) this would be permitted. However, the effective interest rate would be presented along with other gains/losses on held at fair value items so the effective interest rate on those items at fair value and those that are amortised cost are not mixed up. This should enhance comparability with entities with similar business models.

Below is an example of how our proposed approach could be presented. The performance on assets will be appropriately included in either Investing or Operating depending on the entity's business model. The performance of issued debt will be appropriately included in Financing.

Held at fair value		
Trading activities	X	
Equity investments not traded[5]	X	
Debt instruments not traded[6]	X	
Derivatives not designated in a qualifying hedge relationship	X	
Hedge ineffectiveness	<u>X</u>	X
Fair value option assets		
• Fair value gains/losses on designated debt instrument	X	
• Fair value gains/losses on derivative	<u>X</u>	
Total gains/losses for assets designated under the fair value option		X
Held at amortised cost		
Effective interest rate[7]	X	
Foreign currency translation	X	
Impairment	<u>X</u>	X
Issued debt at amortised cost		
Effective interest rate	X	
Foreign currency translation	<u>X</u>	X
Fair value option liabilities		
• Fair value gains/losses on designated debt instruments	X	
• Fair value gains/losses on derivative	<u>X</u>	
Total gains/losses for liabilities designated under the fair value option		X

[5] Dividends and other fair value gains/losses may be disclosed separately.
[6] Effective interest rate and other fair value gains/losses may be disclosed separately.
[7] Disclosure of the fair value adjustment to debt and the associated gain/loss on the derivative may be disclosed separately in the income statement or netted on in the income statement and disclosed separately in the notes.

Hedge accounting - types

To *some* extent hedge accounting is a response to the inadequacies of the existing measurement requirements and therefore full fair value accounting is often cited as the solution that would allow hedge accounting to be eliminated. We believe this solution has limited merit because:

- Net investment hedging is largely a response to the accounting model in IAS 21 *The Effects of Changes in Foreign Exchange Rates*, not IAS 39. There is some complexity associated with recycling the gains/losses of the hedging instrument but this is equally true for recycling the gains/losses on disposal of the foreign operation which is determined by IAS 21. Therefore, irrespective of the outcome of this project and our general concerns about recycling we believe net investment hedging should be retained.

- Cash flow hedge accounting attempts to recognise the gains/losses on a hedging instrument with the timing of the hedged item impacting profit or loss. Unless full fair value accounting introduces the recognition of gains/losses on forecast transactions, which we would not support, there will always be a mismatch in the timing of recognition of gains and losses of the hedged item and hedging instrument which cash flow hedging attempts to overcome. In addition, a comprehensive performance statement (without immediate recognition of gains/losses in equity) will not overcome the demand to recognise gains/losses on a hedging instrument and hedged item in the same period. We believe therefore that there remains a need for cash flow hedge accounting, although we are not in favour of recycling mechanisms in general (see our comments above). Removing cash flow hedge accounting may superficially appear less complex but we believe it is likely to increase complexity and reduce financial statement relevance for financial statement users and preparers.

The arguments in favour of retaining fair value hedge accounting are less compelling than the arguments for retaining cash flow hedging and net investment hedging, however, we believe the arguments at least for now, are persuasive. Fair value hedging introduces a third measurement attribute that is neither fair value nor amortised cost (as it is amortised cost adjusted for fair value movements in the hedged risk). It may appear more simple to remove this measurement attribute as it is a hybrid of fair value and amortised cost accounting but doing so would be a retrograde step when it currently offers entities minimal income statement volatility for highly effective hedges. Fair value hedge accounting is applied mostly for hedging interest rate risk for issued or acquired fixed rate debt. Fair value hedge accounting in these cases allows an entity to get a reasonable accounting match without needing to include credit risk in the fair value measurement of the hedged item. As fair value movements due to credit risk are generally more difficult to value, are less likely to be economically hedged (and if they are hedged they may be hedged by non-derivatives, e.g. purchased financial guarantee contracts), and in the case of own credit risk will result in gains/losses that are more likely to be misunderstood, we believe removing fair value hedge accounting would increase, not reduce, complexity. We recognise that future developments in financial statement presentation may make this argument less compelling and we look forward to revisiting this should that project offer a solution that reduces the need for fair value hedge accounting. In addition, should a mixed measurement model be retained but fair value hedge accounting be removed then consideration will need to be given to the introduction of a fair value option after initial recognition.

The DP includes an alternative method for presenting fair value hedge accounting by deferring gains/losses on the hedging instrument in equity so there is consistency with net investment and cash flow hedging. This approach would have the benefit of treating all gains/losses on hedging instruments consistently and also retaining only two measurement attributes (amortised cost and fair value) instead of a third. However, we propose that such an approach should only be explored if the benefits of any project outweigh the amount of resources that would need to be dedicated to the project. We question whether currently this is the case considering the other financial instrument issues to be resolved as referred to in our response to Question 1.

Hedge accounting – qualification and effectiveness

We also believe the following improvements can be made to the existing hedge accounting requirements:

(i) Qualification

The qualification criteria for hedges of non-financial items should be amended. Currently, an entity cannot hedge a portion of the cash flow variability of an acquisition or sale of a non-financial item. We understand the need for limiting hedges of portions for forecast transactions due to the inherent subjectivity that often exists when determining an identifiable portion of a non-financial item (e.g. the rubber portion of a forecast acquisition of tyres). However, this subjectivity does not apply where the cash flow variability is subject to a contract. For example, if the future acquisition of tyres is subject to a contract, i.e. a firm commitment, where the contract requires the amount paid is variable to a number of factors, for example including changes in the price of rubber, then the rubber price risk should qualify as a hedged risk and the identifiable and measurable component of the cash flow variability that relates to changes in the rubber price should qualify as a hedged item. Equally, the contractually specified inflation-linked portion of cash flows of an operating lease (a non-financial item) should qualify as a hedged risk in the same way as it is possible to hedge contractually specified inflation-linked cash flows of a finance lease (a financial item). In such cases, a portion of the cash flow variability is identifiable and measurable and therefore should be eligible for cash flow hedging. The current Standard does, in our view, unnecessarily prohibit hedge accounting due to the restrictions on hedging portions of non-financial items.

(ii) Hedge effectiveness

The current hedge effectiveness assessment requirements could be simplified without creating the potential for abuse. Currently, the standard is complex for the following reasons:

- The standard requires a continuous prospective assessment of hedge effectiveness at a minimum of each reporting period. When the hedge is highly effective this can be seen as being onerous.
- Different views exist as to whether the prospective test must be quantitative or can be qualitative.
- Different techniques (e.g. dollar-offset, regression, risk-reduction) are used for assessing both prospective and retrospective hedge effectiveness and can lead to different conclusions as to whether a hedge relationship is deemed highly effective, and therefore different accounting treatments.
- Many hedge relationships fail due to the high threshold of ‘highly effective’ with the effect that there is significantly more profit or loss volatility than would be the case if the hedge was deemed effective enough to continue hedge accounting in the period

with recognition of hedge ineffectiveness instead. It could be argued the latter is more representative of the economic gain or loss of the entity.
- The highly effective threshold results in a great number of hedges failure, and therefore deemed termination of hedges due to IAS 39.101(b), with the effect the entity is forced to re-designate, and in many cases, does so on exactly the same basis as the previous hedge relationship. These problems are exacerbated with cash flow hedges because of the need to redefine the hypothetical derivative (see 'hedge terminations' below).

An alternative approach that would alleviate many of these issues would be as follows:

1. At inception, perform a qualitative assessment of hedge effectiveness only.
2. Subsequently, perform a retrospective test of hedge effectiveness using the dollar-offset method (quantitative).
3. If the dollar-offset result is deemed 'effective' (see below), then the entity maintains hedge accounting for the period and moves on to the next period (start over at step 2), i.e. no need to reassess prospectively.
4. If at those subsequent periods, the dollar-offset result is not effective, there is no hedge accounting in the period. An entity would have to qualitatively assess whether the hedging relationship will be effective in future periods if the same hedge relationship is going to be retained (i.e., consider whether circumstances have changed since inception that would call into question the hedging relationships effectiveness). If proved to be qualitatively effective for future periods, then the existing relationship can continue in future periods.
5. If the dollar-offset result is not effective and the entity cannot qualitatively prove that the relationship will be effective in future periods, then the entity must perform a quantitative prospective assessment. If the entity can quantitatively prove that the relationship is expected to be effective, then it can continue hedge accounting for future periods. If not, then the hedge relationship discontinues.
6. Steps 2-5 are repeated, as necessary, at each period end.

The determination of whether hedge accounting is permitted in the period will be lowered from 'highly effective' to merely 'effective' which can be considered as more effective than not (i.e. >50% to <200% dollar-offset). This reduction in the threshold will result in less hedge failures and instead show the extent of ineffectiveness in profit or loss. The introduction of a single technique for hedge effectiveness assessment will result in consistency between entities in passing or failing hedge accounting for the same hedge relationship. In addition, by lowering the threshold of the dollar-offset *and* at the same time requiring dollar-offset we expect this will reduce the existing incentive to use regression and other statistical techniques as an alternative to dollar-offset.[8]

(iii) Hedging portions

We continue to be supportive of retaining the hedging of portions for financial items to the extent the portion is identifiable and measurable. As described in (i) above we would also propose to permit cash flow hedging of a non-financial item for a portion where the variability in cash flows of that portion is explicitly identified in a binding contract (i.e. is not forecast).

(iv) Hedge terminations

[8] We note that in practice the dollar-offset test is often used to support the results of regression anyway.

The Standard currently requires that if a there is a hedge failure because hedge effectiveness falls outside the highly effective 80-125% threshold the hedge relationship is deemed to be discontinued. This leads to the anomaly that a new hedge relationship must be documented in the case where the hedged item and hedging instrument are the same as the original hedge which critically for cash flow hedge accounting will result in the reset of the hypothetical derivative. This resetting results in future hedge accounting being ineffective (or potentially so ineffective that the prospective hedge effectiveness test fails and hedge accounting cannot be applied) even when the hedge failure is a result of an isolated or immaterial event (e.g. a 'small numbers problem' where the hedging instrument and hedged item move by small amount but fail the dollar-offset test). We believe this anomaly can be resolved by allowing in the case of a continuous hedge relationship (i.e. no period where hedge accounting does not apply) for the hypothetical derivative not to be reset in the case when the hedge is not highly effective in a period. As long as hedge effectiveness can be demonstrated prospectively the hedge relationship can continue in the same form.

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?

We believe an intermediary approach as expressed in our response to Question 7 would be beneficial compared to existing standards. We do not believe acceptance of our preferred approach is necessarily a pre-cursor to full fair value accounting for all financial instruments. Further, our preferred approach can only be implemented when there is a completed fair value measurement and reporting financial performance standard. Once this approach and these two new standards have been applied for a reasonable period it will then be possible for the IASB and its constituents to assess whether users have benefited. Only at this point should the IASB then consider whether a full fair value accounting model will be a further improvement to financial reporting which could only be assessed concurrently with a full assessment of the needs of users. We do not necessarily believe our preferred approach as described in our response to Question 7 is necessarily the ultimate solution. By adopting this approach we consider there is a greater chance of knowing in the future whether full fair value accounting would be more meaningful and more importantly whether it would be feasible.

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?***

Our preferred intermediary approach as described in our response to Question 7 is not full fair value accounting and therefore we are not supportive at this stage that fair value is the only meaningful measure.

Even if a full fair value accounting model was introduced we believe as a practical expedient it is reasonable that amortised cost is applied for short-term receivables/payables where their fair value/cash flows are sensitive only to interest rates and credit risk. We recognise that a complexity of this approach is the need to retain an impairment model. However, mandatory fair value measurement of these items would cause preparers to incur a cost (which we recognise will include the need to retain an impairment model) that we believe would exceed the associated benefits.

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?

We agree with the concerns listed in Part B of Section 3. Our comments of the discussion paper on fair value measurement are detailed in our response to you dated 4th May 2007 which is not repeated below. In addition to the concerns raised in that comment letter and this DP we have the following additional comments:

- Future guidance on fair value measurement must clearly distinguish between the 'unit of account' and the 'unit of valuation'. The former is most commonly illustrated with the prohibition on control premiums or block discounts. The latter is a concept that is relevant when fair valuing groups of similar items that when valued as a portfolio have a different valuation dynamic compared to the valuation of single instrument. This is often due to the law of large numbers that is particularly relevant when fair valuing a group of prepayable loans.

- Clarity is needed on the acceptable methods of including the fair valuation of credit risk on a portfolio of derivatives with the same counterparty. This is particularly relevant when multiple derivatives are subject to a master netting arrangement on a portfolio basis. Guidance on the methods of allocating portfolio credit adjustments is needed as this allocation will be relevant if the IASB requires disclosure of financial instruments by the fair value hierarchy (i.e., Level 1, 2 and 3) and is also relevant in determining hedge effectiveness where fair value changes of the derivative are compared with the fair value changes of the hedged item.

- Should Standards continue to require the disclosure of fair value movements of own credit risk for certain financial liabilities measured as at fair value through profit or loss guidance is needed in how to determine this amount in the case of financial liabilities that are asset-backed, typically issued by consolidated special purpose entities. The current Standard allows an entity to determine the fair value due to credit risk by fair valuing the debt and subtracting the fair valuing movements due to the risk-free interest rate. This method has limited relevance when the valuation of the liabilities are driven by the credit risk of the underlying assets, e.g. in a cash-CDO. In some cases, it could be argued that the credit risk is minimal, as the financial liabilities are only obligated to pay cash flows when received and therefore the credit risk is limited to the non-payment risk within the special purpose entity which is more akin to an operational risk.

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 stated above we believe fair value measurement and reporting financial performance need to be completed or at least run concurrently with the intermediate approach. We believe these projects should not be deferred until the completion of the long-term objective. In addition, as stated in our response to Question 1 and 12 we believe there are currently considerable application issues with scope, particularly accounting for contracts for non-financial items, which should be addressed.

If full fair value accounting was to be pursued in the long-term we agree completion of a revised disclosure standard would be a pre-requisite as the focus of a disclosure standard would shift more to the assumptions and techniques used in valuation and away from disclosure of fair values and fair value hedge accounting information.

We believe it would be preferable if there was resolution of the project on financial liabilities and equity before introducing a new financial instruments approach though we recognise that whether this is critical will depend on which approach for financial liabilities and equity is adopted. If a Basic Ownership Approach were to be adopted this would result in a greater variety of liabilities being recognised which would raise measurement and financial statement presentation issues for instruments not currently classified as equity (e.g. for derivatives over own equity and many preference shares). If the financial liabilities and equity model adopted was the Ownership-Settlement approach, which is already similar in many respects to IAS 32, then the need to complete this project before the intermediate approach on reducing complexity would be greatly reduced.

Question 12

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

As already expressed in our response to Question 1 derecognition and scope are both complex areas of accounting for financial instruments and require attention. We note that the former is part of an existing project but the latter is not. The scope requirements of contracts for delivery of non-financial items is critically important for certain sectors, e.g. oil/gas extraction, mining, utilities. There are many entities that have contracts that are subject to the broad definition of net settling, hence are scoped into IAS 39, where the level of net settling is low compared to the total quantity of physical contracts. These entities frequently claim that fair valuing all similar contracts is misleading. Other entities have contracts scoped out of IAS 39 which they believe is misleading but they cannot scope them in. For example, an entity that enters into contracts to sell non-financial items physically at a fixed price in the future, buys at spot and hedges the price differential with derivatives cannot choose to fair value the physical contracts as they are scoped out of scope of IAS 39. Only three paragraphs are included on this subject in existing literature with minimal application or interpretative guidance. We believe the amount of guidance is disproportionately small relative to the importance of this area and also believe that further thought is needed as to whether the guidance is appropriate. Such contracts do not meet the definition of financial instruments but are treated as if they are. As such, we believe that the scoping of these contracts should be subject to a separate project that identifies the practices of 'net-settling' and the IASB reconsiders whether the net settlement criteria is appropriate.

As included in our response to Question 7 we propose that where loan commitments are not in the scope of IAS 39, the impairment should be determined in accordance with IAS 39, not IAS 37 as currently required, so that the determination and measurement of impairment for a loan commitment is consistent with the loan that will be originated from it.

We support the IASB's initiative to undertake a review of the application of IFRS 7 *Financial Instruments: Disclosures*. We note that such a review is in response to the credit crunch and therefore will no doubt be primarily focused on the application by financial institutions. We agree that an analysis of IFRS 7 disclosures is worthwhile but believe that such a review should not be limited to the concerns of financial reporting for financial institutions as IFRS 7 has also been challenging for non-financial institutions. The main areas that should be considered are:

- Liquidity risk:

  We believe there is an imbalance between information on liquidity risk management and the mandatory disclosures on providing undiscounted cash flow information. A disproportionate amount of disclosure is dedicated to disclosing undiscounted cash flows on derivative and non-derivative financial liabilities. This partly reflects that the primary focus in IFRS 7.37 is on undiscounted cash flow information based on a worst-case scenario with a secondary requirement as to how an entity manages those cash flows. A disconnect arises as entities manage their liquidity risk on an expected cash flow basis. In addition, disclosing undiscounted cash flows for derivative liabilities requires a disproportionate amount of effort compared to the benefit to users. A number of problems continue to recur across all sectors:

- providing undiscounted cash flows on held for trading items is of little perceived benefit;
- how to disclose adequately cash inflows on derivative liabilities (e.g. gross settled forwards/swaps);
- how to include the cash flows of an embedded derivative that are settled through settlement of the hybrid contract;
- whether financial liabilities that are exclusively share settled should be included in the maturity analysis.

We understand the IASB will consider some proposals in September 2008 as to how liquidity risk disclosures can be improved to be made more meaningful. We would welcome such a change.

- Credit risk:

  The requirement to show the maximum exposure to credit risk excludes any right of offset. Because IAS 32 does not permit offset where there is not the right and intention to offset then master netting arrangements that force offset in the case of default are ignored for the purposes of providing the maximum exposure to credit risk. The outcome is a maximum exposure to credit risk greater than the actual credit risk that would result if there was a credit event. This is misleading. Consideration should be given to allowing the maximum exposure to credit risk to include the effects of master netting arrangements.

- Fair value:

  We note the draft best practice guidance on disclosures (and measurement) recommended by the IASB's *Expert Advisory Panel on Valuing Financial Instruments in Markets that are no Longer Active*. The draft version includes similar disclosures to IFRS 7 on disaggregating fair values between Level 1, 2 and 3 fair valuation measurements. We would support greater analysis of fair values between those measured at fair value in active markets and those measured using a valuation technique. We understand the IASB will consider potentially including some of these best practice disclosures as part of an amended IFRS 7 and we look forward to further dialogue with you on any proposals.