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Sir David Tweedie
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Dear Sir David,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, I appreciate the opportunity to comment on the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* (March 2008). Principal authors of this comment letter were Peter Bitzyk, Franz Gross, Sonja Kleb, Michael Laminger, Roland Nessmann und Ernst Schönhuber.

Q1. *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 the assertions that the current requirements are too complex?*

The reporting of financial instruments has proved to be of crucial interest recently, especially during the financial turmoil which we are (hopefully) now putting behind us. Analysis suggests that several shortcomings of the existing rules have been at least preconditions for the crisis, if not even exacerbating factors:

- Markets seen as liquid and deep suddenly proved to be the opposite: and here the problem is, what to do in financial reporting if a market which had always been an active market all at once ceases to be so.

- Some risks which had not been perceived as significant risks before the recent turmoils in international financial markets, in particular liquidity and funding risk, contributed considerably to the turbulence, because people lost their trust in the accuracy of risk information in the financial reporting of potential counterparties.
- The principles of IAS 39, as currently in force, provide too little guidance on how to handle some of these problems:
 - The primacy of market values as the fair value of financial instruments, including derivative instruments, reveals its weaknesses when markets cease to be active markets.
 - When there are differing values for an individual financial instrument (perhaps a market value from a single transaction on the market, as compared with fair value based on the market value of other, similar financial instruments), this indicates at the very least a market disturbance. Under these circumstances the market value, which is normally taken as best indicator of fair value, should not be used without an adequate rationale.
 - How can it be established whether a market is active or inactive?
 - There is too little guidance on the measurement of complex structured financial products.

These shortcomings of the existing IFRS need to be corrected in relatively short order. The best way to do this, in our view, is to address and solve the above problems by amending some of the rules, in particular with regard to the fair value principle (when it should be applied and when not; new precedence hierarchy of valuation principles, especially for markets which are temporarily or constantly inactive; measurement techniques for complex structured financial products) and/or providing additional guidance.

Q2.a *Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that IASB should not make any intermediate changes, please answer questions 5 and 6 and the questions set out in Section 3.*

Reducing complexity is not only an intermediate approach, but an important overarching principle for standard setters. As we do not agree with the current long-term approach, which is to account for all financial instruments at fair value through profit and loss, we see no benefits in changes which are only “intermediate approaches”. We see a need for reducing complexity overall, which – bearing in mind the turmoil in financial markets – has to be seen in a broader context: we are concerned about problems arising from:

- The definition of active markets
- The definition of fair value in (temporarily) inactive markets

- Taking the same fair value for a particular instrument regardless of the size of the holding as compared with the average traded and tradable volume of those instruments
- Inconsistencies or inefficiencies in the measurement of complex instruments, where valuations are often based only on external ratings.

Accounting, disclosure and audit guidance for valuations should be enhanced, and a reduction in complexity would be welcome.

Q2.b *Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?*

We do not agree with section 2.2(b), that all changes “must be consistent with the long-term measurement objective”, which is the fair value measurement of all financial instruments (section 2.1). We agree with the rest of the criteria.

An important criterion we feel is missing from section 2.2 is that any change should provide a better insight into the real complexity of certain financial instruments.

Furthermore, we see the need for improved guidance on reliable valuations and valuation processes.

Q3. *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?*

The existing measurement requirements should be amended

- By taking into account the theoretical and practical use of financial instruments: from our point of view, only those financial instruments that can be sold by the reporting entity should be measured at fair value
- To give guidance on distinguishing active and inactive markets in a variety of situations
- To give guidance on the treatment of different uses/intentions for the same financial instrument: if a portion of a holding in a traded security is held for trading, and another portion is held as a long-term cash inflow generating asset, they should be treated differently
- To give guidance on the treatment of the use of economic hedges, e.g., macro-hedging of interest rate risks.

These changes would be in the spirit of section 2.2, because they would provide a better insight into real economic performance as well as into the management of the reporting entity.

Q4.a *Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions: 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?*

From our point of view, the following arguments place limits on the use of the fair value measurement principle:

- In addition to the market-related difficulties of using fair values mentioned in our answer to Q1, we see the same problem with respect to their use for financial instruments which cannot be traded for legal reasons or because of other external restrictions (e.g., compliance with liquidity requirements), because then the fair value is not the appropriate measure.
- The same is true whenever a market ceases to be active (whether temporarily or otherwise) – what should the fair value of a financial instrument in an inactive market be?

Q4.b *How should instruments that are not measured at fair value be measured?*

They should be measured at amortised cost using the effective interest rate.

Q4.c *When should impairment losses be recognised and how should the amount of impairment losses be measured?*

Impairment losses should be calculated on the basis of expected future cash flows and recognised when they occur, as at present; the change we have in mind is to treat an impairment of a financial instrument and its reversal in the same way, because they reflect the same economic reality.

Q4.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?*

Unrealised gains and losses should affect profit and loss only for trading instruments, for all other tradable financial instruments they should affect comprehensive income, and for non-tradable financial instruments (as explained in answer to Q3, first bullet point) unrealised gains and losses should be shown in the notes only. The rules for reporting with respect to hedge accounting and the use of the fair value option should remain unchanged.

Q4.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?*

Reclassifications should be allowed only when there are relevant legal changes; they should be accounted for in accordance with IFRS 8.

We see our suggestions as compatible with section 2.2, taking into account our answer to Q1.

Q5.a *Approach 3 sets out possible simplifications of hedge accounting. Should hedge accounting be eliminated? Why or why not?*

Hedge accounting should not be eliminated, because it provides a better insight into the economic realities.

Q5.ba *Should fair value hedge accounting be replaced? Approach 3 sets out three possible approaches to replacing fair value hedge accounting: which method(s) should IASB consider and why?*

Method (a) – fair value option instead of hedge accounting – could be seen as the easiest method to implement, and provides a good insight into the way the reporting entity manages its financial instruments. A disclosure of the policy underlying the fair value option could be helpful; nevertheless, the problems addressed in subsections 2.41–2.43 could lead to complexities, which could effectively eliminate the key benefits of this solution.

Q5.bb *Are there any other methods not discussed that should be considered by the IASB? If so, what are they and how are your suggestions 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 do not see a need for back testing in fair value hedge accounting, because the evaluation of both instruments is affecting profit and loss.
- Less complex restrictions of cash flow hedge accounting would be helpful, e.g., to allow the designation of commercial liabilities (liabilities yielding less than EURIBOR/LIBOR) as hedges against assets.
- Where the terms and conditions of the hedged risk of the hedging instrument and the hedged item are equivalent but of opposite polarities, the short-cut method should be allowed.

Q6.a *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. What suggestions would you make to the IASB regarding how the existing hedge accounting models could be simplified?*

See answer to Q5.b above.

Q6.b *Would your suggestions include restrictions that exist today? If not, why are those restrictions unnecessary?*

As stated above, we do not see a serious need for back testing in fair value hedge accounting. Both instruments are affecting profit and loss, which shows the changes in the fair values of both hedged and hedging instrument.

Q6.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 partial hedges justify the complexity.*

As hedge accounting is always designated, and constitutes the hedging of a specific risk on a particular financial instrument, we do not see a real need for partial hedges.

Q6.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 affect earnings?*

See answer to Q5.b above.

Q7. *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 IASB consider them?*

As stated in our answer to Q2, we do not see any need for changes in IAS 39 in the form of intermediate approaches. However, reporting on financial instruments would be improved by taking into account our answers to Q2 and Q3 on amendments to existing reporting requirements. And in addition, the results of some working projects already in progress should be taken into account (fair value measurement; performance reporting; distinguishing between equity and liability) first.

Q8–Q11

As all of these questions deal with the IASB long-term objective of implementing the fair value measurement principle for all financial instruments, a policy which we have rejected in our answer to Q1, we have not answered them.

Q12. *Do you have any other comments for the IASB on how it could improve and simplify the accounting for financial instruments?*

From our point of view, it is no simplification to report all financial instruments using fair values, as long as fair value is not sufficiently free from the danger of subjective bias. In addition to which, the complexities of economic life cannot be ignored: by restricting oneself to a single measurement principle, one runs the danger of increasing lack of transparency and comparability, making financial reports less useful for users than they are now.

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl
Chairman