ASC
ACCOUNTING STANDARDS COUNCIL

16 September 2009

International Accounting Standards Board
1st Floor 30 Cannon Street
London EC4M 6XH
United Kingdom

(By online submission)

Dear Sirs:

RESPONSE TO EXPOSURE DRAFT – FINANCIAL INSTRUMENTS: CLASSIFICATION AND MEASUREMENT

The Accounting Standards Council (ASC) appreciates the opportunity to comment on the Exposure Draft – *Financial Instruments: Classification and Measurement* issued by the International Accounting Standards Board (IASB) in July 2009.

We are generally in support of the two-category approach to classification of financial instruments and that instruments should be allocated to the categories that presents the most useful and relevant financial information. However, we have the following comments to the IASB which we hope can bring about a more robust and comprehensive discussion on the IAS 39 replacement project.

General comments

IASB decided to revamp IAS 39 in phases, citing the current crisis and an urgent need to improve accounting for financial instruments as the basis. Given the importance of this standard, we are of the view that sufficient time should be given to conduct a proper field test to determine the impact and practical difficulties that banks and other institutions might face with the current proposals. In addition, as other aspects of IAS 39 replacement project, such as the appropriate impairment model under Phase 2, and other IASB projects, such as fair value measurement and DP on credit risk in liability measurement) will have bearings on the classification and measurement proposals, it is important to review, and issue the standard in a more holistic manner. Alternatively, the IASB may consider allowing some flexibility to reconsider accounting treatments for certain instruments as the related projects are finalised later.

We noted that the US FASB has undertaken a rather different approach for this project – the FASB has proposed that all financial instruments will be presented on the balance sheet at fair value with changes in value recognized in net income or other comprehensive income (OCI), with a measurement exemption for an entity's own debt under certain circumstances. We would strongly encourage the two boards to assess jointly the merits and demerits of the two proposed approaches and to agree on a single

approach that best address the classification and measurement of financial instruments to achieve convergence in accounting standards without unnecessary delays.

Question 1
Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

We agree that generally, amortized cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis. However, the ED suggests that where the two criteria are not met, the default accounting treatment is to carry the financial instrument at fair value. The presumption appears to be that any instrument that is not managed on a contractual yield basis must be managed on a fair value basis. We are of the view that the reliability of fair value could be questioned under certain circumstances, such as for instruments with illiquid or dislocated markets which make the valuation highly uncertain, as observed in the current crisis. In addition, how fair value is defined and the related guidance on valuation adjustments (ED on fair value measurement) will have implications on the use of fair value and hence the classification of financial instruments which reiterates our earlier point on a preferred approach to review and issue the standard holistically.

Question 2
Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a contractual yield basis'? If not, why? What additional guidance would you propose and why?

In its operational guidance on the terms "basic loan features" and "managed on a contractual yield basis", the ED appears to emphasize matters of form rather than substance. We believe that more guidance is required on the application of the two principles and suggest the following:

(I) The guidance on "basic loan features" should include the consideration of the following points:

- **Terms of transactions may have basic loan features that are determined by convention or trade practices rather than contract (for example, credit terms, interest-free receivables or prepaid forward or interest rate swap).**

- **Arrangements that are in substance "loans", but that do not have the contractual terms of "principal" and "interest" (for example, preference shares that are redeemable at the option of the holder). Paragraph B1 explains "interest" as consideration for the time value of money and the credit risk associated with the principal amount. However, the ED can explain the meaning of "principal" to avoid any misapplication arising from a literal interpretation of the guidance notes.**

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- **Interest-free arrangements (e.g. intercompany loans): There appears to be a joint condition that principal and interest co-exist. Paragraph B3 (a) should include a situation where no interest is levied.**

(II) The guidance on "is managed on a contractual yield basis" should include:

- **Situations whereby there are co-existence of contractual yield management and other yield management strategies. In reality, reporting entities apply multiple strategies to managing yields, for example, managing both fair value and contractual yields. To avoid a misapplication of the intent of the ED, the ED may wish to remove the term "contractual" such that a financial instrument with basic loan features and is managed on a "yield basis" could qualify for amortised cost.**

- **Generally, instruments with loan features tend to be passively "managed" and the "management" of these instruments is less important than the "primary benefits" that are derived or "primary obligations" that are generated from these financial instruments. As an alternative, the IASB may wish to consider an emphasis on the nature of the benefits or obligations as opposed to the management of those benefits or obligations:**

  Alternative conditions for amortized cost may be as follows:

  - **The instrument has basic loan features; and**
  - **The instrument's *primary benefits or primary obligations are the cash flows arising from terms of agreement* *between the reporting entity and its counterparty*.**

The Board noted that leverage is not a basic loan feature as it amplifies the variability of cash flows. However, we believe that amplification of variability of cash flows does not necessarily imply that basic loan features did not exist. For example, in market dislocations, cash flows can be amplified beyond original expectations of cash flows and a literal interpretation of the ED may imply that amortised cost is not appropriate, which could be argued otherwise. Further guidance and clarification on this point would be very useful for consistency in the classification and measurement.

While we agree with the ED to associate amortised cost to "non trading" loans as stated in Appendix B B13, additional clarification on the definition of "incurred credit losses" is required for the understanding and consistent application of the principle. For example, it is not clear why a financial asset acquired at a discount that reflects incurred credit losses is not managed on a contractual yield basis. Further guidance would be useful especially in this area, for example, whether a discount in the purchase price constitutes a credit loss.

We would also propose that the terms "*acquired or incurred principally for the purpose of selling or repurchase*" and "*near term*" be clearly defined. It is not clear whether "incurred principally" suggest that this be the primary purpose, or merely a substantial purpose as there could be various reasons for the origination of loans. For example,

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loans may be originated for various intentions - to manage the risk, develop client relationships, earn fees, in addition to selling the loan for a profit depending on the market conditions, price, need for liquidity and capital management. It is also not clear whether the existence of an inclination to sell is considered as evidence of a loan being incurred principally for sale. With regard to the term "near term", US GAAP defines this as hours or days, not months or years. We understand that rules need to be principles-based and are not suggesting a precise number to the definition. However, we believe guidance on whether this is a period of months or a shorter period, would be useful for greater consistency and comparability.

Question 3
Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost? If so, (a) what alternative conditions would you propose? Why are those conditions more appropriate? (b) if additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in information that is more decision-useful than measurement at fair value? (c) if financial assets or financial liabilities that the exposure draft would measure at amortised cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?

(a) Besides debt instruments managed on a contractual yield basis, we propose certain equity instruments not held for short term changes in value or opportunistic price changes, \ be considered for measurement at cost. For example, for entities with investments that are primarily in equities of which a significant portion is categorized as "available-for-sale" (AFS) under the current IAS 39, we believe that the use of cost method is more relevant for the business model for such entities (ie. not held for trading and a longer horizon in terms of timing of divestments) and hence, provides more decision-useful information for users of their financial statements.

In addition, we believe that where an investment is unique, insufficient information (eg. inability to estimate future cash flows reliably, information asymmetry, unavailability of reliable benchmarks) makes measurement at fair value not effective for decision-making. Using fair value despite these limitations may lead to perverse outcomes as is seen in the recent financial crisis.

(b) Examples are private equity investments, unquoted equity investments and investments not held for trading and held for the longer term.

(c) Yes, we agree that if the financial assets or financial liabilities do not meet the proposed conditions, those instruments should be measured at fair value.

Question 4
(a) Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the

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decision-usefulness of information about hybrid contracts. (b) Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (ie tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision-usefulness of information about contractually subordinated interests?

(a) **No, we do not agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated. Instead of simplifying the standards, this approach could create accounting asymmetry for financial institutions that combine host debt instruments and embedded derivatives into structured financial instruments. The ability to bifurcate those instruments allow for the matching of the risks and accounting treatment for the host and derivative element of the hybrid instrument and that option should remain available as this treatment best reflects the economic reality of those transactions from the standpoint of the issuing financial institution. This is especially true for structured deposits. Allowing just one classification and measurement may be over-simplifying the issue and we strongly believe that the accounting treatment of embedded derivative and hybrid contracts is one area that requires significant judgment and a one-size-fits-all approach would not be appropriate.**

Although the existing rules in IAS 39 on the separation of embedded derivatives are complex, they support an underlying principle that the treatment of embedded derivatives should not be different from that of a stand-alone derivative. In that sense, the ED may not be as conceptually robust as IAS 39. Our concern is that a hybrid contract with an embedded derivative may be measured at fair value through other comprehensive income (FVTOCI). This would create a different accounting treatment for an embedded derivative in a hybrid contract from that for a stand-alone derivative.

In our view, a hybrid contract with an embedded derivative that significantly alters the cash flows or fair values of the hybrid instrument should be measured at fair value through profit or loss (FVTPL) and not FVTOCI. This condition would preserve the "significance" criterion that is implicit in IAS 39 paragraph 11A.

(b) **We do not fully agree that the cash flows of the tranches which are not senior tranches arise solely for the compensation for providing credit protection. Generally, loans do not lose their basic loan features (i.e. cashflows on specified dates on principal and interest) simply because they have contractually subordinated interest unless there is a credit default on the issuer. There could be practical difficulties in fair valuing contractually subordinated interests which may not reflect the subordination risk. We suggest additional disclosures as separate item in the balance sheet to reflect the subordinated interest.**

Moreover, we find this guidance rule-based and addresses only one specific situation of a larger pool of transactions. We believe that entities should be allowed to use judgment in deciding which are the tranches that are considered to have received credit protection from other tranches, as this decision would be largely dependent

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on management's intention and the business model of the entity. As a guidance, we would like to suggest that only if the risk is substantial, for example if the incurred loss is significantly more than the expected loss, that the tranches are effectively buying credit protection from the junior tranches and equity holders.

Question 5
Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?

Yes, we agree with the proposed approach.

Question 6
Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

We believe that the fair value option should be allowed in contracts where there are one or more embedded derivatives as we believe that the bifurcation of embedded derivatives should remain as the benchmark treatment with fair value being an allowed alternative facilitated by the fair value option where it is applied in circumstances where it eliminates or significantly reduces an accounting mismatch.

Question 7
Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

No we do not agree that reclassification should be prohibited as there are circumstances which exist that would require re-classification. The re-classification would provide users of the financial statements with more accurate information on how the financial assets or liabilities are managed.

For example, an accounting mismatch (reason for which an instrument may initially have been designated at fair value through profit or loss) may cease to exist over time and the instrument may subsequently be managed on a contractual yield basis. In these instances, an entity should be permitted to reclassify the instrument to amortised cost basis. Like-wise, the ED does not address the situation when a reporting entity ceases to manage a financial instrument by "contractual yields", which in our view, should then be reclassified out of the amortized cost classification. Another possible reason (or justification) for reclassification is where reclassification is necessary to address dislocated markets (as seen from the current credit crisis ie. "rare circumstances").

However, we believe that reclassification between categories should be kept to a minimum to avoid accounting arbitrage and instill discipline on how financial instruments are classified at inception. We suggest that strict parameters in which we are allowed to re-classify would need to be established, for example:

- **the re-classification can only be allowed to be done once, and**

- **added disclosure requirements, for example, describing the reason for re-classification, identifying the assets and amounts being re-classified**

For re-classifications to the trading category, the transfer would be at fair value, with any gains or losses on the re-classification recorded in the profit or loss statement. For re-classifications into the amortised cost category, we suggest a retrospective application.

Question 8

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

If the equity instruments (and derivatives on those equity instruments) are capable of being fair valued, we agree that the fair value information would be very useful for decision making.

However, if the fair value cannot be reasonably ascertained, by having the equity instruments (and derivatives on those equity instruments) fair valued as proposed by the ED would result in information which are not only not useful for decision making but could be misleading to users of the financial statements because the fair value information could be based on grossly non verifiable data in some extreme circumstances and the due accompanying disclosure of how the fair values are determined is not in place.

We believe the reliability of the financial statements should not be compromised when the fair values cannot be determined in a reliable manner. Recognition of gain or loss based on unreliable measures cannot possibly result in more decision-useful information. In cases where unquoted equity investments are valued using largely non-market information that may not be easily verified, the fair valuation process is likely to result in output that is uncomparable across institutions. Users such as analysts tend to place higher value on available information and as the use of fair value measurement for illiquid markets could be difficult, such as in the case of the current financial crisis, cost information would serve as very useful information for investors. In this regard, we believe there is merit to retain the cost exemption for unquoted equity investments (in particular, for start-ups and venture capital investments).

In summary, we believe that in those instances where a reliable measure cannot be obtained, cost should remain the required value for those assets. However, we suggest that entities using the cost method be required to provide supplementary disclosures, in particular the age of the investment, as we believe this is useful information for users of the financial statements.

Question 9

Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

Yes, there may be circumstances where the fair valuation cannot be readily ascertained (as mentioned in our response to Question 8) or based on high level estimates. Exemptions from fair valuation should be permitted with impairment assessment to be performed on such cases, along with supplementary information that explains the limitation of fair value measurement and why the cost method is used in the notes.

Also, in situations where an investment company invests in start-up companies or in companies which have long gestation period involving research and development to discovery and trial production, valuing the equity investments in these companies involve enormous amount of manpower and time in collating the relevant data to run the fair value models. In early stage companies, data required to run valuation model may not be readily and reliably available. Where raw data may be available in some cases, significant judgment needs to be exercised to determine the appropriate variables to run the valuation models. To carry out fair valuation exercise on every reporting date would entail enormous cost which outweighs the benefit of the fair value data which are Level 3 information under the fair value hierarchy.

Aside from the above, some structured complex derivatives written on exotic currencies, hard to value equity, and hard to value indexes are not capable of being fair valued without the full complement of valuation machines to determine the fair value. The complement of such machine comes with a great cost.

The current IAS 39 recognises the reality that there are instances where the fair values of the equity investments are not capable of being reasonably estimated and hence has allowed the cost less impairment method. Removing the cost less impairment category from the ED potentially could lead to implementation difficulties for certain industries as challenges to fair value some of the equity investments (and derivatives on those investments) still remain.

Where impairment needs to be conducted, such as when the financial asset is carried at cost less impairment, the impairment guideline in the current IAS 39 would still be a good guide to conduct the impairment.

Question 10
Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

While we believe it will be helpful to capture the unrealised gains or losses on such strategic equity investments in OCI, we disagree with the ED that actual gains or losses (or dividend income) on such an investment should not be recycled through profit or loss or transferred to retained earnings if the investment is disposed and the gains or losses are realised. We believe that the proposed IAS 39 should minimise arbitrary anti-avoidance rules which are not founded on economic substance of transactions, particularly when the transaction represents the culmination of an earnings process.

Entities which opt for FVTOCI are likely to seek for shelter from adverse fair value changes from being taken to income statement. We do not believe entities which are

confident that the equity investment will perform will opt for FVTOCI as currently earnings per OCI is not a performance indicator. That being the case, FVTOCI is likely to see negative fair values being recorded in OCI and at the opportune time, the equity investment disposed of with the gains being recorded in the income statement. By not allowing recycling at all even on disposal of the equity investment, the returns of the equity instrument may not be faithfully reflected on disposal of the equity investment as gross gains are likely to be reflected via income statement while the fair value losses captured in OCI and not being recycled down to income statement on disposal of the equity investment. It is questionable at this stage that the FVTOCI classification provides more decision useful information.

For many financial institutions such as an investment house, having the main source of income in other comprehensive income will not be decision-useful and have implication to ratings or covenants. There could also be a matching principle mismatch for the case of funds where distributions are accounted for in other comprehensive income while the management fees are still in income statement. Similarly, dividends to shareholders are normally paid from revenue reserves and other comprehensive income rolls up to other reserves. By classifying dividend income in other comprehensive income and not re-cycling realized gains / losses to profit and loss on divestments will create a mismatch in the dividend payment to shareholder

In addition, an unintended distortion may arise with the FVTOCI option when an entity enters into a derivative e.g Total Return Swap (TSR) on the strategic equity investment. Under the scenario, assuming that the strategic investment indeed underperforms which shows up in the form of negative fair value changes which are taken to OCI, the TSR written on it will perform (when the equity investment underperforms) and record a positive fair value which under the ED, is taken to the income statement. A scenario arises where the fair value losses on the equity investment are recorded in OCI while the gain on TSR written on the equity investment is taken to income statement. The gain on TSR is reflected in EPS while the fair value loss recorded in OCI is not captured in EPS. One mitigating measure is to consider having an OCI per share to be shown together with EPS, especially if the Board intends to have the fair value changes of more financial instruments being taken to OCI without allowing recycling to income statement on disposal of the financial instruments.

We have the following suggestions to improve the requirements governing FVTOCI to ensure comparability among financial statements and avoidance of earnings management:

1. **An instrument that is not “held-for-trading” is not necessarily a “strategic” investment. If the intent of the ED is to allow only strategically-held investments to be carried as FVTOCI (p. 12 of ED), this condition should be explicitly stated in the ED as a pre-requisite for the irrevocable election of investments in equity instruments as FVTOCI.**

2. **A hybrid contract with embedded derivatives that significantly alter the cash flows of the host instrument should not be classified as FVTOCI.**

3. **Taking dividends directly to other comprehensive income lacks conceptual merit. As an alternative, dividends should be shown as a realization of the investment's fair value in the balance sheet. The difference in fair value, after taking into account the dividend income, should be taken to other comprehensive income as a net item. Alternatively, the IASB may consider having dividends from equity investment (both trading and non-trading) which are recurring in nature to be classified in profit or loss.**

Question 11

Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not, (a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why? (b) should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

We do not agree that an entity should be permitted to present FV changes and dividends in OCI only if it elects to do so at initial recognition. While we agree that such an approach would be simple and is less subjective to manipulation, circumstances do change which calls for a change in accounting classification and measurement and should not be bounded to the method chosen at initial recognition. For example, an instrument may originally be held for trading, but subsequently fall out of the trading category, due to conditions not controllable by the entity – and the reverse may be true as well. Entities should be allowed to choose the accounting classification and measurement in accordance with how the investment is managed to reflect the true economic substance of the business model.

(a) **We propose that equity instruments "purchased for strategic purposes other than with the primary objective of realizing a profit from increases in the value of the instrument and dividends" to be presented in other comprehensive income.**
(b) **Yes. The principles in (a) should prevail and be the primary criteria of classification and measurement. Where circumstances have changed, the classification and measurement should be changed accordingly. It should be a revocable decision and not bound by initial recognition.**

Question 12

Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

Yes, we agree with the suggested approach. However, it should be extended to all entities and not only to those which opted to early adopt the ED when it becomes a standard. Additionally, it would be useful for the Board to clarify if mandaoty adoption of other phases of the project (eg. impairment model and hedging requirements in phase 2 and 3 respectively) is required if an entity chooses to early adopt the proposals in this phase on classification and measurement.

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Question 13
Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

Yes, we agree with a retrospective application. However, we note that paragraphs 27- 29 state that the classification shall be applied retrospectively and does not mention the same for the measurement requirement. This would require further clarification.

Question 14
Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortised cost, specifically: (a) in the statement of financial position? (b) in the statement of comprehensive income? If so, why?

We do not believe that this alternative approach provides more decision-useful information compared to measuring those financial assets at amortised cost specifically:

(a) in the statement of financial position – because this would not reflect the debt instrument which is not managed on a fair value basis; and
(b) in the statement of comprehensive income – because there is a prohibition to recycle from the statement of other comprehensive income to the profit or loss statement. The statement of comprehensive income should mirror the statement of equity reserves where the AFS reserves were previously tracked. It should not lose the tracking of the realization to profit and loss which provides useful information on the realized vs unrealized gains on the AFS securities.

The proposed approaches also require the tracking of both amortised cost and fair value, which increases, rather than decrease, complexity for both the users and preparers.

Question 15
Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

We do not agree that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft.

Should the Board decide to require entities to bring onto the books the fair value of financial assets and financial liabilities, we would prefer Variant 1 in taking all differences in fair value to the income statement but not necessary to present separately the component (a) and (b) to minimise the risk of adding complexity to the accounting standard.

Whichever approach the Board decides to take on, we hope that the final approach is one that is considered (and agreed) by both the IASB and FASB. It is important for the two Boards to reach consensus on a single approach that best addresses the classification and measurement of financial instruments, so as to achieve convergence in accounting standards.

Yours faithfully,

Dexter Tan
Secretary, Accounting Standards Council