CFA INSTITUTE | Centre for Financial Market Integrity

19 September 2008

Mr. Gavin Francis
Director of Capital Markets,
International Accounting Standard Board
30 Cannon Street
EC4M 6XH
United Kingdom

Re: Comment Letter on the IASB Discussion Paper on *Reducing Complexity in Reporting Financial Instruments*

Dear Mr. Francis,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the IASB Discussion Paper on Reducing Complexity in Reporting Financial Instruments (*DP*).

The CFA Institute Centre represents the views of its members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct.*

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[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

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EXECUTIVE SUMMARY

- We strongly support the greater use of fair value as the single measurement attribute for financial instruments as a means of reducing complexity. We believe, however, that the board needs to clarify the element of complexity being resolved in each of its proposals. There are implementation and interpretation complexities and the board should prioritize solutions to limit interpretation complexity.

- We acknowledge that there are near term implementation hurdles to the full adoption of fair value across all assets and liabilities. Therefore, we are conditionally supportive of the intermediate measures proposed. Our support is based on the premise that there will be a clearly defined roadmap towards the full adoption of fair value for all financial instruments.

- Any adopted intermediate approaches should be directionally consistent with the goal of applying full fair value for financial instruments. We agree with some of the approaches to simplify hedge accounting, particularly the elimination of partial and portfolio hedges as those designations pose significant interpretation challenges for investors.

- We would also encourage the board to eliminate the deferral of gains and losses resulting from cash flow hedge accounting. As a second preference, we would welcome restricting deferrals to the predefined periods, as suggested in the discussion paper. However, we would be concerned about the managerial intent that could be introduced through the fair value election options and would urge the board to make the election irrevocable if it adopts this option.

- Finally, we believe that the board should address the financial instrument presentation and disclosure issues as an equal priority to recognition and measurement. Presentation and disclosure issues should be dealt with as they can resolve a lot of the interpretation complexity that users face due to recognition and measurement anomalies. There are different projects where the board is dealing with financial instrument presentation and disclosure, but it is unclear whether there is consistency in the depth of consideration across these projects. While International Financial Reporting Standard No.7 (IFRS 7) provides an integrated framework of financial instrument disclosure, we have concerns about the period-to-period inconsistencies that can arise under a disclosure regime that requires an approach of 'through the eyes of management'. We would encourage a minimum threshold of disclosure and then management can have the flexibility to discuss their business model beyond that minimum threshold.

Below we elaborate on the different aspects of our response.

1. REDUCING COMPLEXITY AS A GOAL

We support the objective of the discussion paper of reducing complexity in the accounting for financial instruments. We agree with the observation that the many ways of measuring financial instruments is one of the main reasons for today's complexity. Moreover, the different ways to measure financial instruments and report unrealized gains and losses results in two identical instruments being measured differently by the same entity.

We concur with the particular goal of applying fair value for financial instruments as a means of reducing recognition and measurement inconsistencies that occur under the current mixed attribute reporting regime. It is encouraging that the discussion paper affirms the application of full fair value as a long term objective of the IASB. The proposed direction of the board is consistent with the findings of CFA Institute 2007 Financial Reporting and Measurement survey. The survey results show that;

- 58% of respondents prefer fair value as the single measurement basis for financial assets and liabilities with amortised cost information provided as a note disclosure item
- 72% of respondents indicated that companies should not have recognition and measurement options for similar items. This is predicated on the belief that a single measurement basis can allow greater comparability between reporting entities and within items reported by the entity

Another survey[3] conducted by the European Federation of Financial Analysts Society (EFFAS) corroborates our findings as it showed that 61% of their respondents were generally supportive of fair value as the single measurement basis.

Despite the desirability of eliminating complexity as a goal, there is the danger of complexity being a catch all phrase resulting in different constituencies talking at cross purposes. Everyone is likely to agree with the goal of reducing complexity but there is a danger of such a goal meaning different things to different constituencies. Therefore, in its communication to its key constituencies, the IASB should disaggregate the category of complexity that it aims to resolve. The board and staff need to be clear whether what is being resolved is implementation, investor interpretation or volume complexity. There is also a need to distinguish between avoidable and unavoidable complexity. Complex arrangements and the ongoing innovation of financial instruments are part and parcel of modern finance. Managers need to fully convey the nature and the entire spectrum of risks associated with the complexity that they face. Hence financial reporting should efficiently and precisely convey the complexity. In other words, accounting should shed light on the complexity of financial instruments and it should neither exacerbate nor mask the complexity of such instruments.

Overall, we support measures that reduce user interpretation complexity and provide a more accurate depiction of the economic reality of reporting entities.

2. FAIR VALUE FOR FINANCIAL INSTRUMENTS

We have stated in several previous comments letters[4] and in the Comprehensive Business Reporting Model (CBRM), our strong support for fair value as the appropriate measurement basis for all financial instruments. This view is further supported by the results of recent surveys of investment professionals. In particular, of the 2,006 respondents to a March 2008 survey of CFA Institute members on the topic, 79 percent believe that fair value improves financial institution transparency and understanding of risk

[3] Survey: The view of European Professional Investors and their advisors: Attitudes towards Fair value and other measurement concepts: An evaluation of their decision usefulness

[4] 8th May 2006 comment letter on '*Fair Value Option for Financial Assets and Financial Liabilities: Including an amendment of FASB Statement No. 115*' and the 31st October 2006 comment letter to Bob Herz on fair value accounting

profile and 74 percent believe that it improves market integrity. Full fair value accounting of all financial instruments is superior to either amortised cost or to a mixed attribute, multiple measurement basis, for various reasons including the following:

Economic distortions of amortised historical cost

Unlike fair value accounting, under an amortised cost approach, gains and losses can be realised in three distinct stages; when realised at sale, when impairment write-downs are recorded and gradually over the life of an instrument. Due to the untimely recognition of impairment gains and losses, the amortised cost approach can mask economic reality and is not as transparent as the fair value approach. Due to these features, amortised cost accounting can dis-incentivise managers from acting in the best interest of its shareholders. For example, an institution holding a loan recorded at cost that was issued during a phase of market exuberance may be slow to recognize impairment of the loan caused by deteriorating economic conditions. In that case, the cost approach is a lagging indicator of a firm's true economic position.

In contrast to impairment related adjustments, mark to market adjustments convey more meaningful economic information and have higher predictive values. For example, the effective interest rate under fair value accounting is indicative of the likely cost of refinancing at the time of reporting. The same can be said of other risk factors (e.g. prepayment and default rates) applied to valuation of reported assets and liabilities. There are numerous studies[5] that have illustrated the value and economic relevance of fair value. Amortised cost information is nevertheless useful information as it provides data that aids the verifiability checks on the reported fair values and therefore should be provided as a note disclosure.

Perils of Managerial Intent under multiple recognition and measurement options

The adoption of fair value accounting for financial instruments will significantly limit accounting that is based on managerial intent. Recognition and measurement based on managerial intent exacerbates the variation in the reported period to period performance. Under International Accounting Standard No. 39 (IAS 39), *Recognition and Measurement of Financial Instruments*, there are multiple options to account for financial instruments (i.e. available for sale, trading and held to maturity). These options are coupled with multiple locations of recognising gains and losses (i.e. statement of equity or income statement). Some gains or losses incurred are recognized through the income statement (e.g. trading instruments) while other portions of gains or losses are recognized through comprehensive income (e.g. available for sale instruments).

We believe the selection of the multiple options discussed above is susceptible to management bias and manipulation. Firms can manage earnings through the selective realisation of unrealised gains and losses. Thus, the multiple options make it very difficult for users to translate the economic meaning of reported

[5] Hodder, Hopkins and Wahlen (2006) provide evidence showing the risk relevance of fair value recognition and measurement. They provide empirical evidence that supports the notion of risk relevance of fair value volatility. Their study was conducted using data of 202 commercial banks, spanning the 1996-2004 period. The study showed that if reported income was adjusted for items included in other comprehensive income and fair value items that are not recognized, but disclosed only in the notes, then a strong association between the adjusted full fair value and the observed stock prices exists. The adjusted full fair value income volatility for these sample firms captures elements of risk not captured by net income volatility. Full fair value income volatility relates more closely to capital market pricing than does net income volatility.

gains and losses. As mentioned earlier, 72% of respondents to the 2007 CFA Institute Financial Reporting and Measurement Survey indicated that companies should not have recognition and measurement options for similar instruments.

The most vivid illustration of avoidable complexity that arises because of accounting based on managerial intent, is that caused by hedge accounting. In addition to this response we have attached our comment letter to the exposure draft on amendments to US Financial Accounting Standards Board Statement No. 133 (SFAS 133). While there are differences between hedge accounting requirements under International Financial Reporting Standards (IFRS) and those under US standards, there are also similarities that our letter touches upon. In particular, we have concerns related to cash flow hedge accounting. The principal concern lies with the potential for lengthy deferral periods of gains or losses on hedging instruments recognized in other comprehensive income, which are subsequently reclassified into earnings when hedged cash flows affect earnings.

Fair value recognition and measurement encourages greater disclosure of correlated information

A consequence of fair value recognition is that managers could be encouraged to provide more disclosure so as to prevent users misunderstanding the reported numbers. Disclosure can help users to clarify the economic meaning of different accounting numbers e.g. impairment, fair value adjustments and recycled adjustments.

The board acknowledges that a single measurement attribute such as fair value for all types of financial instruments would facilitate comparisons between entities and between accounting periods for the same entity. We believe those benefits would trigger a more extensive level of voluntary disclosures about the underlying causes for changes between accounting periods in fair values. If some firms in a sector voluntarily disclose information, non-disclosing firms will come under pressure to disclose similar information in subsequent periods. The tendency of peer pressure to lead to greater disclosure has been evident during the ongoing credit crisis.

3. COMMENT ON RECOGNITION AND MEASUREMENT PROPOSALS

Due to the earlier stated advantages of fair value relative to amortised cost, our first preference would be for the board to require immediate and full adoption of fair value for all financial instruments. However, we do acknowledge that under the current regime, there are some implementation hurdles to the application of fair value for all financial instruments. Hence, as a second preference we would be conditionally supportive of intermediate measures. If the board chooses one or all of the intermediate approaches, our support would be conditional upon the following:

- Our satisfaction that the changes are directionally consistent with the ultimate adoption of full fair value;
- The provision of a road-map that clearly communicates the movement towards fair value through multiple phases; and
- Changes that significantly reduce user interpretation complexity

INTERMEDIATE OPTIONS

The discussion paper puts forward three intermediate approaches: a) amending the financial instrument classification criteria; b) requiring fair value but allowing optional exceptions; and c) simplifying hedge accounting. The paper describes these approaches as mutually exclusive and therefore, they may all be adopted.

Approach 1: Amending the Financial Instrument Classification Criteria

The discussion paper proposes to amend the classification criteria. IAS 39 currently has four categories for financial instruments: loans and receivables, held to maturity, available for sale and trading. These approaches can result in multiple treatments for the same financial instrument within an entity, across entities and across different time periods. That contributes to interpretative complexity. As noted in the discussion paper, the held to maturity category necessitates the application of tainting rules and this adds another layer of avoidable complexity

However, it would seem that the boundaries around these classification categories are really a secondary consequence of a) the measurement basis and b) the determined location of recognized gains and losses. Hence the real question is whether to:

- apply full fair value; or
- apply full fair value, but allow multiple locations for fair value gains and losses; or
- allow a mixed attribute approach with multiple locations for all gains and losses.

Therefore, the answer lies in the selection of the appropriate measurement basis and we strongly believe that this should be fair value.

Another part of the answer lies in the financial statement presentation approach. The effectiveness of amendments to the classification criteria is inter-linked with the financial statement presentation approach. The discussion paper on this project is yet to be issued and therefore it is unclear which proposals the board is considering and how those proposals would affect the choice of measurement principles. Unfortunately, this paper does not sufficiently address the related financial statement presentation questions and when it does, it seems to be on a fragmented basis across a range of options. There is a recurrent question of where to recognise gains and losses and we would urge the board to deal with this issue holistically.

However, we strongly support an approach that would eliminate the held to maturity category and lower the difficulties associated with the deferral and recycling of available for sale gains or losses. With the application of full fair value and with either a single comprehensive income statement or well disaggregated income statement, there will be no need for the held to maturity and available for sale categories. We believe that full fair value coupled with an adequately disaggregated financial statement presentation would solve concerns about transparency and adequately explain any volatility that may occur between accounting periods. Investors would be able to see the effects on income cause by changes in fair value and draw their conclusions.

Approach 2: Fair value with option exceptions

The paper proposes a requirement of fair value for all financial instruments, but would allow for the cost option with exceptions. As a general principle, we have concerns about accounting that is based on managerial intent and this proposal seems to fall under that category. Nevertheless, we would be cautiously supportive of the premise that this approach would allow more financial instrument categories to be accounted for at fair value. If this approach were allowed, **we would want an irrevocable option to be available only upon the acquisition of an instrument.**

Also, we are concerned about the criteria to determine the exception treatment. The discussion paper mentions that only instruments with fixed cash flow would be eligible for the cost exception. We have concerns that although approach 2 is described as mutually exclusive from approach 1, the application of proposed exceptions could simply end up offsetting any refinements that may be achieved under approach 1. We would be cautiously supportive of this approach in so far as it restricts the exercise of managerial intent. We would also require sufficient accompanying disclosure about the selection of options.

Approach 3: Hedge accounting simplification

The discussion paper proposes either the elimination or simplification of hedge accounting. Our strong preference is the elimination of hedge accounting, but, as an intermediate measure, the simplification of hedge accounting is considered to be an acceptable alternative. This is because of mixed attribute accounting across different financial and non financial assets and liabilities. Therefore, it may be premature to get rid of hedge accounting entirely at this stage prior to the adoption of full fair value for all financial instruments.

However, it is important to ensure that the goal of simplifying hedge accounting is consistent with the goal of providing a better and more complete portrayal of economic reality of reporting firms. On the one hand, investors and other users want an accounting regime that makes it easier to interpret the risk management strategies and the effectiveness of these strategies. On the other hand, financial statement preparers want to minimise their compliance requirements and reported volatility. The set of proposals put forward by the IASB seems to fuse those considerations. This approach is acceptable, but we believe there should be a hierarchy of priorities with investor needs at the top, because financial reporting is supposed to provide decision useful information to providers of capital. In other words, the primary objective **should be simplification that is consistent with faithful representation of economic reality**.

There is also the question of whether simplifying the compliance with hedge accounting is directionally consistent with the long term goal of full fair value accounting. Simplifying compliance is likely to encourage the greater use of hedge accounting. By implication, the increased use of hedge accounting could further entrench hedge accounting and likely impose greater rather than lower financial statement preparer opposition to the full adoption of fair value as a measurement basis.

In the appendix we elaborate on our views on different proposals to simplify hedge accounting. In our comments we agree with some of the approaches to simplify hedge accounting, particularly the elimination of partial and portfolio hedges as those designations pose significant interpretation challenges for investors. We also encourage the board to eliminate the deferral of gains and losses resulting from

cash flow hedge accounting, and as a second preference, we would welcome restricting deferrals to the predefined periods as suggested in the discussion paper.

4. PRESENTATION AND DISCLOSURE AS AN EQUALLY IMPORTANT PRIORITY

The focus of the discussion paper is on recognition and measurement. The paper also acknowledges the importance of presentation and disclosure in reducing complexity, but surprisingly has opted to exclude those key elements as an integral part of its proposed solutions. We therefore would advocate for an integrated rather than a fragmented approach to reducing complexity for financial instruments. Enhanced presentation and disclosure can go a long way towards addressing user interpretation complexity.

Financial Statement Presentation

Within the items covered in the discussion paper, there is the recurrent theme of where gains and losses should be recognised. This is related to:

- Re-measurement of financial instruments classified as liabilities under IAS 32;
- Measurement of changes in fair value of financial instruments designated as hedging instruments under IAS 39; and
- Measurement of changes in fair values of financial instruments classified as "available for sale" under IAS 39.

Unfortunately, this paper does not sufficiently address the related financial statement presentation questions and when it does, it seems to be on a fragmented basis. It is not clear whether the discussion paper on financial statement presentation will address those problems either.

Financial Instruments Disclosure

Membership surveys we have conducted over the last decade consistently show that our members believe there are significant quality gaps[6] in the disclosures of risk management activities and risk exposure. The 2007 and 2003 corporate disclosure surveys showed quality gaps of -1.1 and -1.3 for risk management activities, respectively. The same surveys showed quality gaps in risk exposures of -1.0 and -1.3. These findings are part of a recurrent experience of poor quality disclosures, from the perspective of users. International Financial Reporting Standard Statement No.7, *Financial Instruments: Disclosures* (IFRS 7) promulgated in 2007 provided a good start to redressing the noted shortfalls of disclosure, especially as it integrated key dimensions of risk disclosure of financial instruments.

However, a preliminary review of IFRS 7 implementation would indicate the need for enhancement of currently available disclosures. Two recently published reports[7] by Price Waterhouse Coopers and Fitch Ratings highlight the variation in the implementation across selected financial institutions of IFRS 7. Both

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[6] Quality gaps are differences in the rating of quality and importance (a five-point scale was used, with 5 as very important and high quality). A wide, negative gap is a quality deficit indicating that the information quality is deficient relative to its importance.

[7] 1) Accounting for change: transparency in the midst of turmoil- A survey of banks' 2007 annual reports August 2008- Price Waterhouse Coopers 2) Fair value disclosures: A reality check, June 26th 2008, Fitch Ratings

reports find that there has been some improvement, albeit insufficient, in risk disclosure and there is clearly an issue of poor comparability between firms. The inconsistency seems to be due to the IFRS 7 requirement of disclosure 'through the eyes of management'. While it is early days in the adoption of IFRS 7 and corporate managers may enhance disclosure, our experience is that voluntary disclosure requirements result in boiler plate, meaningless information.

'Through the eyes of management'

Business model heterogeneity is the most frequently cited justification for having disclosure made through the eyes of management. It is hard to argue with the contention that corporate managers do indeed have a superior grasp of the idiosyncrasies of their specific operations. Yet the notion that 'through the eyes of management' disclosure suffices to provide optimal investor requirements overlooks several realities of the investment process. Specifically the reality that investors allocate capital on the basis of a cross sectional view across industries and across firms within an industry. Investment analysis is based on comparative attributes. Therefore, the importance of comparability of information cannot be overstated. Providing comparable information that contributes to an investor's appreciation of relative risk return prospects is more relevant than perfect entity specific information.

A 2007 CFA Institute Comprehensive Disclosure Survey showed that 77% of the respondents prefer a standardised presentation of information while 21% preferred companies to report the way they think appropriate subject to minimum standards. The reasons cited in the elaborative comments in favour of standardisation were that it improves the consistency and comparability of financial reporting. Moreover, we believe that a prescriptive approach would facilitate the disclosure of useful information in an XBRL format.

As was evident from the study conducted by Price Waterhouse Coopers and Fitch Ratings, 'Through the eyes of management' disclosure can result in significant variation across firms and across reporting time periods. Rather than relying on pure 'through the eyes of management' approach, the standard setters should define and mandate a threshold level of meaningful comparable accompanying note information. Management should then have the discretion of exceeding this threshold when they want to convey greater insights about their firms. Such an approach would be analogous to the modified management approach that is applied to segment reporting disclosure. The ongoing acceptance and application of the three level valuation hierarchy required by FASB Statement No. 157 is a good example of the type of minimal disclosure threshold that is meaningful to investors, yet it does not constrain managers from conveying additional specificities about the risk profile of their investments.[8]

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[8] In September 2008, the Division of Corporation Finance sent the following illustrative letter to certain public companies identifying a number of disclosure issues they may wish to consider in preparing Management's Discussion and Analysis. http://sec.gov/divisions/corpfin/guidance/fairvalueltr0908

Additional disclosures

The application of IFRS 7 during the recent market crisis has provided a suitable testing ground and enables the identification of some areas to enhance current disclosure requirements. We would strongly urge the board, to incorporate the findings related to the user disclosure requirements identified by the expert valuation advisory group on the accounting of illiquid financial instruments. These findings should be integrated into the board's efforts to reduce complexity in reporting financial instruments. The areas of additional disclosure include:

Aggregation
This is an area where finding the right balance between 'too summarised' and 'too granular' is important. Aggregation can occur by risk type and by instrument. The point of reference in determining useful information should be user feedback and clearly more work needs to be done.

Fair value disclosures

- Adjustments made to observable inputs
- The differences between valuation effects of observable and unobservable inputs on profit and loss
- Movements and reconciliation of movements across all three levels of the valuation hierarchy
- Sources of unobservable inputs
- Hedge effectiveness and asset/liability management effectiveness of matched items residing in different valuation hierarchies
- Distinction between impairment losses and mark to market adjustments plus a disclosure on the basis of impairment determination.

Sensitivity Analysis
Sensitivity analysis is crucial to conveying the range of outcomes possible as acknowledged in the consultation paper. Similar to aggregation, more guidance is required on the sensitivity analysis that is relevant to users. The earlier mentioned Fitch Ratings' and Price Waterhouse Coopers' studies of a cross section of disclosures, highlighted the variability and shortcomings in the quality of some of the sensitivity analyses currently available under IFRS 7 reporting. Some useful considerations to improving sensitivity analysis include:

- Separating forward looking and retrospective sensitivity analysis
- Providing symmetrical risk analysis -- investors are interested in knowing the upside and downside potential of the assets and liabilities held
- Disclosing multifactor risk analysis because it is more informative than a single factor sensitivity analysis. This is especially the case due to the correlation of key risk factors e.g. liquidity risk and counterparty credit risk and
- Balancing the level of aggregation in sensitivity analyses. Too much aggregation could offset countervailing risk factor effects, yet highly disaggregated sensitivity could provide information overload to investors.

Valuation Methodologies
We believe that disclosure of valuation methodologies is important because it informs investors about the uncertainty and fragility of inputs to and outputs from valuation models. Valuation methodology disclosure should include information about:

- Model limitation disclosures
- Valuation forecast error (i.e. differences between the internal model valuation and the exchange value realised)
- Effect of credit risk deterioration and the credit value adjustments.

CLOSING REMARKS

If you, other board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, CFA, by phone at +44.207.531.0763, or by e-mail at vincent.papa@cfainstitute.org, or Patrick Finnegan, CFA, by phone at +1.212.754.8350, or by e-mail at patrick.finnegan@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht

Kurt N. Schacht, CFA
Managing Director

/s/ Gerald I. White

Gerald I. White, CFA
Chair, Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council

APPENDIX

DETAILED COMMENTS ON SIMPLIFYING HEDGE ACCOUNTING PROPOSALS

We recognise that there are some differences between IFRS and US hedge accounting practices, but there are also similarities as acknowledged in the discussion paper documentation. With respect to specific proposals put forward, as part of our response we have attached our comment letter to the exposure draft on amendments to FASB Statement No.133 dealing with hedge accounting. In our letter to the FASB

- We were cautiously supportive of the restrictions on bifurcation by risk as it is a partial solution. The US requirements still allow foreign currency and own debt interest rate risk, so it is a partial solution at best, but it reduces the measurement inconsistencies when derivatives are used to hedge financial or non financial hedges. It also reduces structuring opportunities.
- We expressed concern about the changes in assessing hedge effectiveness with the elimination of quantitative thresholds, but with no clear definition of an alternative criterion. The changes will reduce compliance complexity but it is not clear whether there will be corresponding disclosure to better inform investors.
- We strongly support derivative related disclosure as an important aspect of reducing user interpretative complexity.
- We support a more prescriptive approach to the reporting of income effects of recycled hedge gains and losses.

Below are our comments on some of the elements put forward in the discussion paper as a means of simplifying hedge accounting:

Deferred gains and losses of Cash Flow Hedge Accounting

In the attached letter to the FASB we highlighted several concerns that we have on cash flow hedge accounting. These include the lengthy deferral periods of gains and losses on hedging instruments designated as cash flow hedges and the significant forecast error. Besides, the discussion paper rightly acknowledges that there is no theoretical basis for the application of cash flow hedge accounting. Therefore, we support the immediate recognition of all cash flow hedge accounting derivative gains and losses through the income statement. Derivative instruments are financial assets and financial liabilities held by reporting entities and they can be monetized. Fair value measurement and immediate recognition of gains and losses through the income statement is the most effective way of reflecting this economic reality. Besides, as implied in the deferral adjustment requirements, there is often a maturity mismatch between the hedging instrument and the anticipated transaction and, therefore, the presumed lock in of risk factors, in relation to the hedged item, is often hypothetical.

As a second preference, we would support the proposal to reclassify into earnings deferred gains and losses. The discussion paper has proposed that reporting entities should state at inception when a hedged transaction is expected to affect earnings and to reclassify gains and losses at that time regardless of the realisation of the forecasted transaction. We would support this proposal as it can limit lengthy deferral periods.

Fair value option a substitute to fair value hedge accounting

On the premise of a fair value option as an intermediate solution, we would give conditional support to its application beyond the spectrum of hedged items and within the spectrum of hedged items (i.e. non financial assets and liabilities). This would be on the understanding that such an option is directionally consistent with the adoption of full fair value. In a previous comment letter we stated that

'We have supported the Board's efforts over the years to increase the use of fair values in financial reporting. We have recognised difficulties and supported the Board's decisions to take a step by step approach. Despite our general aversion to the provision of alternative choices for financial reporting, we gave our conditional support for the Fair Value Option for financial instruments in the expectation that such a step would serve as a near term bridge to the mandating of fair value reporting in the financial statements for all financial instruments'[9]

We would support fair value option as it is a better alternative for fair value hedge accounting. It does not allow the dedesignation and redesignation allowed under fair value hedge accounting. We would encourage the board to extend the fair value option to servicing financial assets.

De-designation and Re-designation

We would encourage the board to restrict the de-designation to the termination, selling or exercising of derivative contracts. De-designation and re-designation is one of the most troublesome areas of hedge accounting. It exemplifies the pitfalls of accounting that is based on managerial intent and significantly contributes to the difficulties in understanding reported derivative gains and losses.

Elimination of Partial Hedges

We support the elimination of partial hedges because this proposal takes cognisance of the economic reality of the interaction and interconnectedness of different types of risk (e.g. market, counterparty and liquidity risk). Hence, it is a fundamental distortion of economic reality for reporting entities to handle these discrete risk types in isolation, during the accounting for derivatives used for risk management purposes. From an accounting perspective, this decision has the further merit of reducing the opportunity for inconsistencies in the accounting for similar derivative instruments. For example, we agree that there should be no difference between the accounting treatment for a derivative instrument used to hedge financial assets and financial liabilities, and the accounting treatment for the same derivative instrument when it is used to hedge non-financial assets and liabilities. Eliminating the bifurcation by individual risk for hedge accounting has the added attraction of reducing possible, non transparent, structuring opportunities that can arise when managers have the option to choose which risks receive hedge accounting treatment.

However, from a user perspective, the incremental utility of the proposed modification has to be assessed by whether the modification allows users to be more informed than they previously were about the basis

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[9] 31st October 2006 CFA Institute Centre comment letter to FASB on Fair value

that reporting entities elect to apply hedge accounting. Users need to have a clear understanding of the full risk exposure profile, including the full spectrum of

- Hedged risk exposures
- Un-hedged risk exposures
- Hedge accounting election exposures
- Exposures excluded from hedge accounting treatment

Elimination of Portfolio Hedges

We support the elimination of portfolio hedges because of the complexities involved in interpreting the effects of such hedges on reported earnings.

Hedge Effectiveness Tests

The discussion paper touches on a number of factors such as the qualification criteria and periodicity of reassessments. Addressing these factors can certainly make hedge accounting less cumbersome and reduce the compliance complexity of financial statement preparers. However the paper does not posit any robust approach that would be an enhancement from current practice of conducting hedge effectiveness test.

In principle, we do not oppose measures that ease the processing of financial reporting information, as long as the proposals do not reduce the transparency of the underlying risk exposures, risk management strategy and risk management effectiveness. It is also important to consider that making it easier for preparers to comply with hedge accounting requirements will not necessarily make it easier for users to interpret its application. Nevertheless should the board decide to relax the current prospective and retrospective hedge effectiveness testing requirements, in order to reduce preparer compliance burden, it should concurrently specify a qualification criteria that will be consistently applied. It should also:

- require companies to provide robust disclosure on how the election was made and
- place restrictions on de-designation.

There is sufficient implementation history upon which the board can decide suitable qualification criteria. This will help to avoid the open ended application of effectiveness tests that could impair the ability of users to make comparisons of the effectiveness of risk management strategies across firms and across different time periods.

Usefulness of hedge effectiveness tests

There are several reasons why the prospective and the periodic retrospective determination of hedge effectiveness are useful for investors. The use of derivative relates to the management of risk exposures and by definition, risk exposures relates to forward looking information. One way of judging risk management capabilities and risk management effectiveness is by obtaining information about the forecast error of reporting managers. Hedge effectiveness tests will also convey information about the model risk of reporting entities. As the recent financial crisis has shown, understanding model risk is crucial for complex financial instruments.

Another reason for the application of hedge effectiveness tests is that they can help to identify misclassification errors that can contribute to the distortion of economic reality. There are two types of misclassification errors:

- effective economic hedges that would not meet hedge accounting requirements (Type I error) and
- ineffective economic hedges that are deemed to meet hedge accounting requirements (Type II error)

In light of the general requirement to fair value all derivative contracts, a Type I error at worst results in the timely recognition of derivative gains and losses. However a Type II error, in the case of cash flow hedge accounting, can result in the inappropriate deferral of derivative gains and losses. We would favour prospective tests that minimise the chances of a Type II error. This is because, all things being equal, from a user perspective, a type II error is more costly than type I error as it results in underestimation of the risk of reporting entities.