EFRAG

European Financial Reporting Advisory Group

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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org or uploaded via our website www.efrag.org by 18 September 2008

Dear Sir/Madam,

Discussion Paper *Reducing Complexity in Reporting Financial Instruments*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the IASB Discussion Paper *Reducing Complexity in Reporting Financial Instruments* (the DP). This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS.

To summarise, the DP argues that existing accounting requirements for financial instruments are too complex and need to be simplified. It identifies two areas—measurement and hedge accounting—as areas that seem to be significant causes of that complexity, and it argues that one of the main ways to simplify the requirements is to reduce the number of different ways of measuring financial instruments. From that it concludes that the long-term objective should be to measure all financial instruments in the same way. The DP concludes that that should be by measuring them all at fair value (so-called 'full fair value'). However, there are a number of issues that need to be resolved before that would be possible, so full fair value should be viewed as the long-term objective. Intermediate improvements need therefore to be found. The DP discusses various possible intermediate approaches.

Our detailed comments are set out in the appendix to this letter. However, to summarise:

- We agree that the existing financial instruments accounting is unacceptably complex. We also agree that a fair amount of the complexity in existing financial instrument reporting is caused by existing standards.

- However, we do not think it follows that adopting one measurement basis for all financial instruments will inevitably reduce this complexity. We think what is needed is a comprehensive debate about measurement so that the usefulness of the various possible measurement bases for users of financial statements is fully explored and some conclusions reached about what basis is most useful in what

circumstances. Bearing this in mind, we do not see how any views can be reached as to what the long-term objective should be at the moment.

- We currently have a mixed measurement model; we will have a mixed measurement model for the foreseeable future; and the objective of any IAS 39 improvement project should be to find ways of improving that mixed measurement model so that the information provided to users is enhanced. In the appendix we make some suggestions as to how this might be done. We also think the existing Financial Statement Presentation project provides opportunities to simplify aspects of financial instruments accounting.

- We think that, for the time being, it should be assumed that hedge accounting will continue to be permitted and that the objective should be to simplify the existing requirements. In our view, a priority should be to develop a principle-based hedge accounting system that would better reflect sound risk management practices and their impact on the economic performance of the entity.

If you would like further clarification of the points raised in this letter, please do not hesitate to contact Svetlana Boysen or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix

EFRAG's detailed comments on the IASB Discussion Paper *Reducing Complexity in Reporting Financial Instruments*

Questions for respondents

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?

1. The DP states that many preparers of financial statements, their auditors and users of financial statements find the requirements for reporting financial instruments complex; and that the IASB has therefore been encouraged to develop an IAS 39 replacement that is principle-based and less complex than the current IAS 39.

2. EFRAG agrees that the way in which financial instruments are accounted for under existing IFRS is complex. We recognise that financial instruments can be complex and the way in which they are used can be complex, but there is no doubt in our minds that the existing accounting requirements add to that complexity.

3. We have heard some preparers and auditors argue that, although the requirements might be complex, the understanding is now there and the systems are now in place so complexity is not currently a significant issue. However, that is not the case for all preparers and auditors and many users tend to view reporting financial instruments as an aspect of the financial statements that is not to be relied on to any significant degree. This is undesirable and, in our view, emphasises the need to improve the way in which financial instruments are reported.

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.

4. We encourage the IASB to address complexity in reporting financial instruments.

5. The DP explains that there are a number of reasons for the existing complexity in the accounting requirements, including "the many alternatives, bright lines and exceptions [in existing standards] that often obscure the underlying principles." One of the main causes of this is, the DP argues, the many ways financial instruments are measured. The DP argues that the best way to eliminate the complexity would be to require all financial instruments to be measured on the same basis. It then argues that this single measurement basis should be fair value. The DP then acknowledges that for various reasons it is not possible to require all financial instruments to be measured at fair value in the short-term, but that should be the long-term objective and that long-term objective should provide direction to any

changes made to the standards in the short- and medium-term (in other words, changes should not be made to the standards that move them away from the long-term objective and generally speaking the aim should be to move standards in the short- and medium-term closer to the long-term objective).

6. We agree that a fair amount of the complexity in existing financial instrument reporting is caused by "the many alternatives, bright lines and exceptions" in existing standards. We agree therefore that they are likely to be areas in which simplifications are possible. However:

   (a) it is in our view important not to lose sight of the overall objective, which is to improve the usefulness of the information provided. Reducing the existing complexity (by reducing the number of options in how financial instruments can be measured) would, we believe, be consistent with that overall objective, but it does not follow that adopting one measurement basis for all financial instruments will inevitably be the most useful approach from a users' perspective.

   (b) the recent market turmoil has asked some pretty fundamental questions about the existing fair value measurement requirements.

7. What we think is needed is a comprehensive debate about measurement. Such a debate would clear away many of the myths, misconceptions and mis-understandings that currently exist. Unless and until such 'noise' is stripped away, we think it is difficult to achieve a high degree of consensus on the way forward.

8. Bearing all this in mind, we think it is premature, and perhaps even inappropriate, to decide that the long-term objective should be full fair value for financial instruments and that changes to IAS 39 should not be allowed unless they represent a step towards that objective (or at least do not involve a step away from that objective). We currently have a mixed measurement model; we will have a mixed measurement model for the foreseeable future; and the objective of any IAS 39 improvement project should be to find ways of improving that mixed measurement model so that the information provided to users is enhanced.

9. We think that objective is achievable and for that reason we encourage the IASB to undertake projects that would try to improve financial instruments reporting based on the mixed measurement model. For example:

   (a) we think that the number of different categories into which IAS 39 requires financial instruments to be classified for measurement and presentation purposes, the actual categories involved, and the rules that are included in IAS 39 to ensure that the classification is done properly are a major source of the current complexity. Simplifying this aspect of the standard—without even changing the basic measurement requirements of IAS 39 (fair value or amortised cost, less impairment)—would probably improve things greatly. We discuss this later in this appendix;

   (b) we think the existing hedge accounting requirements are also a major source of complexity. In our opinion, the long-term objective ought to be to replace the existing requirements with a principle-based model that is capable of dealing comprehensively with modern-day hedging activity. However, even in the shorter-term we believe significant simplifications are possible. Again, we discuss this later in the appendix;

(c) we agree with the DP that the existing scope and derecognition paragraphs are another major source of complexity.

10. The rest of our comments need to be read in the context of the above explanation of our general position on reducing complexity in reporting financial instruments.

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

11. As we state above we believe that the overall objective of a project on improving reporting financial instruments should be to enhance the usefulness of the information provided. Therefore, the test of whether an amendment would improve the accounting should be whether an amendment would enhance the relevance, reliability, comparability and understandability. This is covered by criterion (a). For that reason we think criterion (b) in paragraph 2.2 ("It [the change] must be consistent with the long-term measurement objective. Ideally, a change should increase the number of financial instruments measured at fair value. It must not result in measuring instruments other than at fair value if they are required to be measured at fair value today") is unnecessary. Moreover we also think it is confusing because this criterion is one of the things the discussion paper is seeking input on in its section that deals with a long-term solution for accounting for financial instruments. It seems odd to make an intermediate approach dependent on a criterion that is itself a subject of the debate.

12. Furthermore, we do not think that criterion (c) *("*Ideally, a change should result in simplification for preparers, auditors and users. It must not increase complexity for any of those groups.") is necessary as a separate criterion. In our view it is part of the objective to improve the usefulness of the information, provided this objective is achieved at a reasonable cost, which are the conditions that are covered by criteria (a) and (d).

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?

13. Currently, IAS 39 requires:

    (a) financial assets and financial liabilities to be measured in the main at either fair value or at amortised cost less impairments. These requirements are referred to in this letter as the measurement requirements.

    (b) changes in fair value of some items to be presented in the income statement, whilst the changes in fair value of some other items are initially presented outside the income statement in a statement of comprehensive income and subsequently recycled into the income statement. These requirements are referred to in this letter as the presentation requirements.

    (c) financial assets and financial liabilities to be categorised for measurement and presentation purposes into categories such as held-for-trading, available-for-sale, held-to-maturity and loans and receivables. These requirements are referred to in this letter as the categorisation requirements.

14. In responding to question 3, we will consider each set of requirements in turn.

Measurement requirements

15. For the reasons explained above, we think the focus of the IASB's work should be based on the mixed measurement model, and the objective should be to reduce the complexity of reporting financial instruments within the context of that model. For that reason, we think it should be assumed that, for the foreseeable future, some financial instruments will be measured at fair value and some at amortised cost less impairments. We suggest that the focus of the improvement/less complexity effort should therefore be focused on the presentation and categorisation requirements.

Presentation requirements

16. The main purpose of the presentation requirements is to make it possible for some financial assets to be measured at fair value without requiring the changes in fair value to be recognised immediately in profit and loss. This is achieved by categorising financial instruments as available-for-sale.

17. These requirements either directly or indirectly make accounting for financial instruments more complex. For example, they make it necessary for IAS 39 to set out requirements as to when changes in fair value should be recycled to the income statement. This in turn leads to some detailed rules on the treatment of impairments (which need to be identified and accounted for separately from other decreases in fair value).

18. Currently the available-for-sale category is used for a number of reasons.

    (a) One reason why some companies want to use the available-for-sale category is because they see the gains and losses on items measured on a 'fair value through OCI' basis to be different from the gains and losses that arise on items measured on a 'fair value through earnings' basis. For example, some consider that reporting gains and losses through OCI permits faithful presentation of the effects of financial instruments on the economic performance of the entity if the financial instruments are strategic equity investments of the entity.

    (b) Another reason why some companies want to use the category is because they are concerned about the accounting mismatches that would otherwise arise. For example, currently insurance companies measure their assets, but not their liabilities, at fair value—even though in many cases the liabilities and assets have offsetting risks. If their assets were required to be measured at 'fair value through earnings', reported earnings would appear more volatile than the underlying economics actually are. Measuring them at 'fair value through OCI' therefore keeps the fair value changes away from current earnings.

    (c) A third reason why some companies use the available-for-sale category is because they are concerned about the reputational risk involved in triggering the tainting rules that apply to held-to-maturity investments.

19. Reason (c) has nothing to do with presentation, and can only be resolved by either replacing the held-to-maturity category or by replacing some of the rules that are in IAS 39 to support that category.

20. Reasons (a) and (b) relate to the broader issue of Financial Statement Presentation. The IASB currently has an active project on this subject, and we think that one of the objectives of that project should be to develop an approach to presentation that addresses the concerns underlying Reasons (a) and (b). If that were done—and we think it is achievable, albeit not overnight—much of the demand for an available for sale category would be eliminated. And that, we believe, would address most (if not all) of the complexity arising from the presentation requirements described above.

Categorisation requirements

21. Under existing IAS 39, financial assets and financial liabilities are categorised into categories such as fair value through profit or loss, available-for-sale, held-to-maturity and loans and receivables. This is done in order to be able to apply different measurement and presentation requirements to each category.

22. The existence of these categories, and of the rules that have been included in IAS 39 to support the categorisation process, is a major source of the complexity that the standard brings to accounting for financial instruments. In EFRAG's view, there is room for significant simplifications in this area and, if it is done in an appropriate way, significant improvements in accounting for financial instruments could result. EFRAG believes that the categorisation of financial instruments could be improved if it:

    (a) is based on the facts involved. Such an approach would be much simpler than one that allows considerable choice and flexibility. It would mean for example that like items will be treated alike. It would also mean that reclassification from one category to another would be necessary only if the facts change; as a result, complex rules to police the boundaries between categories (such as the tainting rules that exist today to ensure an appropriate use of the held-to-maturity category) would be unnecessary.

    (b) reflects the business model, so that the information faithfully represents the entity's activities. We recognise that the existing categorisation approach in IAS 39 is an attempt to do that, for example it allows entities to carry an instrument at amortised cost if the purpose is to hold the instrument for its cash flows or apply the fair value option if the instrument is managed on a fair value basis. We also recognise that there are many different business models and it is unrealistic to expect the IASB to develop lots of different categorisation approaches; some compromise is necessary.

23. We think one possibility (although we are not saying this is the only possibility) that might be worth exploring is to replace the existing categories with 'operating' and 'financing and investing' categories. Clearly such an approach would need to be refined to cope with the need for all derivatives and trading books to be at fair value and similar things. However, this categorisation approach would we think be factually based and would be based on the entity's business model. In addition, it would be consistent with the coherence principle and other proposals being developed in the Financial Statement Presentation project.

Embedded derivatives

24. Requirements related to embedded derivatives are clearly one of the complex areas in IAS 39. IAS 39 requires derivatives embedded in other instruments to be separated from the host contract and measured at fair value through profit or loss if

the embedded derivative is not-closely related to the host contract and the whole instrument is not accounted for at fair value through profit or loss. However there is no obvious principle behind the distinction between non-closely related embedded derivatives and closely related embedded derivatives. The requirements to distinguish between the two types of embedded derivatives are largely rule based and in many cases contain exceptions on exceptions. Since the issue of embedded derivatives remains in a mixed measurement model, we believe that this is one of the areas in financial instruments reporting that should be addressed as part of the reducing complexity project.

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?

25. It is possible to express a categorisation model in IAS 39 in terms of a fair value principle for all financial instruments with some optional exceptions.

26. However, this would not be our preference because it implies that there is a general principle: fair value. As explained earlier, we think it is premature, and perhaps even inappropriate, to decide under current circumstances that the only appropriate measure for financial instruments is fair value and that any changes to IAS 39 should represent a step towards that objective. We believe that at the moment improvements to IAS 39 should be made within the framework of the current mixed measurement model.

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

27. The instruments that are not measured at fair value would be measured at amortised cost subject to impairment.

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

28. Many commentators point out that the impairment losses recognition requirements in IAS 39 are inconsistent and in some cases misleading. In particular:

    (a) For financial assets carried at amortised cost the impairment loss is the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. The estimated future cash flows include only those credit losses that have been incurred at the time of the impairment loss calculation ("incurred loss model"). Losses expected as a result of future events, no matter how likely, are not taken into account.

    (b) For available-for-sale financial assets, the impairment loss is calculated as the difference between the acquisition cost and the fair value of the instrument. Some point out that the impairment loss estimated in this way includes declines in values due to other market factors than credit risk. For example, some believe that during the current liquidity crisis, companies were

overstating their impairment losses on available-for-sale securities because fair values were affected by soaring liquidity risk.

(c) Further inconsistencies arise in the way reversals of impairment losses are recorded in accordance with IAS 39. Impairment losses recognised in profit or loss for an investment in an equity instrument classified as available for sale cannot be reversed; while impairment losses recognised in profit or loss on debt instruments irrespective how they are classified are required to be reversed.

29. The DP suggests in Table 2 in paragraph 1.10 that using fair value for all types of financial instruments within the scope of a standard for financial instruments (with changes in fair value recognised in earnings) could reduce complexity related to identification and quantification of impairment. We are not sure whether requiring fair value for all instruments will be a solution in reporting impairment. If the information about what caused a decline in fair value of a financial instrument, for example the credit worthiness of the issuer or other changes in market conditions is useful to users, it will be still necessary to disaggregate impairment losses from overall decline in fair value and a complexity similar to that that exists today (i.e. identification and quantification of impairment) will arise.

30. Therefore, we think the issue of when impairment loss should be recognised and how the impairment loss should be measured have to be addressed as part of a comprehensive debate on measurement and we emphasised the need for such a debate earlier in this letter.

(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?

31. The issue of where unrealised gains and losses should be recognised is a matter of presentation requirements. We addressed this issue in our response to Question 3 pointing that the existing Financial Statement Presentation project provides opportunities to simplify presentation aspects of financial instruments accounting.

(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?

32. In our view the question as to whether reclassifications should be permitted would not arise if a categorisation approach is based on facts – if that were the case the reclassification from one category to another would be necessary only if the facts change.

Question 5

Approach 3 sets out possible simplifications of hedge accounting.

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

33. Hedging is an economic activity which, like other economic activities, should in our view be reflected in financial reporting.

34. There are different ways of representing hedging activities in financial reporting. Currently, IFRS allows entities to apply hedge accounting, to use the fair value

option or to disclose the effects of hedging activities in notes to financial statements. All these approaches, including hedge accounting, have shortcomings in reflecting hedging activities of entities. In fact, currently hedge accounting has so many prohibitive requirements that entities are often discouraged from applying it all together.

35. Nevertheless, we would not recommend eliminating hedge accounting as a means of simplifying the reporting of financial instruments. The focus should be on developing a principle-based hedge accounting system that would better reflect risk management practices and their impact on the economic performance of the entity. We elaborate on this point in our response to subsequent questions in the letter.

(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.

36. The DP considers the following three approaches of replacing fair value hedge accounting:

    (a) Substitute a fair value option for instruments that would otherwise be hedged items.

    (b) Permit recognition outside earnings of gains and losses on financial instruments designated as hedging instruments (similar to cash flow hedge accounting).

    (c) Permit recognition outside earnings of gains and losses on financial instruments.

37. Considering the above three approaches for replacing fair value hedge accounting model we note the following.

<u>Approach (a)</u>

38. Some of the shortcomings of the fair value option as it stands today vis a vis fair value hedge accounting include:

    (a) The fair value option is available only on initial recognition and is irrevocable while hedging relationships can be established and cancelled during the life of the instrument and so can be hedge accounting;

    (b) The fair value option can be applied only to the entire instrument while entities often hedge instruments only for some but not all risks that the instrument is exposed to and hedge accounting foresees a possibility to reflect such hedges in financial reporting; and

(c) The fair value option can be applied to financial instruments only while non-financial items can be subject of a hedge as well and can be designated as hedged items under hedge accounting provisions.

39. On the other hand, the advantages of the fair value option over fair value hedge accounting include:

    (a) The fair value option does not require an effectiveness test. The hedge accounting effectiveness test requires a hedge to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk and that the actual results of the hedge are within a range of 80 to 125 per cent to enable application of hedge accounting. The fact that this bright-line arbitrary rule has a decisive effect on whether a hedge relationship qualifies for hedge accounting or not is not satisfactory. It is not clear what the objective of a qualifying quantitative effectiveness test if actual ineffectiveness is recorded in profit or loss, which is the case for the today's fair value hedge accounting model.

    (b) The fair value option can be used to reflect hedging activities where hedging instruments are cash instruments in contrast to hedge accounting which prohibits a non-derivative financial instrument to be designated as a hedging instrument except if it is a hedging instrument for a hedge of a foreign currency risk.

40. The DP mentions an approach where the fair value option is amended allowing it to be applied to non-financial assets and liabilities and to specific risks or parts of the designated item; and where entities are allowed to apply the fair value option after initial recognition and to dedesignate the fair value option.

41. We think this is an interesting approach that is worth exploring further. For example it might be that, if one devises an approach starting from the fair value option, it would become clearer whether certain restrictions that exist today for the application of both the fair value option and hedge accounting are really needed or could be substituted with more principle driven requirements than the requirements IAS 39 has today. Such a converged approach could enable entities to reflect better in their financial reporting things that are managed (including hedged) on a fair value basis—be it the entire instrument or only a portion of it—resulting in more decision useful information.

Approach (b)

42. The DP lists the following benefits of this approach in paragraph 2.46:

    (a) The carrying amount of the hedged item would not be affected.

    (b) The measurement attribute of the hedged item would be the same whether it was hedged or not.

    (c) There would be fewer ongoing effects on earnings. For example, there would be no ongoing effects on earnings because the effective interest rate of a financial asset would not need to be recalculated following the dedesignation of a fair value hedging relationship.

In addition to these benefits, we note that this approach might help to remove a rather artificial distinction between the cash flow and the fair value hedge accounting models. Risk management practices are not naturally built around such models. The hedging objective is to mitigate an exposure to risk, for example interest-rate risk, reinvestment risk, call risk, default risk, inflation risk, exchange-rate risk, liquidity risk, volatility risk etc. It seems artificial to place all risk mitigating strategies into two hedge accounting models. If approach (b) removes the artificial boundaries between the two hedge accounting models and rather establishes a common principle for reflecting hedging strategies in financial reporting, this could make the hedge accounting less complex to understand.

43. We accept that a challenge of this approach is to develop a robust way of reporting ineffectiveness and recycling gains and losses from equity to profit or loss. We also note that this approach will increase volatility in the balance sheet. Nevertheless, we encourage the IASB to consider this approach further.

Approach (c)

44. We understand that approach (c) is based on the premise that all (or most) financial instruments are accounted for at fair value. The approach permits the designation on initial recognition of certain instruments (those that are not derivatives and that are not held for trading) in such a way that gains and losses on these instruments are reported outside profit or loss. We understand that, if fair value is adopted as a single measurement basis for financial instruments, this approach would help to avoid measurement or recognition mismatches if financial instruments are managed together with other items and those items are accounted for on a different basis than fair value through profit or loss (for example if they are non financial items or financial instruments that are not in the scope of the standard on financial instruments).

45. However, this approach is not compatible with our overall conclusion that it is premature to select the fair value basis as a primary basis for measuring financial instruments for reasons that are explained in our response to question 2 and questions to section 3 of the DP.

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?

46. We have addressed some of the possible ways of amending hedge accounting requirements that the DP considers in this section in our response to question 6. In particular, we mentioned dedesignation and redesignation, partial hedges, hedges of non-financial items, effectiveness testing and cash instruments as hedging instruments are areas that should be considered as part of the project to improve/replace hedge accounting requirements in IAS 39.

47. In addition, we note that the current hedge accounting system is transaction driven, i.e. hedge accounting is possible only if a single item is designated as a hedging another single transaction or item. We understand that such system was devised in order to prevent a misuse of the measurement alternatives that hedge accounting provides. However, usually companies do not hedge specific transactions. Instead, treasury centres accumulate the transactions and determine net exposures that are then laid off in the market. IAS 39 accommodates hedges of net positions to some extent (for example through the fair value hedge accounting for a portfolio hedge of interest rate risk and guidance regarding offsetting internal derivative contracts used to manage foreign currency risk). Although their purpose is to accommodate hedges of net exposures, they are very awkward to apply because they are still rooted in the transaction hedging transaction system. As a result, either entities do not find it possible to use these models at all or they develop a hedge accounting system that is run on different principles from their hedging systems.

48. Therefore, we would support developing a principle-based hedge accounting system that would allow a portfolio of financial instruments to hedge the net exposure on a portfolio of other instruments and positions. We do not underestimate the challenge of developing such a principle and we recognise it would require "blue sky thinking" (otherwise any potential ideas will conflict with the current "IAS 39 way" of thinking). Nevertheless, the very significant benefits that would result if such a model could be developed make it worth trying.

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

49. We accept that there have to be restrictions on the use of hedge accounting. The problem is though that some of the current restrictions seem rule-based and not particularly even-handed. In our view, if we are to allow hedge accounting (and we think it *should* be allowed), we should strive to develop an approach that is logical, comprehensive and is as principle-based as possible. Such an approach should not need rules-based restrictions to make it work.

50. We believe that hedge accounting should be permitted for partial hedges. Financial instruments and non-financial items are often hedged only for some of the risks that these items are exposed to, and there are good reasons for that. For example, some risks might not be hedged because there are no effective hedging mechanisms for such risks in the current market conditions. A good principle-based approach does not differentiate between a hedge of just one of the risks arising on an instrument and a hedge of that same risk when it is the only risk arising from an instrument, or whether the hedged item is a financial instrument or non-financial item.

51. When the IASB was working on the project on hedgeable exposures we understand the IASB staff attempted to develop a principle-based solution that could be used to determine what portions can be designated as hedged items but encountered some difficulties. In spite of these difficulties, we think it would be worthwhile to try to develop a principle based solution enabling hedge accounting for partial hedges in those circumstances where there is a clear link between changes in value of a hedged portion and the value of the total item.

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?

52. Our suggestions for intermediate approaches are mentioned in our responses to preceding questions.

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?

53. As we already stated in our response to question 2 above we believe that it is premature to decide that the long-term objective should be to have a single method of measuring all types of financial instruments. In our response to question 3 we suggested addressing the measurement-related problems within the context of a mixed measurement environment. We suggested doing this by improving the categorisation of financial instruments (for example making categorisation based on facts), enhancing usefulness of information about financial instruments through presentation and making the treatment of embedded derivatives principle based.

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?

54. In our response to question 2, we stated that we think "it is premature, and perhaps even inappropriate, to decide that the long-term objective should be full fair value for financial instruments". We have reached that conclusion because, we find it difficult to accept many of the statements made in the DP about the usefulness of full fair value for financial instruments when:

(a) there is not yet any general agreement as to what fair value is (and when the possibilities being discussed could make a significant difference to the numbers reported);

(b) there is not yet any agreement as to which attributes of an entity's financial position and performance need to be highlighted in the financial statements in order to optimise the usefulness of the information provided;

(c) there is not yet any agreement on a presentation system that will extract significant amounts of useful information out of the financial instrument numbers. We recall here that the report of the Joint Working Group of Standard-setters *Financial Instruments and Similar Items* (published in December 2000) was criticised for not addressing this issue adequately, and little progress seems to have been made in the last eight years. There is a widely held view that, in order to enhance user understanding of reported fair values, gains and losses reported in earnings need to be disaggregated into various categories and that this disaggregation needs to go far beyond what is contemplated currently in the Financial Statement Presentation project. In addition, for fair value to be meaningful to investors sufficient accompanying disclosures needed to be provided on how the fair value has been determined, in order to highlight the degree of uncertainty in the reported amounts. Such disclosures have not yet been devised.

55. Putting that aside for a moment, it is often argued that the fair value of a financial asset better reflects the price of the asset that would be received at the measurement date. We accept that some sort of market-based exit price is a better measure of the price an entity would receive at the measurement date if it sold the asset in that market. However, it is not clear to us why that is a more relevant, more faithfully representational measure of the asset than various alternative measurement bases in all circumstances. A market-based exit price highlights the opportunity cost of holding the asset involved, but we do not understand why that opportunity cost is the measure that financial statements should use. It is also often argued that fair value measures enable users of financial statements to understand risk and uncertainty resulting from the fluctuations in the value of financial assets and liabilities during the holding period. However, we would question whether the use of fair value measures is the only—let alone the best—way of doing this. As stated earlier in our letter, these issues should be first addressed in a comprehensive debate on measurement.

56. In view of the above, EFRAG believes that for the time being the objectives should be to:

(a) to reach a conclusion as to the detailed meaning of the term 'fair value';

(b) to develop material as part of the project on the Conceptual Framework that helps us to understand how many different measurement bases are appropriate for use in financial statements and the circumstances in which each basis should be used;

(c) tackle the other issues described in the DP as representing hurdles that have to be overcome before full fair value could be adopted; and, in the meantime

(d) reducing complexity by improving the way in which financial instruments are categorised and developing a principle-based hedge accounting system.

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?

57. The current liquidity crisis has raised questions about the use of fair value measures, how those fair values should be estimated when markets are illiquid, the use of internal valuation models, and the disclosures that need to be provided to support fair value measures. These are all areas that the IASB needs to keep firmly in mind.

58. However, the issues that the recent crisis has put the spot light on are not new. Such questions as to what is the fair value of an instrument that is not traded in a liquid market, what markets can or cannot be considered liquid, how useful are fair values that are based on internal models for which the opportunities for market calibration are limited cause difficulties for preparers, auditors and users in all circumstances. We believe that these questions need to be addressed as part of the debate on measurement and how fair value measures should be determined.

59. Another issue that we think needs to be addressed concerns credit risk. The DP notes that it can be difficult to estimate the fair value of instruments with significant and variable credit risk. As a result, it can often be a matter of picking one number from a relatively wide range of possible amounts. The DP contrasts this with incurred loss estimates and concludes that earnings calculated using an incurred loss model can be just as subjective as earnings calculated using fair value.

    (a) Although the DP seems to use this observation as a reason to move to fair value, we think the observation shows that measuring such instruments at fair value would not improve financial reporting.

    (b) Indeed, we think it might even cause deterioration in information provided. That is because upwards and downwards movements in fair value recognised in earnings would be derived from a comparison between one number selected from a relatively wide range of possible amounts and another number selected from a similarly wide range of possible amounts.

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?

60. As stated earlier in our letter, we believe that what is needed is a comprehensive debate on measurement. The scope of the debate should be not only what the definition of fair value is and how fair value should be measured, but should also explore the usefulness of the various possible measurement bases to determine what basis is most useful in what circumstances.

(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?

61. In our view, all the issues identified in Part C should be addressed. However, they can have different priorities. For example, our constituents tell us that disclosures for financial instruments are the area that requires the most urgent reconsideration.

Question 12

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

62. We do not have any other comments at the current time.