28 September 2010

Russell G. Golden
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Financial Accounting Standards Board
401 Merritt 7
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Dear Mr Golden

Proposed Accounting Standards Update Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities (File Reference No. 1810-100)

The Asian-Oceanian Standard-Setters Group (AOSSG) is pleased to provide comments on the proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (FASB proposed ASU).

The AOSSG currently has 24 member standard-setters from the Asian-Oceanian region: Australia, Brunei, Cambodia, China, Hong Kong, India, Indonesia, Iran, Iraq, Japan, Kazakhstan, Korea, Macao, Malaysia, Nepal, New Zealand, Oman, Pakistan, Saudi Arabia, Singapore, Sri Lanka, Thailand, Turkey and Uzbekistan.

To the extent feasible, this submission to the FASB reflects in broad terms the collective views of AOSSG members. Other views that are consistent or otherwise with the overall AOSSG comments are also provided within this submission.

Individual member standard setters may choose to make separate submissions that are consistent or otherwise with aspects of this submission. The intention of the AOSSG is to enhance the input to the IASB and the FASB from the Asian-Oceanian region and not to prevent the IASB and the FASB from receiving the variety of views that individual member standard setters may hold.

The AOSSG is writing in response to the IASB's Request for comment on the FASB proposed ASU. We are also sending our comments to the IASB on the understanding that the IASB and the FASB will each be re-deliberating their proposals with a view to converging IFRS requirements and US GAAP.

In addition to this submission letter, the AOSSG included comments about the FASB proposed ASU in its submissions to the IASB on ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* and ED/2010/4 *Fair Value Option for Financial Liabilities*, which are attached.

The AOSSG's key views on the FASB proposed ASU are outlined below.

Classification and measurement

Fair value or mixed measurement model

The AOSSG does not support the expansion of fair value as the default measurement attribute for financial assets and financial liabilities at this stage. The AOSSG considers that, in view of the aim of simplifying the accounting for financial instruments, the FASB proposed ASU classification and measurement as between FVTNI and FVTOCI is relatively more complex than the FVTPL and amortised cost distinction under IFRS 9's financial assets and the IASB's financial liabilities proposals. This is because the AOSSG considers that the basis for the FASB proposed ASU classification is not clear, and that the constituent feedback so far on the IFRS 9 classification criteria (based on the entity's business model in managing its financial assets) and the IASB financial liabilities proposals indicate they will be feasible to implement on a consistent basis. The AOSSG considers that the IFRS 9 requirements and the IASB financial liabilities proposals provide a reasonable balance between moving towards fair value measurement for financial assets and restricting amortised cost to a readily identifiable category of loans and trade receivables. In addition, the AOSSG considers that IFRS 9 and the IASB financial liabilities proposals provide a sound basis for achieving convergence among most jurisdictions for financial instrument accounting.

Accordingly, the AOSSG supports the mixed measurement categories under IFRS 9 and the IASB financial liabilities proposals, which is broadly consistent with the Financial Stability Board's views that are "… supportive of standards that would not expand the use of fair value in relation to the lending activities of financial intermediaries" (Report of the FSB to G20 Leaders, *Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability*, 18 June 2010, page 8).

Symmetrical accounting between financial assets and financial liabilities

AOSSG members acknowledge the consistency of the FASB proposed ASU's classification and measurement between financial assets and financial liabilities. These AOSSG members consider that the IASB's asymmetrical approach as between financial assets under the existing IFRS 9 (that is in accordance with the entity's business model and cash flow characteristics) and the proposals to essentially retain the IAS 39 financial liabilities classification and measurement approach, would be a divergence from the aim of simplifying the accounting for financial instruments. Accordingly, these AOSSG members recommend that the IASB consider revising its proposals to achieve consistency in the classification and measurement criteria for both financial assets and financial liabilities. At the very least, these AOSSG members believe this would involve permitting the bifurcation of financial assets at amortised cost under IFRS 9, which is also raised later in this letter.

Some AOSSG members are open to the IASB's decision not to align the accounting of financial assets with financial liabilities as they believe symmetry in the accounting would not necessarily result in useful information.

Financial liabilities

The majority of AOSSG members generally agree that changes in own credit risk should not affect profit or loss for liabilities designated at fair value as proposed by both the FASB and the IASB. However, the AOSSG considers that the FASB proposed ASU approach in presenting own credit risk remains faithful to its proposed measurement attribute, that is, FVTNI or FVTOCI, irrespective of the fair value context. Furthermore, the FASB proposed ASU is relatively simple compared with the IASB proposal in terms of the presentation of own credit risk within the statement of comprehensive income. The AOSSG also notes that, under the FASB proposed ASU, the bifurcation of fair value changes relating to the entity's own credit risk depends on the significance of the change in own credit risk and that this seems likely to result in fewer cases of bifurcation compared with the IASB proposals, which would also be a welcome simplification.

In addition, some AOSSG members consider that the FASB proposed ASU amortised cost exception lacks an underlying concept, is rules based in nature, and would not be operational. For example, the proposed financial liabilities designation at amortised cost at initial recognition is unconditionally irrevocable, unlike the IFRS 9 subsequent reclassification when an entity's business model has changed. In a dynamic business environment, the prohibition on reclassification could lead to financial information that is internally inconsistent with the criteria used at initial recognition. These AOSSG members are also doubtful about the proposed 50 per cent test for qualifying for measurement at amortised cost, as such arbitrary tests would not necessarily provide meaningful results.

Core-deposit liabilities

The AOSSG considers there is merit in the FASB proposed ASU's accounting for demand deposit liabilities, on the basis that it moves these instruments closer to a fair value basis and could be considered to be consistent with the IFRS 9 model for distinguishing between financial assets measured at that fair value and those at amortised cost. That is because many constituents have indicated that demand deposits are a key source of value for many financial institutions and, if a financial institution leverages off its demand deposits, this is a strong indication that the fair value of those deposits is a key aspect of its business model.

However, the AOSSG also has concerns with the FASB proposed ASU in relation to demand deposits because of the possible complications in determining the 'core' amount of deposits that can be present valued and because it may not be a treatment around which other jurisdictions would want to converge. Accordingly, the AOSSG agrees with the alternative views expressed in paragraph BC248 of the FASB proposed ASU, in that:

(a) the introduction of a new measurement attribute for core deposit liabilities would introduce unnecessary complexity;

(b) the valuation, based on the average core deposit balances, captures an intangible asset for the deposits to be made in the future. However, this intangible asset does not capture the entire intangible asset associated with the core deposits that would be determined in a business combination because it does not reflect the customer relationship intangible associated with the ability to cross-sell other banking services;

(c) the proposals would result in the measure of a core-deposit which reflects the cost of alternative funding, which would provide less decision useful information that reporting core-deposits at the amount withdrawable on demand.

On balance, the AOSSG considers that the FASB and the IASB should not consider the re-measurement of demand deposit liabilities at this stage in the spirit of convergence.

Furthermore, if both the FASB and the IASB believe that fair value measure for core deposit-liabilities would be useful, some AOSSG members consider that fair value disclosures would suffice at this stage.

Classification and measurement of equity instruments

The AOSSG acknowledges that there are equity investments that are not held for trading purposes and consequently, "… presenting fair value gains and losses in profit or loss for some equity investments may not be indicative of the performance of the entity, particularly if the entity holds those equity instruments for non-contractual benefits, rather than primarily for increases in the value of the investment." (IFRS 9 paragraph BC83). Accordingly, the AOSSG considers there is merit in the irrevocable election at initial recognition in IFRS 9 to present subsequent changes in the fair value of equity investments not held for trading in other comprehensive income. On the other hand, the AOSSG notes that the FASB proposed ASU measures equity investments at FVTNI.

The AOSSG considers that questions about the classification of amounts as 'profit or loss' or 'other comprehensive income' are dependent on the principles underlying such a distinction, which have yet to be developed. Therefore, the AOSSG is of the view that the IASB and the FASB should first develop and articulate those principles, to provide a basis for determining the merits of the FASB proposal (that all equity investments should be measured at FVTPL) compared with the corresponding IFRS 9 election (to measure equity investments that are not held for trading at FVTPL or FVTOCI). Until those principles are developed, the AOSSG recommends that neither the IASB nor the FASB proceed with further proposals that mandate the use of OCI.

In addition, some AOSSG members consider it useful for both the FASB and the IASB to retain the existing IAS 39 requirement to measure equity investments that do not have a quoted market price in an active market and whose fair value can not be reliably measured, at cost.

Accounting for hybrid instruments

Symmetrical accounting between hybrid assets and hybrid liabilities

The FASB has been consistent with the treatment of hybrid assets and hybrid liabilities and some AOSSG members consider that this approach is consistent with having a simpler measurement framework for financial instruments. As mentioned before, these AOSSG members do not support the asymmetry of the IASB's approach to accounting for hybrid assets and hybrid liabilities. These AOSSG members understand that one of the reasons for the IASB's approach to hybrid financial assets in IFRS 9 is the relative simplicity of not having to bifurcate (IFRS 9 paragraph BC59). Accordingly, if the IASB were to proceed with its proposals on hybrid liabilities, the AOSSG recommends that the IASB clarify why the approach to hybrid financial assets in IFRS 9 has not been consistently adopted for hybrid liabilities.

On the other hand, some AOSSG members agree with the approach applied to financial assets in IFRS 9 and support the IASB's decision to retain the existing bifurcation requirement for financial liabilities with embedded derivatives. However, these AOSSG members recommend simplifying the accounting for embedded derivatives in IAS 39.

Bifurcation

The AOSSG notes that the FASB proposed ASU would require all hybrid instruments that contain embedded derivative features to be classified in their entirety at FVTNI, and that this would be similar to the IASB's approach in IFRS 9 for financial assets. The AOSSG considers that it is useful to permit an election for bifurcation in circumstances where the embedded derivative in a financial asset and financial liability is not clearly and closely related to its host contract. This is because the AOSSG believes there will be circumstances in which more useful information would result from bifurcation. Early adoption of IFRS 9 in Australia has, for example, revealed a counter-intuitive outcome for certain financial assets containing remote puttable features, which could otherwise be more usefully treated as equity instruments if bifurcation were an option.

Consequently, the AOSSG urges both the FASB and the IASB to consider permitting bifurcation if particular criteria are met for both hybrid assets and hybrid liabilities.

Impairment of financial assets

The AOSSG notes that, as part of the FCAG and G20 recommendations, both the IASB and the FASB have proposed impairment models that would require the earlier incorporation of a greater range of information about the credit quality of financial assets than is currently allowed under accounting standards. Therefore, both the IASB's and FASB's proposals would generally be expected to result in losses being recognised earlier than currently permitted.

However, the AOSSG is generally not convinced that a completely new impairment model based on expected losses would resolve the issue of at least some entities having under-provisioned for losses. Accordingly, the AOSSG would prefer to retain a form of incurred loss model, with modifications that better explain the extent to which forward-looking information is employed in the estimates of incurred losses. The AOSSG recommends that both the IASB and the FASB consider an 'incurred but not reported' (IBNR) loss impairment model. The AOSSG considers that an IBNR model would better reflect a cost-based measurement, consistent with the notion of 'amortised cost' under IFRS 9, in that, there is the occurrence of a 'loss event', and historical evidence and observable data indicate that there are implications from the loss event that will affect future cash flows. Furthermore, the AOSSG considers that the IBNR model would result in more comparable loan-loss provisioning outcomes than the IASB's proposed expected loss model if sufficient implementation guidance were provided.

In addition, the AOSSG has the following specific views about both the FASB and the IASB's proposed impairment models.

(a) The IASB's and FASB's proposals require an initial recognition of impairment loss. Some AOSSG members have indicated a preference for the IASB's approach in recognising the initial expected losses over the life of the asset as they believe that this approach is in line with the entity's business strategy to hold these financial assets for their contractual cash flows until maturity. On the other hand, some AOSSG members prefer the FASB's method of recognising the initial expected losses immediately in profit or loss when the entity does not expect to collect all contractual amounts, at initial recognition or subsequently, and not as an adjustment to the EIR. Accordingly, these AOSSG members do not support the IASB's proposal in requiring two different impairment approaches—initially over the life of the asset; and subsequently directly in profit or loss.

(b) The IASB's proposed expected loss model, in particular, departs from a transaction-based approach by incorporating credit loss expectations in the amortised cost measurement. The AOSSG considers that having each entity determine an interest rate or rates at inception at other than the market rate(s) is a departure from a transaction-based cost model. The AOSSG considers that the effective interest rate (EIR) should be the contractual EIR adjusted for any premium or discount and capitalised transaction fees or costs but not for future credit losses, which is the approach that the FASB has undertaken.

(c) The IASB's proposed expected loss model would corrupt the recognition of revenue that would be expected to flow from financial assets in a cost model. In general, lenders have indicated that they do not manage credit risk as a function of revenue recognition, and feedback from users/analysts suggests that users are interested in knowing how a banking business is managed. This echoes the AOSSG's earlier comment about seeking to clarify and amend the incurred loss model, which is more aligned to the manner in which banking business is managed, and to separately address the measurement attributes of the impairment model from the revenue recognition model. This AOSSG view also reflects the basis for much of the IASB's recent requirements implementing a 'through the eyes of management' approach[1] and could be helpful to users.

(d) The IASB's proposed expected loss model requires considerable management judgment to anticipate future changes in economic conditions in estimating future cash flows and expected credit losses. The AOSSG considers this level of subjectivity to be potentially unauditable. Unlike an expected loss model, an entity under the FASB's proposed model considers all available information relating to past event and existing conditions, but assumes that existing conditions would remain unchanged for the remaining life of the asset, without forecasting future events that do not exist at the reporting date. In this respect, the AOSSG considers that the FASB's proposals are likely to result in greater consistency in determining financial asset impairment.

In addition, some AOSSG members have concerns over the absence of impairment triggers, in that, the application of impairment recognition would be more complex, particularly because both the IASB and the FASB's proposed models require continuous re-estimation of impairment losses. These AOSSG members consider that a financial asset should be assessed for credit impairment only if there is indication that the asset may be impaired, as consistent with the impairment principles of long-lived non-financial assets.

Overall, the AOSSG considers that the FASB's proposed impairment model has some similar features to the suggested IBNR model as mentioned above. Moreover, the AOSSG considers that the FASB's proposed impairment model, although proposed in a fair value context, could be usefully applied in an amortised cost context and would bring forward loss recognition as recommended by the G20 and the FCAG without the complexity of the IASB's proposed model. Accordingly, the AOSSG considers that the FASB's impairment model proposals

[1] For example IFRS 8 *Segment Reporting* adopts a 'through the eyes of management' approach

would form a suitable basis for convergence and would involve fewer transition issues for entities moving from the existing IAS 39 approach to impairment.

Hedging

The AOSSG is supportive of the FASB's proposals and the IASB's tentative decisions to date, in particular, in enhancing the link between entities' risk management strategy and hedge accounting, acknowledging that a reasonable amount of ineffectiveness is unavoidable and hence permitted, and consequently, removing the existing requirement to fulfill an arbitrary threshold test to qualify for hedge accounting. The AOSSG is also supportive of the IASB's tentative decision to permit hedging of portions of non-financial items and urges the FASB to consider this approach.

However, the AOSSG is cautious about the potential onerous documentation requirements on entities applying hedge accounting, and the potential lack of (auditable) methods for assessing hedge effectiveness given the IASB's decision to promote entities' risk management as the key source of information for performing effectiveness assessment. At the very least, the AOSSG considers the existing documentation requirements should be one of the key areas for simplification on hedge accounting.

Since discussions about hedging proposals are ongoing, the AOSSG is unable to comment further on the FASB proposed ASU and will endeavour to submit an addendum to this submission with more comprehensive views on both the FASB and IASB hedging proposals once both parties' discussions on the topic are further advanced.

Presentation and disclosure

The AOSSG does not agree with the FASB proposed ASU presentation approach that proposes two different measurement attributes to be presented for the one financial instrument on the face of the statement of financial position. The AOSSG considers that only one measurement attribute should be reflected in the primary financial statements for a given financial instrument and that this measurement attribute should be either amortised cost or fair value, depending on the business model and the characteristics of the instrument.

The AOSSG is also concerned about the level of detail required on the face of the primary statements. The AOSSG believes the proposals may result in over-detailed primary statements, which can obscure key messages and could complicate rather than improve the communication between preparers and users of financial statements. Accordingly, the AOSSG considers that any additional information that is useful to the understanding of users is best presented in the notes to the financial statements.

Other

The AOSSG considers that the different timing of the IASB and FASB proposals will require duplication of effort by the FASB and its constituents in striving for converged outcomes on financial instruments. The AOSSG urges the IASB and FASB to better coordinate their efforts and make best use of limited standard setting resources and the limited time available to constituents to comment on proposals.

The AOSSG is keen to play a key role in the development of a global set of high quality financial reporting standards and trusts that the FASB and the IASB find our comments helpful in progressing converged replacement standards for financial instruments, derivative instruments and hedging activities.

If you have any queries regarding any matters in this submission, please contact us.

Yours sincerely

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