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Reducing Complexity in Reporting Financial Instruments

A response by

CFA Society of the UK

About CFA Society of the UK

The CFA Society of the UK (CFA UK), formerly the UK Society of Investment Professionals, represents the interests of more than 7,000 leading members of the investment industry. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment industry through the promotion of the highest ethical standards and through the provision of education, professional development, advocacy, information and career support on behalf of its members. Most society members have been awarded either the Chartered Financial Analyst (CFA), or Associate of the Society of Investment Professionals (ASIP) designation.

CFA Institute Centre represents the views of investment professionals and investors on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

CFA UK is the awarding body for the Investment Management Certificate (IMC), the benchmark entry-level qualification for those working in investment management in the UK.

About this response

This response has been prepared by the Accounting Advocacy Committee of CFA UK. Committee members are all users of accounts. They represent buy and sell-side analysts and others involved in managing portfolios of assets and liabilities. The issues that most exercised the committee on the subject of reporting financial instruments were:

- The definition of fair value. We do believe that balance sheets should reflect current values, that market prices provide primary evidence of what this is and that market-based inputs to models are essential. But they may not be sufficient, especially in inactive markets where a variety of other measures will continue to be used. So, we have some doubts about a narrow definition of "fair value" as market exit price.

- Presentation is very important. It is hard to take a firm view on some of the issues the Discussion Paper raises without knowing what the impact will be on the profit and loss account and the cashflow statement. Users would like a clearer view of how these statements and the balance sheet work together. The current arrangement, whereby changes in the value of some financial instruments go through the profit and loss account while others are taken straight to equity, is confusing. This might be helped by reporting remeasurements separately. Users do not only look at earnings per share, especially for a financial institution where balance sheet values and capital ratios are of obvious importance.

- There is support for the valuation hierarchies described in IAS 39 and SFAS157. Classifying instruments according to the ease of valuation using objective criteria has more appeal than classifying them based on management intentions. But we would like to see more clarity in defining the levels eg "current market value", "estimated current market value" and "simulated market value".

- There is an issue of how entities should value their own debt irrespective of whether the market is active or not. While market prices provide useful information, booking profits created by a decline in creditworthiness is counter-intuitive.

- Disclosure of methods, key assumptions and the source of those assumptions is important – IFRS 7 goes some way to tackling this. We look forward to the outcome of the IASB's working group on how to value financial instruments in illiquid markets.

- On hedge accounting, our main concern is to see the economic reality of a company's efforts to mitigate risk. The underlying questions are: What is the risk? How has management chosen to mitigate it? Has the chosen method been effective? How much did it cost and/or what are the material exposures to changes in value of the derivatives involved? While the current line for effectiveness is crude and may not reflect the economics of the hedge, the criteria should remain tough.

Complexity in the reporting of financial instruments partly reflects the complexity of the underlying transactions, so simplification of reporting is welcome if it does the following:

- Defines financial instruments according to the characteristics of the instrument rather than management intentions

- standardises valuation methods for similar instruments

- keeps balance sheet values up to date

- provides users with an easier- to-understand record of performance in terms of the P&L, cashflow statement and changes in balance sheet values, and how those fit together

- helps users understand hedging policies and their impact on performance

Where we have not answered the questions, we hope that the above information about our thinking indicates what our objectives would be, as users of accounts, for any detailed changes in this highly technical area.

Response to questions

Section 1 – Problems related to measurement

Q1 *Do current requirements for reporting financial instruments, derivative instruments or 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?*

The current arrangements make it difficult for users of financial statements to establish the true economic picture and to make meaningful comparisons. We do, however, realise that complexity of reporting often reflects the complexity of the transactions; and we do not wish to lose useful information for the sake of simplicity.

Section 2 – Intermediate approaches to measurement and related problems

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

Yes. Reducing the number of categories of instrument would reduce complexity, as would removing the confusion over what goes through the P&L and what does not. We favour a separate section in the performance statement for remeasurements (as may be proposed in the project on financial statement presentation). The principle for those remeasurements should be to establish current valuations. Efforts by the IASB, and others, to bring more consistency to valuation methodologies are to be welcomed – but not at the expense of producing counter-intuitive outcomes.

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

Yes, but during the changeover period there should be provisions to enable comparisons to be made with previously reported data. For example, if historic cost had been the basis of measurement previously, a user would like to know both the current value and historic cost. There are also some instances where historic cost or face value will always remain a useful piece of information eg the redemption value of a loan. While the current value may increasingly be the one that goes into the balance sheet, there will be other numbers that preparers want to give and users want to see. This may mean that complexity is perpetuated in disclosure requirements, in which case criteria 2.2 c) and d) may be difficult to meet.

Q3 *Approach 1 is to amend the existing measurement requirements. How would you suggest existing measurement requirements should be amended? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph 2.2?*

The parts of approach 1 that would lead to greater simplification, notably reducing the number of categories, can more easily be tackled by having approach 2 as the starting point.

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

CFA UK prefers this approach (broadly agreeing with the advantages set out under 2.21), with the caveat expressed in the introduction about the definition

of fair value. If this approach were adopted and remeasurements were reported separately, the need for different measurement categories would largely disappear. The difficulties lie in providing a "market" value for instruments for which there is no active market, and in some counter-intuitive results such as profits being made on own loans thanks to deteriorating creditworthiness. The former difficulty will be aided by the conclusions of the IASB's working group. The latter, either by exceptions or by a pragmatic approach to valuation methodology. We expect that, in practice, a variety of valuation techniques will continue to be used: the question is whether more consistency can be brought to the methods applied. Disclosure of the key inputs to any calculation is important to users.

Q4 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?*

Users of accounts want consistency in the sense of similar methods being used to measure similar instruments, with the aim of achieving comparability over time and between similar entities. Preparers of accounts should not be able to switch from one measurement method to another unless there are exceptional circumstances that render the previously used method unworkable. These must be fully disclosed.

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

If instruments cannot be measured at market value, the method most likely to provide an objective current valuation should be used. In particular, the redemption value of debt is a crucial number. As a variety of valuation methods will continue to be used, best (or common) practice should be standardised where possible. The more difficult an instrument is to value, the more necessary it is to have disclosure of the methodology, the assumptions and the source of the assumptions.

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

Impairment losses should be recognised immediately, as a remeasurement. They should be triggered by any changes – in comparable market values or economic conditions – that materially affect key valuation assumptions. Those changes in assumptions would be fed into the measurement model.

Q4 d *Where should unrealised gains and losses be recognised on instruments measured at fair value? Why? How are your suggestions consistent with the criteria set out in paragraph 2.2?*

Unrealised gains and losses should be recorded separately, hence our support for a separate section in financial statements containing remeasurements. We are awaiting the outcome of the IASB project on financial statement presentation. Anything that helps users to understand how the P&L account, cash-flow statement and start/end balance sheets fit together is to be welcomed.

Q4 e *Should reclassifications be permitted? What types of reclassifications should be permitted and how should they be accounted for? How are your suggestions consistent with the criteria set out in paragraph 2.2?*

This becomes less of an issue if all remeasurements are grouped together and if management intentions are removed from the classification criteria. Taking as a starting point that instruments should be reported at current value, then

the questions revolve around when the valuation methodology has to be adapted to changing market or economic conditions eg an active market becomes inactive. Conditions for changing measurement methods must be rigorous, and triggered by outside events; and any available market prices should continue to be disclosed. It is up to the management to ensure that objective criteria have been met and the auditors will check this. Any changes in measurement methods must be well explained.

Q5 *Approach 3 sets out possible simplifications of hedge accounting.*

Q5 a *Should hedge accounting be eliminated? Why or why not?*

Accounting should reflect economic reality. Hedging to mitigate risk is obviously an activity that shareholders welcome. For example, if a company has hedged future cashflows, the accounting should reflect this. Accounting should "do no harm" in the sense of inhibiting sensible businesses decisions. According to the document, it seems that a case remains for both fair value hedge accounting and for cashflow hedge accounting, where they follow the economic effectiveness of the hedge. The need for FV hedge accounting would diminish if both sides of the hedge were more often measured at fair value. Cashflow hedging seems to follow the pattern of reporting remeasurements separately, which is referred to in paragraphs 2.35 and 2.36. In both cases the issue of effectiveness cannot be dodged and it will inevitably entail tests and documentation. While simplification of these must be attractive to preparers, the paramount concern of users is to ensure that they can understand what the ongoing exposures are to the risk being hedged and to changes in the value of the derivatives.

Q5 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?*

Paragraphs 2.39 and 2.40 lay out a reasonable path for discussions with preparers.

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.*

Q6 *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.*

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

Paragraph 2.56 summarises the areas that are candidates for simplification. They should all be considered but the criteria for hedge accounting laid down in paragraph 2.57 do need to be satisfied.

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

Q6 c *Existing hedge accounting requirements could be simplified if partial hedges were not permitted. Should partial hedges be permitted and, if so, why? Please also* *explain why you believe the benefits of allowing partial hedges justify the complexity.*

Q6 d *What other comments or suggestions do you have with regard to how hedge accounting might be simplified while maintaining discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings?*

Q7 *Do you have any other intermediate approaches for the IASB to consider other than those set out in Section 2? If so, what are they and why should the IASB consider them?*

Section 3 – A long-term solution – a single measurement method for all types of financial instruments

Q8 *To reduce today's measurement-related problems, Section 3 suggest 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 I the long term, is there another approach to address measurement-related problems in the long term? If so, what is it?
CFA UK believes that fair value should be broadly defined as current value. In many cases this will be market value. If no active market exists then the best (most objective) valuation method available should be used. The society recognises that this will result in the continued use of a variety of methods. These should be fully disclosed. We appreciate that paragraph 3.8 says: "today's standards may require a current settlement value or entry value in some situations."

Q9 *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.*

Q9 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?*
This depends on the definition of fair value, as acknowledged in paragraph 3.9. If it is defined narrowly as a market exit price, then we do not agree that this is the only appropriate measure. In some cases cost-based information, eg debt redemption values, remains a more appropriate measure of "fair" value. Users will often need companies to disclose a variety of measures of value alongside the reported fair value.

Q9 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?*

Q10 *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?*

Q11 *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.*

Q11a *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?*

The IASB should bear in mind what other regulators are doing in overlapping fields eg the Basel committee on capital adequacy and other initiatives prompted by the Financial Stability Forum.

Q11b *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?*

The most important issues are the definition of fair value, the presentation of changes in fair values and the level of disclosure provided to users.

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

September 2008