

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

16 September 2008

Grant Thornton International
Regent's Place
7th Floor
338 Euston Road
London NW1 3BG

Submitted electronically through the IASB Internet site (www.iasb.org)

Discussion Paper Reducing Complexity in Reporting Financial Instruments

Grant Thornton International is pleased to comment on the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* (the Paper). Our main comments and suggestions on the issues raised in the Paper are summarised below. We have also responded to the Invitation to Comment questions to the extent we have additional comments. Our responses are set out in the Appendix.

Support for reducing complexity

We support the International Accounting Standards Board's (the Board) reasons for issuing the Paper. Consistent with the views expressed at BD1 and BD2, we believe that the existing requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) are unnecessarily complex. Consequently, IAS 39 is difficult to understand and apply for many preparers. The effects of its application are perhaps even more difficult for users to interpret.

We therefore concur with the view that the Board should develop a less complex and more principle-based standard on reporting financial instruments. We believe that such an outcome is achievable.

Summary of our views

Our principal comments are as follows:

- we believe the Board should take a broad view of complexity;
- we are not convinced that the Board should make substantive changes to existing requirements if these are intended to be a stepping stone to an ultimate, full fair value goal;
- we suggest that reducing the number of measurement categories for financial assets would be an effective and relatively straightforward way of reducing complexity. This might be accomplished by selecting fair value as the default measurement basis for financial assets with optional exceptions for certain types of non-derivative financial asset;
- we support the continuation of efforts to simplify hedge accounting. We suggest that the Financial Accounting Standards Board's (FASB) current proposals are a suitable starting point for possible simplification of IAS 39. We do however have a concern that the benefits of simplification may be offset by a reduction in the eligibility for hedge accounting of some economically valid hedging relationships.

We expand on these comments in the following paragraphs.

Need for a broad view of complexity

We believe a broad view should be taken of complexity in reporting financial instruments (and financial reporting generally). An excessive number of detailed accounting requirements is one type of complexity and reducing the volume of discrete accounting requirements seems to be the Paper's main focus. However, complexity also arises if apparently simple requirements are actually difficult to apply or produce results which are difficult to interpret (or whose interpretation needs to be facilitated with extensive and possibly complex disclosures).

Scope exceptions are an obvious case in point. By way of example, IAS 39's scope exception for most loan commitments adds to the volume of 'rules' but its removal would arguably make the Standard more difficult to apply. Another example is the measurement at cost of investments in unquoted equity investments when fair value cannot be reliably determined.

Concerns over intermediate approaches

The Paper makes a case for a long-term solution based on measuring all financial instruments in the same way. It argues that fair value is the only suitable single measurement basis. However, we are not convinced that a single measurement basis should be viewed as an end in itself. We also question whether the interests of IFRS preparers and users would be well served by making extensive changes that are intended merely as a stepping stone to an evidently pre-determined long-term solution. We believe the Board should make major changes only if they represent:

- a significant improvement on IAS 39; and
- an appropriate and sustainable long-term solution.

That is not to say that the next stage of development should be the end point. We recognise that accounting requirements evolve over time. Further changes may also become appropriate as circumstances change and the effects of applying new requirements become evident.

Concerns with a full fair value approach

It is clear that a full fair value approach would facilitate a very substantial reduction in the length of a Standard on the recognition and measurement of financial instruments. We also agree that a fair value-type measurement would be the only credible basis **if** a single basis is necessary.

However, in our view moving to a single measurement basis should not be regarded as an end in itself. As explained above, the volume of rules is not in our view the only aspect of the complexity issue. We also believe that greater use of fair value is appropriate only if it will result in improvements in the decision-usefulness of financial statements and the benefits of those improvements exceed any incremental costs.

Part B of Chapter 3 acknowledges the concerns commonly expressed over the use of fair value. We explain below the reasons why we do not support the extension of fair value to all financial instruments, by separate reference to financial assets and financial liabilities.

Our preferred approach

In summary, our suggested approach involves:

- fair value becoming the default measurement basis for financial assets, with limited optional exceptions (which would not extend to derivatives or assets held for trading purposes); and
- amortised cost continuing as the default measurement basis for non-derivative, non-traded financial liabilities; and
- a fair value option for liabilities (other than derivatives and traded liabilities) to be based along similar lines to the existing IAS 39 option.

Measurement of assets

For financial assets, we believe the case for increased use of fair value is stronger. Most (but not all) financial assets are capable of being sold, even if the reporting entity does not intend to sell them. This in our view lends greater weight to the argument that the change in fair value is relevant and is a real world economic phenomenon. The simplification benefits of using fair value for assets are also greater because impairment requirements would become redundant. We do nonetheless have some concerns with:

- cost and benefit considerations for simpler financial assets such as short-term financial receivables;
- reliability of fair value measurement for certain non-traded financial assets. Whilst we certainly agree that irrelevant measures should not be used just because they are simple to determine, we also believe relevance and reliability are inter-related. The relevance of a fair value estimate may be undermined if the range of measurement uncertainty exceeds a certain level. We are also sceptical that an unreliable measure can be made sufficiently reliable by disclosure. We further suggest that extensive disclosure to explain fair value estimates adds to the complexity of financial statements.

We believe these concerns could be addressed through some tightly focused exemptions from fair value measurements for certain types of financial asset. We therefore suggest that a general fair value measurement requirement for financial assets with some specific, optional exceptions offers promise. This is along the lines of Approach 2 in Section 2 of the Paper (but limited to financial assets).

As the Paper identifies, Approach 2 requires attention to be paid to the characteristics of instruments that would be eligible for cost-based measurement. Paragraph 2.19 suggests that the exemption could be based on the extent of variability in each instrument's cash flows. This is an interesting idea which we believe is worth exploring. However, we have some concerns that:

- the Paragraph 2.19 approach does not take any account of problems with reliable measurement or the costs and benefits of fair value measurements;
- there will be scope for confusion and inconsistent application around whether specific instruments are exposed to 'highly variable' or 'slightly variable' cash flows (instruments denominated in foreign currencies, prepayable loans and receivables with moderate credit risk for example);
- given that the existing IAS 39 amortised cost method requires changes in expected cash flows to be taken into account in ongoing measurement, the rationale for basing the boundary on the extent of variability of cash flows is open to question.

We note that paragraph 11.7 of the Board's February 2007 Exposure Draft *IFRS for SMEs* (the SMEs ED) requires some types of instrument to be measured at amortised cost, including investments in unquoted equity instruments whose fair value cannot otherwise be reliably measured. This ED also requires various conditions to be satisfied in order to designate a financial instrument for amortised cost measurement (paragraph 11.9). Although these conditions could be viewed as rule-based, we believe they might nonetheless be a suitable starting point for developing a 'cost option' (or amortised cost option) for financial assets. We believe the boundary proposed in the SMEs ED addresses the concerns listed in the preceding bullet points.

Measurement of liabilities

Our preference at this stage is to retain amortised cost as the default measurement basis for non-derivative financial liabilities. We believe the case for increased use of fair value is less convincing for liabilities for the following reasons:

- the simplification benefits are fewer, given that financial liabilities are not subject to impairment testing;
- financial liabilities are rarely transferred or transferable outside a business combination;
- if instruments are not transferable, their fair value is likely to be subject to greater estimation uncertainty;
- we share the concerns expressed at paragraphs 3.75 and 3.76 concerning the effect of including credit risk;
- even if the 'own credit risk issue' is set aside in some other way, we question the relevance to most non-financial institutions of reporting fair value movements in the income statement for non-derivative financial liabilities.

Regarding the last point, we observe that the main types of non-derivative financial liability used by most non-financial institutions are short-term 'trade creditors' and borrowings. In the case of borrowings, the amortised cost method allocates the financing cost between reporting periods in a systematic manner. This method is simple and, we believe, provides relevant information. Information on future cash flows is also disclosed in accordance with IFRS 7.

There seems little doubt that the use of fair value will increase process complexity for preparers. Despite the arguments set out in 3.32 to 3.38 on the importance of fair value information for liabilities, we are unconvinced as to the practical usefulness of this information. We are indeed sympathetic to the view (expressed in paragraph 3.39) that fair value changes can create 'noise' which may detract from the usefulness of reported earnings.

Accordingly, we suggest that amortised cost should continue to be the default measurement basis for non-derivative, non-traded financial liabilities.

We acknowledge that a similar practical outcome might be achieved by specifying fair value as the default basis, with an 'opt-out' for simpler financial liabilities. However, at present IAS 39 puts the onus on management to demonstrate positive grounds for reporting non-traded instruments at fair value. Our preference is to retain this emphasis.

Boundary issues

The main boundary issue implied by our preferred approach relates to the use of fair value for financial liabilities. We consider that IAS 39's existing fair value option is an appropriate starting point.

Hedge accounting

We acknowledge that there are arguments for eliminating hedge accounting. Elimination would reduce complexity and might improve comparability. The additional 'volatility' that this would lead to for some entities could be explained through disclosure.

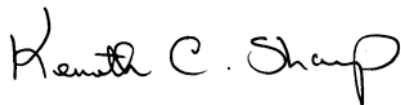
However, we also note that hedge accounting is optional and does not therefore impose incremental costs on preparers. It provides an opportunity for preparers to report their results in a way that is more consistent with how they manage financial risk. Hedge accounting is also subject to restrictions which limit its use to appropriate circumstances. The restrictions and disciplines to which entities applying hedge accounting must adhere are (in our view) an important counter-balance to the potentially detrimental effects on understandability and comparability.

If hedge accounting is to be retained, we support the Board's initiative to explore ways of simplifying the current requirements. However, the simplification options suggested in the Paper all seem either to shift the complexity elsewhere (replacement of fair value hedging with a 'more flexible' fair value option for example), or to reduce complexity at the expense of sacrificing flexibility. Whilst reducing flexibility might be viewed as a positive step by some, we see little merit in retaining a hedge accounting model while making it so inflexible that many economically valid hedging arrangements will not be eligible.

We are of course aware of the FASB's Exposure Draft *Accounting for Hedging Activities an amendment of FASB Statement No. 133*. The Board will no doubt monitor closely the FASB's deliberations in this area and we suggest that these proposals are a suitable starting point for possible simplification of IAS 39.

If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of International Financial Reporting, Andrew Watchman (andrew.watchman@gtuk.com or telephone + 44 207 391 9510).

Yours sincerely,



Kenneth C Sharp
Global Leader - Assurance Services
Grant Thornton International

Invitations to comment questions

We have responded below only to those questions on which we have comments in addition to those in the main body of this letter.

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?

See comments in the main body of this letter.

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.

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

See comments in the main body of this letter.

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?

See comments in the main body of this letter.

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?

See comments in the main body of this letter.

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

At cost or amortised cost.

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

For assets measured at amortised cost, we suggest that specific impairment requirements might be unnecessary by developing the amortised method. The existing amortised cost method involves taking into account revisions to estimated future cash flows (paragraph AG7 and AG8 of IAS 39). This requirement could be expanded to explicitly require a re-estimation of cash flows when circumstances indicate the cash flows anticipated at inception are likely to change.

(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?

We believe unrealised gains and losses on instruments measured at fair value should be reported in profit or loss, with appropriate disaggregation.

(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?

In general we believe reclassifications should be prohibited, except perhaps in situations where a reliable fair value measure becomes available or ceases to be available.

Question 5

Approach 3 sets out possible simplifications of hedge accounting.

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

See comments in the main body of this 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.

We suggest that developing an appropriate replacement for fair value hedge accounting should not be a high priority. Replacing fair value hedge accounting with a more flexible fair value option will simply shift complexity to the operation of the revised fair value option. Changing the mechanics of fair value hedge accounting to be more similar to cash flow hedge accounting would similarly trade one source of complexity for another.

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

If hedge accounting is retained, we believe the FASB's Exposure Draft *Accounting for Hedging Activities an amendment of FASB Statement No. 133* is a suitable starting point for possible simplification of IAS 39. However, we believe that any simplification in this area needs very careful evaluation. This is because:

- the restrictions and disciplines to which hedge accounting is subject are, in our view, an important mitigation against the potentially detrimental effects on understandability and comparability;
- the simplification options suggested in the Paper and in the the FASB's Exposure Draft all seem either to create greater complexity elsewhere (replacement of fair value hedging with a 'more flexible' fair value option for example), or to reduce complexity at the expense of sacrificing flexibility. Whilst reducing flexibility might be argued to be a positive step, we see little merit in retaining a hedge accounting model while making it so inflexible that many more 'economically valid' hedging arrangements will no longer be eligible.

The FASB's ongoing deliberations in this area and the responses to the FASB Exposure Draft will no doubt provide valuable insights into the relative importance of simplicity and flexibility from both users' and preparers' perspectives.

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?

No, we have not identified any other intermediate approaches. However, as noted in the main body of this letter, we favour a single-step move to a sustainable, long-term solution.

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?

See comments in the main body of this letter.

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?**

We do not believe that it is appropriate to measure all types of financial instrument at fair value. Moreover, we do not believe it is necessary to measure all financial instruments in the same way.

We acknowledge that multiple measurement bases adds to the number of requirements in a Standard. However, we believe that a uniform fair value requirement would add significantly to the practical complexity of applying a financial instruments Standard. We recommend that the Board should take a broad view of complexity.

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?

We believe Part B of Section 3 covers all the significant issues.

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?**

As explained in the main body of this letter, we are not convinced that a general fair value requirement is the most appropriate long-term approach. However, if this approach is to be developed, we suggest that the practical difficulties of determining fair values (referred to in paragraph 3.79 but somewhat dismissed in 3.80) need to be considered.

- (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?**

We agree that all the issues referred to in Part C of Section 3 would have to be resolved before proposing a general fair value measurement requirement.

Question 12

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

Definitions - we tentatively agree that the revised definitions of a financial instrument, financial asset and financial liability are an improvement on the existing definitions. One aspect of the existing definition that gives rise to practical problems relates to 'part-executed' contracts for non-financial items and the point at which these give rise to financial assets and liabilities. For example, is an amount recoverable on a construction contract a financial asset immediately upon recognition, or only as amounts are invoiced? The revised definition does not seem any clearer on this point.

Embedded derivatives - we believe IAS 39's requirements on the identification and possible separation of embedded derivatives are difficult to understand and apply for many preparers. Part of the problem is that IAS 39 lacks a clear economic principle on the application of the 'closely related' test. Instead, this is governed by a series of complex and sometimes contradictory rules. We believe that developing a guiding principle on the closely related test (which might still need to be supported by application guidance) would clarify and simplify this aspect of IAS 39.

Scope - we welcome the Paper's discussion of ways to simplify IAS 39's scope at A21 to A63. We would however comment that we believe that the scope of any IFRS should be expressed in unambiguous terms. We suggest that a purely principle-based approach to scope might be difficult to achieve without sacrificing clarity.