Letter of Comment No: 23
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We welcome the opportunity to comment on this proposed Statement which we believe to be a positive development in US GAAP. The proposal will remove much complexity and burden in reporting the results of economic hedging relationships in a manner that reflects the substance of the transactions and the way management views them.

Whilst the proposed Statement may be viewed as a ‘purer’ interpretation of a fair value option than that extant in IFRSs, since it contains no eligibility criteria, there is still considerable work to be done on articulating the relevance and reliability of applying fair value measurement to various financial instruments. This is particularly true in jurisdictions outside the United States where markets in many instruments tend to be less deep and liquid, and data less abundant in order to derive valid modelling. To this extent we welcomed the questionnaire ‘Staff request for information about financial analysis of companies that report some or all financial instruments at fair value’, issued jointly be the IASB and FASB last month.

We encourage the Board to eliminate the differences between the proposed Statement and IFRSs by introducing the same eligibility criteria, as well as aligning disclosure requirements and scope exceptions. We believe the Board should first issue a Statement that converges with IFRSs and then work jointly with the IASB to develop and issue a refined fair value option, following analysis and discussion of responses to the above referenced questionnaire.

We also strongly encourage the Board to allow early adoption in financial statements for fiscal years ending after the issuance of the final Statement, expected in Q3 2006, for foreign registrants who adopt the fair value option under IFRS in their primary statements as this would eliminate a sizeable GAAP difference in the reconciliation to US GAAP. The proposed dates for adoption of the proposed Statement would mean that, for a company with a 31 December year-end, the earliest possible date of adoption would be 1 January 2007. Companies that prepare accounts under IFRSs are already familiar with the use of the fair value option and their 2006 financial statements will be prepared with certain financial instruments designated as at fair value with changes in fair value reported in earnings.
A company that is required to reconcile its IFRSs reported net income to that under US GAAP, would expect to report significant reconciling items in 2006 related to the use of fair value option, especially where the company did not seek to obtain hedge accounting under SFAS 133. These reconciling items are potentially large and volatile, adding little to users' understanding of the financial statements. Adoption of the proposed Standard from 1 January 2006 would eliminate such reconciling items. We believe that such early adoption would benefit all preparers and users, not only those whose primary financial statements are prepared under IFRSs.

Our responses to the specific issues raised by the Board are presented in the attached appendix.

Yours faithfully

Douglas J Flint
Group Finance Director
Appendix

Scope

Issue 1: The scope of this proposed Statement includes the following financial assets and financial liabilities that some may not have considered as being included:

- An investment being accounted for under the equity method
- Investments in equity securities that do not have readily determinable fair values, as described in paragraph 3 of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
- Insurance and reinsurance contracts that are financial instruments, as discussed in FASB Statements No. 60, Accounting and Reporting by Insurance Enterprises, No.97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realised Gains and Losses from the Sale of Investments, and No.113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts
- Warranty obligations that are financial liabilities and warranty rights that are Financial assets
- Unconditional purchase obligations that are recorded as financial liabilities on the purchaser’s statement of financial position as discussed in paragraph 10 of FASB Statement No. 47, Disclosure of Long-Term Obligations.

Should an entity not be permitted the option to initially and subsequently measure those financial assets and financial liabilities or any others at fair value? If so, why should those financial assets and financial liabilities be excluded from the scope of this proposed Statement?

a. We note that the Board, in Appendix A (A6), have stated that the fair value option project should not be used to make significant changes to consolidation practices. We agree and believe that the same argument is applicable to investments that are accounted for under the equity method, such as associates. Associates are strategic investments of a different nature to investments in available-for-sale securities. We believe that the current practice of reporting the percentage of operating profit attributable to the parent entity below operating profit is more meaningful than the information that would be conveyed by allowing such investments to be reported under the fair value option.

b. We believe that investments in equity securities that do not have readily determinable fair values, as described in paragraph 3 of SFAS 115 (equity securities that are not quoted on a securities exchange registered with the SEC), can in most instances be reliably measured at fair value. We agree that such investments should be within the scope of the fair value option.

However, this would then be inconsistent with SFAS 115 and we encourage the Board to consider amending SFAS 115 so that all equity securities for which a reliable fair value can be determined (whether quoted or not) should be classified as available-for-sale with changes in fair value excluded from earnings and reported in other comprehensive income until realised. This would be consistent with measurement at fair value allowed in the proposed Statement and align the treatment of unquoted equity securities with IFRSs. Currently the
difference in treatment is considerable: HSBC reported unquoted equity investments at 31 December 2005 valued US$597 million higher under IFRSs than US GAAP.

c.-e. We agree with these being included within the scope of the proposed Statement.

**Issue 2:** This proposed Statement permits an entity to elect the fair value option at inception for a firm commitment that would otherwise not be recognised at inception under existing generally accepted accounting principles (GAAP) and involves only financial instruments. Should an entity be permitted the option to recognise those firm commitments at fair value at inception of the contract? If so, why is the availability of the fair value option election important for those contracts and what types of entities would likely avail themselves of that fair value option election? Should the scope be limited to forward contracts that meet the definition of firm commitments under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (that is, requiring that the terms of the forward contract include a disincentive for non-performance that is sufficiently large to make performance probable)? If not, why not?

We believe that an entity should be permitted the option to recognise at fair value a firm commitment that is a financial instrument that would otherwise not be recognised at inception. Such an option may be appropriate, for example, if the entity manages risk exposures related to firm commitments on a fair value basis. An example of such a commitment is a forward commitment to sell unlisted equity shares where the contract does not require or permit net settlement.

**Issue 3:** The scope of this proposed Statement would exclude both (a) written loan commitments that are not accounted for as derivative instruments under Statement 133 and (b) financial liabilities for demand deposit accounts. The Board decided to specifically exclude those financial instruments, since the determination of their fair values involves consideration of non-financial components. Should an entity be permitted the fair value option election for those financial instruments? If so, why? What would be the appropriate unit of account for determining the fair value of demand deposit liabilities? What other financial assets and financial liabilities for which their fair values involve consideration of non-financial components should be excluded from the scope of this proposed Statement?

a. We believe that an entity should be permitted the option to recognise at fair value a loan commitment that is a financial instrument that would otherwise not be recognised at inception. Such an option may be appropriate, for example, if the entity manages risk exposures related to loan commitments on a fair value basis. This would permit a bank to measure changes in fair value of loan commitments that result from changes in market interest rates and credit spreads. It would be preferable if the definition of a firm commitment was the same as that within IAS 39 (paragraph 9), excluding the ‘disincentive for non-performance’ criterion.
b. The apparent difference highlighted in paragraph A22.b between the proposed Statement and IAS 39 is small in practice, meaning there is effectively no difference between the treatment of demand deposits under the proposed treatment and that in IFRSs. However, leaving such technical differences between US and International standards is unhelpful.

**Issue 4:** The scope of this proposed Statement would also exclude:

a. An investment that would otherwise be consolidated
b. Employers’ and plans’ financial obligations for pension benefits, other post-retirement benefits (including health care and life insurance benefits), post-employment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements as defined in FASB Statements No. 35, Accounting and Reporting by Defined Benefit Pension Plans, No. 87, Employers’ Accounting for Pensions, No. 106, Employers’ Accounting for Post-retirement Benefits Other Than Pensions, No. 112, Employers’ Accounting for Post-employment Benefits, No. 123 (revised December 2004), Share-Based Payment, No. 43, Accounting for Compensated Absences, and No. 146, Accounting for Costs Associated with Exit or Disposal Activities, and APB Opinion No. 12, Omnibus Opinion—1967

c. Financial liabilities recognised under lease contracts as defined in FASB Statement No. 13, Accounting for Leases. (This exclusion does not include a contingent obligation arising out of a cancelled lease or a guarantee of a third-party lease obligation.)

The Board decided to specifically exclude those financial assets and financial liabilities from the scope of this proposed Statement, as the Board believes that any modifications to the accounting for such financial assets and financial liabilities should be part of a reconsideration of those areas and should not be affected by the fair value option. Should an entity be permitted the fair value option election for those financial instruments? If so, why?

**We agree with the proposed scope exclusions as these areas of accounting need to be reconsidered as part of more fundamental projects.**

**Issue 5:** As noted above, this proposed Statement represents Phase 1 of the fair value option project. Phase 2 will consider permitting the fair value option for selected non-financial assets and liabilities. The Board is seeking input on what non-financial instruments should be included in the scope of Phase 2. Please provide details of those non-financial instruments and why they should be eligible for the fair value option. How would applying the fair value option to those non-financial instruments (a) improve financial reporting, (b) mitigate problems for reported earnings caused by the mixed-attribute model, and (c) enable an entity to simplify its accounting methods? Is fair value information readily available for those non-financial instruments?

Under IFRSs, investment properties are reported at fair value with changes in fair value reported through earnings. We believe that such treatment is appropriate for such investments as it reflects how they are intended to be managed and monitored. We would welcome steps to account for investment properties in this way under US GAAP. The recent memorandum of understanding issued by the FASB and IASB proposes that the FASB will
undertake a study on the possibility of convergence in accounting for investment properties. Depending on the timescale and outcome of this process we believe that, in the absence of a standard that permits investment properties to be measured at fair value with changes in fair value reported in earnings, investment properties should be included in phase 2 of the fair value option project.

We welcomed the recently released SFAS 156 'Accounting for Servicing of Financial Assets' which introduced a fair value option for mortgage servicing rights which eliminated the need not for these to be considered in phase 2 of the project.

Changes in Creditworthiness

Issue 6: This proposed Statement would permit an entity to elect the fair value option for certain financial liabilities, including debt liabilities. Under this proposed Statement, an issuer who has elected the fair value option for its debt liabilities would report changes in fair value of those liabilities, including changes resulting from changes in that issuer’s own creditworthiness, as gains and losses in earnings. If significant changes in fair value of those liabilities occur during a period, qualitative disclosures about the nature of those changes would be required. The Board discussed several possible approaches for curtailing the debtor’s recognition of the portion of a liability’s changes in fair value that is attributable to changes in its own creditworthiness and determined not to provide any curtailment; instead, the Board decided that liabilities should be recorded at fair value when the fair value option has been elected with all changes in fair value recorded in earnings. Do you agree with the Board’s decision? If not, why not? What alternative approaches or additional disclosure requirements should the Board consider?

We agree with the Board’s decision to record liabilities at fair value when the fair value option has been elected with all changes in fair value recorded in earnings. In practice, it is difficult to precisely isolate the change in fair value attributable to changes in credit risk.

Presentation and Disclosure Requirements

Issue 7: The Board discussed several possible approaches for separately reporting changes in the fair values of financial assets and financial liabilities measured at fair value pursuant to the election of the fair value option in the income statement or in the notes to the financial statements. The Board decided that an entity should provide information that would allow users to understand the effect of changes in the fair values of assets and liabilities subsequently measured at fair value as a result of a fair value election, but it did not prescribe detailed guidance on where and how that information should be reported. How should changes in the fair values of assets and liabilities subsequently measured at fair value as a result of a fair value election be reported? Should those changes be aggregated with the effect on earnings derived from other similar financial assets and financial liabilities in the income statement, or should separate display of those changes in the income statement be required? What level of aggregation should be permitted? What additional disclosure requirements should the Board consider?
We believe that changes in the fair values of assets and liabilities subsequently measured at fair value as a result of a fair value election should be reported in the same manner as that prescribed by IFRSs. IFRS 7 ‘Financial Instruments: Disclosures’ requires separate presentation, either on the face of the financial statements or in the notes, of the net gains or net losses on financial assets or financial liabilities designated at fair value through earnings (IFRS 7, paragraph 20). Whilst the FASB’s proposed Statement may aim to include similar disclosure, where wording can be aligned with IFRSs, this should be done where possible. It is also necessary to disclose where the coupon on interest bearing assets and liabilities is reported to gain a full understanding of how a fair value option election has impacted reported results.