

**ABI Comments on IASB  
Discussion Paper "Reducing  
complexity in reporting  
financial instruments"**

September 2008

Thank you for the opportunity to comment the Discussion Paper "*Reducing Complexity in Reporting Financial Instruments*". Please find below answers of the Italian Banking Association (ABI) to the specific questions raised in this paper.

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**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?**

We agree that current requirements for reporting of financial instruments are complex and that they could benefit from some changes.

Generally we don't think that application of different measurement criteria for financial instruments is a source of complexity.

A mixed measurement model, in itself, is quite simple to apply as long as the boundaries of the different categories and the associated measurement basis are clear to both users and preparers.

The problem with current IAS 39 classification is that it lacks a clear rationale that underlies classification of financial instruments.

Looking at current rules, classification is governed by combination of the following criteria:

- business model/intention for which the instrument has been purchased. This is the main criteria of IAS 39 and govern classification between trading vs other categories;
- predictability of cash flows (that govern the possibility to classify instruments in LR or HTM);
- quotation in active market (relevant for classification of debt instruments as HTM or LR).

The resulting classification rules are complex and based on exceptions. For instance the whole standard is strongly oriented to fair value measurement and seems to follow the idea that instruments quoted in active market should be measured at fair value. However quoted instruments can be classified as HTM when specified criteria are fulfilled.

Additional sources of complexity, leaving derecognition apart as it is not in the scope of the discussion paper, are in our opinion the following:

1. mandatory fair value measurement of financial derivatives;
2. rules required to apply hedge accounting;
3. tainting rules for HTM classification;

#### 4. definition of active market.

Mandatory fair value measurement of derivatives instruments introduces complexity in the accounting for financial instruments as it requires rules for separating derivatives embedded in non derivatives instruments as well as exceptions to general measurement criteria for non derivatives instruments that are hedged through derivatives instruments.

We agree however that fair value is the only relevant measurement criteria for derivatives as it enhances the relevance of financial statement.

Accordingly resulting complexity has to be accepted in order to properly represent the deals and in particular to avoid structuring opportunities and "accounting mismatches" not representing the substance of entities' operations.

Regarding hedge accounting and tainting rules (point 2. and 3.) we think that work should be done in order to simplify them as they are source of unneeded complexity.

Hedge accounting requirements in terms of documentation and hedge effectiveness are burdensome for preparers to comply with and for users to understand their actual effects. For instance failure in a single period to comply with such rules, even if the hedge strategy followed by business is unchanged, can trigger accounting re-classification that heavily affects performance as hedge accounting has to be terminated.

Additionally IAS 39 contains many detailed rules on which instruments can be qualified as hedging/hedged instruments as well as which are the hedgeable risks.

Their problem is that such rules often are not founded in business practice. Accordingly auditors and preparers have to face complexity in order to fit hedging policies actually followed in the set of rules provided by the standard.

Tainting rules governing HTM, including prohibition to apply hedge accounting, are a means to ensure that the requirements for achieving such classification are actually fulfilled. Such rules are such strict and prevent representation of the business that many entities prefer not to employ it.

We wonder whether introducing a categories together with rules that represent a disincentive to its adoption results in useful information.

Additionally in our opinion granting compliance with accounting definition should not be a task of the Board but should be left to appropriate bodies such as internal and external auditors as well as regulators.

Regarding definition of "active market" recent market turmoil as well as the debate occurred between entities and auditors<sup>1</sup> to establish whether ABS

markets are active, demonstrate that current requirements for defining when markets are active aren't clear enough. Accordingly we would recommend to start working on this matter.

## 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?**

We agree with the criteria proposed in paragraph 2.2 with the exception of point b (the change must be consistent with long term measurement objective to measure all financial instruments at fair value and should ideally increase the number of financial instruments measured at fair value).

As explained in our answer to question 8 fair value isn't always the measurement criteria that provides the most significant information relating to financial instruments.

Accordingly, in our opinion, a "mixed model" principle based solution should be not only an intermediate step but also a long term goal for the measurement of financial instruments.

## 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?**

Before commenting the solutions proposed under approach 1, we would like to provide some general comments on classification.

In our opinion if the final goal is to achieve a principle based accounting standards on financial instruments, classification should be based on a clear rationale.

In particular, classification should be based on a criteria easily understandable by both preparers and users because based on the features of the financial instruments to be classified or on a clear business rationale. Example of criteria that could underlie classification are the following, some of them are actually discussed in approaches discussed in the DP.

*Quotation in active market:* According to such solution, classification and measurement criteria would be based on features associated with the market in which the instrument is traded.

For instance, as proposed in par. 2.12 quoted instruments are measured at fair value while unquoted instruments are measured at cost. Such solution would have the benefit to address some of the issues concerning reliability of fair value measurement as such criteria would be employed only for those instruments that have a published price quotation that is representative of actual market transaction.

Additionally it would simplify classification provided that "quotation in active market" is a feature well known to both users and preparers.

However we observe that, given present rules, such solution would be difficult to apply as there isn't a clear definition of active markets. As mentioned in our answer to question 1, current requirements aren't clear enough and are subject to different interpretations; accordingly if such classification were based on current rules inconsistent classification between entities would probably arise with a reduction of comparability between entities. Implementation of this solution would require additional work for development of criteria for establishing when an instrument is quoted in active market or not.

In this context, we observe that quotation on active markets should refer to risks underlying financial instruments and not to the contract itself.

For instance regarding OTC derivatives, such as IRS, there isn't an active market for the contract itself, however there is an active market for the basic underlying risk parameters. Accordingly, if we assess the whole contract, these instruments would be considered as not quoted (and therefore measured at cost) however there are few doubts that fair value is the relevant measurement criteria.

*Variability of cash flows:* according to such solution, classification and measurement criteria would be based on type/features associated with the instruments.

Such solution would simplify accounting for financial instruments as long as instruments features are easily acknowledgeable.

However due to continuing financial innovation and difficulties in providing definition of instruments (such as distinction between equity and liabilities), makes it difficult to achieve such solution

For instance, as proposed in par 2.19 onward, financial instruments with highly variable cash flow would be measured at fair value while instruments with slightly variable cash flows would be measured at cost.

The solution proposed as currently drafted would be source of further complexity as there isn't a clear understanding of which instruments have highly variable cash flows and which have slightly variable cash flows.

Additionally the DP proposes that in deciding whether cash flows are highly or slightly variable, the entity should consider also credit risk.

This rule is, in our opinion, complex to apply as it would generate endless debate on which credit risk thresholds has to be employed in order to define whether instruments cash flows are highly or slowly variable.

Additionally measures of credit risk, such as public ratings, are not available for every financial instrument. Accordingly there would be a problem in classifying instruments that have not a public rating; this is especially true for entities that don't employ internal credit risk models.

Finally this solution would lead to a fair value measurement of impaired debt instruments. We fail to see how fair value of such exposures provide a measure that is more significant than the expected recoverable amount estimated using current techniques.

*Business intention/model:* According to such solution financial instruments would be categorized according to the reason why they are held by the entity. In particular entities can acquire financial instruments with the intention to profit from changes in market price of the instrument itself or to profit from cash flow stream that the instrument will generate until its maturity/for an indefinite period of time.

Such solution has the merit to make financial statements reflect the actual performance achieved by the entity considering its pursued business model. It is also founded on a criteria that is commonly understood by financial statements users.

Also, as entities acquire with the intention to profit from fair value changes, instruments whose risk factors are quoted in active market, it ensures that only instruments with a reliable fair value would be measured according to this criterion.

While Discussion Paper discusses the first two criteria, we are somewhat disappointed to see that business intention hasn't been considered as a possible classification criteria.

We note that business intention already underlies IAS 39 classification criteria and that it has been considered by IASB in order to define the accounting of financial statements item different from financial instruments (for instance Properties, which can be designated as Investment or used for business purposes, Non current assets which can be designated as Held for Sale *etc.*).

Adoption of a classification approach based on business intention would also determine less stringent rules for reclassification that, in general, would

be allowed provided there is a documented change in entity's business model. Please refer to question 4e. for additional detail

We are aware that classification criteria purely based on pursued business model would not be consistent with criterion listed in par. 2.2.b which requires intermediate steps to increase the number of financial instruments to be fair value measured.

In particular adoption of such classification criterion could lead to measure at cost/amortised cost instruments currently classified as AFS (such as quoted debt instruments and equities).

A possible solution to address this issue would be to couple business intention (which would be the main classification criterion) with a "second level" criterion ensuring that certain instruments are measured at fair value. However, in our opinion, any model based on more than a single criteria would lead to a classification approach not far different from the one already employed in IAS 39.

For instance, an approach that classify financial instruments considering primarily business intention (which would lead to a differentiation between "Financial instruments fair value managed" and "Financial instruments not fair value managed") and that requires financial instruments quoted in active market to be fair value measured even if not managed this way would lead to three or four classification categories depending on the fact that changes in fair value on instruments not managed on a fair value basis are recognized in earnings or in OCI.

If such changes in fair value are recognized in earnings, classification categories would be in principle 3:

- financial instruments managed at fair value to be measured at fair value through profit or loss;
- financial instruments not managed at fair value quoted in active market to be measured at fair value through profit or loss;
- financial instruments not managed at fair value not quoted in active market to be measured at amortised cost plus impairment.

This solution, which is substantially equivalent to elimination of AFS and HTM categories (with the possible exception of non-quoted equity instruments), would determine a simplification in accounting as it would solve complexity associated with:

- recognition of impairment on AFS instruments;
- hedging of AFS instruments;
- separation of embedded derivatives.

However such solution would not properly represent the actual period earning of the entity especially when financial instruments are not held for subsequent resale.

If such changes in fair value are recognized in OCI, classification categories would be in principle 3:

- financial instruments managed at fair value to be measured at fair value through profit or loss;
- financial instruments not managed at fair value quoted in active market to be measured at fair value through OCI;
- financial instruments not managed at fair value not quoted in active market to be measured at amortised cost plus impairment.

This solution is substantially equivalent to elimination of HTM category.

It's very likely, however, that need to simplify the accounting (in the area of embedded derivatives and, depending on solution adopted, hedge accounting) would lead to the introduction of a Fair Value Option Accounting adding a fourth category.

We are aware of the fact that all proposed solutions (as well as almost every mixed measurement model) would not determine elimination of rules related to identification and valuation of embedded derivatives. Nonetheless we think that this issue can't be solved in a mixed measurement model and accordingly we need to accept it. Additionally we invite IASB to work in this area in order to better clarify in which circumstances embedded derivatives shall be separated from the host instrument.

To summarize in our opinion categorization of financial instruments should be based primarily on entity's business model. Such solution could be coupled with a secondary classification criteria based on the fact that risks underlying financial instruments are or not quoted in active markets in order to address IASB concerns even if we observe that such solution would be substantially equivalent to elimination of HTM category.

However in our opinion, even if fair value measurement is applied for financial instruments quoted in active markets there is the need to recognize change in fair value in OCI and not in earnings when such instruments are not managed on a fair value basis according to entity's business model.

We indicate in the following our comments to the different approaches proposed by IASB.

Approach 1 discusses several changes to current IAS 39 categories.

The first change proposed (par. 2.20) is to eliminate HTM category. This would determine the classification as AFS of quoted debt instruments. Such solution would reduce complexity by eliminating tainting rules, however it determines the recognition in OCI of changes in fair value of quoted debt instruments which can be seen as inconsistent when the entity

intends to hold such financial instruments until maturity or for an indefinite period of time.

It has to be considered, however, that due to the mentioned tainting rules, we have the feeling that many entities do not employ such category; accordingly such amendment would not represent a significant change from current rules.

The second change proposed is elimination of AFS category. This would determine the measurement of financial instruments currently classified in AFS (mainly quoted debts and quoted/unquoted equities) at fair value through P&L.

We agree that such solution would determine a strong simplification in accounting as it would solve complexity associated with:

- recognition of impairment on AFS instruments;
- hedging of AFS instruments;
- separation of embedded derivatives.

However such solution would not properly represent the actual period earning of the entity especially when financial instruments are not held for subsequent resale.

This problem could be particularly relevant for equity investments; we remind that AFS is currently the only category in which equity investments that don't qualify as investment in subsidiaries/associates/Joint Ventures can be classified.

In many cases such investments are not "available for sale" according to entities business model but represent strategic investments.

Elimination of AFS category would force the recognition in earnings of changes in fair value attributable to such strategic investments; this approach would not be consistent with entities' business purposes.

The third proposal is to measure at fair value all instruments traded in active markets.

The DP doesn't specify if changes in fair value will be recognized in OCI or in earnings.

We don't support such solution if Board intention is to recognize fair value changes in earnings; implementation of this solution requires additional work for development of criteria for establishing when an instruments is quoted in active market or not. As mentioned in our answer to question 1 current requirements aren't clear enough and are subject to different interpretations; accordingly if such classification were based on current rules inconsistent classification between entities would probably arise with a reduction of comparability between entities.

Finally we think that focus shouldn't be on quotation of instruments but instead of quotation of underlying risk.

**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?**

As stated in our answer to question 3 we support a classification primarily based on business model.

Accordingly we would agree with a fair value measurement principle with some optional exception only provided such exceptions are drafted to take into account entity's business model.

In particular we don't support a classification criteria based on the degree of variability of future cash flows because:

- variability of cash flows isn't a concept commonly known by users and preparers, accordingly guidance would need to be developed in order to apply such concept;
- to the extent that variability of cash flow takes into account credit risk, there would be issues in defining which is the level of credit standing that trigger classification as well as in measuring assets currently defined as impaired.

A classification approach that could be worth exploring could be based on the fact that risk underlying the instruments are, or not, quoted in active market.

While we would prefer a classification criteria exclusively based on business intention, this solution could address Board concern about the measurement at cost/amortised cost of quoted instruments.

However, also in this case, it would be important to distinguish instruments managed or not on a fair value basis both in term of presentation and in term of where changes in fair value are recognized (OCI vs earnings)

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

Financial instruments not measured at fair value would be measured at cost/amortised cost plus impairment.

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

In our opinion, as a general principle, any impairment model should be based on the estimation the amount that will be recovered.

Given this premise, we think that it's indisputable that impairment shall be recognized when there is evidence of default or other difficulties in servicing debt, of the borrower.

In this context, for financial instruments measured at amortised cost, we support the current impairment methodology that determines the expected recoverable amount by discounting expected cash flow using original EIR.

We don't think that, for estimating impairment, fair value is a useful measure; for specifically impaired asset, fair value isn't a measure less complex to calculate than current expected recoverable amount because also fair value estimation would be based on discounting of future expected cash flows.

Additionally reference to fair value would also take in consideration changes in value attributable to change in interest risk. This circumstance isn't consistent with a cost/amortised cost method.

Also when there isn't evidence of default of single borrower (i.e. when the loan is performing) past evidence gathered from historical experience for similar instrument usually indicate that expected recoverable amount may be lower than carrying amount. This circumstance underlies calculation of expected losses by financial institution.

Current IAS 39 requirements, however, doesn't fully acknowledge such issue by subordinating recognition of general impairment to the occurrence of a trigger event and by explicitly prohibiting recognition of impairment losses on initial recognition of financial instruments.

This dichotomy has determined difficulties for financial institution in developing methodologies that could be considered IAS compliant while relying on risk management tools developed for managing credit risk and resulted in accounting values different from the actual estimate of the probable losses resulting from credit risk management tools.

Additionally we suspect that different interpretation of the meaning of "trigger event" as well as methodology for calculating impairment resulted in application of different methodologies by banks.

Considering the sensitiveness of this issue for banks we urge IASB to clarify this matter.

In our opinion two alternative solution can be pursued:

- 1) adopt an impairment approach that calculate impairment as the difference between estimated expected recoverable amount and carrying amount. This solution would likely result, for performing loans, in the recognition of losses since origination and regardless of occurrence of a specific trigger event. This approach would have the benefit to be principle based and to determine results consistent with credit risk management methodology applied.

- 2) Clarify and develop the existing "incurred loss" model for instance by clarifying that for performing loans the aims of the approach would be to recognize worsening in credit standing since the origination (for instance evidenced by an increase in PD or by a rating downgrade) and that the expected recoverable amount should be estimated by discounting the future expected cash flow resulting from the mentioned worsening in credit standing.

**(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?**

According to the proposed solution changes, in fair value on financial instruments managed on a fair value basis will be recognized in P&L while changes in fair value of *quoted* financial instruments not managed on a fair value basis, if recognized, would be posted in OCI.

**(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?**

According to our proposals reclassification from different categories should be permitted in case of a documented change of the business model followed.

Additionally, provided that quoted instruments are measured at fair value through OCI, reclassification should be allowed when an active market disappear for its underlying risk factors and viceversa.

Reclassification from a category measured at fair value through profit or loss to a category measured at amortised cost should be accounted for using fair value observed at the date of reclassification as amortised cost.

Reclassification from a category measured at cost to a category measured at fair value should be accounted for using amortised cost observed at the date of reclassification and, thereby, recognizing in P&L or in OCI the difference between amortised cost and fair value observed at the date of reclassification.

**Question 5**

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

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

As discussed before we support adoption of a mixed measurement model. In such model hedge accounting is required in order to avoid accounting mismatch between derivatives (measured at fair value through P&L) and items not measured at fair value or measured at fair value through OCI.

Elimination of hedge accounting would determine the recognition in P&L of changes in fair value of derivatives only.

It must be observed that in such case the entity entered into derivatives not in order to profit from changes in fair value of the underlying risk but in order to hedge an opposite risk incurred in an instruments fair value managed. Such increase in volatility should not affect performance as it doesn't represent the economic substance of the transaction.

Additionally we think that elimination of hedge accounting would increase complexity of financial statements; as results presented would not reflect the actual performance of the entity, there would probably be the need to explain such circumstance as well as the real results in the notes to financial statements.

**(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?**

In principle we don't support none of the methods proposed as we would prefer to substantially simplify current hedge accounting requirements. In particular we feel that the main complexities surrounding hedge accounting don't arise from the accounting method but from the set of rules on documentation, effectiveness and qualifying hedged and hedging instruments.

The first method proposed is to replace Fair Value Hedge with Fair Value Option.

As the DP observe, existing requirements make FVO an unsuitable replacement of FVO due to the following reasons:

- irrevocability of FVO designation;
- impossibility to apply partial hedges to instruments classified at FVO;
- impossibility to designate non financial items as hedged item.

As a Bank that mostly hedges interest rate risk underlying loans and other bank instruments we think that most important issue is number 2 (impossibility to apply partial hedges).

Such solution, in fact, would determine the recognition of changes in fair value due to credit risk which in most cases is neither hedged nor managed on a fair value basis.

The changes proposed to FVO in order to address the mentioned issue would make this category to converge to a simplified fair value hedge accounting that we in principle support. However such simplification need to be extended to cash flow hedges.

The second method proposed is the recognition in OCI of gains and losses on the hedging instruments. While this solution would introduce some benefits we don't think that it alone would determine a real simplification of hedge accounting as it would not solve the main complexity surrounding this area.

The third method proposes the recognition outside earning of gains/losses on the hedged item. We don't support such solution as it seems to imply substantially a full fair value measurement of financial instruments with changes recognized either in OCI or in earnings.

Also the methodology doesn't discuss the possibility to hedge financial instruments, if any, held at cost/amortised cost.

- (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 that your comments are consistent with your suggested approach to changing measurement requirements.**

No there are not.

#### **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?**

As previously mentioned, in our opinion, the main complexity in current hedge accounting requirements arises from the set of rules governing documentation, effectiveness testing and qualifying hedged/hedging instruments.

Accordingly we propose to move from the current rule based approach to a principle based approach based in which current requirements are substantially eased.

In particular under this approach both fair value hedge and cash flow hedge could be applied as long as:

- the hedge is consistent with entity's documented hedging policy;
- ineffectiveness is recognized in earnings.

Such solution would reduce current complexity by substantially reducing documentation requirement and by eliminating ineffectiveness requirement. We don't think would result in less relevant and understandable information but, on the contrary, would determine a better representation of the actual hedging policy pursued by the entity.

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

Our suggestion would remove many of the restrictions that exist today. We are aware of the fact that hedge accounting, being based on an exception to the accounting treatment defined on initial recognition that result from management intent, has to be disciplined.

However we think that requiring consistency with entity's documented hedging policy is a condition sufficient in order to prevent possible abuses while avoiding excessive documentation burden.

We note that current IFRS in which accounting is based on management intention (IFRS 5, Restructuring provision in IAS 37 and FVO in IAS 39) generally require existence of a plan or similar documentation without introducing the degree of requirement dictated by current IAS 39. Accordingly we think that our proposal is consistent with current IFRSs.

Additionally we think that as long as ineffectiveness is recognized in P&L there is no need of dictating effectiveness thresholds, as such rule would already be self policing for entities.

**(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.**

In our opinion partial hedges should be permitted as it is common practice of entities to hedge only a single risk type underlying the hedged financial instruments. For instance while risks underlying loans comprises both interest rate risk and credit risk, it's common practice to hedge interest rate risk only.

Prohibition of partial hedge would determine to recognize change in value that is not hedged through derivative thereby reporting artificial volatility.

Additionally we would add that, as acknowledged by the DP, users of financial statements are interested in seeing changes in fair value disaggregated into major components.

Accordingly complexity surrounding the measurement of "partial fair value" would still remain.

**(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?**

No comment.

#### **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 comment.

#### **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?**

We don't believe that adoption of a single measurement criteria for financial instruments would be the most appropriate solution.

Adoption of a single measurement criteria, being it cost/amortised cost or fair value, doesn't allow to represent the actual performance of the entity which mainly depends from its business model.

In order to grant relevant information and to decrease complexity, we think that a principle based standard based on a mixed measurement model can be a proper long term solution.

As explained a mixed measurement model has to live with complexities such as hedge accounting and separation of embedded derivatives, however such complexities are, in our opinion, unavoidable considering the degree of financial innovation as well as the fact that financial instruments are complex themselves.

#### **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?**

No, in our opinion fair value isn't the only measurement attribute that is appropriate for all types of financial instruments. In our opinion fair value is appropriate for some kind of financial instruments while cost based measurement is appropriate for other. Differentiation should be primarily based on management intention.

There are several reasons why fair value can't be considered as the only appropriate measurement attribute.

The first reason regards the usefulness of the information.

As indicated in ED on framework, the objective of financial statements is to provide information that is useful to investors, lenders and other creditors in making decisions. In particular the focus of the information is entity's ability to generate net cash inflows and management's ability to protect and enhance the capital providers' investments.

Given this premise, in our opinion, a mixed measurement model based on business model is best suited to represent the cash inflows that the entity will generate.

For instruments managed on a fair value basis, fair value is the best representation of future cash flow that will actually be incurred by the entity that has entered into a position in order to profit from capital gains. In such cases profit/losses arising from changes in fair value provide the best representation of the entity's performance as they will actually be realised.

For instruments not managed on a fair value basis, especially debt instruments, the amount resulting from application of cost plus impairment is the best representation of entity's net cash inflows; of course fair value could change following changes in underlying risk factor, however as the

entity will not take a profit or loss from such changes, the actual net cash inflows that it is going to generate will remain substantially unchanged.

Such solution would, in our opinion, better serve the interests of both equity holders and lender as it would allow to depict the actual financial position as well as its actual performance thereby providing information on stewardship.

For instance lenders are interested in knowing entity's ability to pay interest and redeem capital when due.

This ability depends on the fact that cash inflow from assets can pay the cash outflows requested to settle liabilities.

Accordingly lenders are interested in financial position and timing of future cash inflows and outflows of the entity.

No measurement criteria can portrays timing of future cash flow.

This information can be displayed only in notes to financial statements.

Regarding financial position, the employment of different measurement criteria in accordance with management's intention, allows an estimation of actual cash flows that will be paid or received by the entity in accordance with its strategies and policies.

If the entity's strategy is to hold assets until maturity, lenders must rely on cash flow generated by interest and reimbursement in order to have their debt repaid.

As the entity has not the intention to sell the asset, lenders cannot expect that an increase/decrease in fair value will translate in higher/lower resources available for redeem debt.

On the contrary for assets/liabilities that management intends to trade fair value is representative of the resources that will be available for the entity to pay its debts, as according to entity strategy the market value of the instruments will be translated in actual cash flows.

Investors are interested in the return offered by their investment given by capital appreciation and dividends.

Capital appreciation depends on the market value of the entity shares which cannot be measured in financial statements unless all the assets and liabilities of the entity are fair value measured. However IASB does not allows recognition of all the assets appreciated by the market such as internally generated intangible assets (such as goodwill).

Regarding dividends, the consideration of management's intention to hold or trade allows the recognition of income and losses that better represent actual dividends for investors.

Dividend is that part of equity that can be distributed to shareholder without decreasing issued capital and reserves which are mandatory for legal purposes.

Dividend that can be distributed, however, depends, other than from applicable commercial law, from management intention regarding actual realization of gains and losses.

Entities will not distribute dividends which come from gains they know will not be realized.

Distribution of not realizable gain would lead to a decrease in issued capital/mandatory reserve.

On the contrary application of a Full fair value measurement can lead to situations where the dividends distributed are higher than current profit.

For instance if the fair value of a fix rate loan, that entity intends to hold, decreases due to an increase in the benchmark market rate, the entity recognizes a loss.

However the amount of distributable dividends can be determined without taking into account such loss.

In fact, as the entity pursues a strategy in which its actual income is not affected by these gains and losses, it has enough resources to distribute dividends which are higher than the reported profit without decreasing issued capital and mandatory reserves.

Such concerns about the relevance of fair value measurement for instruments that will be retained until maturity or for an indefinite period of time are strengthened if we consider the fact that many financial instruments lack an active market for their underlying risk and accordingly fair value measurement would be the result of entity's own estimate.

We are aware of the fact that, as stated in Discussion Paper, also impairment is in many cases based on an entity's estimate, however:

- impairment leads to the recognition of losses only while a full fair value measurement would lead to recognition of both gains and losses. While we are aware that prudence in recognising unrealised profit shall not be the main feature of IFRS Financial Statement, we think that on certain kind of instruments a certain degree of conservatism has to be employed;
- on the contrary of a fair value measurement, impairment isn't automatic but it's triggered after management's assessment of the exposure. While this doesn't determine an increase of the certainty of the estimate, it ensures that the amount reported as a loss has been carefully assessed.

**(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?**

For the reason indicated above we don't think that there is a single measurement model that is appropriate for every financial instruments.

On the contrary we support adoption of a principle based mixed measurement model that, in our opinion, is the best solution to portray the cash flow prospects of the entity.

As stated several times complexity of the standard doesn't arise from using several measurement criteria but, above all, from all the rules of the standard.

#### **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 think that IASB has correctly identified the main sources of concern about fair value measurement.

We would, however, add one more element: possible increases in cost and complexity of presentation and disclosure.

As argued in the Discussion Paper even though a single measurement criterion is adopted there will always be demand for to provide information such as:

- classification category of financial instruments (for instance even if a full fair value measurement is applied, adoption of the proposed Part B of financial statements presentation project would still require to classify financial instruments in different categories as operating, investing and financings);
- differentiation between realised and unrealised gains/losses;
- possibly, at least for some instruments, a split of unrealised gains/losses according to underlying risk factor (market risk vs credit risk);
- interest income/expenses for debt instruments (possibly calculated using EIR for some of them);
- classification of fair value according to some kind of hierarchy along the lines of current FAS 157.

Such information requirements, coupled with a full fair value measurement, would represent increase of the information to be provided also increasing cost of producing them.

Additionally such requirements would, in effect, impede to achieve the reduction in complexity that should be one of the objective of adopting a full fair value criterion.

#### **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?**

We think that IASB has identified all the relevant issues to be addressed before proposing a fair value requirements.

**(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?**

No there are not.