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22 June 2010

Dear Françoise

EFRAG Draft Comment Letter on the IASB Exposure Draft 'Fair Value Option for Financial Liabilities'

Thank you for providing the UK Accounting Standards Board (ASB) with the opportunity to comment on your draft comment letter (DCL) to the International Accounting Standards Board's (IASB's) Exposure Draft (ED) 'Fair Value Option for Financial Liabilities'.

The ASB broadly agrees with the views set out in the EFRAG DCL, in particular that the fair value changes relating to own credit risk for liabilities designated under the fair value option should not have an impact on profit or loss. We also agree with EFRAG's support for the one-step approach to presentation. However, we do not agree with EFRAG's view (in response to Question 2) that in extremely rare circumstances when the fair value changes of financial assets are linked to an issuer's own credit risk, the effects of changes in the own credit risk of the liability should be recognised in profit and loss account if this reduces an existing accounting mismatch. We believe that using the fair value option for financial liabilities is already an exception to the general measurement principles for financial liabilities and introducing a further exception would not be justified.

Appendix 2 of the EFRAG DCL discusses some of the overarching aspects of the new requirements for classification and measurement of financial instruments. In particular, we share the concern that different requirements for the classification and measurement of financial liabilities will create complexity. That said, we do not think that the IASB should go back on their earlier decision to eliminate bifurcation of embedded derivatives for financial assets. In addition, we do not have any specific concerns over elimination of the cost exemption for derivative financial liabilities on unquoted equity instruments.

Our response to the IASB on this ED is attached for your information.

Should you have any queries regarding this response please contact me, or Deepa Raval, Project Director, on +44 207 492 2424 or by email d.raval@frc-asb.org.uk.

Yours sincerely

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Gavin Francis
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22 June 2010

Dear Gavin

IASB Exposure Draft 'Fair Value Option for Financial Liabilities'

This letter sets out the comments of the UK Accounting Standards Board (ASB) on the above Exposure Draft (ED).

The ASB broadly supports the proposals in the ED in so far as they address the issue of own credit risk for financial liabilities measured using the fair value option. The ASB agrees that recognising the effects of changes in own credit risk on a liability in profit or loss does not provide meaningful information unless the liability is held for trading. However, the ASB does not agree with the proposed two-step approach. The ASB prefers the alternative one-step approach on the basis that it is consistent with the view that changes in own credit risk on a liability should not affect profit or loss, it is less complex than the two-step approach and it does not introduce a new method of presentation under IFRS.

Our responses to the questions contained in the 'Invitation to Comment' section of the ED are included in the Appendix to this letter. However, the ASB has a number of overarching comments when the model for financial liabilities is considered in the context of IFRS 9.

a) We would recommend that the IASB consider permitting reclassifications for financial liabilities when there is a change in business model as the business model concept applies to both financial assets and financial liabilities. Accounting mismatches are likely to occur in a situation where financial assets and financial liabilities are managed together but the financial assets are reclassified due to a change in the business model.

b) Many of the financial liabilities requirements from IAS 39 are being moved across to IFRS 9 as part of the phased approach adopted for the financial instruments project. As this ED has a narrow focus, it is difficult to evaluate the financial liabilities requirements in IFRS 9 in their entirety. Whilst we understand the reasons for aspects of this project being split into separate phases, we would recommend that the IASB publish a comprehensive ED on all phases of IFRS 9 before the end of 2010. We believe this will enable constituents to consider the proposals for financial instruments and their adequacy in the round.

If you would like to discuss any of the comments, please contact Deepa Raval on 020 7492 2424 or myself on 020 7492 2434.

Yours sincerely

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Appendix: Response to the Invitation to Comment

Question 1 Do you agree that for all liabilities designated under the fair value option, changes in the credit risk of the liability should not affect profit or loss? If you disagree, why?

1. We agree that changes in the own credit risk of a liability should not affect profit or loss for all liabilities designated under the fair value option. Recognition of changes in own credit risk for a liability carried at fair value in the profit an loss account leads to counter-intuitive accounting and does not provide decision-useful information.

Question 2 Or alternatively, do you believe that changes in the credit risk of the liability should <u>not</u> affect profit or loss unless such treatment would create a mismatch in profit or loss (in which case, the entire fair value change would be required to be presented in profit or loss)? Why?

2. We do not believe that changes in own credit risk on a liability designated under the fair value option should be recognised in the profit and loss account. This view is formed on the basis that recognition of changes in own credit risk in the profit and loss account does not provide meaningful information to users.

Question 3 Do you agree that the portion of the fair value change that is attributable to changes in the credit risk of the liability should be presented in other comprehensive income? If not, why?

3. We agree that the portion of the fair value change that is attributable to changes in own credit risk of the liability should be presented in other comprehensive income. However, we would encourage the IASB to examine the purpose of other comprehensive income and establish a principle for recognition of gains and losses therein.

Question 4 Do you agree that the two-step approach provides useful information to users of financial statements? If not, what would you propose instead and why?

4. We do not agree with the two-step approach. In our view, presenting the fair value change attributable to changes in own credit in the profit and loss account,

then backing it out into other comprehensive income adds another layer of complexity and introduces a new method of presentation under IFRS.

Question 5 Do you believe that the one-step approach is preferable to the two-step approach? If so, why?

5. We prefer the one-step approach as it is consistent with the view that changes in the own credit risk on a liability should not affect profit or loss.

Question 6 Do you believe that the effects of changes in the credit risk of the liability should be presented in equity (rather than in other comprehensive income)? If so, why?

6. No. We do not support an approach where the effects of changes in own credit risk of a liability are taken directly to equity. Gains and losses relating to changes in own credit risk are not transactions with equity holders. Therefore, it is more appropriate to recognise such changes in other comprehensive income.

Question 7 Do you agree that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income (or included in equity if you responded 'yes' to Question 6) should not be reclassified to profit or loss? If not, why and in what circumstances should they be reclassified?

7. Yes. We consider that this decision is in line with the IASB's position in IFRS 9 where recycling of gains and losses on equity instruments presented in OCI is not permitted.

Question 8 For the purposes of the proposals in this exposure draft, do you agree that the guidance in IFRS 7 should be used for determining the amount of the change in fair value that is attributable to changes in a liability's credit risk? If not, what would you propose instead and why?

8. We agree that the guidance in IFRS 7 provides a reasonable proxy for determining the amount of the fair value change that is attributable to changes in own credit risk of a liability. Paragraph 10(a)(ii) gives an entity the option of using an alternative method for determining the own credit risk element of the fair value change if this is provides a more faithful representation. We believe that the guidance in paragraph B4 of IFRS 7 together with option in paragraph 10(a)(ii) is adequate.

Question 9

Do you agree with the proposals related to early adoption? If not, what would you propose instead and why? How would those proposals address concerns about comparability?

9. We agree that early adoption should be permitted as this is consistent with the classification and measurement requirements for financial assets in IFRS 9. To avoid 'cherry-picking', if an entity chooses to early adopt this piece, we believe it is necessary for that entity to adopt all other phases of IFRS 9 that it has not already adopted.

Question 10

Do you agree with the proposed transition requirements? If not, what transition approach would you propose instead and why?

10. We support retrospective application. IFRS 7 already requires an entity to disclose the amount of change attributable to changes in own credit risk for financial liabilities designated as at fair value through profit and loss. Given that the ED is limited in scope, the costs of retrospective application should be minimal.