DRAFT COMMENT LETTER

Comments should be sent to Commentletters@efrag.org by 6 July 2010

EFRAG

European Financial Reporting Advisory Group

XX July 2010
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/ Madam

IASB ED *Fair Value Option for Financial Liabilities*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the IASB Exposure Draft *Fair Value Option for Financial Liabilities* ('the ED'), which was issued in May 2010. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would have been reached in its capacity of advising the European Commission on endorsement of the definitive IFRS.

The ED sets out proposals for the measurement of financial liabilities in the scope of IFRS 9 to which an entity elects to apply the fair value option. In particular, the ED proposes that the effects of changes in the own credit risk of such liabilities should not affect profit or loss, but should be reported in other comprehensive income (OCI). Except for a consequential amendment arising from the first phase of IFRS 9, other classification and measurement requirements for financial liabilities will be carried forward from existing IAS 39.

EFRAG agrees that fair value changes due to changes in an entity's own credit risk from remeasurement of liabilities designated under the fair value option should not impact profit or loss. In this way, the IASB addresses long-standing concerns that reporting the effects of changes in own credit risk of liabilities that are not held for trading purposes in profit or loss is misleading.

EFRAG agrees that the portion of the fair value change that is attributable to changes in the credit risk of a liability should not be presented directly in profit or loss. However, we do not support the two-step approach. We believe that the introduction of such a new presentational method in IFRS is not justified before a proper debate is had on fundamental issues related to performance reporting such as (a) the notion of performance and the impact of business models on it, (b) the content of performance statement(s) and (c) recycling.

Our detailed responses to the questions in the ED are set out in Appendix 1 to this letter.

Note for EFRAG's constituents

The exposure draft only focuses on accounting for own credit risk on liabilities that entities choose to measure at fair value. However, we would like to use this opportunity to solicit views of constituents on some overarching aspects of the new requirements for classification and measurement of financial instruments. Therefore, we would appreciate your responses to the questions set out in Appendix 2.

If you would like to discuss our comments further, please do not hesitate to contact Marius van Reenen or me.

Yours sincerely

Françoise Flores

EFRAG, Chairman

Appendix 1

EFRAG's responses to the questions in the ED

Notes for EFRAG's constituents

1 *EFRAG usually includes notes for EFRAG's constituents that provide background information to questions asked in an Exposure Draft. Such notes have not been included here, as the IASB has included similar information before each question in the Exposure Draft,*

Presenting the effects of changes in a liability's credit risk in profit or loss

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?

EFRAG's response to Questions 1

EFRAG supports the IASB's proposal that changes in the credit risk of all liabilities designated under the fair value option should not affect profit or loss.

2 In our comment letter on the IASB's Discussion Paper *Credit Risk in Liability Measurement,* we argued that changes in the credit risk of a liability (i.e. an entity's own credit risk), which is not held for trading purposes and not actively traded, should not be recognised in profit or loss. We consider that this would not provide relevant information to users. In addition, we argued that it might actually obscure information that is relevant. We believe that this is the case for financial liabilities designated under the fair value option, as these liabilities by definition are not held for trading purposes.[1]

3 Therefore, EFRAG agrees with the IASB's proposal that changes in the credit risk of liabilities designated under the fair value option should not affect profit or loss.

1 For more details on EFRAG's position regarding credit risk effects in liability measurements please refer to EFRAG's comment letter on the discussion paper "Credit Risk in Liability Measurements" published 23 September 2009 on our website (www.efrag.org).

Question 2

Or alternatively, do you believe that changes in the credit risk of the liability should not 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?

EFRAG's response to Question 2

EFRAG believes that generally changes in the credit risk of the liability should not affect profit or loss. However, in extremely rare circumstances where the fair value changes of financial assets are directly linked to an issuer's own credit risk, the effects of changes in the credit risk of the liability should be recognised in profit or loss if this reduces an existing accounting mismatch.

General

4 Paragraph BC19 of the Basis for Conclusions considers a situation in which assets measured at fair value through profit or loss are managed together with liabilities designated under the fair value option. It notes that some believe that in such circumstances the existence of an accounting mismatch might justify reporting in profit or loss of changes in the credit risk on the liability.

5 We note that accounting mismatch was one of the arguments in favour of reporting credit risk effects in profit or loss mentioned in the discussion paper "Credit Risk in Liability Measurement". That paper explained that it was often argued that the failure to include own credit risk in the measurement of liabilities can result in an accounting mismatch between the measurement of assets and liabilities.

6 EFRAG disagrees with that argument because:

(a) The credit risks inherent in the financial assets held by the entity and in its own liabilities are unlikely to be identical, as the credit risks of the former relate to the underlying investee and the latter relate to the reporting entity. There is therefore an economic mismatch.

(b) Although we agree that credit risk is included in fair value from the perspective of those that hold an entity's liability as an asset, we think the perspective of holders of those instruments and the perspective of those obligated to settle the instruments are fundamentally different.

7 Therefore, we generally believe that even if the elimination of an accounting mismatch is the reason why the entity designates a liability under the fair value option, it is inappropriate to report own credit risk effects from remeasurements of liabilities in profit or loss.

Interpretation of the term "credit risk"

8 We note that some of the concerns that the proposals in the ED may cause an accounting mismatch may be due to confusion about the meaning of the term "credit risk of financial liabilities" as it is used in the ED.

9 For example, we understand that there are concerns in the insurance industry that under the proposals in the ED an accounting mismatch could arise on unit-linked contracts. The fair value of such unit-linked contracts responds to changes in the credit risk on the underlying financial assets. Such changes in credit risk are not changes in own credit risk of the insurer. However, the concern is that the way the proposals in the ED are drafted means that the credit risk of financial liabilities includes the effects of changes in credit risk of the financial asset underlying the unit-linked contract. If this were the case, a mismatch would arise because changes in the credit risk on the financial asset would be reflected in profit or loss, while those on the unit-linked contract are reflected in the other comprehensive income.

10 We understand that this is not the intention of the ED. In addition, paragraph 10 of IFRS 7 makes clear that in the case of unit-linking features, the changes in the performance of the related internal or external investment fund are part of the changes in market conditions. Finally, we note that the recently issued FASB Exposure Draft *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* clearly distinguishes between fair value changes due to changes in own credit risk from the fair value changes caused by shifts in the price of credit which affects not just the individual entity.

11 We recommend that the IASB further clarify the wording of the ED to emphasise that only changes in value arising from changes in the risk of the entity not meeting its contractual obligations should be reflected in OCI.

Financial assets linked to an issuer's own credit risk

12 The fair value of some financial assets includes an element that reflects an entity's own credit risk. This can arise when the financial asset is a derivative over an entity's own credit risk. However, this also arises in some countries where a counterparty may be entitled to repay an entity by delivering bonds (or other financial instruments) issued by that entity in payment of a receivable with the same nominal value. In the latter case, the fair value of the financial asset includes an element that reflects an entity's own credit risk.

13 EFRAG believes that in the above examples an accounting mismatch could arise. Currently it is possible under paragraph AG4E of IAS 39 to account for the own credit risk on both financial assets and financial liabilities in profit or loss.

14 EFRAG believes that in extremely rare circumstances when financial assets are linked to an issuer's own credit risk, the effects of changes in the credit risk of the liability should be recognised in profit or loss if this reduces an existing accounting mismatch. However, an entity that recognises in profit or loss the effects of changes in own credit risk on financial liabilities should be required to disclose the impact.

Questions to constituents

15 *Do you agree with EFRAG's view concerning the accounting mismatch that arises in the case of financial assets that are linked to an issuer's own credit risk?*

16 *Are you aware of any other circumstances in which this type of mismatch arises?*

Presenting the effects of changes in a liability's credit risk in other comprehensive income

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?

EFRAG's response to Question 3

EFRAG agrees that the portion of the fair value change that is attributable to changes in the credit risk of the liability should be presented in OCI. However, we regret that no proper debate has taken place yet on fundamental issues related to performance reporting.

17 An approach to measure liabilities designated under the fair value option could be to exclude completely the effects of changes in the own credit risk in the measurement of the liability (a so-called "frozen credit spread" approach). EFRAG supported this approach in its response to the discussion paper "Credit Risk in Liability Measurements". However, as noted in paragraphs BC26 and BC27 of the Basis for Conclusions to the ED (and EFRAG received similar feedback directly) users are strongly opposed to such a measurement attribute. Based on these arguments EFRAG has re-evaluated its position and no longer favours this approach. EFRAG now believes that liabilities designated under the fair value option should be measured at the full fair value in the statement of financial position.

18 If the frozen credit spread approach is ruled out, the question arises where and how the portion of the fair value change that is attributable to changes in the credit risk of a liability designated under the fair value option should be presented. In its ED, the IASB considers the alternatives of:

(a) reporting that amount in profit or loss and immediately reversing it out (the two-step approach) versus recording the amount outside the profit or loss directly (the one-step approach) (questions 4 and 5);

(b) reporting the amount in OCI or in equity (question 6); and

(c) permitting or prohibiting reclassification of the amount reported in OCI to profit or loss (question 7).

Our detailed views on the above alternatives are presented in the responses to the corresponding questions.

19 Currently, IFRS does not set out principles that guide which items should be reported in OCI. EFRAG agrees that the portion of the fair value change that is attributable to changes in the credit risk of a liability should not be presented directly in equity. We regret that no proper debate has taken place yet on fundamental issues related to performance reporting such as (a) the notion of performance and the impact of business models on it, (b) the content of performance statement(s) and (c) recycling.

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?

EFRAG's response to Question 4

EFRAG does not support the two-step approach and argues that the introduction of such a new presentational method in IFRS is not justified. EFRAG believes that the additional transparency that the IASB aims for could be achieved by note disclosures.

20 We agree that information about (a) the fair value of the financial liability, (b) the total fair value change of the financial liability and (c) the portion of the total fair value change that is attributable to changes in the liability's credit risk, is useful to users.

21 While the two-step approach requires presentation of these items of information, it also introduces a new presentational method that requires items presented in profit or loss to be reclassified to OCI immediately.

22 Under current IFRS there are already three methods of presenting performance, i.e. recognition of gains and losses:

(a) in profit or loss

(b) in OCI without reclassification

(c) in OCI with reclassification to profit or loss at a later stage

We do not welcome the proposed introduction of a fourth method of presenting performance (i.e. recognition of gains and losses in profit or loss with reclassification to OCI) for a number of reasons.

23 Firstly, there does not appear to be a conceptual basis for the introduction of this additional approach to performance reporting. In our view, the fundamental conceptual issues related to performance reporting should be debated prior to deciding on their presentation.

24 Secondly, we do not believe this method of presentation is helpful to users of the financial statements. As mentioned in paragraph BC27 of the Basis for Conclusions "...almost all users told the Board that changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading...".

25 Thirdly, information about the total fair value change of the financial liability could easily be disclosed as part of the notes to the financial statements, thereby avoiding the need for a fourth method of presenting performance.

26 Finally, we believe that transparency could be achieved by disclosure of this information in the notes to the financial statements.

Question to constituents (in particular users of financial statements)

27 If you prefer the two-step approach, please explain why you believe it provides information that is more useful?

Question 5

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

EFRAG's response to Question 5

EFRAG believes that the one-step approach is preferable.

28 For the reasons mentioned in response to Question 4 above, we believe that the one-step approach is preferable.

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?

EFRAG's response to Question 6

EFRAG believes that the portion of the fair value change that is attributable to changes in the credit risk of the liability should not be recorded in equity.

29 EFRAG agrees with the IASB's observation in the Basis for Conclusions in paragraph BC34 (b) that remeasurements of assets and liabilities should not be presented directly in equity because remeasurements meet the definition of gains (or losses) and are not transactions with equity holders.

Reclassifying amounts to profit or loss

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?

Note for EFRAG's constituents

30 As explained below while majority of TEG members argued in favour of reclassification of own credit risk related gains and losses reported in OCI to profit or loss, a substantial minority was against reclassification. Therefore, EFRAG would like to draw constituents' attention to this question in particular. EFRAG will evaluate the arguments against and in favour of reclassification when finalising its comment letter.

EFRAG's response to Question 7

EFRAG considers that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income should be reclassified to profit or loss if the liability is extinguished before its maturity date.

31 Due to the lack of principles with respect to the use of OCI versus profit or loss views often diverge whether amounts that were initially recorded in OCI should ever be reclassified to profit or loss.

32 In this particular case, the majority of EFRAG members are of the opinion that the fair value changes that are attributable to changes in own credit risk should be recycled out of OCI to profit or loss if the liability is extinguished before its maturity date. At the same time, the minority of EFRAG members who were against reclassification was quite significant.

33 Those EFRAG members who are in favour of reclassification argue that:

(a) It is difficult to understand why derecognition of a debt instrument measured at amortised cost would result in gains and losses that are recorded in profit or loss, but if an entity records credit related gains and losses in OCI they will not be recycled to profit or loss if the debt is extinguished before its maturity.

(a) Amounts included in OCI should always be recycled into profit or loss as a matter of principle.

34 Other EFRAG members are not in favour of reclassification.

(a) Though some of these EFRAG members support reclassification of gains and losses generally, they do not support reclassification in this particular instance because when an entity extinguishes a liability before its maturity date, economically no gain (or loss) is realised as the entity would need to refinance at a higher (lower) rate.

(b) Some EFRAG members are of the opinion that reclassification from OCI should be prohibited as a matter of principle.

35 If the IASB decided to retain the prohibition on recycling, we note that the ED permits transfer of the cumulative gain or loss within equity. However, the Basis for Conclusions in paragraph BC32 suggests that the IASB will consider in its redeliberations of the proposals in the exposure draft whether to prohibit an entity from transferring the cumulative gain or loss within equity. While such restrictions may exist in some jurisdictions, we believe that the IASB should not impose such restrictions without first developing a conceptual basis for such a restriction.

Question to constituents

36 Are you in favour of reclassification of gains or losses resulting from changes in a liability's credit risk to profit or loss? If so, why? If not, why not?

Determining the effects of changes in a liability's credit risk

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?

EFRAG's response to Question 8

EFRAG believes that an entity should only be permitted to use a method for determining the effects of changes in the credit risk that provides a faithful representation of the amount of the change in the fair value that is attributable to changes in the liability's credit risk.

37 We agree with the proposal in the ED to carry forward the IFRS 7 default method for determining the effects of changes in the credit risk. However, we believe that entities should not be permitted to use the IFRS 7 default method if it does not provide a faithful representation of the amount of the change in the fair value that is attributable to changes in the liability's credit risk.

Effective date and transition

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?

EFRAG's response to Question 9

EFRAG agrees with the IASB's proposal to require that all previously adopted requirements in IFRS 9 have to be implemented when the entity adopts the amendments addressed in the ED.

38 In view of the particular circumstances caused by the financial crisis, the IASB decided to split the IAS 39 replacement project in phases and complete them one by one to be able to meet certain deadlines. However, one of the problems with such an approach is that it may result in significant incomparability among entities until all of the phases of the project are mandatorily effective.

39 To avoid creating an unnecessary lack of comparability, EFRAG agrees that an entity that wants to adopt early the amendments in the ED should be required to apply all requirements in IFRS 9 that it does not already apply.

Question 10

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

EFRAG's response to Question 10

EFRAG agrees with the proposed transitional provisions to apply the requirements retrospectively.

40 In line with EFRAG's long standing position, EFRAG supports retrospective application because we think it is very important for users to be able to compare the financial performance of an entity over time unless this is impracticable.

41 We did not identify any reasons why retrospective application should be impracticable in this case.

Appendix 2

Additional questions to constituents

Note for EFRAG's constituents

The Exposure Draft only focuses on accounting for own credit risk on liabilities that entities choose to measure at fair value. However, we would like to use this opportunity to solicit views of constituents on some overarching aspects of the new requirements for classification and measurement of financial instruments. Therefore, we would appreciate your responses to the questions set out in this Appendix, in addition to your comments on EFRAG's draft responses to the questions as set out in Appendix 1. This input will help EFRAG both in finalising its response to the current Exposure Draft as well as in further work on the financial instruments project, which may include commenting on FASB's Exposure Draft Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. This Appendix does not state views or positions of EFRAG.*

Questions concerning asymmetrical treatment of assets and liabilities in IFRS 9

42 This Exposure Draft proposes limited changes to classification and measurement requirements for financial liabilities set out in IAS 39 *Financial Instruments: Recognition and Measurement*. In particular, the IASB is proposing that all gains and losses resulting from changes in own credit risk from remeasurement of financial liabilities that an entity chooses to measure at fair value under the fair value option should not affect profit or loss.

43 By finalising the classification and measurement requirements for financial liabilities the IASB will complete the classification and measurement phase of the IAS 39 replacement project. (The remaining two phases of the project that the IASB is currently working on are the impairment methodology and hedge accounting.)

44 The IASB intends to finalise the classification and measurement phase of the IAS 39 replacement project such that the new financial instruments standard's requirements for classification and measurement of financial assets and financial liabilities will be different.

45 EFRAG understands that some constituents believe that this is an appropriate way forward. They do not think that, except for the issue of own credit risk, there is a need to change the existing requirements for financial liabilities. The problems with classification and measurement arose mainly on the asset side and the IASB has addressed them. Furthermore, some note that under IAS 39 classification and measurement requirements for financial assets are different from those for financial liabilities. These constituents believe that the fact that the differences will remain is justifiable in order to avoid many more liabilities being carried at fair value when such reporting would not produce relevant information.

46 Other constituents, however, argue that applying different classification and measurement principles depending on which side of the balance sheet the item is

located may increase complexity, result in lack of comparability and cause accounting mismatches (although the latter could be eliminated by applying the fair value option). Some of these commentators are particularly concerned that entities will not be able to bifurcate embedded derivatives from their hybrid financial assets but will be required to bifurcate hybrid liabilities. Furthermore, some point out that the existing IAS 39 requirements for bifurcation have been always criticised for their rule-based nature and the resulting application difficulties. These constituents argue that the new standard on financial instruments reporting should not carry forward the current requirements, but that new, principle-based, bifurcation requirements need to be developed.

Questions to constituents

Question 1

47 *Do you believe that that an asymmetrical treatment of assets and liabilities in IFRS 9 would negatively affect the quality of provided information? If so, please explain why. If not, please explain why not.*

Question 2

48 *Currently the rationale for bifurcating embedded derivative is that an entity should not be allowed to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in another contract. Since leveraged financial assets will be at fair value through profit or loss under IFRS 9, embedded derivatives will be reported in profit or loss as part of the total instrument. Therefore, there will be no need to have requirements to bifurcate embedded derivatives for reasons of anti abuse.*

49 *Should IFRS 9 nevertheless allow entities to bifurcate embedded derivatives? If so, why?*

Question 3

50 *If you believe that bifurcation should be allowed for hybrid financial assets, when and how should embedded derivatives be separated?*

Removal of a reliability exemption for derivative financial liabilities on unquoted equity instruments

51 When the IASB finalised IFRS 9 it decided to remove the reliability exemption for unquoted equity instruments and derivatives on unquoted equity instruments. Once financial liabilities are brought within the scope of IFRS 9, there will no longer be a reliability exemption for derivative financial liabilities on unquoted equity instruments.

52 Some constituents agree with this decision. They point out that, while IFRS 9 requires that fair value should be determined for all unquoted equity instruments (and all derivatives on such instruments), it also provides guidance for measuring such instruments and that guidance explains that cost can be representative of fair value in some circumstances. Furthermore, IFRS 7 *Financial Instruments: Disclosure*s will

require substantial disclosures that should enable users to appreciate the uncertainty around such valuations.

53 Others constituents disagree with the removal of the cost exemption because they are concerned this might result in measurement of financial assets and financial liabilities that is not sufficiently reliable.

Question to constituents

<u>Question 4</u>

54 Do you have any specific concerns about the fact that, as a consequence of the application of the IFRS 9 requirements to financial liabilities, there will be no reliability exemption for derivatives financial liabilities on unquoted equity instruments? If so, why?