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IASB ED/2010/4 Fair Value Option for Financial Liabilities

The ICAEW welcomes the opportunity to comment on EFRAG's draft comment letter, published in March 2009, on the International Accounting Standards Board Exposure Draft ED/2010/4 *Fair Value Option for Financial Liabilities*. Our responses to the main issues highlighted by EFRAG are set out below.

Question on paragraph 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?

We do not agree that an exception should be made to allow accounting mismatches to be presented in profit or loss. We agree with EFRAG's assessment that many of the concerns that the proposals may cause an accounting mismatch are due to confusion surrounding the meaning of the term 'credit risk'. If it is made clear that "changes in the credit risk of the liability" refers to the effect of the credit quality of the issuer on the financial liability rather than to credit risk more generally, mismatches should occur only rarely, if ever. It would reduce complexity if the standard does not address such rare situations.

If the alternative approach were to be adopted, then it should be made mandatory that the whole fair value movement of the liability is presented in profit or loss if presenting it outside profit or loss would give rise to a mismatch. Introducing an additional option would not be helpful.

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Question on paragraph 16: Are you aware of any other circumstances in which this type of mismatch arises?

The proposals as currently worded are of particular concern for the insurance industry. For certain products, such as unit linked business, it may not be desirable that a change in the market price of credit should necessarily result in the movement in the liability being taken to OCI. This is because the credit risk of the liability will not necessarily be the same as the credit risk of the issuer. We are concerned that a movement in market spreads that causes unit linked assets to fall in value would result in part of the corresponding fall in the value of the unit linked liabilities being taken to OCI, because it relates to a change in the market price of credit for the insurer. If the default method in IFRS 7 was used then this could result in a mismatch in the income statement.

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

We do not support the 'two-step' approach. In practical terms, including the number in both profit or loss and OCI potentially increases complexity and reduces understandability. The rationale for the two-step approach is to provide useful information, but this objective can be better met through note disclosure. Therefore we would support, as an alternative to the two-step approach, a requirement for note disclosure of the total fair value change of the financial liability, together with the amount that is due to own credit.

Question on paragraph 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?

We are unable to agree or disagree whether gains and losses should be reclassified. It is unfortunate that a clear conceptual case has not been made regarding the presentation of the elements of the performance statement. The question of whether or not recycling should be permitted is arbitrary in the absence of a clear articulation of the purpose of OCI. As a result there are different views relating to recycling and different treatments of items within IFRS. For example recycling is required on disposal of foreign investments in IAS 21 and prohibited on the disposal of an equity investment where the option has been taken to carry this investment at fair value through OCI under IFRS 9. Those who believe that net income should include all realised gains and losses support recycling in appropriate circumstances, believe that recycling should be required where a liability is derecognised before its maturity. In the absence of conceptual justification for the IASB's approach, the prohibition on recycling can be seen as an arbitrary rule. We note there is nothing in IFRS to prohibit the transfer of gains and losses from OCI to the profit and loss account reserve when the liability is derecognised. It may be useful for the application guidance to make this point.

Question 1: 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.

We do not believe that an asymmetrical treatment of assets and liabilities is possible, given that one entity's equity is another entity's financial asset, nor necessarily desirable since amortised cost often provides better information about the expected future cash flow for liabilities that will be settled. However, we have concerns about importing wholesale the remaining IAS 39 provisions without appropriate amendment. IFRS 9 is intended to be the enduring, less complex standard for financial instruments and as such, the benefits of reviewing, rationalising and aligning the language for financial liabilities as far as possible with that of financial assets, so that the standard works as a coherent whole, must exceed the costs in terms of the time needed to conduct this work and to conform the final standard. We recognise, however, that creating the best standard possible may be incompatible with meeting the June 2011 deadline.

Question 2: 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. Should IFRS 9 nevertheless allow entities to bifurcate embedded derivatives? If so, why?

Question 3: If you believe that bifurcation should be allowed for hybrid financial assets, when and how should embedded derivatives be separated?

In an ideal world, we would strongly encourage the Board to draft a standard for financial liabilities that uses the principles, language and concepts underlying IFRS 9 to the maximum extent possible. We believe it should be possible to revise the language, such that a bifurcation approach is based upon the characteristics of financial asset notion in IFRS 9, without significantly changing the underlying accounting for financial liabilities and thus retaining the bifurcation requirements. Although we understand the IASB believe that such an approach is likely to have the same outcomes as IAS 39, retention of the IAS 39 rules will result in inappropriate anomalies between holders and issuers of financial instruments. For example, the issuer would not have to bifurcate an embedded derivative which could result in less than double the rate of return but such a feature would result in the holder having to fair value the instrument. Similarly, it is not clear why an interest rate cap in a loan may result in an embedded derivative that requires bifurcation by the issuer of the loan but not result in the holder having to fair value the financial asset.

However, it should be recognised that some liabilities may contain equity-like features where the application of a bifurcation test based upon the characteristics of financial asset notion in IFRS 9 may not be appropriate, for example the ability to defer coupon payments. Such terms are not considered to be embedded derivatives in IAS 39 and although such instruments would be measured at fair value by the holder under IFRS 9 we do not believe such instruments should be measured at fair value under any modified proposals for financial liabilities.

Question 4: 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?

No, we are content for the requirements for financial liabilities to be aligned with financial assets in this area.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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