Our ref: ICAEW Rep 68/10

Your ref: ED/2010/4

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
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Dear Sir David

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

The ICAEW is pleased to respond to your request for comments on the Exposure Draft *Fair Value Option for Financial Liabilities.*

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

Yours sincerely

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ED/2010/4 *FAIR VALUE OPTION FOR FINANCIAL LIABILITIES*

Memorandum of comment submitted in July 2010 by the ICAEW, in response to the IASB's Exposure Draft *Fair Value Option for Financial Liabilities* published in May 2010.

Contents	**Paragraph**

INTRODUCTION

1. The ICAEW welcomes the opportunity to comment on the Exposure Draft *Fair Value Option for Financial Liabilities* published by the IASB.

WHO WE ARE

2. The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.

MAJOR POINTS

Support for the proposals

4. We agree with the proposals to exclude the effects of changes in own credit from profit or loss for liabilities designated under the fair value option. There appears to be general agreement, including from users, that presenting gains and losses arising from changes relating to the entity's own credit risk in profit or loss is counterintuitive, unless they result from trading activities, and undermines the usefulness of net income. We also agree with the Board that including such gains and losses in net income is appropriate where the financial liability is held for trading as reflective of their business model.

5. Since these gains and losses are not transactions with equity holders in their capacity as capital providers we agree with the proposals that they should not be presented directly in equity. Therefore, the only place they can be presented is in Other Comprehensive Income (OCI). However, we would note that it is difficult to recommend a specific presentation in the performance statement when there is no over-arching principle distinguishing the different elements of performance and hence what OCI is for. We strongly encourage the Board to address this issue as part of their Financial Statements Presentation project.

Proposals for financial liabilities

6. We note that the ED represents the only proposed changes to the accounting for financial liabilities. As a result, all of the other provisions of IAS 39 relating to financial liabilities would be imported directly into IFRS 9, including the need to bifurcate embedded derivatives where the specific requirements are met. We agree that, except for the treatment of gains and losses attributable to changes in own credit risk of financial liabilities designated at fair value, there were no significant issues arising for financial liabilities as a result of the financial crisis, that many are familiar with the accounting requirements for financial liabilities, including the embedded derivative rules, and that these requirements are operating satisfactorily in practice. We also agree that there need not be symmetry between assets and liabilities not least because equity, including embedded equity features, should be treated differently by the issuer and the holder.

However, we do not agree with the conclusion that the provisions of IAS 39 relating to financial liabilities should be included in IFRS 9 without amendment.

7. We believe that importing the provisions of IAS 39 without amendment, other than those proposed in the ED will result in a very different conceptual basis, approach and language being used for financial assets as opposed to financial liabilities. IAS 39 is a more rules-based approach than IFRS 9 and includes different definitions to describe similar concepts. For example IAS 39 includes the notion of ‘held for trading’, whereas IFRS 9 includes the notion of “held to collect contractual cash flows”. Both terms are used to describe the business model of the entity but are not necessary consistent with each other which may lead to confusion.

8. Therefore, 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 unless it could at least double the holder’s initial rate of return on the host contract and result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract, 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.

9. 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.

10. We recognise that creating the best standard possible may be incompatible with meeting the June 2011 deadline. 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.

RESPONSES TO SPECIFIC QUESTIONS

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?

11. We agree. We support the proposals to exclude the effects of changes in own credit from profit or loss for liabilities designated under the fair value option. There appears to be general agreement, including from users, that presenting gains and losses arising from changes relating to the entity's own credit risk in profit or loss is counterintuitive, unless they result from trading activities, and undermines the usefulness of net income. Including such gains and losses in net income is appropriate where the financial liability is held for trading as reflective of their business model.

12. However, we are concerned that it may not always be clear what is meant by 'changes in the credit risk of the liability', particularly for liabilities that are contractually linked to the performance of assets, for example unit-linked contracts and liabilities arising from securitisation structures. Some believe that the wording of the proposed standard would result in fair value movements relating to the credit risk of the related assets embedded within the liability being included in OCI, which we do not think is the IASB's intention. We would encourage the Board to make it clear that the objective of the proposals is to present the effect of fair value movements of the liability relating to the credit quality of the issuer within OCI and fair value movements of the liability related to non-issuer credit risks would be presented in profit or loss.

13. 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 (because of other factors such as regulatory framework etc). 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 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?

14. <u>No</u>. As we state in paragraph 12 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.

15. 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.

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?

16. Yes, by default. We agree that this portion of the fair value change should be presented outside profit or loss. As this change is not a transaction with equity holders in their capacity as capital providers it should not be presented directly in equity. Therefore, the only place it can be presented is in Other Comprehensive Income (OCI).

17. However, we consider that it is unfortunate that there is not yet conceptual clarity surrounding the presentation of items in the performance statements (or statement). It is difficult to recommend a certain presentation in the performance statement when there is no over-arching principle as to which items should go where and why, and particularly what OCI is supposed to represent.

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?

18. No. In practical terms, including the number in both profit or loss and OCI potentially increases complexity and reduces understandability. The profit or loss entry would be the reverse of the actual effect of own credit on fair value, so a fair value gain would appear as a debit and vice-versa. Although the description of this item should make it clear that this is a partial reversal of the total change in value; users less familiar with the requirements of the standard could find this presentation confusing. We do not support creating a precedent by effectively recycling from net income to OCI which would be unique to this situation.

19. 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 5: Do you believe that the one-step approach is preferable to the two-step approach? If so, why?

20. We believe that the one-step approach is preferable. As set out in our answer to question 4 we believe that the two-step approach is repetitious and adds complexity for no benefit to the user. However, we would suggest that note disclosure should be made of the total fair value change of the financial liability.

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?

21. No. As set out in the response to question 3, changes in the fair value of financial liabilities are not transactions with equity holders and therefore should not be presented directly in equity.

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?

22. It is not possible to answer this question because, as already noted, no clear conceptual case has yet 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 when a realisation event occurs, believe that recycling should be required where a liability is derecognised before its maturity. Others believe that all gains and losses should be reported only once and that the cash flow statement deals with realisation issues. In the absence of conceptual justification for the IASB's approach, allowing or prohibiting recycling is an arbitrary rule. (We note there is nothing in current 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 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?

23. As set out in the response to question 1, it is not always immediately obvious what is the issuer credit risk in a financial liability, so clearer articulation of this measurement attribute is required. In addition there can be difficulties in separating the effect of changes in the credit quality of the issuer from fair value changes resulting from other factors such as liquidity and the price of credit more generally. Therefore, we believe that the guidance in IFRS 7 should be modified slightly to first require entities to determine the amount of the change in fair value attributable to issuer credit risk in a manner than most faithfully represents the definition of the changes in issuer credit risk in a financial liability, even where that is different to the approach in IFRS 7. Where the method described in IFRS 7 is either the most appropriate or the only practical method then it should be used. In either scenario the methodology applied to determine the amount of the change in fair value attributable to issuer credit risk must be disclosed.

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?

24. We agree that entities should be able to elect to adopt the provisions early. The proposals are mainly about presentation and entities should be able to use IFRS 7 disclosures to restate comparative periods with little difficulty.

25. We understand the concerns about allowing implementation of different phases of the IFRS 9 project at different times. A plethora of alternatives for financial instrument accounting created by allowing entities to mix and match different parts of IFRS 9 and IAS 39 would not be helpful to comparability over a long transition period. Therefore, we are generally supportive of the requirement to adopt earlier phases of IFRS 9 if later phases are to be early adopted.

26. However, these proposals are relatively narrow and self contained and could be applied whether an entity is using IAS 39 or IFRS 9. They represent changes that many think will improve financial reporting by removing counterintuitive results from net income and are a presentational change. Therefore, we would support allowing these changes to be adopted fairly quickly and without a requirement also to adopt the existing IFRS 9. In fact, we believe there is a case for requiring the adoption of the change in a relatively short period after it is finalised, with earlier adoption permitted. This could be achieved by a making a limited amendment to IAS 39 in addition to including text in IFRS 9.

Question 10: Do you agree with the proposed transition requirements? If not, what would you propose instead and why?

27. We agree with the proposed transition requirements. In this situation, it seems clear that the benefits of achieving consistency between periods outweigh the costs. We believe that the disclosures prepared for IFRS 7 provide a useful starting point in computing the amounts to be recognised on adoption, however, we would not suggest prescription of the use of the IFRS 7 amounts where a more faithfully representative number can be obtained.

28. If these proposals were to be decoupled from the rest of IFRS 9 as suggested in the response to question 9, we also suggest that consideration should be given to allowing entities to reconsider their use of the fair value option for liabilities on transition. Before the recent market dislocation, the fair value option was used for financial liabilities with substantive embedded derivatives, which resulted in significant gains and losses relating to own credit. To reduce this problem, some entities made efforts to bifurcate embedded derivatives for similar liabilities issued after the market dislocation. If gains and losses related to the liability's credit risk are to be included in OCI, entities are likely to use the fair value option for subsequent liabilities. Entities may wish to use the fair value option for all similar liabilities and it would be helpful if the fair value option could be reopened to facilitate this. Such an approach would not only have operational benefits for these entities but it would make their financial reporting less complex as like items would be treated in the same way.

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