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Comments on ED Financial Instruments: Fair Value Option for Financial Liabilities

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16 July 2010

International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Dear Sirs:

Exposure Draft Financial Instruments – Fair Value Option for Financial Liabilities

I am pleased to provide, in my personal capacity, comments on the above exposure draft.

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?

I disagree that there should be a difference in the treatment for financial liabilities and financial assets that are designated under the fair value option, without a clear principle to explain or justify the differences in accounting. The basis of conclusions attributes the decisions to feedback received from its outreach programme (BC7 and BC8). While user preferences may be used to corroborate a central principle, they do not displace it. User preferences differ from time to time and there is a risk that standards may be moving away from the principles-based roots that the IFRS is known for. Further, in relying solely on user preferences, the robustness of the survey methodology, the adequacy of the sample size and the significance of the survey results, for example, must be clearly established. This is not to imply that survey of stakeholders is not important. The IASB should be lauded for reaching out to its constituents and for taking on board their concerns and comments. However, it is not clear what the conceptual "spine" of the ED is and one has to infer the implicit rationale. In summary, the ED supports full fair value on the balance sheet but differential treatment in the income statement for financial liabilities and financial assets. The latter raises some thorny issues.

Management for liabilities on a fair value basis is not different from that for assets. Fair value provides a common metric to evaluate exposures and performances at the entity level and it is unlikely that management would review financial assets differently from financial liabilities. Senior management is likely to evaluate risks and performance in a holistic manner and determine effects on a net basis with reference to net income.

Even when there is no "mismatch", there is a need to consider the merits of not recognizing full fair value changes in net income. A financial liability that contains an embedded derivative has the same economic substance as a combination of two separate instruments. However, the ED will lead to different impact on the income statement, depending on whether the derivative is issued as a separate instrument or as part of a hybrid instrument. In this respect, the accounting for hybrid financial assets is more robust than that of financial liabilities.

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?

Not applicable – refer Question 1.

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?

I do not agree. Without a conceptual framework to define and clarify the nature of net income and other comprehensive income, the ED is at risk of exacerbating the growing confusion surrounding "net income" and "other comprehensive income".

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?

The two-step approach is a relatively better approach than the one-step approach in that it mitigates (but does not eliminate) concerns raised in Question 1. The two-step approach:

- Recognizes that the change in fair value due to own credit risk should be recognized in the income statement in principle (even though it is backed out in the second step); and
- Provides information to users on the full fair value change and the impact on the income statement if there is no second step to back it out from the income statement.

Question 5

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

Not applicable – refer Question 4.

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?

No – the transactions between an entity and its lenders are not transactions among owners and the changes in the credit risk of the liability should not be presented 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?

The recycling of other comprehensive income in the ED should be consistent with the treatment of other comprehensive income across IFRSs. Given the existing framework, I agree with the ED's position but would encourage the IASB to provide greater clarity and consistency on issues relating to other comprehensive income, their differentiating characteristics and subsequent unwinding.

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?

The default method in IFRS 7 is a reasonable basis to determine the change in fair value that is attributable to changes in a liability's credit risk.

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?

I agree with the proposals on early adoption.

However, greater clarity can be provided on the proposals. The Board proposes that if an entity elects to apply requirements early, the entity must also apply all earlier requirements that it does not already apply. However, it is not clear if the reverse is true. If an entity applies an earlier requirement, is it obligated to apply all subsequent requirements on an early basis?

Question 10

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

I agree, on the basis that entities who invoke the fair value option would have the information from the application of the default method in IFRS 7 in an earlier period.

Yours sincerely

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