Australian Government

Australian Accounting Standards Board

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Sir David Tweedie
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Dear David

AASB comments on IASB Exposure Draft ED/2010/4
Fair Value Option for Financial Liabilities

The Australian Accounting Standards Board (AASB) is pleased to provide comments on Exposure Draft *Fair Value Option for Financial Liabilities* (ED/2010/4).

The AASB acknowledges that the global financial crisis has highlighted that users of general purpose financial statements require improved and simpler accounting for financial instruments. One concern that was highlighted was the perceived counter-intuitive nature of an entity recognising gains in profit or loss when its credit rating was deteriorating. This featured in the letter from G-20 leaders to the IASB and the recommendations of the Financial Crisis Advisory Group. However, the AASB considers that the concern regarding the impact of changes in credit risk is best dealt with via disclosure and does not support the IASB's proposals in ED/2010/4 on both conceptual and practical grounds.

The AASB believes that the proposal to separately present in other comprehensive income (OCI) changes in the fair value of financial liabilities designated at fair value through profit or loss (FVTPL) due to changes in credit risk does not remain faithful to the concept of FVTPL. The IASB is introducing a new measurement attribute, thereby creating further complexity and the potential for confusion in accounting for financial instruments. In addition, the AASB is concerned about the IASB introducing new requirements about presentation in OCI prior to the completion of its project on Financial Statement Presentation.

The AASB believes that it is unclear whether the IASB's proposal to eliminate the impact of credit risk from profit or loss refers to the general price of credit (that impacts an industry or economy) or credit risk that is specific to an entity. If the IASB is to require separate presentation of changes in fair value resulting from changes in credit risk, the AASB believes that the amount separately presented should only reflect changes in the credit quality of the issuer – that is, credit risk specific to the entity.

The methodology in IFRS 7 *Financial Instruments: Disclosures* poses practical difficulties for determining the effect of changes in credit risk specific to the entity because in most instances it will incorporate the impact of other factors that also lead to changes in interest spreads, including demand and supply for the financial instrument, market sentiment and traded volumes. The AASB is concerned that there are many situations in which it will not

be possible to identify the change in interest rate spreads relating to entity specific credit risk versus other market risks. Therefore, the AASB considers that the IFRS 7 methodology would only rarely be a reasonable proxy for determining the impact of changes in credit risk specific to an entity.

The AASB considers the IASB's decision to retain the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* in respect of the recognition and measurement of financial liabilities to be significant. The AASB notes that the FASB has undertaken a comprehensive review of its financial instruments requirements in Exposure Draft *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* and has sought comments on all aspects of the proposals. The AASB believes that constituents should have been provided with an explicit opportunity to comment on the IASB's proposal to retain the IAS 39 requirements in respect of financial liabilities and not just on the proposals pertaining to the presentation of changes in fair value due to changes in own credit risk.

In addition, the AASB notes the commitment made by the IASB and the FASB in the Memorandum of Understanding to "… issue comprehensive improvements … that will foster international comparability of financial information about financial instruments." The AASB also notes that the IASB has released a Request for comment on the FASB Exposure Draft, which is due for comment by 30 September 2010. The AASB does not believe that this is the process envisaged in the Memorandum of Understanding. The AASB considers that the different timing of the IASB and FASB proposals will require duplication of effort by the IASB and its constituents in striving for converged outcomes on financial instruments. The AASB urges the IASB and FASB to better coordinate their efforts and make best use of limited standard setting resources and the limited time available to constituents to comment on proposals.

The AASB encourages the IASB to be mindful of the cross-cutting issues raised by ED/2010/4 and trusts that its comments will be helpful to the IASB in making progress on a consistent and balanced manner in respect of the topics of both financial instruments and financial statement presentation.

The AASB views, as summarised above, are explained in more detail in Appendix A.

If you have any queries regarding any matters in this submission, please contact us.

Yours sincerely

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Australian Accounting Standards Board

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Appendix A

Scope of proposals on own credit risk

(Broadly relates to ED/2010/4 Question 1)

1. The Financial Crisis Advisory Group (FCAG) made the following comments in its report:

   "...reporting gains in profit or loss seems counterintuitive and may not provide relevant, decision-useful information when the gain results from a change in the credit risk of the borrower rather than from the general price of credit, especially when the borrower lacks the ability to buy its own debt and actually realize the gain."

2. Accordingly, the main concern of the FCAG is with presenting in profit or loss changes in fair value due to changes in credit risk when entities do not have the ability and opportunity to buy back their own debt, which appears to be much narrower in scope than the proposals in ED/2010/4. If the proposals were narrowed along the lines of the FCAG report, they would exclude debt instruments designated at fair value that are widely traded.

3. Furthermore, while the FCAG comments seem to be focussed on changes in entity-specific credit risk, the scope of ED/2010/4 addresses a broader notion that includes movements in industry or economy-wide credit risk.

4. The AASB considers that the concern regarding the impact of changes in credit risk is best dealt with via disclosure and does not support the IASB's proposals. Given that the impetus for the IASB's ED/2010/4 proposals are recommendations such as those made by the FCAG, rather than for any conceptually-based standard setting purpose, if they are to proceed, they should be limited to responding to those recommendations. Accordingly, the AASB believes that, if the IASB proposals were to proceed, they should only apply to the impact of the entity's own credit risk and only when the entity lacks the ability to buy back its own financial liabilities.[1] If the IASB goes beyond this limited scope, the AASB believes that the IASB should explain why it has not adhered to the FCAG recommendations.

Focus on financial liabilities measured using the fair value option

(Broadly relates to ED/2010/4 Question 1)

5. The AASB notes that a reason given by the IASB for only addressing effects of changes in own credit risk in respect of financial liabilities designated under the fair value option is because the issue of credit risk would remain only in the context of those financial liabilities. Paragraph BC11 notes that most liabilities "...would continue to be subsequently measured at

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1 For an entity to be in a position to buy back its own financial liabilities, there would probably need to be an active market for those instruments.

amortised cost or would be bifurcated into a host, which would be measured at amortised cost, and an embedded derivative, which would be measured at fair value. Liabilities that are held for trading (including all derivative liabilities) would continue to be subsequently measured at fair value through profit or loss, which is consistent with the widespread view that all fair value changes for those liabilities should affect profit or loss."

6. The AASB considers that, for the proposals to result in useful and conceptually consistent outcomes, they need to be the subject of a comprehensive review and it is inappropriate to focus only on financial liabilities designated at FVTPL. Credit risk plays a role in determining the value of all liabilities measured at fair value or using another current value basis, such as liabilities measured in accordance with IAS 17 *Leases*, IAS 19 *Employee Benefits* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* - not only financial liabilities at FVTPL. The AASB believes that if the IASB considers it is appropriate to address issues regarding the impact of own credit risk, it should address those issues from a conceptual perspective. Otherwise, the IASB risks proliferating the number of measurement bases in IFRSs, adding to the complexity and confusion faced by preparers and users of financial statements.

Treatment of impact of changes to own credit risk
(Broadly relates to ED/2010/4 Questions 1, 2, 3, 6 and 7)

7. Whilst the AASB understands the argument that the proposals might help eliminate the perceived counter-intuitive recognition of gains in profit or loss from declines in the fair value of financial liabilities resulting from increased credit risk, the AASB does not support the IASB's proposals. The AASB believes that the proposals will result in inconsistent application of measurement bases across liabilities carried at a current value and measurement of amounts in profit and loss and OCI that individually have no clear known measurement attribute. Unless attributes are clear, it is not possible to explain the meaning of the recognised amounts.

8. The AASB considers that, if an entity elects to measure assets or liabilities at fair value, the basis of measurement in both the balance sheet and the income statement should remain faithful to the concept of fair value. That is, once an entity applies the FVTPL measurement basis, and a movement is recognised, that basis should not be corrupted by 'recycling' some of the fair value movements to or from OCI.

9. The feedback received from the IASB's outreach programme suggests that a justification for the IASB's proposed approach is that, unless the liability is held for trading, the entity will generally not realise the effects of changes in the liability's credit risk and as such, those effects should not affect profit or loss. The same could be said of provisions measured in accordance with IAS 37, but the IASB is not proposing to deal with provisions within ED/2010/4. Further, the AASB does not believe that this is a valid basis for presenting a component of fair value change in OCI. If anything it is an argument for presenting all fair value changes in OCI or not recognising them at all (that is, using a cost model).

10. The FASB ED *Accounting for Financial Instruments, Revisions to the Accounting for Derivative Instruments and Hedging Activities* (FASB ED) proposes that changes to the fair value of financial liabilities can be presented either in profit or loss or in OCI depending on the entity's business model. That is, for financial liabilities measured at FVTPL, the change in fair value is all recognised in profit or loss and a significant change in credit standing is separately identified within profit or loss. On the other hand, for financial liabilities that are measured at fair value through OCI (FVTOCI) all changes in fair value are recognised in OCI, with separate presentation of the portion that is a result of a significant change in credit standing in OCI. These proposals do not change the location of a change in fair value due to credit risk, and therefore remain true to the measurement attribute – either FVTPL or FVTOCI. Accordingly, the AASB considers the FASB proposals to be more consistent than the IASB's proposals in the application of fair value measurement attributes (see comments in paragraphs 7 and 8 of this Appendix). Therefore, the AASB recommends that the IASB consider the measurement basis of the liability in determining what should be done with the entire change in fair value and not just the credit risk component, especially given the concerns with determining the amount of the fair value change associated with changes specifically in own credit risk.

11. Nevertheless, the AASB would not support the IASB expanding the use of FVTOCI as a measurement basis (per the FASB ED), or for the presentation of fair value changes due to credit risk changes, until a comprehensive review of the presentation of items in OCI is undertaken. The AASB understands that the IASB's project on Financial Statement Presentation will address issues about the presentation of comprehensive income.

12. The AASB notes that there are entities that apply IFRSs, each of whose financial assets and financial liabilities (designated at FVTPL) are impacted by the same source of creditworthiness. For example, some entities hold debt that is secured against particular assets, and the same credit risks affect the fair values of both the liabilities and assets. Therefore, the impacts of changes in credit risk may largely offset one another. Similarly, some entities' financial liabilities and assets are affected by changes to the credit of a single government. Therefore, changes in credit risk associated with a change to the creditworthiness of the government will affect the financial assets and financial liabilities of the entity, thereby largely offsetting one another. In these cases, it would be inappropriate to report a net profit or loss effect from separately recognising credit risk associated only with financial liabilities in OCI. Not only would this separate presentation result in an artificially increased profit or loss volatility (which is inconsistent with the objective of ED/2010/4), but it would also not give a useful reflection of the financial risks to which the lender is exposed. These circumstances demonstrate the dangers of the asymmetry of thinking that underlies ED/2010/4.

13. In addition, the AASB believes that recycling undermines the notion that items of revenue are 'income' and items of expense are 'expenses' regardless of where they are presented in the statement of comprehensive income, and therefore does not support the proposal to reclassify amounts to profit or loss. The AASB notes that its view is consistent with the basis for recognising gains or losses on investments in equity instruments in OCI, where the instruments are not held for trading purposes (paragraphs 5.3.1 and B5.12 in Appendix B of IFRS 9).

14. Therefore, before progressing the proposals in ED/2010/4, the AASB would strongly encourage the IASB to consider and address some fundamental questions:

    (a) what is the purpose of OCI and its separation from 'earnings';

    (b) what are the characteristic and meaning of items presented in OCI; and

    (c) should there be any recycling from OCI to profit or loss or vice versa and, if so, what characteristics would items need to possess to qualify for recycling?

15. The AASB does not support presenting changes in credit risk in equity because such amounts do not represent a transaction between the entity and equity holders.

16. In addition, the AASB believes that, if the proposals were to proceed, the IASB should consider introducing a further requirement into the proposals. The AASB suggests that

entities should be prohibited from presenting the impact of changes in credit risk in OCI if doing so would compromise the users' understanding of the financial statements. In such instances, entities should be required to present the entire change in fair value of those liabilities in profit or loss. The AASB believes that this approach would help to alleviate some of the concerns raised about the proposals, such as that noted in relation to situations where the credit rating of the lender and borrower are the same (as discussed in paragraph 12 of this Appendix).

Two-step or one-step approach

(Broadly relates to ED/2010/4 Questions 4 and 5)

17. The AASB notes that ED/2010/4 discusses two approaches:

    (a) two-step approach – which initially records the entire fair value movement in profit or loss, and subsequently transfers the portion of the fair value that relates to changes in own credit risk to OCI – therefore, presenting the gains or losses in two locations; and

    (b) one-step approach – which only presents the gains or losses associated with changes in own credit risk directly in OCI. It is proposed that these amounts would not be recycled back to profit or loss even when the instrument has been realised.

18. The AASB considers that;

    (a) the two-step approach does not provide any more useful information than the one-step approach;

    (b) it is not appropriate to transfer or recycle amounts between profit or loss and OCI; and

    (c) it adds complexity to IFRSs and introduces a new method of presentation.

19. As discussed in paragraph 8 of this Appendix, the AASB believes that recycling undermines the notion that items of revenue are 'income' and items of expense are 'expenses' regardless of where they are presented in the statement of comprehensive income.

Determining the impact of changes in credit risk

(Broadly relates to ED/2010/4 Question 8)

20. The AASB notes the IASB's intention to use the methodology in IFRS 7 *Financial Instruments: Disclosures* that attributes the change in fair value of financial liabilities to changes in the benchmark rate and changes in the entity's credit risk.

21. The IASB has acknowledged the difficulty in determining the impact of own credit risk, and notes that whilst the methodology prescribed in IFRS 7 does not deduce an exact measure of the impact of own credit risk, there is support for the methodology as a reasonable proxy.

22. The IASB notes the views of some in paragraph BC45 to ED/2010/4 that the change in fair value of a liability due to a change of credit risk should only reflect changes in the credit quality of the issuer and not the price of credit or liquidity risk, which also affects other entities in the industry and the economy. The AASB supports this view and considers that, in most cases, the IFRS 7 methodology is almost certain to incorporate the impact of other factors that also lead to changes in interest spreads, including supply and demand for the financial instrument, market sentiment and traded volumes. The AASB is highly concerned that there are many situations in which it is not possible to identify the change in interest rate spreads between credit risk and other market risks relating only to an entity's own credit risk. Therefore, the AASB does not support the use of the IFRS 7 methodology as a proxy for determining the impact of credit risk.

23. These concerns are consistent with the sentiments expressed in the FASB ED. The FASB is clear in its ED that the focus of its proposals is the credit risk change related only to the entity. In addition, the FASB ED rejects the IFRS 7 methodology as a reasonable proxy for determining own credit risk. Instead, the FASB ED does not prescribe a method for determining the change in fair value attributable to a change in an entity's own credit standing. It notes that there may be several different methods to determine the change in fair value excluding the change in the price of credit, and includes possible methods for isolating own credit risk in an Appendix.

24. If the proposals were to proceed, the IASB should provide more guidance regarding the appropriate benchmark rate that forms part of the IFRS 7 methodology. That is, whether the price of own credit risk should be determined based on the issuer's own credit spread relative to:

    (i) an overall market benchmark rate;

    (ii) the prevailing rate for a particular sector;

    (iii) the prevailing benchmark rate for the next highest credit rating in the particular sector or

    (iv) the risk-free rate (such as a government bond rate).

Transition requirements

(Broadly relates to ED/2010/4 Questions 9 and 10)

25. The AASB is concerned with the interaction between the transition requirements in respect of financial liabilities in IFRS 9 and the proposed requirements in ED/2010/4. The transition requirements in IFRS 9 allow entities to designate or de-designate retrospectively financial liabilities measured at fair value through profit or loss (paragraph 8.2.9 of IFRS 9).

26. In contrast, ED/2010/4, paragraph BC51, states "...the exposure draft does not allow entities to make new designations or revoke its previous designations as a result of the proposals..." on the basis that there has not been a change to the classification or measurement approach for financial liabilities. While this is the case for the measurement of financial liabilities designated at FVTPL in the balance sheet, there is certainly an impact on profit or loss resulting from the IASB's proposals that had preparers been given these proposed rules at the time they originally chose to designate then some preparers would have possibly made a different decision to not designate. As such, the AASB believes that entities should be provided with the opportunity to reassess whether, in light of new accounting requirements, their accounting policy elections for financial liabilities should be revisited. It is disingenuous of the IASB otherwise to impose a new treatment on financial liabilities (that is, treating the gains / losses differently) without giving preparers the same opportunity again as they had initially when choosing their designations. Accordingly, entities should be allowed to designate or de-designate financial liabilities if the IASB effectively changes the basis on which liabilities designated at FVTPL are treated.

27. Therefore, the transition requirements in ED/2010/4 should be reconciled with the transition requirements for financial liabilities in IFRS 9 to allow the designation, re-designation or de-designation of financial liabilities if the proposals are progressed.

Other comments – due process

28. The AASB is concerned by the approach adopted by the IASB for developing the accounting requirements for financial liabilities. The decision to retain the requirements in IAS 39 in respect of financial liabilities is significant given both the IASB's objective to review comprehensively the requirements for financial instruments and the direction that the FASB has taken. For example, consider the asymmetrical accounting for embedded derivatives in asset and liability hosts. The FASB proposes symmetry by disallowing bifurcation for both asset and liability hosts. The AASB believes that the IASB should clearly justify its change

of decision to not address comprehensively financial liabilities by requiring embedded derivatives to be taken into consideration when classifying assets (that is, the hybrid instrument is classified and measured in its entirety) but not when classifying liabilities. This will create asymmetry in the profit or loss is some situations where the entire asset is carried at fair value (incorporating credit risk) but the entity chooses to not carry the liability at fair value (removing credit risk), exacerbated by the fact that financial liabilities carried at fair value cannot include credit risk under these proposal.

29. Whilst the AASB does not necessarily disagree with the proposed outcome (because we consider the choice of separating embedded derivatives should be allowed for both financial assets and financial liabilities), it believes that constituents should have been provided with an explicit opportunity to comment on the IASB's proposal to retain the IAS 39 requirements in respect of financial liabilities and not just on the proposals pertaining to the presentation of changes in fair value due to changes in own credit risk.