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Project	<b>Fair value option for financial liabilities</b>
Topic	<b>Exposure draft comment letter summary</b>

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## Purpose of this paper

1. In May 2010 the Board published the exposure draft *Fair Value Option for Financial Liabilities* (ED). The comment period ended on 16 July 2010. This paper provides a summary of the 108 comment letters that were received by that deadline.
2. We continue to receive letters. In total, 125 responses have been received as of the date of the posting of this paper. If we identify UUUadditional issues in the letters received after the comment deadline, we will provide an update to the Board at a later meeting.
3. In addition to responding to the questions in the ED, many respondents provided general comments. In this paper, we have summarized those general comments first and then addressed the responses to the questions in the ED. This paper provides a high level summary. During re-deliberations, we will include a more detailed analysis of each issue in the relevant agenda paper.
4. Before issuing the ED, the staff undertook extensive outreach activities with users of financial statements. This included a questionnaire, to which we received approximately 90 responses. A follow-up questionnaire was posted on the IASB webpage to solicit feedback on particular aspects of the ED from users of financial statements. As of 16 July we had received 12 responses from users to that questionnaire and this paper includes that feedback. The feedback received from the user questionnaire is clearly identified in this paper so that board members can distinguish it from the feedback received from the comment

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This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in *IASB Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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letters. The feedback received from all of our outreach activities with users before and after issuance of the ED is similar, with the exception noted below in paragraph 44 regarding recycling.

**General comments**

5. Many respondents expressed broad concerns about the project:
  - (a) the meaning of the phrase ‘changes in a liability’s credit risk’;
  - (b) the Board’s decision to carry forward most of the guidance in IAS 39 *Financial Instruments: Recognition and Measurement* for measuring financial liabilities and the resulting asymmetry between the measurement requirements for financial assets and financial liabilities;
  - (c) the interaction between this project and other ongoing projects on the Board’s agenda; and
  - (d) convergence between the IASB and the FASB.

***Meaning of ‘changes in a liability’s credit risk’***

6. If an entity has designated a financial liability under the fair value option (FVO), IFRS 7 currently requires the entity to disclose the amount of the change in the fair value of the liability that is attributable to changes in the liability’s credit risk. IFRS 7 defines *credit risk* as ‘the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.’
7. IFRS 7 also contains application guidance on how to measure the effects of changes in a liability’s credit risk (paragraph B4) and an example of how that guidance could be applied in practice (IG7-IG11).
8. However, some respondents expressed concern that the meaning of *credit risk* currently is not consistently interpreted in practice. Those respondents urged the Board to provide additional guidance to more clearly explain the principle that

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underlies the identification of changes in credit risk. They urged the Board to discuss in any finalised guidance what factors should be included in the determination of the effects of changes in a liability's credit risk—and which factors should be excluded from that determination. For example, respondents asked for clarification on the following topics:

- (a) The difference between the **credit risk of the entity** and the **credit risk of the liability**—eg, some respondents asked whether liabilities issued by a consolidated special purpose entity have credit risk if those liabilities only “pass through” to an investor the cash flows of specified (ring-fenced) assets.
- (b) Whether liabilities with **unit-linking features** have credit risk.<sup>1</sup>
- (c) Whether **contractual terms that are triggered by a change in the entity's financial health** (eg deterioration in its credit rating) should be included in the determination of the liability's credit risk—eg some liabilities have features that increase the rate of contractual interest payable if the issuer's credit rating deteriorates.

9. One reason for the diversity in the interpretation of the term *credit risk* seems to be that IFRS 7 permits a default method for determining the effects of changes in a liability's credit risk, which attributes all changes in fair value, other than changes in a benchmark interest rate, to changes in the credit risk of the liability. Some respondents noted that in some cases the default methodology can be an imprecise estimation of the effects of credit risk and, therefore, causes confusion about the meaning of the term *credit risk*.<sup>2</sup> However, most respondents believed

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<sup>1</sup> We note that paragraph 10 of IFRS 7 says that for contracts with unit linking features, changes in the performance of the related internal or external fund are not changes in the liability's credit risk.

<sup>2</sup> We note that in the Basis for Conclusions on IFRS 7, the Board acknowledges that quantifying the change in a liability's credit risk might be difficult in practice and that it believes that the default method provides a reasonable proxy for changes in the liability's credit risk. We also note that IFRS 7 permits an entity to use a different methodology if it more faithfully represents the effects of changes in the credit risk of the liability.

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that the approach in IFRS 7 was a pragmatic approach that reflected the difficulty in isolating the effects of changes in a liability's credit risk.

***The Board's decision to carry forward most of the guidance in IAS 39 for measuring financial liabilities***

10. The Board decided to retain most of the existing classification and measurement requirements in IAS 39 for financial liabilities. (The Board's rationale for that decision is described in paragraphs BC5-BC13 of the ED.)
11. Many respondents agreed that the Board's decision was a pragmatic and suitable solution—and agreed that none of the alternative approaches explored by the Board for the subsequent measurement of financial liabilities was less complex or would result in more useful information than the existing requirements in IAS 39. Those respondents also agreed that the accounting issues arising during the financial crisis related primarily to financial assets and noted that there is no pressing need for fundamental changes to IAS 39's measurement model for financial liabilities. However, a few respondents who agreed with the Board's decision to maintain the requirements in IAS 39 requested that the Board add a project to its post-2011 agenda to simplify and improve the bifurcation requirements in IAS 39 to address particular practice problems.
12. However, some respondents did not agree with the Board's decision to carry forward the guidance in IAS 39 for measuring financial liabilities. Most of those respondents said that there should be some symmetry between how an entity measures its financial assets and financial liabilities. They encouraged the Board to either:
  - (a) permit bifurcation of financial **assets** (since the Board has decided to retain bifurcation for financial **liabilities**); or
  - (b) develop a bifurcation methodology for financial liabilities that uses the two classification conditions in IFRS 9 *Financial Instruments* .

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13. Almost all respondents agreed that the Board's decision to maintain the existing requirements was a better solution than applying the requirements in IFRS 9 to financial liabilities.
14. A few respondents noted that they disagreed with the Board's decision to eliminate the cost exception for derivative liabilities that will be physically settled by delivering unquoted equity instruments whose fair values cannot be reliably determined. Consistent with the feedback received on the July 2009 exposure draft *Financial Instruments: Classification and Measurement*, those respondents believe that it is very difficult to measure such derivatives at fair value and the costs of estimating their fair values exceed the benefits of that information.
15. A few respondents noted that the Board should have solicited comments on its decision to maintain most of the existing requirements for measuring financial liabilities. (This comment was made both by respondents who agreed with the Board's decision and those who did not agree.)

***Interaction with other projects***

16. Some respondents expressed concern about the interaction between the proposals in the ED and other projects being considered by the Board. Specifically, respondents stated:
  - (a) **Conceptual Framework/Financial Statement Presentation**—The proposals in the ED expand the use of 'other comprehensive income' (OCI) and introduce a new interaction between profit or loss (P&L) and OCI (ie amounts are presented in P&L and subsequently 'backed out' and presented in OCI), but the Board has not yet addressed OCI comprehensively, specifically (1) the attributes that distinguish items in P&L from items in OCI and why that distinction is important and (2) whether recycling from OCI to P&L is appropriate and if so, under what circumstances.

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- (b) **Insurance -phase II**—Insurance companies are concerned about facing two rounds of major change in a short period of time if the mandatory effective date of any aspect of IFRS 9 proceeds the mandatory effective date of any new IFRS on insurance. Moreover, some insurers are concerned about the scopes of IFRS 9 and any new IFRS on insurance—eg some were concerned about whether particular liabilities, such as participating investment contracts, will ultimately be within the scope of IFRS 9 or the insurance standard.

***Convergence between the IASB and FASB***

17. Some respondents noted that they appreciated that the IASB is mindful of convergence and has asked its constituents to provide feedback to the FASB on the proposals in the FASB's exposure draft. However many of those respondents are concerned with the apparent deepening divergence between the IASB and the FASB in their proposals for financial instruments and noted that it is unclear what level of convergence the boards can achieve, given their different conclusions to date. Those respondents said that convergence must remain a top priority and urged the boards to work towards further convergence in financial instruments accounting.
18. Most of the respondents who commented on convergence supported the IASB's 'mixed measurement' model. However a few respondents expressed concern that the IASB is proceeding with proposals that might not result in globally converged standards.

**Responses to questions in the ED**

19. This section provides a high-level summary of the responses to the questions in the ED. As noted above, we will provide more detailed analyses of comments relating to these issues in topic-specific agenda papers.

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***Should changes in a liability's credit risk affect profit or loss? [Question 1 and 2 in the ED]***

20. For all liabilities designated under the FVO, the ED proposes that changes in the liability's credit risk should not affect P&L. However, the ED also proposes an alternative view whereby changes in the liability's credit risk should not affect P&L **unless** such treatment would create a mismatch in P&L (and, in this case, the full fair value change would be presented in P&L).

*General approach*

21. Most respondents agreed with the proposals that the effects of changes in a liability's credit risk ought not to affect P&L unless the liability is held for trading.<sup>3</sup> That is because the entity generally will not realize the effects of changes in the liability's credit risk unless it is held for trading. Those respondents said that reporting in P&L the portion of the fair value change attributable to changes in the liability's credit risk is counter-intuitive, confusing, and does not result in useful information. They noted that preparers often disregard those gains and loss for their internal analyses and users of financial statements also disregard such gains and losses.
22. However, some respondents disagreed with the proposals and expressed a preference to keep the current requirements, which require that the entire fair value change is reported in P&L (**including** the portion attributable to changes in liabilities' credit risk). Those respondents gave various reasons for their view including:
- (a) The proposals would create significant mismatches in P&L for some entities. Rather than develop a 'patch' to address those mismatches (eg, the alternative view described below), the Board should revert to the existing requirements for the FVO in IAS 39.

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<sup>3</sup> Many respondents noted that their views were consistent with their responses to the discussion paper *Credit Risk in Liability Measurement*.

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- (b) The FVO is a choice. If an entity does not want the effects of changes in liabilities' credit risk in P&L, it can choose not to apply the FVO. But if an entity elects to use the FVO, it should be required to present the entire fair value change in P&L.
  - (c) Presenting a portion of the fair value change in OCI is creating a new measurement attribute. In other words, it is inconsistent with the notion of 'fair value through profit or loss'. Rather than excluding those amounts from P&L, the Board should require them to be separately presented within P&L (consistent with the FASB's proposals). This would allow users of financial statements to easily identify the amounts and exclude them from their analysis if they want.
  - (d) It is very difficult to isolate the effects of changes in credit risk and the measurement methodologies often result in 'crude' estimations. That estimation error should not be captured outside of P&L (ie it should not be presented in OCI).
  - (e) The proposals are increasing complexity by removing controversial items from P&L and transferring them to OCI.
23. Also, some respondents were disappointed that the Board decided not to propose the 'frozen credit spread method' (described in paragraph BC6(b) in the ED) to address the credit risk issue. These respondents believe that changes in the liability's credit risk should not affect the performance statement **at all**—ie not P&L **or** OCI. These respondents also noted that the proposals will create significant volatility in OCI and raise difficult questions about recycling—and the frozen credit spread method avoids those issues. However, respondents who would have preferred the frozen credit spread method generally agreed that the proposals in the ED were an improvement to the current requirements in IAS 39.

*Mismatches in profit or loss*

24. Many of the respondents who agreed that the effects of changes in liabilities' credit risk should not affect P&L acknowledged that those proposals could



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create an accounting mismatch in P&L in some rare cases. There were differing views on how to address those mismatches.

(a) Some respondents agreed that the alternative view is an acceptable solution. However, some of those respondents viewed the alternative view as an ‘exception’ and noted that it needs to be (a) required (not optional) if presenting the effects of changes in a liability’s credit in P&L would create a mismatch and (b) sufficiently narrow and robustly described such that it would only capture circumstances where an entity would have a true mismatch if it presented the effects of changes in the liability’s credit risk in P&L.

(b) However, others did not support the alternative view. Rather, they believe that all liabilities designated under the FVO should be treated in the same way (ie effects of changes in liabilities’ credit risk should be presented in OCI). They were concerned that the alternative view would create additional complexity and decrease comparability – both among different entities and within the same entity if the entity applied the alternative view to only some of its liabilities designated under the FVO. These respondents suggested that information about mismatches could be described in the notes to the financial statements.

25. Other respondents did not support the alternative view because they were not convinced that mismatches would occur. They acknowledged that the default method for determining the effects of changes in credit risk (described above in paragraph 9) could give rise to mismatches because that method captures changes in the price of credit, which also affects financial assets measured at fair value. But these respondents were skeptical that ‘true’ mismatches would occur because they think that there is rarely (or never) a direct link between changes in

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the credit risk of an entity's liabilities and changes in the credit risk of the assets held by the entity.<sup>4</sup>

26. Finally, as noted above, a few respondents said that the proposals would create significant mismatches in P&L for some entities and, therefore, the Board should revert to the existing requirements for the FVO in IAS 39 rather than pursuing the alternative approach. However, if the Board decides to pursue the proposals in the ED, these respondents would support the alternative view.

[We plan to address the issue of mismatches with the Board in September. At that meeting, we will provide additional information about the types of mismatches that were identified by respondents and respondents' views on addressing those mismatches.]

***Where should the effects of changes in a liability's credit risk be presented? [Questions 3 and 6 in the ED]***

27. The ED proposes that the portion of the change in a liability's fair value attributable to credit risk is presented in OCI. An alternative view was to present that amount directly in equity.
28. Most respondents who agreed that the effects of changes in a liability's credit risk should not be included in P&L agreed with the proposal to present those amounts in OCI. However, some of those respondents were concerned about expanding the use of OCI without a comprehensive review of OCI, (as we discussed above in paragraph 16(a)). Despite those concerns, these respondents concluded that OCI is the best pragmatic solution.
29. Almost no respondents were in favour of presenting changes in a liability's credit risk in equity because those amounts do not represent transactions with equity holders. They noted that changes in a liability's credit risk should be presented in the performance statement, consistent with all other asset and liability remeasurements.

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<sup>4</sup> Several comment letters discuss scenarios where a 'true' mismatch would occur. As noted above, at a subsequent meeting we will provide additional information about the types of mismatches that were identified.

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30. However, a few respondents believe that the portion of the fair value change attributable to changes in a liability's credit risk should be reported directly in equity because the change should not affect the entity's performance but does serve as an indicator of the entity's economic strength.

31. In their responses to the user questionnaire, most users thought that presenting the effects of changes in liabilities' credit risk directly in equity would **not** provide more useful information. Those users who provided comments generally thought that direct transfers to equity do not provide useful information. However, one user noted that the effects of changes in liabilities' credit risk is 'undue noise' regardless of whether those amounts are presented in P&L, OCI or equity.

***Should the effects of changes in a liability's credit risk be reflected in the performance statement via a 'one-step' or a 'two-step' approach? [Questions 4 and 5 in the ED]***

32. The ED proposes a two-step approach to present the portion of the fair value change attributable to changes in the liability's credit risk in the statement of financial performance. In the first step, the entity would present the entire fair value change in P&L. In the second step, the entity would 'back out' from P&L the portion of the fair value change attributable to changes in the liability's credit risk and present that amount in OCI. An alternate one-step approach was presented in the ED whereby the effects of changes in liabilities' credit risk would be reported directly in OCI.

33. Most of the respondents preferred the one-step approach. They pointed out that the one-step approach provides users with the same information as the two-step approach but is less complicated and more efficient (eg it requires fewer line items in the performance statement).

34. Those respondents said that the two-step approach is inappropriate because it introduces a new presentation method — ie a new interaction between P&L and OCI that requires an entity to present the entire fair value change in P&L and then subsequently to 'back out' from P&L the portion attribution to changes in

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credit risk. They added that it looks like a form of recycling. They said that there is little (if any) added benefit of the 'gross' presentation in the two-step approach and the extra line items on the face of the performance statement result in unnecessary 'clutter'.

35. Also some respondents noted that the ED proposed that changes in a liability's credit risk should not affect P&L, therefore it is inappropriate to present that amount in P&L (even though it has no ultimate effect on P&L because it is subsequently 'backed out'). Finally, some of the respondents who preferred the one-step approach pointed out that the two-step approach becomes increasingly unnecessary if the Board finalises the current proposal to present a statement of financial performance with two sections (profit or loss and items of other comprehensive income) because the one-step approach would present all of the relevant information on that statement.
36. Some respondents who preferred the one-step approach on the face of the performance statement suggested that the two-step approach could be disclosed in the notes if the Board thinks that it provides additional information.
37. Some respondents preferred the two-step approach. Those respondents said that it provides users with clearer information and enables a straight-forward reconciliation between the statement of financial position and the statement of financial performance.
38. A few respondents expressed indifference between the two methods because they provided the same information and have the same net effect on P&L and OCI.

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39. In their responses to the user questionnaire, most users indicated that the two-step approach would **not** be more helpful to their analysis than the one-step approach. The comments suggested that users generally thought that presenting the entire change in P&L and then backing out the effects of changes in liabilities' credit risk would be 'too much'. Also, some of the users responded that changes in the liabilities' credit risk should have nothing to do with P&L. However, one user noted a preference for the two-step method because it provides more information.

***Should amounts presented in OCI be recycled to P&L? [Question 7 in the ED]***

40. The ED proposes to prohibit recycling amounts from OCI to P&L.
41. Many respondents disagreed with the proposal. They agreed that there would be no amounts to recycle if the entity repays the contractual amount. However, they believe that if the entity repays an amount other than the contractual amount, the realised amounts in OCI should be recycled to P&L. These respondents view OCI as a 'temporary holding place' for unrealised gains or losses and believe that realised and unrealised amounts should be treated differently.
42. Some of the respondents who supported recycling noted that it would be consistent with the guidance for liabilities measured at amortised cost, which requires all realised gains and losses to be presented in P&L. They also note that if the entity holds the liability until maturity and repays the contractual amount, the cumulative effect of any changes in the liability's credit risk would net to zero and, therefore, there would be no amounts left in OCI attributable to changes in the liability's credit risk. They think that the same result should occur for liabilities settled at an amount other than the contractual amount —ie there should not be any amounts left in OCI after the liability is derecognised.
43. However, some respondents agreed with the Board's proposal to prohibit recycling, especially if the proposal for a single statement of comprehensive

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income is finalised. These respondents agree that a gain or loss should only be recognised once, and point out that recycling is a confusing notion.

44. While most users indicated that it is appropriate to **prohibit** recycling, most of the users that provided comments seemed to **support** recycling if the amounts are realised (consistent with all other realised amounts) – which is also consistent with the other feedback received from users. One user said that if recycling was prohibited, retained earning would be misstated. One user noted that there was not enough explanation in the questionnaire about the meaning of ‘recycling’.
45. However, all users supported note disclosure of the amount of any gains or losses that have been realised in the current period.

***How should an entity determine the effects of changes in a liability’s credit risk?  
[Question 8 in the ED]***

46. The ED proposes that the application guidance currently in IFRS 7 should be used to determine the portion of the change in fair value that is attributable to changes in a liability’s credit risk.
47. Most respondents agreed that the guidance in IFRS 7 is sufficient and operational. Those respondents noted that determining the effects of changes in liabilities’ credit risk can be complex so it is necessary to allow entities to have some flexibility in how they calculate it. Some of these respondents acknowledge that the default method in IFRS 7 can be imprecise because it captures all fair value changes above the change in a benchmark rate. However, most respondents accept the default method as a reasonable proxy in many cases. Also respondents noted that IFRS 7 allows an entity to use a different method if it more faithfully represents the effects of changes in the liabilities’ credit risk. But some respondents urged the Board to make it clearer that methods other than the default method are acceptable (and, in some cases, required) if they result in better faithful information.

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48. As noted above in paragraph 6-9, many respondents requested that the Board provide additional guidance on the meaning of ‘changes in liabilities’ credit risk’ and on how to determine that amount (eg what is a ‘benchmark rate’?). They noted that while the current level of guidance in IFRS 7 might be appropriate because it applies only to disclosures, the ED proposes elevating this information to the face of the financial statements. Therefore, there is an increased need for more robust guidance to ensure consistency and comparability.
49. A few respondents did **not** agree with the proposals to use the guidance in IFRS 7. They said that the guidance in IFRS 7 is not clear or robust enough and does not result in a precise enough measure of the effects of changes in liabilities’ credit risk. Some of these respondents were concerned about the diversity in practice, especially because the ED proposes that this information would be presented on the face of the financial statements. Many of these respondents generally agreed with the FASB’s proposal, which would require an entity to separately present significant changes in the fair value of liabilities resulting from changes in the entity’s **credit standing** (excluding effects of changes in the price of credit).
50. Some respondents said that the FASB’s approach may be a conceptually better answer but they questioned whether it is operational.

***Should early adoption be permitted and ‘linked’ to early adoption of other parts of IFRS 9? [Question 9 in the ED]***

51. The ED proposes permitting entities to early adopt the proposals. In addition, the ED proposes that if an entity elects to adopt these proposals early, the entity must at the same time apply all requirements in IFRS 9 that it does not already apply.
52. Almost all respondents agree with the proposal to permit early adoption. They believe that the proposals improve financial reporting and, thus, entities should be allowed to adopt them as soon as possible.

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53. Some of those respondents also agree with that if an entity elects to adopt these proposals early, it must adopt at the same time all of the other requirements in IFRS 9. They note that this proposal increases comparability among entities.
54. However, many respondents think that entities should be permitted to adopt the proposals in the ED **without** also adopting the rest of IFRS 9—and some suggest that the proposals in the ED could be finalised as an amendment to IAS 39 (rather than IFRS 9). These respondents argue that the proposals in the ED are unrelated to the requirements in IFRS 9 because the former relates to the FVO for financial liabilities and the latter relates to the measurement of assets. Many respondents point out that the Board decided to have different measurement models for financial assets and financial liabilities; therefore, early adoption of the respective requirements should not be ‘linked’. Furthermore, respondents note that the adoption of IFRS 9 is far more complex and will take more time to implement than the proposals in the ED.
55. In their responses to the user questionnaire, most users indicated that if an entity chooses to adopt the proposals in the ED early, it **also should be required** to adopt the new requirements for financial assets in IFRS 9. Comparability seemed to be users’ primary concern.

***What should the transition requirements be? [Question 10 in the ED]***

56. The ED proposes fully retrospective application upon transition.
57. Almost all respondents agreed with retrospective application. However, many respondents believe that the Board should allow entities to reassess their FVO designations upon adoption of the proposals in ED. They note that entities likely will want to de-designate some liabilities currently under the FVO or newly designate liabilities that are not currently under the FVO in light of the new requirement.
58. This is especially important to entities if the Board does not address the issue of mismatches described above in paragraph 24-26. Those entities may prefer to measure their liabilities at amortised cost—rather than recognise mismatches in



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their P&L caused by the new requirements for changes in the liabilities' credit risk.