16 July 2010

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear David

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

The Asian Oceanian Standard Setters Group (AOSSG) is pleased to provide comments on Exposure Draft *Fair Value Option for Financial Liabilities* (ED/2010/4).

The AOSSG currently has 24 member standard setters from the Asian-Oceanian region: Australia, Brunei, Cambodia, China, Hong Kong, India, Indonesia, Iran, Iraq, Japan, Kazakhstan, Korea, Macao, Malaysia, Nepal, New Zealand, Oman, Pakistan, Saudi Arabia, Singapore, Sri Lanka, Thailand, Turkey and Uzbekistan.

To the extent feasible, this submission to the IASB reflects in broad terms the collective views of AOSSG members. On some occasions, the majority and minority views of AOSSG members are expressed in this submission. The minority view is separately expressed in the subheading marked as "Other comments" in Appendix A. Individual member standard setters may also choose to make separate submissions that agree or disagree with aspects of this submission. The intention of the AOSSG is to enhance the input to the IASB from the Asian-Oceanian region and not to prevent the IASB from receiving the variety of views that individual member standard setters may hold.

This submission has been reviewed by members of the AOSSG after having been initially developed through the AOSSG's Financial Instruments Working Group. In developing the submission, individual members of the Working Group sought and considered the views of constituents in AOSSG jurisdictions.

The AOSSG acknowledges that the global financial crisis has highlighted that users of general purpose financial statements require improved and simpler accounting for financial instruments. One aspect that was highlighted was the perceived counter-intuitive nature of an entity recognising gains in profit or loss in relation to some financial liabilities measured at fair value when its credit rating was deteriorating. This is featured in the letter from G-20 leaders to the IASB and the recommendations of the Financial Crisis Advisory Group.

The majority of AOSSG members are supportive of the IASB's proposals to:

(a) separately present in other comprehensive income (OCI) changes in the fair value of financial liabilities designated at fair value through profit or loss due to changes in credit risk;

(b) use the two-step process in presenting changes in fair value due to changes in credit risk using a two-step process; and

(c) use the IFRS 7 *Financial instruments: Disclosures* methodology for determining credit risk.

However, a minority of AOSSG members have identified significant concerns with the IASB's proposals on both conceptual and/or practical grounds. These members have raised concerns about the use of the OCI classification and strongly encourage the IASB to first complete its project on Financial Statement Presentation to address issues about the presentation of comprehensive income. In addition, these members are concerned that the proposals do not remain faithful to the concept of fair value through profit or loss. In their view, a new measurement basis is being proposed that would create further complexity in accounting for financial instruments.

It is unclear whether the IASB's focus is on the impact of a change in credit risk generally (the price of credit) or the impact of a change in credit risk specific to an entity. The AOSSG believes that changes in credit risk that result in separate presentation in OCI should be specific to the entity. As such, although the majority of AOSSG members support use of the IFRS 7 methodology, there are concerns with the practicality of the methodology in determining the effect of changes in credit risk specific to the entity.

The AOSSG considers the IASB's decision to retain the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* in respect of financial liabilities to be significant. The AOSSG is concerned that the requirements will result in asymmetric accounting for assets and liabilities which has not been appropriately justified—for example, the treatment

of embedded derivatives. The AOSSG notes that the FASB has undertaken a more comprehensive review of its financial instruments requirements in its 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. In this respect, the AOSSG encourages the IASB to work closely with the FASB to issue comprehensive improvements to the financial instruments requirements.

In addition, the AOSSG 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 AOSSG 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 AOSSG 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 AOSSG is keen to play a key role in the development of a global set of high quality financial reporting standards and trusts that the IASB finds our comments helpful in progressing the replacement standard for IAS 39.

The AOSSG 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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Chairman of the AOSSG

Kevin M. Stevenson
Leader of the AOSSG Financial Instruments Working Group

AOSSG ASIAN-OCEANIAN STANDARD-SETTERS GROUP

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Focus on financial liabilities measured using the fair value option

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

1. The AOSSG notes the IASB's comment, in paragraph BC11, that most liabilities "... would continue to be subsequently measured at 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."

AOSSG comments

2. Some AOSSG members have expressed the view that it is inappropriate to focus only on financial liabilities designated at fair value through profit or loss (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 designated at FVTPL. If the IASB wants to address issues regarding the impact of own credit risk, it should research the issues in a broader context. Otherwise, the IASB may proliferate the number of measurement bases in IFRSs, which will further add to the complexity faced by preparers and users of financial statements.

Scope of proposals on own credit risk

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

3. 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."

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4. The comments made by FCAG focus on the concern with reporting in profit or loss changes in fair value due to changes in credit risk of the borrower when entities do not have the ability and opportunity to buy back their own debt. Accordingly, FCAG's main concern appears to be much narrower in scope than the proposals in ED/2010/4. Presumably the FCAG is less concerned about the impact of changes in own credit risk being recognised in profit or loss when an entity is capable of realising the relevant gain or loss. 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 and would not address the impact of changes in credit risk that are industry-wide or economy-wide.

5. Furthermore, the IASB notes the views of some in paragraph BC45 of ED/2010/4 that the change in fair value of a liability due to 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. In this context, the FASB is clear in its ED that the focus of its proposals is the credit risk change related only to the entity.

AOSSG comments

6. The majority of AOSSG members believe that the IASB should reconsider the scope of its proposals and only require entities to present in other comprehensive income (OCI) changes in fair value that result from changes in credit risk in respect of financial liabilities when those entities do not have the ability to buy back their own debt.

7. These AOSSG members also consider that the IASB proposals should only apply to an entity's own credit risk and it should be made clear that anything other than this is not acceptable or contemplated—that is, the focus of 'changes in credit risk' should be entity specific and not the broader notion of credit risk that includes movements in industry or economy-wide credit risk. (Also see paragraph 29 of this Appendix)

Treatment of impact of changes to own credit risk

(Broadly relates to ED/2010/4 Questions 1, 2, 3, 6 and 7)

8. AOSSG members acknowledge the pressure for the IASB to develop improved requirements for financial instruments, and there are mixed views among the members of the AOSSG

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regarding the proposals in ED/2010/4 about the treatment of impact of changes to own credit risk.

AOSSG comments

9. The majority of AOSSG members support the proposed treatment because they believe it eliminates the perceived counter-intuitive recognition of gains in profit or loss from declines in the fair value of financial liabilities that are a result of increased credit risk. The majority of AOSSG members believe that recognising fair value changes attributable to changes in own credit risk in profit or loss does not provide useful information, except when the liabilities are held for trading purposes or when the liabilities are managed, or their performance is evaluated, on a fair value basis.

10. In any case, the majority of AOSSG members do not support presenting changes in credit risk in equity (as opposed to OCI) because such amounts do not represent transactions between the entity and equityholders.

11. In addition, the majority of AOSSG members do not believe that recognising fair value changes due to changes in an entity's own credit risk in profit or loss would often result in an accounting mismatch. This is because the credit risk associated with a financial asset relates to the underlying debtor or investee, whereas the credit risk of a financial liability is confined to the reporting entity itself and the entity is normally unable to benefit from (and does not lose from) movements in credit risk. Therefore, the majority of AOSSG members support the proposals and believe that, even if an entity elects to designate a financial liability under the fair value option, it is inappropriate to recognise changes in fair value that relates to entity's own credit risk in profit or loss.

12. However, some of these AOSSG members support the proposals:
    (a) only if recycling from OCI to profit or loss is required when the liability has been realised. This is on the basis that profit or loss represents the entity's total performance and any recycling from OCI to profit or loss would provide useful information about the overall performance of the instrument and the entity. These members see it as a fundamental principal that realised gains or losses be reflected in the profit or loss when derecognising assets or liabilities; or

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(b) on pragmatic grounds, but only if a one-step approach is used with a direct debit or credit to OCI and without recycling. These members see this as the simplest and most easily understood outcome.

Other comments

13. A minority of AOSSG members does not support the proposed treatment of the impacts of changes in own credit risk and believes it would undermine the consistent application of measurement bases.

14. In addition, that minority of AOSSG members disagrees with the proposals on the basis that, if an entity elects to measure assets or liabilities at FVTPL, the basis of measurement in both the balance sheet and the income statement should remain faithful to the concept of FVTPL. That is, once an entity applies the FVTPL measurement basis, it should not corrupt that basis by 'recycling' some of the fair value movements to or from OCI.

15. The feedback received from the IASB's outreach programme suggests 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. A minority of AOSSG members rejects this argument for presenting a component of fair value change in OCI because it is an argument for presenting the entire fair value change in OCI, not just the effects of movements in own credit risk, or not recognising them at all (that is, using a cost model). They do not see a nexus between selecting a measurement attribute and whether a liability or asset is traded.

16. 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, remaining true to the measurement attribute – either FVTPL or FVTOCI. Accordingly, if the ED/2010/4 proposals were to proceed, a minority of AOSSG members are supportive of the FASB proposals over the IASB proposals because they are more consistent in their application of fair value measurement attributes (see comments in paragraphs 13 and 14 of this Appendix).

17. A minority of AOSSG members notes that the IASB's project on Financial Statement Presentation will address issues about the presentation of comprehensive income. Therefore, at this stage, those members would not support the IASB expanding the use of FVTOCI 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. Before progressing the proposals in ED/2010/4, those members believe the IASB needs to address some fundamental questions:
    (a) what is the purpose of OCI and its separation from 'earnings'?:
    (b) what are the characteristics and meaning of items presented in OCI?
    (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?

18. A minority of AOSSG members believe 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 do not support the proposal to recycle amounts to profit or loss. These members, who oppose recycling of amounts, note that their 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).

19. In addition, a minority of AOSSG members considers that there are cases where the proposals would create a mismatch. Accordingly, if the proposals were to proceed, they would prefer the IASB's alternative approach whereby the reclassification to OCI is not made when it would give rise to a mismatch.

20. In particular, the minority of AOSSG members that disagree with the treatment of impact of changes to own credit risk believe that there are AOSSG jurisdictions in which the lender and borrower can both be entities of a single government and the credit ratings of the lender and borrower are determined by the creditworthiness of the government. Therefore, the credit risk

associated with fair valued financial assets and financial liabilities will largely be offset and it would be inappropriate to separately recognise credit risk associated with financial liabilities in OCI. Not only would this separate presentation result in increased profit or loss volatility (which is inconsistent with the objective of ED/2010/4), it would also not give a true reflection of the financial risks to which the lender is exposed. This situation draws out the asymmetry of thinking between accounting for assets and liabilities that underlies ED/2010/4.

Two-step or one-step approach

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

21. 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 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 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.

AOSSG comments

22. The majority of AOSSG members note that, in terms of the FVTPL measurement basis, the two-step approach is closer to recognising the full fair value change of financial liabilities in profit or loss rather than separating gains or losses arising from changes in own credit risk. On the other hand, it could be argued 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.

23. As discussed in paragraph 14 of this Appendix, some AOSSG members believe that recycling between the OCI and the profit or loss 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. Accordingly, for opponents of recycling, the one-step

approach could be considered a more acceptable approach for presenting the effects of changes in own credit risk.

Other comments

24. If the IASB proceeds with its ED/2010/4 proposals, a minority of AOSSG members believes that the IASB should consider an 'exemption' to applying its proposals. That is, entities would apply the proposals in ED/2010/4 unless doing so would compromise users' understanding of the financial statements. In such instances, the entity would be required to present the entire change in fair value of those liabilities in profit or loss. The exemption would help alleviate some of the concerns raised by a minority of AOSSG members 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 20 of this Appendix).

Determining the impact of changes in credit risk

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

25. The IASB is proposing 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.

26. 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.

27. The AOSSG notes that there are other factors that also lead to changes in interest spreads, including supply and demand for the financial instrument, market sentiment and traded volumes, and it is not always possible to accurately attribute the change in interest rate spreads between credit risk and other market risks – certainly not with the IFRS 7 methodology. These concerns are consistent with the sentiments expressed in the FASB ED.

28. 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.

AOSSG comments

29. The majority of AOSSG members support the use of the IFRS 7 methodology as a reasonable proxy in determining credit risk subject to the IASB addressing two concerns, namely:
    (a) the practical difficulties of determining the effect of changes in an entity's credit risk; and
    (b) clarifying whether the IASB's focus is on the impact of a change in credit risk generally (the price of credit) or the impact of a change in credit risk specific to the entity (see comments in paragraph 7 of this Appendix).

30. In addressing those concerns, the IASB should clarify that it is the credit risk associated with the entity (and not a general change in the price of credit) that is being identified for separate presentation in OCI. In addition, 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 credit risk should be determined based on the issuer's credit spread relative to, for example:
    (i) an overall market benchmark rate;
    (ii) the prevailing rate for a particular sector; or
    (iii) the risk-free rate (such as a government bond rate).

Other comments

31. A minority of AOSSG members believes that, until the IASB undertakes a detailed analysis to assess whether the 'simplified' method is satisfactory in determining the actual impact of credit risk that relates only to the entity for measurement purposes, the IFRS 7 methodology is only appropriate for disclosing the impact of changes in credit risk on the fair value measurement of financial liabilities.

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Transition requirements

(Broadly relates to Questions 9 and 10)

AOSSG comments

32. The AOSSG 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 retrospectively designate or de-designate financial liabilities measured at FVTPL (paragraph 8.2.9 of IFRS 9).

33. 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." The IASB considers that it has not changed the classification and 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 an impact on profit or loss resulting from the IASB's proposals relating to credit risk. As such, the AOSSG 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 would provide useful information for users. 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.

34. 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 issues

(1) Treatment of embedded derivatives

35. In its deliberations, the IASB considered the appropriateness of the existing accounting requirements for classifying and measuring financial liabilities and concluded that they are less complex and provide more useful information than any other approaches. Therefore, the IASB decided to retain almost all of the IAS 39 requirements for the classification and measurement of financial liabilities, which means that financial liabilities that are held for

trading would continue to be measured at fair value, and embedded derivatives would be bifurcated from the host and separately measured at FVTPL.

36. As a result, there will be asymmetry in the basis of measuring financial assets and liabilities that have embedded derivatives. Financial assets will be measured based on the criteria in the newly issued requirements in IFRS 9 compared with existing IAS 39 criteria for financial liabilities.

AOSSG comments

37. The majority of AOSSG members are concerned with the proposed retention of the existing requirements for the recognition and measurement of financial liabilities in light of the changed requirements for financial assets in IFRS 9. These would result in inconsistent accounting for financial assets compared with financial liabilities.

38. For example, consider a loan liability with interest repayments indexed to the price of gold. The commodity-indexed interest embedded in the host debt instrument is not considered to be closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar (paragraph AG30(e) of IAS 39). Therefore, the borrower would be required to bifurcate the financial liability in accordance with IAS 39 and measure the host contract at amortised cost and separately measure the embedded derivative at fair value.

39. On the other hand, the lender would be required to assess the hybrid in its entirety in accordance with paragraph 4.2(b) IFRS 9. Since the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding and the interest amounts are not consideration for the time value of money on the principal amount outstanding, the loan receivable would be measured in its entirety at fair value through profit or loss.

40. Therefore, the issuer and the borrower will account for the instrument differently. It is not clear why the IASB considers it appropriate to determine the classification and measurement of hybrids with financial asset hosts in their entirety, but not for hybrids with financial liability hosts.

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41. The FASB ED achieves a greater level of consistency in the accounting for financial assets and financial liabilities in the treatment of embedded derivatives. Under the FASB proposals, the measurement basis of a hybrid instrument would be determined based on the features of the entire contract and embedded derivatives would not be bifurcated from their financial asset or liability hosts.

Other comments

42. A minority of AOSSG members believes that, if the existing IAS 39 requirements for the recognition and measurement of financial liabilities were to be retained, the IASB should reconsider the 'closely related' criterion in respect of hybrid financial instruments. It is acknowledged that there is diversity in the application of this criterion and it would be helpful to preparers if the IASB were to provide guidance.

(2) Retaining the requirements of IAS 39 – due process

AOSSG comments

43. The AOSSG is concerned about 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 the recognition and measurement of financial liabilities is significant given the IASB's objective to comprehensively review the requirements for financial instruments and the direction that the FASB has taken. Whilst some members do not necessarily disagree with the proposed outcome, the AOSSG believes that constituents should have been provided with an explicit opportunity to comment on the IASB's proposal to retain IAS 39 requirements in respect of the recognition and measurement of financial liabilities and not just the proposals pertaining to the presentation of changes in fair value due to changes in credit risk.