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

Email: CommentLetters@iasb.org

Dear Sir/Madam

SAICA SUBMISSION ON EXPOSURE DRAFT ON *FAIR VALUE OPTION FOR FINANCIAL LIABILITIES*

In response to your request for comments on the IASB's exposure draft on *Fair Value Option for Financial Liabilities,* attached is the comment letter prepared by The South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but also secretariat for the Accounting Practices Board (APB), the official standard-setting body in South Africa. The SAICA comment letter results from deliberations of the Accounting Practices Committee (APC), which is the technical advisory body to the APB.

This comment letter includes comments received from members of the South African banking industry and audit practitioners.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director – Accounting

cc: Moses Kgosana (Chairman of the Accounting Practices Board)
Prof Alex Watson (Chairman of the Accounting Practices Committee)

Integritas, 7 Zulberg Close, Bruma Lake, 2198 POSTAL ADDRESS PO Box 59875, Kengray, 2100, Johannesburg
TEL +27 11 621 6600 FAX +27 11 621 3321 CALL CENTRE 08610 SAICA (72422) EMAIL saica@saica.co.za WEB saica.co.za | accountancysa.org.za

SAICA SUBMISSION ON EXPOSURE DRAFT ON FAIR VALUE OPTION FOR FINANCIAL LIABILITIES

GENERAL COMMENTS

The majority of our constituents are supportive of presenting the effect of fair value changes, due to changes in the credit risk of financial liabilities designated at fair value through profit or loss (designated liabilities), in other comprehensive income. However, we believe that a one-step approach, with note disclosure, is preferable to the two-step approach proposed in the exposure draft.

The exposure draft is presented as proposals for incorporation into IFRS 9 – *Financial Instruments* (IFRS 9). We encourage the IASB to consider incorporating the proposals into IAS 39 – *Financial Instruments: Recognition and Measurement* (IAS 39), with early adoption permissible, to allow entities to benefit from the improved approach to accounting for designated liabilities without having to adopt IFRS 9.

SPECIFIC COMMENTS

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?

The majority of our constituents agree that the recognition of changes in fair value attributable to the credit risk of designated liabilities should not affect profit or loss. We believe that the recognition of changes in the credit risk of designated liabilities creates unnecessary volatility in profit or loss.

We also believe that it is counterintuitive for an entity to recognise fair value gains in profit or loss on designated liabilities when the entity's own credit rating deteriorates (i.e. the entity's credit risk increases). Similarly, we believe that it is also counterintuitive to recognise fair value losses in profit or loss when the entity's own credit rating improves.

We agree with the responses to the IASB's outreach programme (as mentioned in paragraph BC7 of the exposure draft) indicating that the recognition of changes in fair value attributable to the credit risk of designated liabilities in profit or loss is inappropriate as these changes in fair value are generally not realised. We believe that this supports the different presentation approaches for designated liabilities and financial liabilities that are held for trading.

Furthermore, we note that the proposals may simplify the accounting for financial liabilities that are hedged economically as the need to apply hedge accounting will be reduced. For example, an entity that issues floating-rate liabilities may choose to hedge the cash flow interest rate risk on these liabilities economically by entering into an interest rate swap. In terms of the existing requirements of IAS 39, if the entity designates the liabilities at fair value through profit or loss, then it may still exhibit volatility in profit or loss as a result of changes in fair value attributable to the credit risk of the liabilities. Currently, this can only be resolved through the application of IAS 39's hedge accounting requirements. The proposals will result in the changes in fair value attributable to the credit risk of the liabilities in this example being presented outside of profit or loss, thereby eliminating the need to apply hedge accounting.

We do, however, note that a minority of our constituents believe that the changes in fair value attributable to the credit risk of designated liabilities should affect profit or loss. These constituents do not believe that there is a principled basis for differentiating designated liabilities and presenting changes in fair value attributable to the credit risk of these instruments differently to other financial instruments accounted for at fair value through profit or loss. These constituents believe that it would be more appropriate to address concerns regarding the counterintuitive impact on profit or loss of changes in the credit risk of designated liabilities through enhanced disclosure.

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?

We do not support presentation of the entire fair value change in profit or loss in certain circumstances. We believe that such differentiation would necessitate the inclusion of detailed rules, which would conflict with the IASB's principles-based approach to the development of financial reporting standards.

We also believe that the proposal that changes in the credit risk of designated liabilities do not affect profit or loss should, in the majority of instances, not create a significant mismatch in profit or loss. An entity is often able to address any potential mismatches by determining an appropriate measurement of the changes in fair value attributable to credit risk. We note that credit risk may differ for various liabilities of an entity (depending on the liabilities' features, such as the contractual term, linkage to certain assets and the order of payment of liabilities) and that the measurement of credit risk may therefore differ across an entity's designated liabilities.

We are supportive of the IASB's proposals to retain the existing guidance in IFRS 7 – *Financial Instruments: Disclosures* (IFRS 7), as discussed further in our response to Question 8. We believe that this guidance allows an entity to consider the specific features of its designated liabilities when measuring credit risk.

The current guidance in IFRS 7 permits an entity to determine the amount of change in fair value attributable to credit risk as the amount of the total change in fair value that is not attributable to changes in market conditions that give rise to market risk. The credit risk element of a liability could therefore incorporate all entity-specific features of the liability. The identification of an appropriate benchmark rate to represent market factors is therefore critical in measuring credit risk (and therefore avoiding any unnecessary mismatches in profit or loss).

For example, assume that an entity has issued financial liabilities linked to the performance of an underlying portfolio of financial assets. The underlying portfolio of assets is ring-fenced such that the fair value of the issued financial liabilities is linked directly to these assets and does not incorporate the entity's own credit risk. The entity designates both the financial assets and the financial liabilities at fair value through profit or loss. In this instance, we believe that an appropriate benchmark rate would include the performance risk of the underlying portfolio of assets. The changes in fair value attributable to the credit risk of the liabilities would therefore be nil and the application of the proposed approach in the exposure draft would therefore not create any mismatch in profit or loss.

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?

By definition, the fair value of a financial liability is required to include the instrument's credit risk. In order to achieve fair value measurement in the statement of financial position, it is therefore necessary to recognise the portion of changes in fair value that is attributable to changes in credit risk. However, as indicated in our response to Question 1, we do not believe that this portion of the change in fair value should affect profit or loss. We also do not believe that this portion of the change in fair value should be recognised in equity (as motivated in our response to Question 6 below).

We therefore agree that the portion of the fair value change attributable to changes in credit risk should be presented in 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?

No, we do not agree that the two-step approach provides useful information to users of financial statements. The exposure draft responds to users' preference that changes in credit risk of designated liabilities should not affect profit or loss and proposes that such amounts be presented in other comprehensive income. We believe that recognising and then removing such amounts from profit or loss in separate line items, per the proposed amendments to IAS 1 – *Presentation of Financial Statements* (IAS 1), contradicts the principle that such amounts should be presented in other comprehensive income.

We note that the two-step approach is inconsistent with other areas of existing IFRS that allow or require gains/losses to be presented in other comprehensive income (e.g. hedge accounting and accounting for defined benefit post-retirement employee benefit plans).

We acknowledge that visibility of the amount of changes in credit risk of designated liabilities in the financial statements is important. However, we believe that this would be achieved by requiring that the information outlined in the proposed amendment to paragraph 82 of IAS 1 (per paragraph A6 of the exposure draft) be presented in the notes to the financial statements. We note that where fair value gains/losses (net of the credit risk element) on designated liabilities are relevant to an understanding of the entity's financial performance, the existing paragraph 85 of IAS 1 would require separate presentation on the face of the entity's statement of comprehensive income.

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

Yes, as motivated in our response to Question 4 above, we believe that the one-step approach (together with appropriate note disclosure) would be preferable. This approach would align with the proposed principle that changes in credit risk of designated liabilities should not affect profit or loss.

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, we do not believe that the effects of changes in the credit risk of designated liabilities should be presented in equity as these effects do not arise from transactions with equity owners in their capacity as equity owners.

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?

In our deliberations on the proposals relating to reclassification (per paragraph 3 of the exposure draft) our constituents had divided views.

Those who did not support reclassification noted that this would be consistent with the precedent set by the IASB in IFRS 9, which prohibits reclassification to profit or loss in respect of equity investments measured at fair value with fair value changes presented in other comprehensive income.

Those who supported reclassification to profit or loss supported such reclassification only upon settlement of the liability. It was noted that the early settlement of a financial liability measured at amortised cost has an impact on profit or loss, which includes the effect of the liability's credit risk. A prohibition on the reclassification to profit or loss of amounts included in other comprehensive income for designated liabilities would therefore result in inconsistent treatment of the credit risk component of financial liabilities at amortised cost and designated liabilities.

However, there are current inconsistencies in IFRS regarding the reclassification of amounts recognised in other comprehensive income. For example, revaluations recognised in terms of IAS 16 **–** *Property, Plant and Equipment,* are not reclassified to profit or loss. In contrast, the foreign currency translation reserve arising from translating a foreign operation in terms of IAS 21 **–** *The Effects of Changes in Foreign Exchange Rates,* is reclassified to profit or loss on disposal of the foreign operation.

We therefore believe that it is first necessary for the IASB to address the overall principles applicable to items of other comprehensive income and their reclassification to profit or loss before addressing this issue specifically for designated liabilities.

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?

We agree with the proposal to apply the existing guidance in IFRS 7 when determining the portion of the fair value change that is attributable to changes in the credit risk of designated liabilities. The existing guidance in IFRS 7 allows the use of either a benchmark rate approach or an alternative method that is more faithfully representative. We believe that it is appropriate to provide entities with this choice and that the existing guidance is useful.

As indicated in our response to Question 2, a critical element of applying the first-mentioned approach (the benchmark rate approach) is the identification of an appropriate benchmark rate. IFRS 7 does not define the appropriate benchmark rate that should be used (which we believe is appropriate as the specific features of the liability need to be considered) and we therefore suggest that the IASB consider requiring an entity, if applying the first-mentioned approach, to disclose specifically the benchmark rate selected.

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?

We agree with the proposals related to early adoption. Specifically, we agree that an entity early adopting the requirements relating to designated liabilities (as incorporated into IFRS 9) should at the same time apply any requirements in IFRS 9 that it does not yet apply.

However, we note that this could result in entities applying different versions of IFRS 9, which incorporate different requirements depending on the early adoption dates of various entities. This could create confusion for users of the financial statements. We therefore recommend that the IASB consider requiring an entity to disclose the version of IFRS 9 being applied where an entity early adopts IFRS 9. Such disclosure should be required until the mandatory adoption date of IFRS 9.

We also believe that the proposals represent an improvement to the accounting for financial liabilities and that an entity should be able to benefit from this improvement without having to adopt IFRS 9 (and therefore comply with the new requirements for financial assets). We therefore propose that the IASB also issue these proposals as amendments to IAS 39. We would further propose that such amendments to IAS 39 be available for early adoption and be subject to the same transitional provisions outlined in paragraph 5 of the exposure draft.

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

We believe that entities should have the necessary information available to apply the proposed amendments retrospectively and we therefore agree with the proposed transition approach.

In addition to the transitional provision provided in paragraph 5 of the exposure draft, we believe that it is also appropriate for the existing transitional provisions (particularly, the transitional relief) in section 8.2 of IFRS 9 to apply to financial liabilities. It is unclear whether this is the IASB's intention and we suggest that this be clarified.

Other comments

Non-financial liabilities

We note that the IASB's discussion paper on *Credit Risk in Liability Measurement* (as issued in June 2009) addressed both financial and non-financial liabilities. The IASB's recent exposure draft, *Measurement of Liabilities in IAS 37*, does not address the issue of credit risk in the measurement of non-financial liabilities. We suggest that the IASB consider whether any further amendments to IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets* and insurance contract accounting are required to achieve consistency with these proposals for financial liabilities.

Designation of financial liabilities with embedded derivatives

As indicated in paragraph BC15 of the exposure draft, we understand that it is the IASB's intention to retain the existing IAS 39 eligibility conditions for designating financial liabilities at fair value through profit or loss. Paragraph A4 of the exposure draft therefore proposes that paragraph 11A of IAS 39 be moved to IFRS 9. However, we note that paragraph 11A was amended by IFRS 9 (as issued in November 2009) such that a hybrid contract may only be designated at fair value through profit or loss if the host is outside the scope of IFRS 9. Given the IASB's intention with IFRS 9, this restriction in the amended paragraph 11A of IAS 39 should apply only to assets and not liabilities. We recommend that the IASB address this current drafting inconsistency.

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