Hong Kong Institute of
Certified Public Accountants
香港會計師公會

13 May 2010

To: Members of the Hong Kong Institute of CPAs
All other interested parties

INVITATION TO COMMENT ON IASB EXPOSURE DRAFT OF *FAIR VALUE OPTION FOR FINANCIAL LIABILITIES*

Comments to be received by 2 July 2010

The Hong Kong Institute of Certified Public Accountants' (Institute) Financial Reporting Standards Committee (FRSC) is seeking comments on the IASB Exposure Draft which has been posted on the Institute's website at: http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/exposure-drafts/.

The proposal follows work already completed on the classification and measurement of financial assets (IFRS 9 *Financial Instruments*).

The IASB is proposing limited changes to the accounting for liabilities, with changes to the fair value option. The proposals respond to the view expressed by many investors and others in the extensive consultations that the IASB has undertaken—that volatility in profit or loss resulting from changes in the credit risk of liabilities that an entity chooses to measure at fair value is counter-intuitive and does not provide useful information to investors.

When the IASB introduced IFRS 9 many stakeholders around the world advised the IASB that the existing requirements for financial liabilities work well, except for the effects of changes in the credit risk of a financial liability ('own credit') that an entity chooses to measure at fair value.

Building on that global consultation on IFRS 9, the IASB sought the views of investors, preparers, audit firms, regulators and others on the 'own credit' issue. The views received were consistent with the earlier consultations—that volatility in profit or loss resulting from changes in 'own credit' does not provide useful information except for derivatives and liabilities that are held for trading.

The IASB is therefore proposing that all gains and losses resulting from changes in 'own credit' for financial liabilities that an entity chooses to measure at fair value should be transferred to 'other comprehensive income'. Changes in 'own credit' will therefore not affect reported profit or loss.

No other changes are proposed for financial liabilities. Therefore, the proposals will affect only those entities that choose to apply the fair value option to their financial liabilities.

Importantly, those who prefer to bifurcate financial liabilities when relevant may continue to do so. That is consistent with the widespread view that the existing requirements for financial liabilities work well, other than the 'own credit' issue that these proposals cover.

--- A summary prepared by the IASB on the Exposure Draft is set out in the attached Appendix.

In accordance with the Institute's Convergence Due Process, comments are invited from any interested party. The FRSC would like to hear from both those who do agree and those who do not agree with the proposals contained in the IASB Exposure Draft.

Comments should be supported by specific reasoning and should be submitted in written form.

To allow your comments on the IASB Exposure Draft to be considered, they are requested to be received by the Institute on or before **2 July 2010**.

Comments may be sent by mail, fax or e-mail to:

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Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

May 2010

Appendix

Exposure Draft

Financial Liabilities: Classification and Measurement Fair Value Option

This snapshot is a brief introduction to a proposed amendment to the fair value option (FVO) for financial liabilities. It provides an overview of the proposals published in an exposure draft (ED) for public comment by the International Accounting Standards Board (IASB).

The proposals form part of the IASB's response to the global financial crisis and recommendations made by the G20, the Financial Stability Board and others. The proposals have been developed following extensive consultation with investors.

Project objective:	Address the volatility in the income statement (P&L) caused by changes in the credit risk of a financial liability ('own credit'). In particular the ED proposes changes in the accounting for financial liabilities that an entity chooses to measure at fair value.
Project stage:	In November 2009, the IASB issued IFRS 9 *Financial Instruments* which addressed the classification and measurement of financial assets. When finalising IFRS 9 the IASB committed to address financial liabilities in the near term, specifically considering the issue of own credit. The IASB has undertaken an extensive outreach programme to explore different approaches to own credit. This ED is a result of that outreach.
Comment deadline:	The ED is open for public comment until 16 July 2010.

International Accounting Standards Board®

Background

The IASB initially proposed to address the accounting for financial assets and financial liabilities at the same time. The ED that preceded IFRS 9 proposed a symmetrical model for financial assets and liabilities.

In response to that ED the IASB was advised that the most urgent issue to address as a result of the financial crisis was the treatment of financial assets.

Many also recommended delaying changes to the accounting for financial liabilities until more feedback was obtained about how best to address the own credit issue.

In response, IFRS 9 was issued in November 2009 and addressed the classification and measurement only of financial assets.

What is the own credit issue?

The accounting effect of changes in the credit risk of a financial liability is referred to in this Snapshot as 'own credit'.

Changes in a financial liability's credit risk affect the fair value of that financial liability. This means that when an entity's creditworthiness deteriorates, the fair value of its issued debt will decrease (and vice versa). For financial liabilities measured using the FVO this causes a gain (or loss) to be recognised in the P&L.

Many investors find this result counter-intuitive and confusing. This was confirmed in responses to the June 2009 discussion paper *Credit Risk in Liability Measurement* and in the user questionnaire on own credit that the IASB issued as part of its outreach activities.

The IASB undertook outreach on the issue of own credit in preparation for the publication of this ED, including discussions with preparers, audit firms, regulators and investors.

What did investors tell the IASB?

Extensive input was obtained from investors, including a questionnaire to which there were more than 90 responses. Whilst there was a range of responses, in general investors confirmed that:

- P&L volatility caused by own credit does not provide useful information (except for derivatives and liabilities held for trading);
- they did not want us to develop a new measurement method; but
- information on the effects of own credit can still be useful.

What is the IASB proposing?

In response to the input received, the ED proposes a limited change that addresses the issue of own credit for financial liabilities that an entity chooses to measure at fair value by introducing a two-step approach.

The two-step approach proposed in the ED would address the P&L volatility arising from own credit as follows:

- the fair value change of liabilities under the FVO would be recognised in P&L;
- the portion of the fair value change due to own credit would be reversed out of P&L and recognised in other comprehensive income.

Current requirement:	
Income statement (P&L) Liabilities under fair value option	
Total change in fair value	100
Profit for the year	100

Proposed two-step approach:	
Income statement (P&L) Liabilities under fair value option	
Step 1 – Total change in fair value	100
Step 2 – Change in fair value from own credit	(10)
Profit for the year	90
Statement of comprehensive income Liabilities under fair value option	
Step 2 – Change in fair value from own credit	10

No other changes are proposed for financial liabilities.

The current requirements for the measurement of financial liabilities would not be changed in any other way.

Importantly, the current requirements to split structured debt into a 'vanilla' instrument measured at amortised cost and a derivative component measured at fair value (bifurcation) would remain. As a result, those who prefer to bifurcate financial liabilities when relevant could continue to do so.

What are the effects of the proposals?

P&L volatility will no longer result from changes in own credit while information on own credit will still be available for investors.

Consistent with investor requests, all liabilities an entity *chooses* to measure at fair value under the FVO will continue to be on the balance sheet at fair value and a 'new' measurement method will not be introduced.

The proposals would not apply to financial liabilities that are *required* to be measured at fair value (being derivatives and liabilities held for trading).

Who is affected by the proposal?

The proposal will affect only entities that choose to apply the FVO to their financial liabilities. Most commonly these are large financial institutions.

Why the limited change?

The IASB has received consistent and widespread feedback that existing requirements for financial liabilities work well, other than the own credit issue that this ED addresses.

In addition, the IASB has been told by many investors that a symmetrical model for the measurement of financial assets and financial liabilities does not provide useful information in many situations.

The IASB explored several alternative ways to address the own credit issue during its extensive outreach. There was no clear preference from constituents for any particular approach.

To avoid causing undue disruption to current practice, the IASB decided to make the minimum changes necessary to the accounting for financial liabilities while responding to the concerns raised about own credit for financial liabilities that an entity chooses to measure at fair value using the FVO.

continued

How can I comment on the ED?

Respondents are invited to comment on any or all of the questions contained in the ED and to comment on any other issue that the IASB should consider in finalising the proposal. The IASB's redeliberations of the proposals will take place in public meetings as announced on the IASB's website.

The deadline for comments on the ED is 16 July 2010. To view the ED and submit your comments, visit www.iasb.org.

Where does this ED fit in with the bigger project on financial instruments?

This project is the remaining part of the classification and measurement phase of the project to replace IAS 39. Other phases of the project address the impairment of financial assets and hedge accounting.

The ED *Financial Instruments: Amortised Cost and Impairment* is available for public comment until 30 June 2010, while an ED on hedge accounting has not yet been published.

Notes

Notes

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