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

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.iasb.org)

16 July 2010

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

Dear Sirs,

IASB Exposure Draft on *Fair Value Option for Financial Liabilities*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Exposure Draft (ED). Our responses to the questions raised in your ED are set out in the Appendix for your consideration.

We generally support the IASB's aims to remove the impact of changes in "own credit" risk on a liability from profit and loss. We agree that recognition of changes in own credit risk for a liability carried at fair value in the profit or loss leads to counter-intuitive accounting and does not provide decision-useful information.

Although we agree that fair value changes due to changes in an entity's own credit risk from re-measurement of financial liabilities designated under the fair value option should not affect profit or loss, and accept the recognition of these gains/losses in other comprehensive income (OCI) as a pragmatic solution to this issue, we are concerned that the proposal is another requirement to classify items into OCI without a clear and conceptual meaning of what is OCI and what it should be used for. We therefore strongly recommend that the IASB's project on *Financial Statement Presentation* should consider the purpose of OCI, establish a principle for recognition of gains and losses therein and consider the appropriateness of recycling between profit or loss and OCI.

If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong, FCPA, FCA
Director, Standard Setting Department

SO/WC/jn

Hong Kong Institute of CPAs

Comments on the IASB Exposure Draft on *Fair Value Option for Financial Liabilities*

<u>Question 1</u>

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?

We agree that changes in own credit risk of a liability should not affect profit or loss for all liabilities designed under the fair value option. In our comment letter on the IASB's Discussion Paper *Credit Risk in Liability Measurement*, we are of the view that most liabilities are settled through performance rather than through transfer. Accordingly, except for those liabilities that are held for trading purpose, we believe that recognition of changes in own credit risk for a liability carried at fair value in the profit or loss leads to counter-intuitive accounting and does not provide decision-useful information.

<u>Question 2</u>

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 agree with the alternative proposal. While some element of accounting mismatch could arise where changes in the credit risk of the liability is recognized in OCI, we believe that the inclusion of two forms of fair value option will add additional complexity to accounting under the fair value option, including. Furthermore, the use of two fair value options will lead to a lack of comparability regarding whether remeasurements of liabilities measured at fair value are included in profit or loss or OCI for different entities based on their holding of assets rather than the nature of the liability.

<u>Question 3</u>

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?

Although we agree that fair value changes due to changes in an entity's own credit risk from re-measurement of financial liabilities designated under the fair value option should not affect profit or loss, and accept the recognition of these gains/losses in OCI as a pragmatic solution to this issue, we are concerned that the proposal is another requirement to classify items into OCI without a clear and conceptual meaning of what is OCI and what it should be used for. We therefore strongly recommend that the IASB's project on *Financial Statement Presentation* should consider the purpose of OCI, establish a principle for recognition of gains and losses therein and consider the appropriateness of recycling between profit or loss and OCI.

<u>Question 4</u>

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 support the two-step approach to the presentation of changes in own credit risk as it adds complexity while introducing a new method of presentation. The one-step approach provides the same new result in profit or loss and OCI, and is more easily understood.

However, we consider that information about (a) the fair value of the financial liability, (b) the total fair value change of the financial liability and (c) the portion of the total fair value change that is attributable to changes in the liability's credit risk, is useful to users of financial statements and thereby enhancing transparency in financial reporting. To achieve transparency, we therefore suggest additional disclosure of the above information in the notes to the financial statements.

<u>Question 5</u>

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

We prefer the one step approach as set out in our response to Question 4.

<u>Question 6</u>

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?

We consider fair value change attributable to changes in credit risk does not represent a wealth transfer between the creditors and the equity owners nor a transaction between the entity and the equity owners and therefore should not be presented directly in equity.

<u>Question 7</u>

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?

No. We believe that fair value changes that are attributable to changes in own credit risk should be recycled out of OCI to profit or loss if the liability is extinguished before its maturity date. The principal objection to recognition of gains (and losses) arising from changes in own credit risk of financial liabilities in profit or loss have historically originated from a perceived inability (in most cases) for the entity to realize such a gain (loss) by extinguishing the liability prior to contractual maturity. However, in cases where the entity is able to do so we believe that the cumulative gain/loss previously recognized in OCI should be recycled to profit or loss to appropriately reflect the realization of this discount/premium. We also note that this reversal occurs automatically if the financial liability is held to maturity, leaving no cumulative entry in OCI, and believe that the position should be consistent in circumstances where the financial liability is extinguished early.

Nevertheless, we note that due to the lack of principles with respect to the use of OCI versus profit or loss views often diverge whether amounts that were initially recorded in OCI should ever be reclassified to profit or loss. We therefore strongly urge the IASB to consider the issue of recycling of gains and losses previously recognized in OCI as part of their project to determine the purpose of OCI.

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 that the guidance in IFRS 7 provides a reasonable basis on which to determine the amount of the fair value change that is attributable to changes in own credit risk of a liability. Paragraph 10(a)(ii) gives an entity the option of using an alternative method for determining the own credit risk element of the fair value change if this is provides a more faithful representation, and therefore provides sufficient flexibility to preparers. However, we recommend that the IASB should clarify the definition of 'own credit' risk with respect to unit-linked liabilities, as (in the absence of credit guarantees by the reporting entity) the credit risk of such liabilities is often based on the fair value of a portfolio of specified financial assets rather than the reporting entity on a consolidated basis.

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?

In view of the particular circumstances caused by the financial crisis, the IASB decided to split the IAS 39 replacement project in phases and complete them one by one to be able to meet certain deadlines. However, one of the problems with such an approach is that it may result in significant incomparability among entities until all of the phases of the project are mandatorily effective.

To avoid creating an unnecessary lack of comparability, we agree that an entity that wants to adopt early the amendments in the ED should be required to apply all requirements in IFRS 9 that it does not already apply.

Question 10

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

We support retrospective application. Given that IFRS 7 already requires an entity to disclose the amount of change attributable to changes in own credit risk for financial liabilities designated as at fair value through profit or loss, we do not believe there would be a significant burden in restating prior periods.