

July 16, 2010

Submitted electronically via [www.iasb.org](http://www.iasb.org)

International Accounting Standards Board  
30 Cannon Street, 1<sup>st</sup> Floor  
London EC4M 6XH  
United Kingdom

Dear Sirs:

**Re: Exposure Draft, *Fair Value Option for Financial Liabilities***

This letter is the response of the staff of the Canadian Accounting Standards Board (AcSB staff) to the IASB's Exposure Draft, *Fair Value Option for Financial Liabilities*, dated May 2010. Responses to the specific questions posed in the Exposure Draft are included in the Appendix to this letter.

The AcSB staff discussed the Exposure Draft with the AcSB and its User Advisory Council. The views expressed in this letter take into account comments and perspectives of these groups. However, they do not necessarily represent a common view of the AcSB, its Committees or staff. Views of the AcSB are only developed through due process.

We reiterate the AcSB's fundamental concern that the IASB is proceeding with proposals to modify accounting for financial instruments in a manner that will not result in globally converged standards. In this case, we think that the separate line treatment for the effect of changes in an issuer's credit risk on the fair value of its financial liabilities and the more specific definition of credit risk proposed by the FASB in its Exposure Draft, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, are theoretically preferable to the approach proposed in the IASB Exposure Draft. However, we are concerned that measurement of the effect of a change in credit risk would not be sufficiently reliable to warrant separate line recognition.

We agree that an entity should provide information about the effect of changes in credit risk on its financial liabilities. We disagree with presenting those changes in other comprehensive income. We

think that when an entity elects to use the fair value option to measure a liability, all changes in fair value should be reported in net income (profit or loss). The portion attributed to changes in the credit risk of the instrument can be disclosed separately either on the face of the income statement or in the notes as at present. More importantly, we remain concerned about the lack of a clearly articulated principle for deciding which items of comprehensive income should be recognized in net income and which in other comprehensive income.

If the IASB concludes that the effect of changes in credit risk should be recognized in other comprehensive income, we disagree with the proposal that those amounts would not be reclassified to net income when realized. We think that changes in the fair value of a financial liability due to changes in the instrument's credit risk should be reported in net income of the entity. Credit risk is inherent in the initial price of a liability; it is recognized as a component of interest expense over the life of the instrument. When an entity realizes a gain or loss on early extinguishment of a liability that is measured at amortized cost, it recognizes that gain or loss in net income. We think the entity should report the same amount as the cumulative gain or loss when fair value is deemed by management to be the more appropriate measurement basis for the liability. If an instrument is held to maturity, the amounts recognized in other comprehensive income will automatically be included in net income as fair value converges to the maturity amount over time. We think there is no conceptual basis for reaching a different conclusion simply because the credit risk component is realized in a single transaction.

Moreover, one of the major arguments against recognizing changes in credit risk at all, made by critics of measuring liabilities at fair value, is that these amounts cannot be captured or realized. Surely, if such amounts are realized on early extinguishment, they should be included in net income. We disagree that reclassifying items between other comprehensive income and net income results in reporting the gain or loss more than once. Comprehensive income in the period of realization is identical whether or not the gain or loss is reclassified.

We think that it is very difficult to isolate and observe the effect of changes in credit risk. The default measurement in IFRS 7 is very crude and captures more than the credit risk of the instrument. Even when some evidence of the price of the instrument's credit risk exists, in most cases it is unlikely that the entire issue could be settled at that price. We can see no conceptual justification for capturing this estimation error temporarily or permanently outside net income.

We do not think the proposal would be implemented consistently. We expect that, if the credit risk portion of fair value changes is excluded from net income, greater attention would be paid to refining the measurement by those entities with the resources to do so.

We agree that hybrid financial liabilities should not necessarily be measured at fair value. However, we note that retaining bifurcation for liabilities with embedded derivatives does not eliminate "the complex and rule-based requirements in IAS 39" and hope that the IASB will thoroughly reconsider the consistency in approach to derivatives embedded in both financial and non-financial hosts.

We would be pleased to elaborate on our comments in more detail if you require. If so, please contact me, Peter Martin, Director, Accounting Standards (+1 416 204-3276 or email [peter.martin@cica.ca](mailto:peter.martin@cica.ca)) or Kate Ward, Principal, Accounting Standards (+1 416 204-3437 or email [kate.ward@cica.ca](mailto:kate.ward@cica.ca)).

Yours truly,

A handwritten signature in black ink that reads "Peter Martin". The signature is written in a cursive, slightly slanted style.

Peter Martin, CA  
Director, Accounting Standards

**Appendix****Responses to detailed questions****Questions 1 and 2 - Presenting the effects of changes in a liability's credit risk in profit or loss**

*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?*

*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 disagree. We think that the decision to use the fair value option for a financial liability should affect the timing but not the amount of income recognized over the life of the obligation. If all credit risk effects were included in net income as we recommend, there would be no need for the Board to include an exception to its proposal, which simply increases the complexity of the standard.

We think that the credit risk of a financial liability reflects the risk of the assets and activities that support it. The so-called counterintuitive effect of an increase in credit risk should be offset by either a decline in the value of those assets or a decrease in profitability.

If the fair value option is applied to liabilities that are managed on a fair value basis or hybrid liabilities when separate measurement of embedded derivatives is not reliably possible, we think that bifurcation of the credit risk portion does not make sense. In the first case, it is the total fair value of the instrument that is evaluated by management, not an arbitrarily determined portion. In the case of a hybrid instrument, fair value measurement is applied because bifurcation yields an inappropriate result. If separate measurement is not possible for contractually defined elements of the instrument, we do not think separate measurement of the credit risk portion would be meaningful or even possible.

**Question 3 - Presenting the effects of changes in a liability's credit risk in other comprehensive income**

*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?*

We disagree with the use of other comprehensive income to remove controversial items from net income. There is no clearly identified and consistently applied principle for distinguishing items to be recognized in net income from those recognized in other comprehensive income. We agree that disclosure of an estimate of the effect of changes in credit risk together with a description of how the entity calculates that effect is useful to financial statement users.

#### **Questions 4 and 5**

*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?*

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

We disagree with excluding the credit risk portion of the change in fair value of a liability from net income. We think this information should be provided by disclosure either on the face of the statements or in the notes.

#### **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?*

We disagree with bifurcating the effect of credit risk and we think that the effect of changes in credit risk should be reported in net income.

#### **Question 7 – Reclassifying amounts to profit or loss**

*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?*

We disagree with presenting gains and losses in other comprehensive income but if a principle can be articulated defining appropriate use of the concept, we strongly disagree that any gains or losses would not be reclassified to net income on realization. In this proposal, failure to permit recycling could result in misstating a gain or loss reported in net income should the liability be settled prior to its maturity. If the Board really intends to prohibit the inclusion of changes in a liability's credit risk in net income, it must freeze the credit risk inherent in the price of the instrument in other comprehensive income at initial recognition. Nothing can be included as the result of fair value changes over the term of the instrument.

#### **Question 8 – Determining the effects of changes in a liability's credit risk**

*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 think that it is incorrect to presume that the entire spread above a benchmark interest rate is the entity's own credit risk. The spread captures, at a minimum, liquidity of the market and the market's price for the class or category of instrument in addition to the credit risk of the specific instrument being measured. In most cases, we do not think that it is possible to reliably measure the portion of the

spread that represents the credit risk of the specific instrument because credit risk is a function of individual market participants' perception of the entity over their particular investment horizon. We note that this is the conclusion the FASB reached when it reconsidered the portion of the coupon interest rate that would be considered 'interest' for purposes of the hedging requirements in SFAS 133 (although it appears from their recent proposals that they have changed that view). We think that the approach in IFRS 7 where the entity defines its own views on how credit risk affects the market price of its liabilities is a useful disclosure but not sufficiently reliable for the purposes of determining net income.

#### **Questions 9 and 10 – Effective date and transition**

*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?*

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

In general, we agree that early adoption should be permitted for any new accounting standard that improves financial reporting and that a new standard should be applied retrospectively, subject to practicability. However, we think that proceeding with IFRS 9 without convergence with US GAAP is inappropriate given the global nature of capital markets.