The Association of Corporate Treasurers

Comments in response to
Exposure draft EC/2010/4 fair value option for financial liabilities
Issued by the IASB
May 2010

15 July 2010

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this matter.

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Valuations

The valuation of an asset or liability can be taken as the net present value of the cash flows discounted at a suitable rate. The rate is normally derived from a benchmark "risk free" rate for the appropriate maturity plus an addition to the rate to reflect the credit risk on the instrument. The adjustments to the risk free rate can be analysed into further components such as an illiquidity premium.

Over time the credit risk component of the rate may change because of a general change in pricing of risk in the market or through the riskiness of the specific instrument/issuer itself changing. On liabilities that specific instrument element can be referred to as an "own credit" effect.

The arguments for removing own credit effects from profit or loss are strong and marginally less strong as regards the effects of more general changes in credit risk pricing. We believe that the default method of determining changes in values attributed to changes in credit risk taken from IFRS 7, namely all valuation changes other than that from the benchmark rate is a reasonable proxy. However for companies that want to take a more accurate view of "own credit" effects IFRS7 permits use of a different method if it provides a more faithful representation. Our interpretation of this is that disaggregating more general changes in the pricing of risk is therefore possible and we welcome this degree of flexibility.

Specific questions

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 ACT supports the IASB proposal that changes in the credit risk of the liability should not affect profit or loss. We agree with the rationale that you have mentioned including the belief that to take profits or losses would not provide useful information unless those liabilities are held for trading. In the case of the own credit risk component of pricing a company whose credit standing is deteriorating would otherwise show a profit on its own liabilities and this is widely regarded as counter intuitive and even perverse.

The occasions when the Fair Value Option (FVO) may be invoked include those times when doing so results in more meaningful information because it eliminates or significantly reduces a measurement inconsistency (accounting mismatch).

In many cases that we could envisage the own credit element of the MTM valuation of liabilities introducing a basis difference as compared to the asset it is being "matched" against. So more often than not removing the own credit element to OCI makes for a better match. For example - a company has borrowed floating rate for 5 years and done a swap into fixed for 10 years such that lack of effectiveness means that strict hedge accounting cannot be applied. In such a case the FVO is a good next best way of minimising mismatch. In this example the swap valuation has no (or minimal) impact from own credit whereas the liability valuation does. Removing the own credit element on the liability makes for a better natural offset between the swap and the liability.

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?

In most cases the valuation effects of credit risk changes are best removed to OCI but if occasions do arise where such treatment itself creates a mismatch we would regard it as acceptable for the entire fair value change in the liability to be presented 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?

The ACT agrees with the measurement basis being proposed so that the balance sheet continues to reflect the total fair value rather than using some other basis such as a frozen credit spread method. Valuations will vary with changes in the credit risk of the liability and as stated above it is potentially misleading to show this in profit or loss, not least because in most cases its is unlikely that gains or losses can be crystalised / realised. We support the taking of this element to OCI.

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?

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

The two-step approach of first taking the total fair value changes to profit or loss and then immediately taking the liability's credit risk related portion to OCI achieves the aim of providing information to users in a high profile position in the accounts. To an extent is does seem to be elevating this information to a degree of prominence it does not really deserve. Furthermore it does seem to introduce a complication in that this methodology differs from the established ways of presenting performance, namely recognition of gains and losses:
(a) in profit or loss
(b) in OCI without reclassification
(c) in OCI with reclassification to profit or loss at a later stage.

Accordingly we have a marginal preference for the one-step approach.

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 see no strong logic for taking the effect of credit risk changes to equity.

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?

On this question we do not support the proposal that there should be no recycling.

If a liability measured at amortised cost is extinguished prior to maturity the gain or loss is recorded in profit or loss so that it would be consistent to do the same for liabilities held at fair value through profit or loss. If a company buys back its debt or enters into a reconstruction / rearrangement of its debt so that the original debt is extinguished any gains or losses are effectively realised so recycling is in our view appropriate.

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?

As discussed in our section headed valuations above we agree that the IFRS 7 guidance is equally applicable in the context of this exposure draft.

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 believe that the changes to the FVO should be capable of early adoption and independent of the rest of IFRS 9 on the basis that this will solve the own credit issue that exists in the current version of IAS 39. This might allow it to be endorsed by the EU independent of the rest of IFRS 9.

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

We agree

The Association of Corporate Treasurers

The ACT is the international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for international treasury, providing the widest scope of benchmark qualifications and continuing development through training, conferences and publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

Our 3,600 members work widely in companies of all sizes through industry, commerce professional service firms.

Further information is available on our website (below).

Our policy with regards to policy and technical matters is available at
http://www.treasurers.org/technical/manifesto

Contacts: Martin O'Donovan, Assistant Director, (020 7847 2577; modonovan@treasurers.org) Policy and Technical John Grout, Policy and Technical Director (020 7847 2575; jgrout@treasurers.org) Stuart Siddall, Chief Executive (020 7847 2542 ssiddall@treasurers.org)	The Association of Corporate Treasurers 51 Moorgate London EC2R 6BH, UK Telephone: 020 7847 2540 Fax: 020 7374 8744 Website: http://www.treasurers.org