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Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

20 July 2010

Dear Kevin

Exposure Draft ED 196 *Fair Value Option for Financial Liabilities*

I am enclosing a copy of the PricewaterhouseCoopers response to the International Accounting Standards Board's exposure draft ED/2010/4 *Fair Value Option for Financial Liabilities.* The letter reflects the views of the PricewaterhouseCoopers network of firms and as such includes our own comments on the matters raised in the exposure draft.

We would welcome the opportunity to discuss our views at your convenience. Please contact me on (02) 8266 8350 if you would like to discuss this further.

Yours sincerely

Regina Fikkers

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Partner
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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

16 July 2010

Dear Sir

Fair value option for financial liabilities

We are pleased to respond to your Exposure Draft – Fair value option for financial liabilities.

Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of the member firms that commented on this Exposure Draft. "PricewaterhouseCoopers" refers to a network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Our response to this Exposure Draft addresses the classification and measurement of financial liabilities only in the context of IAS 39/IFRS 9: Financial Instruments. It does not consider the model proposed by the FASB in its Exposure Draft, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.

Financial liabilities

Overall, we support retaining the IAS 39 model for financial liabilities other than those for which the fair value option has been elected. The guidance in IAS 39 for financial liabilities has generally worked well. Although the guidance related to the bifurcation of hybrid instruments can be complex, it is largely understood in practice. Nevertheless, we recommend the Board revisit the IAS 39 embedded derivatives guidance as part of its post 2011 agenda to consider whether it can be simplified.

We also support classifying the changes in 'own credit risk' in OCI for liabilities designated at fair value using the fair value option. This is a pragmatic solution to the concerns raised over the recognition of 'own credit risk' in profit or loss where the gains and losses are not expected to be realised through trading. However, we continue to believe that the Board should develop a set of consistent principles to govern the use of OCI. While we accept the proposed expansion of the use of OCI to help resolve the 'own credit risk' issue, we strongly believe that the Board needs to add to its post 2011 agenda a project to address the purpose of OCI, what types of items should be recognised in OCI and to what extent recycling is appropriate.

Although we support the classification of changes in 'own credit risk' in OCI for liabilities designated at fair value using the fair value option, we do not agree with prohibiting the transfer of such amounts to profit or loss upon early extinguishment of the liability in this project. We believe that changes in 'own credit risk' should be recycled to profit or loss when they are realised prior to maturity. The mechanics of the Board's proposal effectively result in gains and losses from 'own credit risk' being reversed out of OCI for liabilities that are held to maturity and settled at their contractual amount. It appears inconsistent to preclude OCI balances from being recycled to profit or loss where the liability is extinguished early and OCI amounts are realised. In addition, the accounting should be consistent with the treatment of equivalent gains and losses on financial liabilities held at amortised cost which will continue to be recognised in profit or loss.

Presentation

We prefer a one-step approach rather than the two-step approach proposed for presentation. We believe the two-step approach results in a cumbersome presentation that provides no additional information for users.

Transition

We do not believe that it is necessary for IFRS 9 to have been adopted if an entity wishes to early adopt the proposed guidance for financial liabilities designated using the fair value option. The concerns over the recognition of 'own credit risk' in profit or loss are valid regardless of the timing of the adoption of IFRS 9 for financial assets. Therefore we believe that the Board should allow this amendment to IAS 39 for financial liabilities to be early adopted on a standalone basis.

Because the ability to re-designate the fair value option for financial assets and liabilities is only allowed upon adoption of IFRS 9 for financial assets, we support requiring the adoption of the new guidance for financial liabilities upon early adoption of IFRS 9. However, we believe entities that have already adopted IFRS 9 at the time the proposed guidance is finalised should then be given the opportunity to reassess their prior fair value option designations on transition to the new financial liability standard.

The Board recently announced that it intends to issue a document soliciting stakeholder input regarding the effective date and transition methods for major Memorandum of Understanding projects. We support this plan and believe that a coordinated consideration of the most appropriate transition to all of the new accounting standards will be well received by the Board's constituents. We strongly encourage the Board to move quickly on this so the benefits of the input can be applied to this project prior to its completion.

We have expanded on some of the above points and responded to the specific questions raised in your Exposure Draft in the appendix to this letter.

If you have any questions in relation to the letter please do not hesitate to contact John Hitchins, PwC Global Accountant (+44 207 8042497) or John Althoff (+44 207 213 1175).

Yours faithfully

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

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Appendix:

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?

We agree, changes in 'own credit risk' should not affect profit or loss for liabilities designated at fair value using the fair value option. This is a pragmatic solution to the concerns raised over the recognition of 'own credit risk' in profit or loss where the gains and losses are not expected to be realised.

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 agree with the alternative suggestion. Although there is the potential for some accounting mismatches to arise where changes in the credit risk of the liability are not recognised in profit or loss, this concern is outweighed by the additional complexity of having two types of fair value option accounting. Furthermore, determining whether an accounting mismatch is created by recognising changes in the 'own credit risk' of the liability in profit or loss may be challenging and require the development of additional detailed guidance.

We believe that the flexibility in IFRS 7 to calculate 'own credit risk' directly, (rather than indirectly using the default method) will allow entities to largely limit the amount and likelihood of mismatches. Calculating changes in 'own credit risk' directly can avoid including the wider market price of credit and liquidity in the amounts recognised in OCI and therefore mitigate the risk of mismatches.

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?

Yes, we agree that changes in 'own credit risk' should be presented in OCI rather than equity. Although we believe changes in 'own credit risk' should not be recognised in profit or loss until realised, they do reflect an element of the performance of the entity and therefore should be presented in the performance statement. Additionally, we do not believe it is desirable to begin using equity in lieu of OCI pending the Board establishing a comprehensive set of principles to govern the use of 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?

No, we do not support the proposed two-step approach to the presentation of changes in 'own credit risk'. The two-step approach results in a cumbersome presentation which is more complex than needed and does not provide any additional information to users. The one-step approach gives the same overall result in both profit or loss and total comprehensive income, provides all necessary information for users and is more straightforward.

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

Please see our response to question 4

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?

Please see our response to question 3

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?

We continue to believe that the Board should develop a set of consistent principles to govern the use of OCI. While we accept the expansion of the use of OCI in this project to help resolve the 'own credit risk' issue, we strongly believe that the Board needs to add to its post 2011 agenda a project to address the purpose of OCI, what types of items should be recognised in OCI and to what extent recycling is appropriate. Pending the completion of that project, we support changes in 'own credit risk' being recycled to profit or loss when they are realised prior to maturity. The mechanics of the Board's proposal effectively result in gains and losses from 'own credit risk' being reversed out of OCI to profit or loss for liabilities that are held to maturity and settled at their contractual amount. It appears inconsistent to preclude OCI balances from being recycled where the liability is extinguished early and OCI amounts are realised. Therefore, to provide consistency between liabilities extinguished at different points in their maturity (including those at amortised cost), we support reclassification from OCI to profit or loss where a gain or loss has been realised on the extinguishment of the liability.

The main objective of these proposals is to address the problem of recognising changes in 'own credit risk' in profit or loss where these gains and losses are not realised. That rationale for avoiding recording these gains and losses in profit or loss does not exist once they have been realised.

Question 8
For the purposes of the proposals in the 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?

Yes, we support maintaining the flexibility that IFRS 7 provides to entities for calculating credit risk. Calculating 'own credit risk' can be complex and as yet there is no consensus as to a single methodology to calculate 'own credit risk' directly. The ability to use differing methodologies is needed to reflect the different nature of the liabilities concerned and to address the challenges of gathering appropriate information for the calculation where inputs are not often directly observable. We note that in line with existing requirements in IAS 8, entities should apply their methodology for determining the amount of 'own credit risk' consistently.

However, we recommend that the Board clarify in the final standard the definition of 'own credit risk' with respect to unit-linked liabilities as set out in IFRS 7 paragraph 10. The amount of the obligation associated with such liabilities is generally based on the fair value of a referenced pool of assets. We believe the 'own credit risk' for these liabilities should clearly exclude the credit risk inherent in the asset pool irrespective of which methodology is used.

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 do not believe that it is necessary for IFRS 9 to have been adopted if an entity wishes to early adopt the proposed guidance for financial liabilities designated using the fair value option. The concerns over the recognition of 'own credit risk' in profit or loss are valid regardless of the timing of the adoption of IFRS 9 for financial assets. Therefore we believe that the Board should allow this amendment to IAS 39 for financial liabilities to be early adopted on a standalone basis.

Because the ability to re-designate the fair value option for financial assets and liabilities is only allowed on adoption of IFRS 9 for financial assets, we support requiring the adoption of the new guidance for financial liabilities on early adoption of IFRS 9. However, we believe entities that have already adopted IFRS 9 at the time the proposed guidance is finalised should then be given the opportunity to reassess their prior fair value option designations on transition to the new financial liability standard.

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

The Board recently announced that it intends to issue a document soliciting stakeholder input regarding the effective date and transition methods for major Memorandum of Understanding projects. We support this plan and believe that a coordinated consideration of the most appropriate transition to all of the new accounting standards will be well received by the Board's constituents. We strongly encourage the Board to move quickly on this so the benefits of the input can be applied to this project prior to its completion.