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July 16, 2010

Sir David Tweedie
Chair
International Accounting Standards Board
30 Cannon Street
London, United Kingdom EC4M 6XH

International Accounting Standards Board Exposure Draft,
Fair Value Option for Financial Liabilities

Dear Sir David,

The CFA Institute,[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the International Accounting Standards Board (IASB or the Board) Exposure Draft, *Fair Value Option for Financial Liabilities* (the ED or Exposure Draft).

CFA Institute represents the views of its investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

General Comments

It has been the long-standing position of CFA Institute that financial statements should be useful to investors and other financial decision-makers. Investors' decisions depend critically on the information provided in the financial statements. We believe that transactions and financial decisions are based on fair values. Hence, fair value is the most relevant measurement attribute for items included in the financial statements. All other bases, including historical cost, sacrifice usefulness and relevance. We also note that the Financial Accounting Standards Board's (FASB's) Financial Instruments Exposure Draft calls for different accounting for financial liabilities, in particular they propose a very different method for computing own credit changes.

[1] With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

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If the FASB and IASB have convergence as an objective, we urge the organizations to seek uniform treatment for financial liabilities as well as other accounting matters currently under review as part of the convergence project.

As stated in our response to the Discussion Paper *Credit Risk in Liability Measurement*,[3] we do not support an accounting model that allows companies to choose whether to fair value only certain individual financial liabilities (i.e. fair value option). While we supported the original proposal for a fair value option, that support was based on the view that it would be a step towards mandatory fair value measurement for financial assets and liabilities. Given the IASB's latest proposals, we realize that our expectation was misplaced.

Experience with the fair value option has shown that companies appear to elect fair value opportunistically, for example to reduce accounting mismatches, and investors are often unable to discern the reason why the fair value option was elected. Major financial institutions have used the option to fair value portions of, in some cases, more than ten balance sheet captions. Disclosures are insufficient for investors to understand the reasons for and the effects of these choices. Cherry-picked application of accounting measurements substantially reduces the usefulness, and accentuates accounting asymmetry and lack of comparability of financial reports to investors. Furthermore, in our *Financial Instruments Survey (November 2009)* 59% of respondents indicated that it was appropriate to report financial liabilities at fair value – with only 21% indicating it was inappropriate and 20% undecided – while 72% to 80% favour reporting all financial assets are fair value – with only 9-13% indicating it was inappropriate and 12-18% undecided. Overall, the 624 respondents found financial liabilities at fair value was appropriate over inappropriate at a nearly 3:1 ratio.

Changes in Fair Value for Financial Liabilities Affecting Profit and Loss
We believe recognizing the effects of changes in credit risk of a liability in profit and loss provides useful information to users. As noted in our previous comment letter on *Credit Risk in Liability Measurement* the inclusion of credit risk yields useful information on the effective interest rate of the liabilities and portrays what would be the likely refinancing requirement at the time of reporting. Declines in the fair value of liabilities due to higher credit risk often indicate that there has been a decline in the fair value of assets that, implicitly or explicitly, provide collateral for an entity's liabilities. Although we understand that a subset of users, such as credit analysts focus on contractual cash flows, there is significant and important information content conveyed to all users when the effects of changes in credit risk are included in the measure of profit and loss.

In IASB Agenda Paper 2A prepared for the February 10, 2010 Board meeting, the results of your survey on own credit were discussed. We find the comments conveyed more telling than the respondent percentages and reflective of our position on this issue. For example, one user respondent remarked in their response to the question regarding whether analysts exclude own credit gains and losses from performance measures:

> *"Own credit needs to be disaggregated because it communicates an important change in company's standing. I believe this GAAP measure has meaning and should be clearly*

[3] CFA Institute Comment Letter *Credit Risk in Liability Measurement* , September 1, 2009

labelled own credit gain/loss" If analysts exclude it from pro forma earnings, that does not mean they are not using this number, it just means that it has more of one-time nature that would be put aside in analysis of normalised earnings. Just because it does not make it into the normalised earnings numbers does not mean it is not being used."

When completing our *Financial Instruments Survey (November 2009)* – where as noted above we found that 59% of our members supported fair valuing financial liabilities – we also found that 32% of respondents found inclusion of own credit appropriate, 32% found it inappropriate and 37% were not sure. The greatest proportion of respondents were undecided. Upon further consideration of these findings, we believe that greater education, on the part of the IASB, regarding the information content of the movement in own credit (i.e. the movement in own credit may signal information regarding asset quality) and the perceived counterintuitive nature of movements in own credit is necessary. This combined with greater education on the asset and liability accounting asymmetry for financial assets and financial liabilities and demonstration of entities which have crystallized such movement in own credit would assist in revolving this uncertainty (i.e. in favour of greater use of fair value).

We stress that, as a general principle, the Board should consider that users have differing information needs and should develop standards that serve the needs of the broadest range of users and, therefore, it is imperative to reflect these changes on the face of the financial statements.

Changes in Fair Value Due to Credit Risk Recorded in Other Comprehensive Income
Separating fair value changes due to credit risk from non-credit changes seems to be predicated on the mistaken belief that other comprehensive income (OCI) is a category that investors do not devote substantial attention to. We have stated on various occasions that there are significant transactions accounted for through OCI without any conceptual basis. Such transactions include fair value changes associated with available-for-sale securities, gains and losses on cash flow hedges, foreign currency translation effects and postretirement benefit adjustments. Their deferral in OCI, and subsequent recycling through net income, makes it difficult for investors to fully evaluate the economic meaning of these transactions.

Adding yet another item to the already significant list of recognition and measurement changes in OCI simply adds another category of economic events to this list of conceptually unsupported transactions. OCI acts essentially as a suspense account that contains key elements of a reporting entity's performance and risk and, in essence, renders income statements less meaningful. The effect of the OCI category is to disconnect the inherent volatility associated with a business from the volatility of its earnings – that is, earnings are made to artificially appear less volatile than they truly are. We believe this conceptually unsupported use of OCI does a considerable disservice to investors.

Although we strongly oppose transactions being recorded in OCI, should the Board decide to require changes in credit risk to be separated and recorded in this category, we support a two-step approach for greater transparency and usefulness rather than a one-step approach. Additionally, we believe that it is important that the following be disclosed:

1) the fair value of the financial liability,

2) the total change in the fair value of the financial liability,
3) amortized cost, and
4) the portion of the total fair value change that is attributable to changes in the entity's credit risk.

More specifically, the entity should be required to disclose how the credit valuation adjustment is calculated, including current exposure, potential for future exposure or other approach, the model used and its inputs and source of those inputs. These components, when accompanied by comprehensive disclosures regarding the reasons for the changes during the reporting period, will provide useful information regarding the overall riskiness of the entity and the impact on its future financing costs.

Because we believe that deferral through OCI is not the appropriate accounting for the transactions noted above, we oppose the re-cycling of economic changes which have been included in OCI since the full effects of these transactions become difficult for investors to fully evaluate. We note that the Financial Accounting Standards Board's (FASB's) Financial Instruments ED calls for the recycling of certain items include in OCI. We believe the FASB and IASB should develop a conceptual justification for OCI and a rational for what items are or are not to be recycled

Determining the Effects of Changes in a Liability's Credit Risk
The ability to make a reasonable differentiation of own credit risk from other market price changes includes many subjective assessments. Using the requirements under paragraph B4 of IFRS 7, *Financial Instruments: Disclosures,* to determine the changes in market conditions related to the benchmark interest rate is a reasonable starting point for that component. However, other factors may need to be considered including instrument-specific credit enhancements, such as third party guarantees. We believe that an entity should use a method which is most appropriate in its own circumstances for determining the effects of fair value changes associated with credit risk accompanied by robust disclosures of the methodologies used to determine the valuation impact of own credit risk. This will facilitate the consistent disclosure across periods and across company practices and bolster financial reporting comparability.

We also note that the FASB Financial Instruments ED – which not only calls for different accounting for financial liabilities – sets forth a very different method for measuring the effect of own credit changes. If the FASB and IASB objective is convergence, we question why consensus on this measurement principle cannot be achieved.

Effective Date and Transition
We concur with the Board's decision to permit early application provided that an entity must apply at the same time any requirements in IFRS 9 that it does not already apply.

We support retrospective application of the newly issued standards because it is important for users to be able to compare the financial results of an entity over the periods presented.

Conceptual Framework and Convergence
When considering the measurement of financial liabilities, it is our observation that the IASB is developing very different liability measurement models depending upon whether the liability is covered by the Insurance Contracts Project, the IAS 37 Replacement Project, the Leasing Project, the Revenue Project or the Financial Instruments Project. Certain of the projects will result in complex liabilities being updated for movements in measurement attributes such as discount rates (e.g. insurance and IAS 37 liabilities) while other projects do not (i.e. operating lease obligations, bank deposits, own debt). We believe that users of the financial statements need a conceptual framework from which to understand the measurement basis of liabilities and the rationale for differences in such measurement and why measurement optionality such as that proposed in this ED enhances the decision-usefulness of the financial statements.

We also believe that taking time to develop of a conceptual framework for the measurement of such liabilities would be useful in achieving greater consistency among International Financial Reporting Standards, and helpful to pursuing the objective of convergence as set forth in the 2006 Memorandum of Understanding.

Closing Remarks

If you, other members of the IASB or your staff have questions or seek further elaboration of our views, please contact either Matthew M. Waldron by phone at +1.212.705.1733, or by e-mail at matthew.waldron@cfainstitute.org, or Sandra J. Peters by phone at +1.212.754.8350, or by e-mail at sandra.peters@cfainstitute.org.

Sincerely,

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