Organismo Italiano di Contabilità – OIC
(The Italian Standards Setter)
Via Poli 29, 00187 Rome, Italy
Tel. +39/06/6976681 fax +39/06/69766830
e-mail: presidenza@fondazioneoic.it

EFRAG
35 Square de Meeûs
B-1000 Brussels
BELGIUM
commentletter@efrag.org

5 July 2010

Re: *EFRAG draft comment letter on IASB ED Fair Value Option for Financial Liabilities*

Dear Sir/Madam

We are pleased to provide EFRAG with our comments in order to contribute to the finalization of the EFRAG comment letter on the IASB Exposure Draft *"Fair Value Option for Financial Liabilities"* ('the ED').

Generally, the Italian Standards Setter agrees with EFRAG and IASB that fair value changes due to changes in an entity's own credit risk from re-measurement of liabilities designated under the fair value option should not impact profit or loss. Nevertheless, the Italian Standards Setter cannot find a strong rationale for recognizing in OCI the effects of changes in own credit risk. The main reason advocated by the IASB is a consequence of the decision not to recognize the effects of changing own credit risk in P/L, without introducing a new measurement model as it would increase confusion for the users. In this regard, the EFRAG acknowledges that "*the IASB addresses long-standing concerns that reporting the effects of changes in own credit risk of liabilities that are not held for trading purposes in profit or loss is misleading*". Apparently, the word *misleading* recalls the reasons for the project, that the IASB clearly described in the press release that accompanied the ED: "*the proposals respond to the view expressed by many investors and others in the extensive consultations that the IASB has undertaken—that volatility in profit or loss resulting from changes in the credit risk of liabilities that an entity chooses to measure at fair value is counter-intuitive and does not provide useful information to investors"*. The proposed model mitigates the volatility of P/L, but does not deal with the volatility of Equity and Statement of comprehensive income caused by the changes in own credit risk. In the absence of a principle that explains the rationale of OCI, and establishes the differences with the P/L, the Italian Standards Setter does not agree with the proposed accounting model.
Moreover, it is acknowledged that the so called "*counter-intuitive*" effect is not overcome by the recognition of the changes of own credit risk in OCI. With the model proposed, an entity

that suffers a deterioration in its own credit risk will continue to present an increase in its equity in its statement of financial position. This is still a counter-intuitive effect.

The ED illustrates alternative applicable accounting models. One of them, the frozen credit spread approach, is the only one that ensures that neither the statement of financial position nor the statement of comprehensive income are affected by the "*counter-intuitive*" effects of the changes in own credit risk. The Italian Standards Setter supports this accounting treatment, which would represent an improvement in the current accounting model for financial liabilities.

In relation to accounting for financial liabilities not designated under the fair value option, the Italian Standards Setter agrees that a mirror accounting between the asset and the liability sides of the statement of the financial position is not strictly necessary.
The Italian Standards Setter welcomes the retention of the bifurcation methodology in IAS 39 for financial liabilities, and understands the benefits in terms of accounting for changes in own credit risk, but it makes less clear the rationale for abandoning the bifurcation for financial assets. We believe that the Board should clarify why these two accounting models might coexist. However, we suggest the Board amend the accounting model for financial assets, allowing the bifurcation of hybrid financial assets.

Bearing in mind these general concerns, detailed responses to the ED questions are as follows:

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?

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?

As already mentioned above, the Italian Standards Setter agrees that changes in the credit risk of the liability should not affect profit or loss. The use of the fair value option responds to the need to depict in the Statement of financial position a group of financial liabilities or financial assets and financial liabilities managed on a fair value basis. This does not imply that the impacts on Statement of comprehensive income from changes in fair value of assets and liabilities are equivalent. For instance, a change in the fair value of an asset as a consequence of changes in the debtor's credit standing may not imply a similar change in the fair value of the liabilities. However, an accounting mismatch in P/L is justified.

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?

As already explained, the Italian Standards Setter does not agree with the recognition of the changes in own credit risk into OCI, because the objectives of the project do not seem to be achieved. The issue related to the volatility due to changes in own credit risk is only shifted from P/L to SCI and equity, and in the meantime all the concerns related to the so-called "counter intuitive" effects are retained. In addition, it is relevant to point out that the Italian Standards Setter does not agree with the use of OCI simply as a residual section of the items that should not affect P/L. The IASB should develop a framework that establishes which

changes in value of the items included in the Statement of Financial Position should affect OCI and why.

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?

Leaving aside the general comment, the Italian Standards Setter shares the position of the EFRAG on the two-step approach. The proposed presentation of the two items in the P/L and one item in OCI is an undue disaggregation that is not counterbalanced by any additional information for the users, as a similar level of disaggregation is already required 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?

The rationale to consider the changes in own credit risk as a transfer of value between shareholders and creditors is not convincing. The deterioration in own credit risk is not a transaction and, therefore, cannot be considered a transaction with owners in their capacity as owners as defined in IAS 1.

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?

Generally, the Italian Standards Setter is in favour of allowing recycling of OCI items when realization events occur. Some argue that in this circumstance the realization event is the settlement of the liability and then, at that time, recycling should be allowed. Others stress that when an entity settles a liability, the gain from the derecognition is counterbalanced by the higher interest rate that the same entity will pay for the new funds that it necessarily has to obtain (normally a deterioration in credit risk is a consequence of the financial difficulties of the entity) although the entity might fund the settlement through other means (for instance a capital increase).
Although both positions have some merits conceptually, allowing the recycling when the liability is settled seems to be more aligned with the general principle of accounting for the derecognition of a financial liability, regardless of the accounting model at which the liability is carried in the statement of financial position.

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?

The Italian Standards Setter agrees with the proposal to carry forward the criteria currently described in IFRS 7 for calculating changes in own credit risk. It is noted that these criteria are easier to apply for quoted financial instruments. Alternative methods would create confusion to the users.

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?

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

The Italian Standards Setter agrees with the proposals of both early application and transition requirements.

* - * - *

If you have any queries concerning our comments, please do not hesitate to contact us.

Yours faithfully,
Angelo Casò
(Chairman)