



15 July, 2010

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Board Members:

Consejo Mexicano para la Investigación y Desarrollo de Normas de Información Financiera (CINIF), the accounting standard setting body in Mexico, welcomes the opportunity to submit its comments on the Exposure Draft on Fair Value Option for Financial Liabilities (the ED), issued for exposure in May, 2010. Set forth below you will find our comments on the topics included in the Exposure Draft.

We have divided our letter in two sections. In the first section you will find our comments on recognizing liabilities at fair value. The second section includes our comments on the issues that would exist if it is accepted that liabilities be recognized at fair value.

Recognition of financial liabilities at fair value

This is a very contentious issue. Some have argued that if financial assets are recognized at fair value and impairment of the assets is recognized, financial liabilities should follow the same standard. Thus far IAS 39, *Financial Instruments: Recognition and Measurement*, recognizes certain cases in which a financial liability must or may be valued at fair value.

A financial liability must be recognized at fair value when it meets the definition of held for trading. One of the three categories, derivatives, in the definition is very easy to deal with. It is logical that a derivative be recognized at fair value, since it has no nominal value, and its value is based on the value of the underlying.

The other two categories apply mainly to entities in the financial services industry. Such entities incur financial liabilities that are repurchased in the short term and manage a portfolio of identified financial instruments for which, since their initial recognition, there is evidence of a recent actual pattern of short-term profit-taking. The key argument for recognizing financial liabilities at fair value in these cases is that there is evidence that the operations of the entity are constantly carried out with short-term trading objectives.

In the situation described in the preceding paragraph, there is a clear business model that operates on a fair value basis. Therefore fair value recognition of financial liabilities is not an issue in such cases.

What is contentious is when an entity elects the fair value option, since in the two cases permitted by IAS 39, there is no requirement that the financial liabilities be incurred and repurchased actively in the short term, but only that there are assets recognized at fair value and that the variations in the values of the assets are compensated by the variations in the values of the liabilities. Such are the case of the accounting mismatch and the case of a portfolio managed on a fair value basis and the performance of management being evaluated on such basis.

We believe that the fact that the changes in fair values of financial liabilities appear to compensate the changes of fair values of the financial assets is not sufficient to designate the financial liabilities at fair value. To be operational, the assets and liabilities should be tradable and an active liquid market should exist. In the case of financial assets, any gain is usually realizable in the market. The question is whether this can be done in the case of a liability. To be able to do so, the entity must have the possibility of repurchasing its debt financial instruments at any time and not just when the liability is due, since in the latter case it is most likely that the amount to be paid would be the contractual amount, not the market value.

This is not indicated in IAS 39, neither in paragraph 11A, nor in paragraphs AG4B to AG4K. Therefore, the fair value option is accounted for based only on the theoretical assumption that the changes in the fair value of the liability are compensating the changes of the fair value of the assets. However, the question of the possibility of realizing the profit on the financial liability is not addressed, when that question is always present in the determination of the value of the financial assets.

Therefore, we question whether the fair value option for financial liabilities is feasible, unless the debt instruments of the entity are quoted in a market and the entity has the resources to take the profits on such debt instruments.

In Mexico the use of fair value for trading liabilities, other than derivative financial instruments, does not exist as far as the market for financial debt instruments is not very liquid. In the case of the fair value option, the Mexican National Banking and Securities Commission does not allow financial sector regulated entities to use that option. Therefore the use of fair value for liabilities has not been an issue in Mexico and our comments are based more on the accounting logic.

Issues if financial liabilities are recognized at fair value

We are concerned that the eligibility conditions to irrevocably designate a financial liability at fair value through profit and loss are contained in IAS 39, which is to be replaced by the new standards on financial instruments. Therefore, reference should not be made to a standard that will not exist in the near future.

We believe that the new standard should be more precise regarding the eligibility of financial liabilities to be measured at fair value and the requirement that the financial liability be tradable is a key eligibility factor. To do so, the related paragraphs should be carved out from IAS 39.

Once the issue of the eligibility factor is resolved, we can address the segregation of the own credit risk element in the change of value of the financial liability, which would affect only those for which the fair value option is elected.

Our answers to the specific questions raised in the Exposure Draft are as follows:

Question 1

Do you agree that for all the liabilities designated under the fair value option, changes in the credit risk of the liability should not affect profit and loss? If you disagree, why?

Yes. The basis for not affecting profit or loss for the changes in the value of liabilities rests on the theory of transfer of wealth, which is a new concept for accounting purposes. Assuming that this concept becomes generally accepted, there is a basis to include the effect of such changes in other comprehensive income. We do not disagree with the concept and believe it would be prudent to segregate this effect from the decline in value of a liability until it is realized. We believe this is conservative, since the value of a financial liability frequently goes down and rarely will go up.

This would not apply to all liabilities, since the full change in value of those for which there is an evidence of active trading or that are a derivative financial instrument, must be recognized in profit and loss.

Question 2

Or alternatively, do you believe that changes in the credit risk of the liability should not affect profit and loss unless such treatment would create an accounting mismatch in profit and loss (in which case, the entire fair value change would be required to be presented in profit and loss)? Why?

No. As we indicated before, the effect of derivative financial instruments and trading liabilities should affect profit and loss. This is due to the fact that in the case of trading, management is not interested in why the fair value of the financial liability is changing, but in taking profits, as it does for assets, due to changes in market values. Also, for practical purposes, trying to determine the effect of its own credit risk on securities that are frequently purchased or sold would be rather difficult.

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 believe that presenting such portion in other comprehensive income is appropriate until the debt is paid and its final fair value is known. Therefore, this effect should ultimately flow through profit and loss, when management is able to realize the transfer of wealth.

Question 4

Do you agree that the two-step approach provides useful information to user of financial statements? If not, what would you propose instead?

No. We believe the two-step approach provides information that could be useful for a very sophisticated analyst who is closely following the performance of an entity over several periods. As we indicated above, what goes to other comprehensive income should be on a transitory basis, until the financial liability is paid.

Question 5

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

Yes. As we indicated above, both the one and two step approaches would be useful, but only for a sophisticated analyst who is closely following the performance of an entity over several periods.

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?

No. It is difficult to understand why the effect of own credit risk in the valuation of a liability could be a contribution to or a distribution of the equity of an entity, when there is no actual contribution or distribution of equity from or to the owners. If this were correct, the forgiveness of a portion of debt in a distressed renegotiation should affect equity, and this is not the case. Equity should only be directly affected by transactions with owners in their capacity as owners.

Question 7

Do you agree that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income should not be reclassified to profit and loss? If not, why and in what circumstances should they be reclassified?

No. The gains or losses resulting from changes in a liability's credit risk that are separated from other changes in value arise from a "transfer of wealth" that will not be realized until the liability is finally paid off. However, when the liability is settled it is finally earned and should be reclassified to income on that date, since management has realized the transfer of wealth, which would be similar to the consensus indicated in paragraph 9 of IFRIC 19.

Question 8

For the purpose 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?

No. We believe that if the default method of IFRS 7 is used, the change due to a general market perception may be attributed by default to a specific change in own credit risk if the benchmark interest has not changed.

This method would give an approximate of how much the effect of own risk may be, but it is a rough estimate, since the effects of other risks, such as the liquidity risk, would be included in such amount. This is why it is necessary to consider that what is recognized as other comprehensive income is transitory and will be ultimately confirmed when the financial liability is paid.

Unfortunately, we do not foresee a method that would give a reliable estimate of how much of the change in value of a financial debt instrument arises from own risk.

Question 9

Do you agree with the proposals related to early adoption? If not, what would you propose and why? How would those proposals address concerns about comparability?

Yes. We agree that if an entity elects to apply these proposals early, the entity must at the same time apply any requirements in IFRS 9 that it does not already apply, because the new proposals are linked in such a way that a partial use of some of them would create inconsistencies and a lack of comparability.

Question 10

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

Yes. We agree with the transition requirements.

Should you require additional information on our comments listed above, please contact Juan M. Gras at (52) 55 5596 5633 ext. 105 or me at (52) 55 5596 5633 ext. 103 or by e-mail at jgras@cinif.org.mx or fperezcervantes@cinif.org.mx, respectively.

Sincerely,

C.P.C. Felipe Perez Cervantes
President of the Mexican Accounting Standards Board
Consejo Mexicano para la Investigacion y Desarrollo
de Normas de Informacion Financiera (CINIF)