



Memorandum

To:	FRSB and AASB members	Date:	2 March 2010
From:	Christina Ng and Sarah Bate	Agenda Item:	B3B.1
Subject:	Financial Liabilities: Classification and Measurement	File:	-

Action

For your information.

Background

1. Most respondents to the IASB Exposure Draft *Financial Instruments: Classification and Measurement* (IASB Classification ED) and Discussion Paper on *Credit Risk in Liability Measurement* raised concerns about the IASB's direction in recognising the effects of changes in an entity's own credit risk in profit or loss. In particular, the proposals in the IASB Classification ED would result in the measurement of financial liabilities that are held to pay contractual cash flows and have non-vanilla cash flow characteristics, e.g. instruments with payments that are linked to a market index (also referred as Category B instruments in this memo), to be fair valued through profit or loss, which most respondents to the IASB Classification ED and IASB user outreach programme disagreed. The concern is that recognising the effects of changes in an entity's own credit risk in profit or loss does not result in useful information when the entity is holding the liabilities to pay the contractual cash flows. As a result, the IASB had decided to address the requirements for financial liabilities separately from IFRS 9 *Financial Instruments*, which deals only with classification of financial assets.
2. At the joint IASB-FASB meeting in January 2010, both Boards discussed and tentatively decided on four possible approaches to measuring changes in own credit risk for financial liabilities. These approaches are recapped in this memo:
 - Approach (a): Isolate the effects of changes in own credit risk and account for that amount differently than the other components of the fair value change;
 - Approach (b): Bifurcate the instrument into a host and the embedded features;
 - Approach (c): Measure the entire instrument at amortised cost and present its fair value on the face of the balance sheet in brackets; and
 - Approach (d): Measure the entire instrument at fair value and record the total fair value change in other comprehensive income (OCI).
3. At the joint IASB-FASB meetings in February 2010, both Boards also noted the collated results from the user outreach programme and considered the responses when making tentative decisions on the best approaches to recognise and measure the effects of own credit risk (attached as agenda paper B3B.2). In addition, three

financial categories for financial liabilities were identified, which the Boards discussed how to address the issue of changes in own credit risk in the remeasurement of these financial liabilities categories:

- Category A: Instruments that are not held to pay contractual cash flows (for example, standalone derivatives and all liabilities that are held for trading);
- Category B: Instruments that are held to pay contractual cash flows and have non-vanilla contractual cash flow characteristics (for example, own debt that the entity holds to maturity and whose payments are linked to a market index); and
- Category C: Instruments that are held to pay contractual cash flows and that have vanilla contractual cash flow characteristics.

4. The Boards also discussed whether a fair value option (FVO) should be retained for financial liabilities and if so, what the eligibility conditions should be, and how to address the issue of own credit risk. The IASB agenda paper on the discussion of FVO is attached as agenda paper B3B.2.
5. A high-level summary of the IASB and FASB tentative decisions on the alternative approaches (paragraph 2) to remeasure the financial categories (paragraph 3) and FVO (paragraph 4) is included in Table 1 of this memo.

Table 1 Summary of IASB and FASB tentative decisions on the classification and measurement of financial liabilities

Financial liabilities categories	Possible approaches (and high-level comments)	Staff recommendation on possible approaches	IASB-FASB tentative decisions on possible approaches
Category A (Instruments not held to pay contractual cash flows)	FVTPL (Further discussions at forthcoming meeting)	✓	✓
Category B (Instruments held to pay contractual cash flows and with non-vanilla cash flow characteristics)	<u>Approach (a)</u> Instrument to be fair valued separately for: <ul style="list-style-type: none"> • Effects of own credit risk, to be “frozen” or isolated via OCI; and • other changes in fair value to be recognised through profit or loss. 	✗	✗
	<u>Approach (b)</u> Instrument to be bifurcated based on the: <ul style="list-style-type: none"> • existing conditions under IAS 39¹; or • classification conditions in IFRS 9². 	✓	✓ (IASB only)
	<u>Approach (c)</u> Instrument to be measured at amortised cost and the fair value amount to be presented in brackets on the face of the balance sheet.	✗	✗
	<u>Approach (d)</u> Instrument to be measured at fair value on the balance sheet and changes in fair value go through OCI.	✗	✗

¹ An embedded derivative would be separated from the host if, and only if:

- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics of the host;
- (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- (c) the entire (hybrid) contract is not measured at fair value through profit or loss.

² An instrument would be bifurcated, if a component (the host) of the structured liability has cash flow characteristics that are solely payments of principal and interest on the principal amount (i.e. a component meets the condition in para 4.2(b) of IFRS 9).

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<p>Category C (Instruments held to pay contractual cash flows and with vanilla cash flow characteristics)</p>	<p>Amortised cost (IASB approach) FVTOCI (FASB approach) (Further discussions at forthcoming meeting)</p>	✓	✓ (IASB only)
<p>Instruments with fair value option (FVO)</p>	<p>Addressing the retention of FVO:</p> <ul style="list-style-type: none"> • Remove FVO • Retain FVO, either by: <ul style="list-style-type: none"> ⇒ retaining the existing FVO and its conditions for election under IAS 39³; or ⇒ adopting the IFRS 9⁴ approach/conditions. 	✗	✗
	<p>Addressing the issue of own credit risk:</p> <ul style="list-style-type: none"> • Approach (a): Instrument to be measured at fair value separately for the effects of own credit risk to be isolated through OCI, and other changes in fair value to be recognised through profit or loss; or • Approach (d): Instrument to be measured at fair value on the balance sheet, but changes in fair value go through OCI; or • Hybrid of approaches (a) and (d): <ul style="list-style-type: none"> ⇒ Instrument is recognised at full fair value on balance sheet and total fair value changes in profit or loss; ⇒ The portion attributable to changes in own credit risk is recognised in OCI (with an offsetting entry to profit or loss) ⇒ The portion of own credit risk in OCI will be recycled to profit or loss when the instrument is derecognised. 	✗	✗
		✗	✗
		✓	✓ (IASB only)
		✓	✓ (IASB only)
		✓	✗

³ IAS 39 permits entities to irrevocably elect the FVO on initial recognition if one (or more) of the following three conditions is met:

- (a) it eliminates or significantly reduces a measurement or recognition inconsistency or ‘accounting mismatch’ that would otherwise arise from measuring assets or liabilities or recognising the gains or losses on them on different bases;
- (b) a group of financial assets, financial liabilities, or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel;
- (c) the financial asset or financial liability contains one or more embedded derivatives (and particular other conditions described in paragraph 11A of IAS 39 are met) and the entity elects to account for the hybrid (combined) contract in its entirety.

⁴ IFRS 9 permits entities to irrevocably elect the FVO on initial recognition if it eliminates or significantly reduces a measurement or recognition inconsistency or ‘accounting mismatch’ that would otherwise arise from measuring assets or liabilities or recognising the gains or losses on them on different bases.

Next steps

6. Staff will provide a verbal update on any further progress and relevant decisions emerging from the IASB in the lead-up to the March joint FRSB-AASB meeting.

Attachments

- Agenda Paper B3B.2– IASB/FASB Agenda Paper 2A/34A: Results of user questionnaire on own credit
- Agenda Paper B3B.3 – IASB/FASB Agenda Paper 8C: The fair value option