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Project	<b>Financial instruments: classification and measurement of financial liabilities</b>
Topic	<b>The fair value option</b>

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## Purpose of this paper

1. At the 10 February 2010 joint meeting the boards discussed the measurement of two categories of financial liabilities—Category A and Category B. Agenda paper 8A for this meeting asks the IASB how financial liabilities in Category C should be measured.
2. **In this paper, we ask the IASB whether a fair value option (FVO) should be retained for financial liabilities and if so,**
  - (a) **what the eligibility conditions should be; and**
  - (b) **how to address the issue of own credit risk<sup>1</sup>.**

## Issue 1: Whether a FVO should be retained for financial liabilities and if so, what the eligibility conditions should be

### ***Relevant requirements in IAS 39 “Financial Instruments: Recognition and Measurement”***

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

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<sup>1</sup> The term *own credit risk* is used in this paper as it was used in the IASB discussion paper *Credit Risk in Liability Measurement*. Almost no respondents differentiated between (a) the price of credit and (b) the credit standing of the issuing entity; therefore we use the term in this agenda paper to reflect both.

This paper has been prepared by the technical staff of the IASCF and the FASB for discussion at a public meeting of the IASB or the FASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB or the FASB.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

The tentative decisions made by the IASB or the FASB at public meetings are reported in the IASB's *Update* or the FASB's *Action Alert*. Official pronouncements of the IASB or the FASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

## IASB Staff paper

- (a) It eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an ‘accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and 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.

### ***The proposals in the exposure draft “Financial Instruments: Classification and Measurement”***

- 4. The exposure draft proposed to retain the eligibility condition described above in paragraph 3(a). The Board’s reasoning for retaining that condition is in paragraph BC50 of the exposure draft.
- 5. Under the approach proposed in the exposure draft, the eligibility conditions in paragraph 3(b) and 3(c) were not needed because the proposals would have required any item that is managed on a fair value basis to be measured at fair value and would have classified hybrid contracts with financial hosts in their entirety (hence eliminating the requirement to identify and account separately for embedded derivatives).

### ***Feedback received on the exposure draft***

- 6. Almost all respondents supported the proposal to retain the FVO if such designation eliminates or significantly reduces an accounting mismatch.
- 7. Some respondents preferred an unrestricted FVO (similar to existing US GAAP). However, some of those respondents acknowledged that an

unrestricted FVO has been opposed by many in the past and that it may not be practical to pursue it now.

8. The respondents who preferred retaining the requirements in IAS 39 for hybrid contracts generally supported retaining the FVO in cases where the hybrid contract must otherwise be separated.

**Staff recommendation**

9. Consistent with the feedback received, we think that the FVO should be retained. Also the FVO will be discussed in the context of the hedge accounting phase of the project to replace IAS 39. Moreover the Board's conclusions in phase II of the insurance project will also be relevant as to whether or not a FVO is necessary and should be retained. Therefore, we think elimination of the FVO at this point would be premature.
10. Moreover, we think that the three eligibility conditions in IAS 39 should be retained. That is because the tentative decisions on 10 February coupled with our recommendations for this meeting essentially would maintain the existing measurement requirements in IAS 39 for financial liabilities (subject to the discussion on how to address the issue of own credit risk for liabilities designated under the FVO, which is discussed later in this paper). Specifically:
  - (a) On 10 February the Board tentatively decided to measure liabilities in Category A at fair value through profit or loss.
  - (b) On 10 February the Board tentative decided to bifurcate the liabilities in Category B. In agenda paper 8B we recommend that the Board retain the existing bifurcation requirements in IAS 39.
  - (c) In agenda paper 8A we recommend that the Board measure liabilities in Category C at amortized cost.
11. Maintaining the requirements in IAS 39 could result in a slight change in the population of liabilities that are in Category A. Agenda paper 2 for the 10 February meeting we described Category A as "liabilities that are not held to pay contractual cash flows". If the Board wants to maintain the requirements in IAS 39, we think that Category A would need to be described as "liabilities that are held for trading" to be consistent with the requirements in paragraph 47 of

IAS 39. We think that changing the description actually has little, if any actual effect on the population of liabilities in Category A. We think that almost all financial liabilities are either held for trading or held to pay contractual cash flows (and therefore “**not** held to pay cash flows” in the context of financial liabilities almost always means “held for trading”).

12. Alternatively, the Board could decide to make changes to the requirements in IAS 39 (ie maintain the label of Category A and make a corresponding change to the eligibility requirements for the FVO).
13. We think that such changes will have an insignificant effect on the measurement of financial liabilities. Consistent with our analysis in agenda paper 8B, we think any possible benefits of those changes do not outweigh the costs associated with changing the methodology and disrupting existing practice (eg systems changes, etc) at this point. Therefore we do not recommend “tinkering” with the requirements in IAS 39 at this point.

**Question 1: Retaining the FVO**

Does the Board agree with the staff recommendation that

- (a) the FVO should be retained; and
- (b) all three eligibility conditions in IAS 39 should be carried forward?

If not, what does the Board want to do instead and why?

**Issue 2: How to address the issue of own credit risk**

14. Most respondents to the IASB’s exposure draft and the discussion paper on credit risk in liability measurement and participants in our outreach activities **disagreed** with recognizing the effects of changes in an entity’s own credit risk in profit and loss. This is consistent with the long-standing concern raised by many (including users of financial statements) that recognizing the effects of changes in an entity’s own credit risk in profit or loss does not result in useful information.
15. In January 2010 we developed a questionnaire to solicit feedback from users on the issue of own credit risk. The primary message in the responses was that

information about changes in own credit risk should be included in profit or loss **only if** the entity has the opportunity and ability to buy back its own debt. One of the questions in the questionnaire specifically asked whether any of the respondents' answers depended on the reasons **why** own debt has been measured at fair value—ie because it simplifies the accounting or it reflects the way that the entity manages its debt. Over 80% of the respondents said “no”. Most of the comments to that question said that the effects of changes in own credit risk should affect profit or loss only if the entity is regularly trading its own debt.

***Alternatives for addressing own credit risk***

16. We have identified two broad alternatives for addressing the issue of own credit risk for liabilities designated under the FVO:

**Alternative (a)—measure the entire instrument at fair value** and record the total fair value change in other comprehensive income (**OCD**); or

**Alternative (b)—isolate the effects of changes in own credit risk** and account for that amount differently than the other components of the fair value change.

17. These alternatives (and many of the variants described below) are the same as those discussed in agenda paper 2 for the 10 February meeting. However, we think there is an important difference between the discussion on 10 February and today's discussion—that is, **the population of liabilities** to which these alternatives would be applied. At the 10 February meeting, we discussed liabilities in Category B—a broad category that would capture many financial liabilities issued by many types of entities that are measured at amortized cost or are bifurcated under existing requirements.
18. In contrast, this paper is discussing liabilities that an entity elects to measure at fair value, which is a much narrower subset of financial liabilities.
19. We noted in paragraph 32 of agenda paper 2 for the 10 February meeting that

Many constituents noted during our outreach activities that in general only companies with sophisticated valuation capabilities (mainly banks) are applying the FVO to financial liabilities and, thus, are applying the disclosure requirements in IFRS 7. And even the companies with sophisticated valuation capabilities noted the complexity of determining the effects of changes in their own credit risk. Those constituents also noted that if the boards pursue [an approach that

would require an entity to identify own credit risk], many more companies will have to compute own credit risk – and compute it for many types of liabilities – which will be very challenging.

20. That statement is not as relevant for today’s discussion. That is because we are discussing those entities that are already applying the FVO (assuming that the Board agrees with our recommendation to retain the existing FVO)—and are already applying the disclosure requirements in IFRS 7 that require them to determine and disclose the effects of own credit risk.

*Alternative (a): Measure the entire instrument at fair value and record the total fair value change in OCI*

21. The liability would be measured at “full” fair value on the balance sheet but the entire fair value change would be presented in OCI.
22. This alternative was analyzed in agenda paper 2 for the 10 February 2010 joint board meeting. For board members’ convenience, we have included the relevant portions of that agenda paper as an appendix to this paper (please refer to paragraphs A17–A22 of the appendix). We do not analyze this alternative further in this paper.

*Alternative (b): Isolate the effects of changes in own credit risk*

23. There are several variants of Alternative (b):
- (i) present the entire fair value change in profit and loss but present separately (in profit or loss) the portion attributable to the change in own credit risk (ie in brackets or as a separate line item)
  - (ii) present the change in own credit risk in equity
  - (iii) present the change in own credit risk in OCI
  - (iv) use an “adjusted” fair value measurement attribute that does not reflect changes in own credit risk (the “frozen credit spread” method)
24. Variants (iii.) and (iv.) were analyzed in agenda paper 2 for the 10 February 2010 joint board meeting. For board members’ convenience, we have included the relevant portions of that agenda paper as an appendix to this paper (please refer to paragraphs A3–A14 of the appendix). We do not analyze those variants further in this paper.

25. **Present the total fair value change in profit or loss (variant i):** The liability would be at full fair value on the balance sheet and the total fair value change would be in the profit or loss. The own credit risk component would be separately presented so that users could easily identify it (and “back it out” if they so chose). Also because this information would be on the face of the income statement rather than in the notes, it would be provided on a more timely basis than it is now. We think the primary criticism of this variant is that the change in own credit risk would still create volatility in profit or loss. That is, some will say that the Board has not gone “far enough” to address the issue of own credit risk because that amount should not affect profit or loss unless the entity is trading its own debt.
26. **Present the change in own credit risk in equity (variant ii):** The liability would be remeasured at “full” fair value on the balance sheet but the portion of the fair value change attributable to changes in own credit risk would be presented **directly in equity**. All other changes in fair value would be recognized in profit or loss. We think the primary criticism of this variant is that the own credit risk component would not be recognized in the performance statement at all (**not** in profit or loss and **not** in OCI). Also, similar to variant (iii), the Board would have to address questions about (a) whether the fair value change should be further disaggregated so that interest expense is imputed and (b) recycling in cases where the liability is derecognized before maturity. However, this variant would avoid criticism that the Board is expanding the use of OCI before they have addressed OCI comprehensively (ie how OCI should be used).

***Staff commentary and recommendation***

27. We do not support measuring the entire instrument at fair value and recording the total fair value change in OCI (Alternative (a)) because we think it goes “over-board”. That is, we think the IASB’s objective is to address issues related to own credit risk but this alternative would exclude **the entire fair value change** from profit or loss.

28. We recommend that the Board pursue a **hybrid** of the variants described in Alternative (b) above. Under that hybrid, for all liabilities designated under the FVO, an entity would be **required** to
- (a) recognize the total fair value change in profit and loss **and**
  - (b) recognize the portion attributable to the change in own credit risk in equity (with the offsetting entry to profit or loss).
29. Under this approach, the liability would be measured at “full” fair value on the balance sheet. That avoids the creation of an “adjusted” fair value, which would be the case under variant (iv).
30. Moreover, the entire fair value change would be presented in profit or loss, which is consistent with recognizing “full” fair value on the balance sheet. However, the portion attributable to changes in own credit would not have a “net” effect on profit or loss (because that amount would be recognized in equity with an offsetting entry to profit or loss), which is consistent with the majority of feedback received on this issue. This approach would provide users of financial statements with all relevant information on the face of the income statement—the total fair value change **and** the amount attributable to changes in own credit risk—while responding to the almost unanimous message that changes in own credit risk should not affect profit or loss unless the entity regularly trades its own debt.
31. This approach would not expand the use of OCI, which is consistent with many responses to the exposure draft. Also this approach is consistent with the argument described in the discussion paper on credit risk in liability measurement that a change in the credit risk of the entity’s liabilities represents a transfer of wealth between the liability holders and equity holders (that argument is described in paragraphs 32–34 of that discussion paper).
32. The primary criticism of this approach is that it would require an entity to compute the own credit risk component, which is challenging. However, as we noted above in paragraphs 18–20, this approach would apply only to entities that are already applying the FVO—and are already applying the disclosure requirements in IFRS 7, which require them to determine that amount.

33. We think this hybrid approach should be **required for all liabilities** designated under the FVO. That is consistent with the feedback from users that the effects of changes in own credit risk should affect profit or loss only if the entity is regularly trading its own debt. Moreover if this approach was optional or only applicable to some liabilities designated under the FVO, comparability would be significantly reduced.
34. If the Board pursues this hybrid approach, we think that amounts recognized in equity should be recycled from equity to profit or loss if the liability is derecognized before maturity. We think that would properly reflect the profit or loss realized on that liability, which is consistent with the feedback from users. If the liability is settled as per the contractual requirements, then of course any balance in equity would revert to zero at maturity.

**Question 2: Addressing own credit risk**

Does the Board agree with the staff recommendation for addressing the issue of own credit risk for liabilities designated under the FVO?

Under that recommendation, an entity would be required to do the following for all liabilities designated under the FVO:

- (a) recognize the total fair value change in profit or loss; and
- (b) recognize the portion attributable to changes in own credit risk in equity (with the offsetting entry to profit or loss)

If not, what would the Board like to do and why?

**Question 3: Recycling**

Does the Board agree with the staff recommendation that amounts recognized in equity should be recycled from equity to profit or loss if the liability is derecognized before maturity?

If not, what would the Board like to do and why?

**APPENDIX: Relevant portions of Agenda paper 2 from the 10 February 2010 joint meeting—*Financial liabilities***

***Alternatives for Category B***

- A1. We have identified four broad alternatives for the instruments in Category B:
- (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
  - (b) **bifurcate** the instrument into a host and the embedded features
  - (c) **measure the entire instrument at amortized cost** and present its fair value on the face of the balance sheet in brackets
  - (d) **measure the entire instrument at fair value** and record the total fair value change in **OCI**
- A2. We have described those alternatives—and the feedback that we have received on them—in the paragraphs below. One benefit that is common to **all alternatives** is that changes in own credit risk would not affect profit or loss, which is responsive to constituents' concerns. Alternatively, as mentioned in paragraph 5 [of agenda paper 2 from the 10 February 2010], the boards could decide **not** to address the issue of own credit risk and instead measure these instruments at fair value with all changes in profit or loss (consistent with the IASB's exposure draft and FASB's decisions to date).

*Alternative (a): Isolate the effects of changes in own credit risk*

- A3. There are at least two variants of this alternative—(1) present the change in own credit risk outside of profit or loss (ie in OCI) **or** (2) use an “adjusted” fair value measurement attribute that does not reflect changes in own credit risk (the “frozen credit spread” method).
- A4. **Present the change in own credit risk outside of profit or loss:** The liability would be remeasured at “full” fair value on the balance sheet but the portion of the fair value change attributable to changes in own credit risk would be presented in OCI while all other changes in fair value would be recognized in profit or loss.

- A5. **The “frozen credit spread” method:** The liability would be remeasured at a current value that ignores changes in the issuer’s own credit risk. This adjusted fair value measurement would be updated for all other fair value changes.
- A6. A benefit of both variants of Alternative (a) is that the complexities of bifurcation would be avoided.
- A7. A benefit that is specific to presenting changes in own credit risk in OCI is that a new measurement attribute would **not** be introduced on the balance sheet — “full” fair value would be presented. As a result, all derivative features would be remeasured at fair value (albeit with some changes presented in OCI), which is consistent with the boards’ long-held position. In contrast, the frozen credit spread method would introduce a new “adjusted” fair value measurement attribute, which may have unknown or unintended consequences. Furthermore, derivative features would not be remeasured at fair value (assuming that the credit risk of the **entire** instrument is frozen).
- A8. However, a benefit specific to the frozen credit spread method is that it would avoid the expanded use of OCI and, thus, would avoid increased volatility in OCI and questions about recycling. Those issues and questions would arise if changes in own credit were presented in OCI.
- A9. The most significant criticism of both variants of Alternative (a) is that isolating the “own credit risk” component of a fair value change is **very difficult**. That is because it is difficult, and perhaps impossible, to separate own credit risk from other components of the fair value change (eg liquidity or the market’s “appetite” for a particular instrument). Also it is difficult to be objective about own credit risk (as opposed to a counterparty’s credit risk).
- A10. Moreover, the effects of changes in own credit risk and changes in own share price or other equity-like features (and the correlation between the two) provide particular difficulties (for example, consider deeply subordinated liabilities issued with features such as mandatory deferral of interest or mandatory conversion into ordinary shares that are triggered if Tier 1 regulatory capital levels reach particular levels).

- A11. IFRS 7 *Financial Instruments: Disclosures* requires an entity to disclose for all liabilities designated under the FVO the amount of change (during the period and cumulatively) in the fair value that is attributable to changes in the credit risk of the liability. Topic 825, *Financial Instruments*, requires an entity to disclose for all liabilities designated under the FVO that have been significantly affected during the reporting period by changes in the instrument-specific credit risk the estimated amount of gains and losses from fair value changes included in earnings that are attributable to changes in the instrument-specific credit risk and how those gains and losses were determined.
- A12. For IFRS 7 purposes, entities generally assume that the entire spread above the benchmark rate is attributable to own credit risk. For Topic 825 purposes, changes in instrument-specific credit risk are generally determined based on the changes in the reporting entity's own credit spreads. However, the approach can vary depending on the nature of the liability.
- A13. Many constituents noted during our outreach activities that in general only companies with sophisticated valuation capabilities (mainly banks) are applying the FVO to financial liabilities and, thus, are applying the disclosure requirements in IFRS 7. And even the companies with sophisticated valuation capabilities noted the complexity of determining the effects of changes in their own credit risk. Those constituents also noted that if the boards pursue Alternative (a), many more companies will have to compute own credit risk – and compute it for many types of liabilities – which will be very challenging.
- A14. Finally, both variants raise the question about whether the fair value change should be **further disaggregated** so that interest expense is imputed (and presented separately in the income statement) for liabilities that are measured at fair value (or adjusted fair value). As described below in paragraph 44 [of agenda paper 2 from the 10 February 2010] many users think that such information should be provided. However, both boards have struggled in the past (without reaching a conclusion) to decide how to disaggregate fair value changes. This further disaggregation could be difficult for the instruments in Category B given their non-vanilla contractual cash flow characteristics.

*Alternative (b): Bifurcation*

A15. [Not relevant to the FVO]

*Alternative (c): Measure the entire instrument at amortized cost*

A16. [Not relevant for the FVO]

*Alternative (d): Measure the entire instrument at fair value and record the total fair value change in OCI*

A17. The liability would be measured at “full” fair value on the balance sheet but the entire fair value change would be presented in OCI (rather than profit or loss).

A18. The primary benefit is that the complexities of identifying own credit risk (described above in Alternative (a)) and bifurcation would be avoided. Moreover, a new measurement attribute would **not** be introduced on the balance sheet—“full” fair value would be used. As a result, all derivative features would be remeasured at fair value (albeit with changes presented in OCI), which is consistent with the boards’ long-held position.

A19. However, this alternative would raise difficult questions about what (if any) amounts should be recognized in profit or loss, both:

- (a) during the life of the instrument (ie interest or other financing costs); and
- (b) upon derecognition (ie recycling).

A20. If the boards decide that a portion of the total fair value change should be recognized in profit or loss during the life of the instrument, determining **how much** could be difficult for the instruments in Category B. Based on our recent user questionnaire (described in paragraphs 48-52 [of agenda paper 2 from the 10 February 2010]), many users think that interest expense **should be** imputed and presented separately in the income statement for debt that is measured at fair value.

A21. The boards have discussed the topic of disaggregating fair value changes on numerous occasions—without reaching any conclusions. For example in 2006 the staff performed extensive outreach with users to determine what disaggregated information would be decision-useful. While users agreed that some disaggregated information is required, the feedback varied on **what** would

be useful. However, if the boards decide to pursue this alternative, one way to calculate an interest expense amount would be to apply the amortized cost methodology described in Alternative (c). That is, fair value would be presented in the balance sheet but interest expense could be computed using an amortized cost methodology.

- A22. Another criticism of this alternative is that it goes “over-board”. That is, the boards’ objective is to address issues related to own credit risk but this alternative would exclude the entire fair value change from profit or loss. Moreover, those amounts would create volatility in OCI.