



Project	Financial Instruments – Replacement of IAS 39
Topic	Classification and measurement of financial liabilities

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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.

Appendix A – Relevant paragraphs from the discussion paper *Reducing Complexity in Reporting Financial Instruments*

Why recognise an unrealised gain or loss on a financial liability when the entity's obligation is unchanged?

- 3.72 This concern implies that the recognised amount of a financial liability represents the face amount of the obligation. However, the recognised amount of a financial liability does not represent nor is it intended to represent the face amount of an obligation, even if a cost-based method is used. For example, if two entities whose credit standing differs issue an unsecured note promising to pay CU1 million in five years, the proceeds will be different. Although the two entities have the same obligation in five years, the liability amount each entity recognises will be different until the issue discount is fully accreted.

Why recognise unrealised gains on financial liabilities when bad things happen (or unrealised losses when good things happen)?

- 3.73 If changes in the credit risk of an entity's financial liabilities are taken into account, a decrease in the probability that the financial liabilities will be settled creates a gain to earnings in the financial statements of a borrower. To some, however, intuition would indicate that a decrease in an entity's ability to pay should be associated with a loss instead of a gain.
- 3.74 The following points explain why a decrease in the probability that a financial liability will be settled is associated with a gain in the financial statements of a borrower:
- (a) The liability is a contract between two entities. Generally, when circumstances change that result in one entity incurring a loss, it might be expected that the other party will have a gain. That leads to a conclusion that, when a lender recognises a loss, the borrower should recognise a gain.
 - (b) A financial liability's fair value on initial recognition reflects its credit risk. It seems inconsistent to include credit risk in the initial fair value measurement of a financial liability but not in the subsequent measurement of the financial liability.
 - (c) The apparent gain does not occur in a vacuum. The reason why a borrower is unable to pay is that it has suffered losses or expects to have shortfalls in profits. If those losses are fully recognised in the financial statements of the borrower, the amount of the losses is likely to exceed the amount of gain arising from a decrease in fair value of the liability. However, not all of the losses or shortfalls are recognised in financial statements. For example, losses arising from decreases in value of unrecognised intangible assets are not recognised. The gain on the liability might provide a signal to users of the borrower's financial statements that unrecognised losses or shortfalls have been incurred.
 - (d) Equity holders of an entity are not required to make any additional investment to cover losses incurred by the entity except to the extent that the equity holders have a binding obligation to do so. However, when the credit risk of an instrument increases, the lender might suffer a loss. Therefore, the apparent gain to the borrower can be seen as an allocation of deficits from the owners of the borrower to the lender.
- 3.75 However, some have concerns about requiring an entity to consider the effect of changes in the credit risk of a financial liability in remeasuring the fair value of the liabilities. In their view, a liability remeasurement that reflects changes in the credit risk of a financial liability is confusing. When a financial liability's credit risk deteriorates, there is a gain (ie an increase in an owner's equity). In their view, such an effect is counter-intuitive. They argue that it is not useful to report lower liabilities when an entity is in financial difficulty and that it is difficult to explain to users of financial statements the reasons why a gain would be recognised when a liability's creditworthiness deteriorates.
- 3.76 In their view, for the purposes of remeasuring a liability, users of financial statements are better served by a measurement that focuses on the obligation. They suggest that financial statements should portray the present value of an obligation in such a way that two entities with the same obligation but different credit standing would report the same carrying amount.
- 3.77 IASB members are aware of these concerns. They also acknowledge that these concerns relate to (a) what is meant by fair value and (b) what is the appropriate measurement attribute for remeasuring

financial liabilities. These issues will be considered in due course. For example, the IASB will consider the effect of non-performance risk¹ (including the effect of credit risk) as part of its project on fair value measurement.

¹ Non-performance risk in SFAS 157 refers to the risk that an obligation will not be fulfilled and affects the value at which the liability is transferred.

Appendix B - Agenda paper 2 from the 6 October 2009 IASB board meeting: *Reflecting changes in own credit risk for financial liabilities measured at amortized cost*

Introduction

- A1. In the exposure draft *Financial Instruments: Classification and Measurement* ('the ED') the Board highlighted the interaction between the ED proposals and the issues addressed in the Board's discussion paper *Credit Risk in Liability Measurement* ('the DP'). The Board noted that the responses to the DP would be relevant to the project to replace IAS 39 *Financial Instruments: Recognition and Measurement* and that the Board intended to consider the responses in the reconsideration and finalisation of the proposals in the ED.
- A2. Almost all respondents to the DP, including users, stated that measuring some types of financial liabilities at fair value and recognising fair value changes arising from changes in own credit risk in profit or loss does not provide useful information. (Although there was not a specific question in the ED on this issue, the feedback from almost all respondents to the ED and other outreach activities undertaken by the staff was consistent with the responses to the DP).
- A3. The staff notes that this view is a long-standing view of many of our constituents. For example, this topic was exhaustively discussed in the discussion paper *Reducing Complexity in Reporting Financial Instruments*, and the responses to that discussion paper are totally consistent with the views expressed by respondents to the more recent due process documents.
- A4. Some respondents to the ED asked the Board to defer work on the project to replace IAS 39 or scope out financial liabilities until the Board reaches a decision regarding recognising changes in own credit risk in current measurements of liabilities. Others also proposed that the Board first makes decisions regarding the financial statement presentation project. Others suggested that this phase of the project to replace IAS 39 should address the issue of own credit risk when a current measurement of financial liabilities is required.

Purpose of this paper

- A5. This paper sets out possible approaches for the Board to address the concerns summarised in the preceding section. This paper recommends an approach that the Board should take in this project.**
- A6. The staff recognises that the concerns raised are far broader than financial liabilities. However, if the Board wishes to issue a standard on the classification and measurement of financial instruments according to the Board's own timetable the Board must decide whether to, and how to, address this concern in the context of financial liabilities, or scope financial liabilities out of any new standard.
- A7. The approaches presented in the paper, the staff analysis and the staff recommendation only address financial liabilities within the scope of this project.
- A8. This paper does not address whether a fair value definition should include or exclude the effects of changes in own credit risk (this is covered by the fair value measurement project).
- A9. The staff also notes that any decisions made on this issue may impact other ongoing projects, including:
- (a) non-financial liabilities and liabilities outside the scope of this project, including insurance liabilities and post-employment benefits; and
 - (b) financial statement presentation.
- A10. In terms of structure, this paper:
- (a) summarises the ED proposals for financial liabilities, and the comments received from respondents to the ED and the staff outreach programme
 - (b) summarises potential approaches the Board could take to address the concerns expressed
 - (c) discusses the candidates for the identified potential approaches. Namely, whether they should be applied to all financial liabilities measured at fair value or only some, and

- (d) analyses the identified potential approaches to address the concerns expressed.

Interaction with other agenda papers

- A11. Own credit risk and the treatment of hybrid contracts with financial liability hosts are interrelated.
- A12. This paper identifies two possible approaches that could address the broad concerns raised by constituents. The Board could decide to require one of those approaches. That decision will impact the Board's decision on whether to eliminate bifurcation accounting for hybrid contracts with financial liability hosts. That is, a trade-off for the Board might be to:
 - (a) require one of the approaches discussed in this paper, and to eliminate bifurcation accounting for hybrid contracts with financial liability hosts, or
 - (b) not require one of the approaches discussed in this paper, but to maintain bifurcation accounting for hybrid contracts with financial liability hosts.
- A13. This is further discussed in agenda paper 3 for this meeting.
- A14. Furthermore, we note that the issue of own credit risk is also relevant to other types of financial liabilities that may be measured at fair value – for example, financial liabilities measured at fair value through profit or loss by use of the fair value option.

Proposals in the ED

- A15. The ED proposes two principal measurement methods for the subsequent measurement of financial liabilities within its scope:
 - (a) amortised cost
 - (b) fair value.
- A16. As currently defined in IAS 39, fair value includes an entity's own credit risk for financial liabilities (see *inter alia* paragraph IAS 39.AG82(b) that addresses factors to consider in determining fair value using valuation methods).

- A17. Fair value is the measurement attribute applied on initial recognition and hence, credit risk is recognised in **all initial measurements** of financial liabilities within the scope of IAS 39 regardless of whether the item is subsequently measured at fair value or amortised cost.
- A18. The ED proposes requiring or allowing particular financial liabilities to be measured at fair value with changes in fair value (including changes in fair value arising from changes in own credit risk) recognised in profit or loss when such changes occur.
- A19. For financial liabilities subsequently measured at amortised cost, the carrying value is not updated for changes in credit risk (or any other market factor). For such financial liabilities, changes in own credit risk (as well as changes in other market factors) are recognised only if an item is transferred or settled (ie, derecognised) prior to maturity.

Comments received in the comment letters to the ED and during the outreach programme²

- A20. **General comments:** Many commentators were concerned about the financial reporting effects of changes in an entity's own credit risk that would arise as a result of the proposals in the ED.
- A21. As noted previously, some respondents to the ED asked the Board to defer work on the project to replace IAS 39 or scope out financial liabilities until the Board reach a decision regarding recognising changes in own credit risk in current measurements of liabilities. Others also proposed that the Board first make decisions regarding the financial statement presentation project. Others suggested that this phase of the project to replace IAS 39 should address the issue of own credit risk when a current measurement of financial liabilities is required.

² For an analysis of comments received on the DP, please refer to agenda paper 13 of the main September Board meeting.

A22. Respondents had the following specific concerns related to the fair value effects of changes in own credit risk and the ED proposals for financial liabilities:

- (a) the proposed elimination of bifurcation accounting for hybrid contracts with a financial host that are financial liabilities³
- (b) the impact of the ‘basic loan features’ criterion for some types of financial liabilities issued by entities (in particular, more subordinated instruments)
- (c) the proposed accounting for tranches in waterfall structures from the perspective of the issuer.

A23. In general, these commentators believed that more types of financial liabilities⁴ would be required to be accounted for at fair value on an ongoing basis than is the case today.

A24. **Initial measurement:** Almost all respondents that addressed the issue agreed that credit risk should be reflected in the amount initially recognised in the financial statements. This is consistent with the comments received on the DP. The staff interprets this as a general consensus that fair value on initial recognition is the most decision-useful measurement attribute for the initial measurement of financial liabilities.

A25. **Subsequent measurement:** Almost all respondents (including users) believed that reflecting changes in own credit risk does not result in decision-useful information, in particular for financial liabilities that contractually or legally cannot, or are highly unlikely to be, transferred or settled prior to maturity.

A26. Such respondents preferred using amortised cost, a current measurement that does not reflect changes in own credit risk in profit or loss (eg a measurement that keeps the credit spread constant) or presenting changes arising from own credit risk in other comprehensive income (OCI).

A27. A few respondents believed that reflecting changes in own credit risk in profit or loss is decision-useful in all situations.

³ See agenda paper 3 for this meeting.

⁴ Although no quantitative analysis was provided.

A28. Some respondents noted that they would reconsider their views on the ED proposals (eg whether hybrid contracts should be classified in their entirety) if the Board appropriately addresses the issue of own credit risk.

Potential approaches for the Board to address concerns raised

A29. At the time of writing the paper the Board has tentatively decided:

- (a) the basic classification model, and
- (b) that financial liabilities should remain in the scope this phase.

A30. Consistent with these tentative decisions, the staff believes the Board could use the following approaches to address the issue discussed in this paper:

- (a) **Approach A:** specify another measurement approach for (some) financial liabilities
- (b) **Approach B:** present changes in fair value related to changes in own credit risk outside profit or loss (ie, OCI) for some or all financial liabilities measured at fair value.

A31. Of course the Board could simply confirm the proposals in the ED for financial liabilities. In light of the comments received on both the ED and the DP, and the Board's decisions on scope of the project and the general classification model, the staff thinks that is not a viable way forward. Constituents of all types, including users, expressed concerns over the usefulness of presenting changes in own credit risk in profit or loss. (The Board could alternatively decide to address some of the concerns of constituents by requiring the bifurcation of hybrid financial liabilities. That issue is discussed in paper 3.)

A32. Before discussing the potential approaches A and B in more detail, it is worth noting that both alternatives could be applied to some or all financial liabilities not measured at amortised cost. The following section considers the possible candidates to which either of the approaches could be applied. Following that, we will then move on to look at the 2 approaches in greater detail.

The candidates for either of the potential approaches

- A33. If the Board wishes to apply potential approaches (a) or (b) to only some financial liabilities, then they could be applied to:
- (a) all financial liabilities not measured at amortised cost, apart from held for trading liabilities; or
 - (b) all financial liabilities not measured at amortised cost, apart from held for trading liabilities or liabilities for which a fair value option election is made; or
 - (c) all financial liabilities that (i) are not eligible for amortised cost measurement, but (ii) are managed as part of a contractual cash flow business model.
- A34. It is worth noting that (b) and (c) are similar in terms of the instruments that are captured. The difference is that (c) would require that an instrument is part of the business model with the objective of paying contractual cash flows rather than realising fair value changes, whereas (b) would not make that requirement.
- A35. So let's look at (a).
- A36. Most respondents noted that for financial liabilities held for trading (including derivatives) subsequent measurement should be at fair value and that includes changes in own credit risk.
- A37. The staff agrees. In such cases the entity is in a position to realise fair value, including changes in its own credit risk. **Therefore the staff recommends that the Board define a subset of instruments** to which either (a) a current measurement approach other than fair value is applied, or (b) if fair value is applied, then changes in fair value related to changes in own credit risk are presented outside profit or loss.
- A38. So let's consider (b) and (c).
- A39. Historically much of the concern regarding the effects of changes in own credit risk of financial liabilities measured at fair value was expressed in the context of the fair value option. Obviously, many hybrid financial liabilities are currently

required to be bifurcated and so the concerns about such instruments did not previously arise (even for the derivative components separately accounted for).

- A40. In many of the responses to the ED proposals, as well as the outreach activities, the concerns regarding own credit risk were expressed in the context of financial liabilities that did not have basic loan features but for which the entity would simply pay contractual cash flows as they fell due.
- A41. Some respondents highlighted that the business model under which the financial liability is issued would indicate if the entity would be able to (legally and/or contractually) realise any fair value changes arising from changes in own credit risk, or if an entity would actually ever realise such changes if they had the legal and/or contractual ability to do so.
- A42. Both (b) and (c) described above would address the concerns regarding hybrid financial liabilities and the financial reporting effects of fair value changes arising from changes in own credit risk.
- A43. Both (b) and (c) would exclude financial liabilities designated under the fair value option. The staff notes that the fair value option is an option, unlike the situation that a financial liability does not have basic loan features despite the entity either being unable to or unlikely to ever realise fair value changes arising from changes in own credit risk.
- A44. The staff also notes that the Board will reconsider the fair value option in the context of hedge accounting as well as insurance phase II. Therefore the staff believes that changing the fair value option to some other measurement or presentation option is premature.
- A45. In summary, **the staff recommends that** if the Board decides to require that either (a) a current measurement approach other than fair value, or (b) if fair value is applied, then changes in fair value related to changes in own credit risk are presented outside profit or loss, that the financial liabilities to which such approaches are applied to are **all financial liabilities that (i) are not eligible for amortised cost measurement, but (ii) are managed as part of a contractual cash flow business model. That is (c) as described in paragraph A33.**

A46. The staff believes that (c) is more consistent with the overall classification model being developed by the Board.

Let's now look at the potential approaches identified earlier in this paper

A47. Having defined the subset of financial liabilities that are candidates for an alternative accounting we can now address what that alternative accounting could be.

A48. As mentioned in paragraph A30, the staff believes that there are two choices for the Board to address the issue of own credit risk:

- (a) specify another measurement approach for (some) financial liabilities
- (b) present changes in fair value related to changes in own credit risk outside profit or loss (ie, OCI).

Specify another measurement method for (some) financial liabilities

A49. The Board could specify another current measurement method that incorporates own credit risk only on initial measurement. This would apply to the subset identified in the preceding paragraphs.

A50. Generally, respondents to both the ED and the DP agreed that own credit risk should be incorporated in the initial measurement of a financial liability.

A51. Many respondents noted that for some financial liabilities subsequent changes in own credit risk should not be reflected in current measurement (or at least have no impact on profit or loss). However, many believed it is appropriate to reflect **other** changes in market risks in the measurement.

A52. The measurement approach described in the DP on credit risk is to keep the credit spread (as determined on initial recognition) constant, ie use a 'frozen credit spread' but reflect changes in other risks in subsequent measurement.

A53. If such a 'frozen credit spread' approach is used, on initial recognition the credit spread has to be determined. In most cases the credit spread of a financial liability is not directly observable, even at inception, but has to be inferred.

- A54. Of course, the Board has discussed this issue many times in the past. Most recently, in the context of the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures*. (The staff notes that respondents to the DP on credit risk could not or did not suggest a more appropriate approximation method that was different to that contained in IFRS 7 today).
- A55. So let's consider possible methods to determine the initial credit spread.
- A56. IFRS 7 uses an approximation approach (see below). Other possible methods include adjusting other available credit information (eg using spreads of credit default swaps) or attempting to "rebuild" the original pricing of credit risk.
- A57. The staff thinks that if the Board decides to require a current measurement method that excludes changes in credit risk, then a default method to determine the frozen credit risk spread should be provided (this could be a practical expedient), but that alternative methods should also be permitted if the entity believes this more faithfully represents the initial credit spread.
- A58. That default method could use the guidance given in IFRS 7.10, .B4 & .IG11 as a starting point. This approach attributes all parts of the internal rate of return (which is based on the **contractual** cash flows) that are not the benchmark/risk-free interest rate to the credit spread. However, this assumes that the internal rate of return (yield to maturity) includes only the effects of time value of money and credit risk. Other risk factors (eg liquidity risk) under this approach are assumed to form part of credit risk.
- A59. The staff notes that this approach has some significant drawbacks that are difficult to assess or quantify. Namely:
- (a) the cut is an approximation and works best for simple instruments that only have interest and credit risks incorporated
 - (b) the identified candidates for such an accounting treatment will include contractual features that may result in such an approximation becoming less faithfully representational (because the candidates will not have basic loan features).

- (c) the approximation approach – if not modified – locks in all other risk components except for benchmark/risk-free interest risk because it treats such risks as forming part of credit risk.
- A60. In summary, the more complex the instrument is the more numerous the other factors that could be included in the frozen spread if the approach is not modified.
- A61. IFRS 7.B4 acknowledges this problem and requires adding back the effect of other significant risks (eg the fair value of an embedded derivative).
- A62. To mitigate this problem the Board could decide to allow the default method only for relatively simple instruments where the effect of non-basic loan features is insignificant. Otherwise, the credit spread must be determined using more sophisticated methods that are a better approximation of the credit spread. For example, any risks other than credit should be incorporated in the expected cash flows to ensure that the spread to be frozen only includes the credit risk portion.
- A63. We believe whatever approach the Board decides on, an entity should be required to disclose the methods and inputs used to determine that credit spread⁵.
- A64. Further, the question is whether to require or permit a current measurement using a frozen credit spread. The comments received imply that the effects of changes in own credit risk do not provide useful information in certain circumstances. Hence, the staff believes for such financial liabilities any such measurement method should be **required**.
- A65. If the Board decides to require such a measurement, the question arises whether to continue to require the fair value disclosures in accordance with IFRS 7.25. The staff notes that many users, even if they do not prefer to have changes in own credit risk recognised in the primary financial statements, want to have fair value information available in the notes. Hence, we recommend keeping the fair value disclosures in IFRS 7 if the Board decides to use a frozen credit spread approach.

⁵ This is in line with the IASB's expert advisory panel guidance, see paragraph 159-164 of the final report of the panel.

Present changes in fair value related to changes in own credit risk outside profit or loss

- A66. An alternative to a ‘frozen credit spread’ **measurement** approach would be a **presentation** approach to allow or require an entity to present any changes in fair value that result from changes in own credit risk in OCI. In other words, the liability would be measured at fair value but the change in fair value would be disaggregated into a credit risk-related component (presented in OCI) and the residual fair value component (presented in profit or loss).
- A67. This approach would maintain the two measurement methods for financial assets and financial liabilities – fair value and amortised cost.
- A68. However, this would increase the use of OCI and be contrary to the requests of many respondents to the ED (and the DP on credit risk) that the Board complete the financial statement presentation project and in doing so articulate the purpose of OCI presentation before expanding the use of OCI.
- A69. In addition, the same issues as for a frozen credit spread approach arise with regard to disaggregating fair value changes. Indeed, this issue would be exacerbated as the split would have to be performed on an ongoing basis as it would have to be reassessed at every reporting date (and not only at inception).
- A70. Hence, the staff thinks at this point the Board should not pursue a split presentation approach.

Staff recommendation

A71. The staff recommends:

- (a) adopting a frozen credit spread for some, but not all, financial liabilities that are not measured at amortised cost.**
- (b) this measurement should be required for all financial liabilities that (i) are not eligible for amortised cost measurement, but (ii) are managed as part of a contractual cash flow business model.**
- (c) the IFRS should not prescribe a method to determine the initial credit spread, but should provide a default method an entity can use in case of simple instruments.**

- (d) disclosures about the methods and inputs used to isolate the credit spread should be required.
- (e) the fair value disclosures for all financial liabilities should continue to be required in accordance with IFRS 7.

Questions to the Board

Does the Board agree with the staff recommendation to:

1. require a frozen credit spread measurement method for some financial liabilities that are not measured at amortised cost
2. require a frozen spread measurement method for all financial liabilities **that (i) are not eligible for amortised cost measurement, but (ii) are managed as part of a contractual cash flow business model.**
3. provide the default method to isolate the initial credit spread, but not prescribe a method
4. require disclosures about the methods and inputs used to isolate the initial credit spread
5. continue requiring fair value disclosures in accordance with IFRS 7?

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

Appendix C - Agenda paper 3 from the 6 October 2009 IASB board meeting: *Accounting for embedded derivatives*

Objective of the paper

- A1. This paper discusses the accounting for hybrid contracts as proposed in ED/2009/7 Financial Instruments: Classification and Measurement ('the ED').
- A2. The paper includes:
- (a) an overview of the proposals in the ED;
 - (b) an overview of the FASB's tentative decisions;
 - (c) a staff analysis of comments received from constituents and during other outreach activities;
 - (d) possible approaches for the Board; and
 - (e) a staff recommendation (set out in paragraph A29).
- A3. This paper interacts with paper agenda paper 2, which addresses the issue of own credit risk in financial liabilities.
- A4. One way of addressing that issue is the Board deciding to require one of the two approaches in agenda paper 2. If the Board decides that, then this paper recommends the Board confirm its proposals to eliminate embedded derivative accounting for all hybrid contracts with a financial host.
- A5. If the Board decides not to adopt one of the two approaches in agenda paper 2, then this paper recommends that the Board maintains the requirements for the bifurcation of hybrid contracts with a financial liability host, but to eliminate embedded derivative accounting for hybrid contracts with a financial asset host.
- A6. Therefore, the staff recommendation is split in two in this paper.
- A7. This paper does not address transition. Many of the comment letters proposed that grandfather hybrid contracts be grandfathered if the Board finalises the proposals in the ED. We will address this issue when we address transition.

A8. This paper also does not address contractually subordinated interests (tranches in ‘waterfall’ structures).

Overview of the proposals in the ED

A9. The ED proposes to eliminate bifurcation accounting for embedded derivatives in hybrid contracts where the host is *within* the scope of IAS 39 *Financial Instruments: Recognition and Measurement* (herein referred to as ‘financial hosts’).

A10. Many respondents to the discussion paper (‘the DP’) *Reducing Complexity in Reporting Financial Instruments* highlighted that the current requirements in IAS 39 including its accompanying guidance are complex, rules-based and internally inconsistent. The Board shared these views in its deliberations on the ED.

A11. The ED did not propose any changes to hybrid contracts where the host is *outside* the scope of IAS 39 (eg leases with an unrelated foreign currency embedded derivative). The Board was aware of the importance of the issue, but decided to defer any decisions in this area until it deliberates scope and hedge accounting because of the interaction of these issues. For such hybrid contracts the existing guidance in IAS 39 would be retained for the time being if bifurcation of embedded derivatives is required.⁶

A12. The remainder of this paper only addresses the accounting for hybrid contracts with financial hosts.

A13. For hybrid contracts with financial hosts the entire hybrid contract would be assessed against the classification model in the ED and hence an entity would assess the entire hybrid contract as to whether the contract:

- (a) is managed in a business model that has the objective to on a contractual yield basis; and
- (b) has the required contractual cash flow features.

⁶ See BC47 of the ED.

- A14. As a result, some hybrid contracts would be accounted for at amortised cost in their entirety (if the classification criteria are met) while others would be measured at fair value through profit or loss in their entirety.
- A15. As noted in paragraphs BC44-BC46 of the ED, during its deliberations the Board discussed three approaches of the way forward for bifurcation accounting where the host is financial:
- (a) keep the current requirements in IAS 39
 - (b) use ‘closely related’ (used in IAS 39 to determine whether an embedded derivative is required to be separated from the host) as the classification criterion for the contract in its entirety
 - (c) use a single classification approach for all financial assets and financial liabilities including hybrid contracts.
- A16. The Board rejected the first two approaches as they would still rely on the ‘closely related’ assessment which has been identified as troublesome by many commentators and could lead to outcomes that are inconsistent with the general classification criterion of ‘basic loan features’ as set out in the ED (that is, there would be two classification models). The Board also believed that these approaches would not improve the reporting for financial instruments.
- A17. The Board decided to use the classification model for the entire hybrid contract as this would ensure only one classification model is applied to all financial instruments within the scope of IAS 39. This promotes comparability by ensuring consistency in classification.

FASB’s tentative decisions

- A18. The FASB has tentatively decided to keep its existing guidance on bifurcation of embedded derivatives for hybrid contracts within the scope of its financial instruments project. However, instead of using the guidance to determine the unit of account for classification and measurement purposes the FASB has tentatively decided to use the guidance as part of the classification model.

- A19. Consequently, if the current guidance in US GAAP would have mandated bifurcation, the entire hybrid contract would be accounted for at fair value through net income under the FASB tentative model. If bifurcation would not have been required under the existing guidance and the other criteria under the FASB's classification model are met, an entity could elect to measure the hybrid contract at fair value through other comprehensive income if it so chooses.
- A20. As the existing guidance on bifurcation would be retained, the FASB approach is similar to the approach described in paragraph A15(b) in terms of the items required to be measured at fair value through profit or loss.

Analysis of comments received

- A21. With regard to the proposed elimination of embedded derivative accounting the exposure draft asked constituents for input on the following question:

Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

- A22. Some respondents agreed with the proposals as they consider the current embedded derivative accounting model as a significant source of complexity in accounting for financial instruments.
- A23. However, many respondents, mainly preparers, preferred keeping or modifying the current bifurcation model, for the following reasons:
- (a) **The proposals would lead to volatility.** As a host contract would no longer be split and be eligible for amortised cost, income volatility would be increased.
 - (b) **The proposals aggravate the issue of own credit risk.** For hybrid contracts that have financial liability hosts, measuring the entire hybrid contract at fair value through profit or loss will exacerbate the issue of recognising changes in own credit risk in profit or loss which they believe

does not provide useful information. Some commentators recommended that any decision on the accounting for hybrid contracts (at least for hybrid contracts with financial liability hosts) should be deferred until the Board has concluded its project on reflecting own credit risk in liability measurement.

- (c) **Bifurcation accounting in many circumstances would better reflect the underlying economics and risk management considerations in the transaction.** Elimination of bifurcation accounting would also contradict the business model view of the proposed classification model as the components of many instruments are managed separately. For example, a deposit liability might be managed as part of the funding book whereas embedded derivative features that were included in the liability in order to encourage savers to make the deposit would be transferred to a derivatives risk management book. Those respondents considered bifurcation accounting as “good” complexity as it renders more decision-useful information if it reflects the way the entity manages risk.
- (d) **The proposals would account for like things differently and would create structuring opportunities.** For example an entity could enter into two separate transactions that have the same economic effect as entering into a single hybrid contract, but would be accounted for differently. This would contradict the qualitative characteristic of ‘substance over form’ and would impair comparability.
- (e) **Never change a running system.** The current guidance is well understood by all constituents and consistent application has evolved in practice in areas of uncertainty. If at all, changes should be made only where current guidance (or lack of it) leads to divergence in practice.

A24. Some respondents also highlighted that the fair value option should be retained if the current approach in IAS 39 is retained. This topic is discussed in agenda paper 6 for this meeting.

Possible approaches for the Board

A25. The Board has the following alternatives:

- (a) to finalise the guidance as proposed in the ED
- (b) to keep the existing guidance in IAS 39, or develop new guidance, to determine **the item (component of a hybrid contract)** to which the classification model would be applied⁷; or
- (c) to keep the existing guidance in IAS 39, or develop new guidance, for **classification** purposes (this would be similar to the FASB approach).

A26. The Board could defer any decision on the accounting for hybrid contracts with financial hosts until consideration of hybrid contracts with hosts outside the scope of IAS 39, and/or when deliberations on own credit risk are completed (which might for financial instruments happen within this project).

A27. However, as the proposals in the ED are expected to be finalised in time for early adoption by 2009 year-end reporting entities, deferring a decision on this issue could be an impediment for early adoption. Depending on the outcome of such later deliberations entities would have to change their accounting again or, alternatively, if any form of grandfathering was granted, users have to deal with multiple accounting treatments for similar contracts.

A28. Hence the staff does not recommend deferring this decision.

Staff recommendation – alternative 1: the Board addresses own credit risk

A29. The following recommendation applies if the Board decides to address the concerns with own credit risk by requiring one of the two approaches in paper 2 for particular financial liabilities.

A30. The staff recommends eliminating bifurcation accounting for all hybrid contracts with financial hosts as proposed in the ED.

⁷ This is consistent with Alternative 1A of agenda paper 3A1 of the June 2009 meeting.

Staff analysis

Reducing complexity

- A31. The staff believes that the elimination of the embedded derivatives guidance for hybrid contracts with financial hosts as proposed in the ED would reduce the complexity in financial reporting of financial instruments by eliminating another classification approach and improve the reporting for financial instruments. Many constituents agreed with this conclusion.
- A32. Keeping the existing guidance, for whatever purpose it is used, would perpetuate the complexity, inconsistency and lack of principles evidenced in today's requirements. On the contrary, in the staff's view approaches retaining or modifying the existing guidance would not meet this project's objective of improving reporting for financial instruments and hence should not further be pursued.

Component of a contract

- A33. The proposed approach would also ensure that no virtual components of a contract (or 'units of account') are created that imply separate future streams of cash flows where in fact there will be only one stream of interrelated cash flows arising under the contract.
- A34. The staff does not think that the underlying rationale for bifurcation accounting was to reflect risk management activities (this one of the objectives of hedge accounting), but to avoid circumventing the recognition and measurement requirements for derivatives. That is, it is an exception to the definition of the unit of account (the contract) to avoid abuse⁸. The staff observes that generally constituents are opposed to:
- (a) exceptions to a principle; and

⁸ Cf. IAS 39.BC37.

(b) anti-abuse considerations as the underlying rationale for developing guidance.

- A35. Hence, the staff thinks arguments brought forward that the proposed approach would not reflect risk management are not valid.
- A36. The staff further thinks the concerns brought forward that this would not reflect the business model in which the hybrid contracts are held are flawed as those commentators generally focus on the risk management aspects laid out above, rather than the cash flow aspects of the business model. Staff has been repeatedly told that there is a big difference between managing cash flows and monitoring risk. The staff shares this view⁹.
- A37. Furthermore, the staff accepts that an entity could easily circumvent the provisions by entering into two transactions. However, two contracts represent two units of account and lead to two streams of cash flows (assuming no netting arrangements exist). This raises a broader issue of what the most useful unit of account for reporting financial instruments is and whether linkage of transactions is necessary to ensure accounting reflects substance and not merely form¹⁰. Staff notes that reconsideration of the basic unit of account does not form part of this phase of the project, forms part of a far broader issue for financial reporting and attempting to address this issue would ensure that any timetable of the Board is not met.
- A38. The arguments brought forward that the embedded derivative features often do not meet the ‘basic loan feature’ criterion and hence lead to the entire hybrid contract to be accounted for at fair value through profit or loss are valid¹¹. However, the staff believes that the outcome provides more relevant information than today’s accounting as the embedded derivative feature impacts the ultimate cash flows arising from the instrument. Having a single unit of account, the contract, to which the classification model is applied increases decision-

⁹ See also paragraph 43 of agenda paper 3B of the 29 September 2009 meeting.

¹⁰ The staff thinks that the current unit of account in most cases appropriately reflect the economics underlying the transactions.

¹¹ While this might be true for the type of hybrid contracts, commentators did not provide a quantitative analysis of the impact.

usefulness as the information provided depicts more faithfully the amount, timing and uncertainty of future cash flows.

- A39. The staff understands the concerns raised over the ‘landslide’ effect when measuring the entire hybrid contract at fair value through profit or loss. Respondents were particularly concerned over this in connection with the issue of own credit risk.
- A40. We think that this issue is sufficiently mitigated through the proposed alternative measurement or presentation for some financial liabilities as discussed in agenda paper 2, including some hybrid financial liabilities.
- A41. Further, advocating bifurcation raises the question where componentisation should stop. This has been a recurring practice (and IFRIC) issue in the context of today’s embedded derivative requirements. For example, should all financial instruments be decomposed into their components if risk is monitored and managed that way (a ‘risk management view’)? And does this result in more useful information? What is the nature of a ‘host’ contract (equity or debt)? Should you have to determine the host before identifying the derivative? Etc. Etc. Etc.
- A42. Lastly, we think accounting for the hybrid contract as one unit of account is consistent with the project’s objective – to improve decision usefulness for users in their assessment of the timing, amount and uncertainty of future cash flows and reduce complexity in reporting financial instruments.

Elimination of embedded derivative accounting for hybrid contracts with hosts that are within the scope of IAS 39

If the Board decides to address the concerns with own credit risk by requiring one of the two approaches in paper 2 for particular financial liabilities:

Does the Board agree with the staff recommendation to eliminate embedded derivative accounting for hybrid contracts where the host is within the scope of IAS 39 and assess the entire hybrid contract under the proposed classification model?

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

Staff recommendation – alternative 2: the Board does not address own credit risk

A43. This recommendation applies if the Board decides not to adopt one of the two approaches in paper 2 to address the concerns regarding changes in own credit risk.

A44. Many respondents to the ED, including users, have highlighted that eliminating bifurcation accounting for hybrid contracts that are financial liabilities increases the volatility in profit or loss created by changes in own credit risk. Those respondents stated that for hybrid financial liabilities, the host contract is often managed on a contractual yield basis and hence, any changes in fair value including changes in own credit risk relating to the host will rarely, if ever, accrue to the entity.

A45. As evidenced in the comment letters, many believe that if a hybrid contract with a financial liability host is held to pay the contractual cash flows, reflecting changes in own credit risk in the income statement is misleading and not decision-useful. They encouraged the Board to further pursue its project on credit risk in liability measurement before finalizing the proposals for hybrid contracts that are financial liabilities.

A46. On balance, we believe that if the Board does not address the issue of own credit risk, the requirement of bifurcation accounting for hybrid contracts with financial liability hosts should be retained. We further recommend that the bifurcation criteria are ultimately aligned with the overall classification model. (That bifurcation approach is described below.)

A47. We think it would be an improvement of financial reporting to eliminate bifurcation for all hybrid contracts with financial hosts. However, in the staff's view, the issues raised by constituents in relation to own credit risk if financial liabilities are measured at fair value outweigh the incremental benefits from eliminating bifurcation accounting for hybrid contracts with financial liability hosts.

A48. **However, we recommend eliminating bifurcation accounting for hybrid contracts with financial asset hosts as the concerns over own credit risk do not arise for assets.** The staff acknowledges that having two different models for hybrid contracts with financial hosts is far from optimal. However, the staff thinks the issues surrounding own credit risk justify the different accounting treatment.

Aligning bifurcation criteria with the overall classification model

A49. Aligning the bifurcation criteria with the classification model would better articulate the rationale for requiring amortised cost or fair value measurement in the classification model and in the bifurcation approach. In our view, this also minimises structuring opportunities.

A50. Many of the comments received noted that hybrid contracts with financial liability hosts often have a funding or host component that the entity manages on a contractual yield basis.

A51. Those commentators believed it would better reflect the actual business model if this funding or host component is accounted for at amortised cost. The remaining “other” component of the contract would appropriately be accounted for at fair value through profit or loss.

A52. The staff thinks that any host component must meet the two criteria of the classification model in order to be bifurcated and accounted for at amortised cost (using the terminology of the ED):

- (a) it is managed on a contractual yield basis, and
- (b) it has basic loan features.

A53. All other hybrid contracts would be accounted for at fair value through profit or loss in their entirety.

A54. However, this approach would require further research and development of guidance (eg how to identify the host component/the other component). Given the timetable the Board has signed up to we do not think it is feasible to fully develop the model considering all potential ramifications in time. **As an interim measure, the staff recommends that the Board should retain the IAS 39**

bifurcation model for hybrid contracts with financial liability hosts for the time being and develop a new bifurcation model for such contracts subsequently.

Retain bifurcation accounting for hybrid contracts with financial liability hosts, but eliminate bifurcation accounting for hybrid contracts with financial asset hosts

1. Does the Board agree with the staff recommendation to retain the IAS 39 bifurcation accounting for hybrid contracts with financial liability hosts?

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

2. Does the Board agree with the staff recommendation to eliminate bifurcation accounting for hybrid contracts with financial asset hosts?

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

Appendix D - Agenda paper 12G from the October 2009 IASB board meeting: *Scope of the IFRS*

Background

- A1. At the 29 September meeting the Board tentatively decided that the scope of this phase of the project should include financial assets **and** financial liabilities.
- A2. At the 6 October meeting the Board tentatively decided to require a frozen credit spread measurement method for all financial liabilities that are:
- (a) not eligible for amortised cost, but
 - (b) are managed as part of a contractual cash flow business model (it follows that this measurement would not apply to financial liabilities held for trading, including stand-alone derivatives, and financial liabilities for which the entity uses the fair value option (FVO))
- A3. The Board took this tentative decision to address long-standing concerns raised by many, including many investors, that recognising the effects of changes in an entity's own credit risk (which could include changes in own credit standing and changes in the price of an entity's credit) does not result in useful information. This concern is a widespread concern, as illustrated by the responses to the IASB discussion paper *Reducing Complexity in Reporting Financial Instruments*, the IASB discussion paper *Credit Risk in Liability Measurement* and the IASB exposure draft *Financial Instruments: Classification and Measurement*.
- A4. To remind the Board, this issue is **not** about many financial liabilities that would be measured at amortised cost because they are managed as part of a business model that has the objective to pay the contractual cash flows and that have the required contractual cash flow characteristics. The Board has been clear in its deliberations that such financial liabilities would be measured at amortised cost.
- A5. This issue is also **not** about liabilities that are part of a trading activity (including stand-alone derivatives). The Board has been clear that such liabilities would be measured using fair value.

- A6. This issue **is about** hybrid contracts that have a financial liability host and include non-basic loan (or ‘embedded derivative’) features. This issue **is also about** financial liabilities that an entity would elect the fair value option for.

Issues raised about those tentative decisions

- A7. Since then, the staff has had several discussions about this tentative decision with individual board members. During these discussions a number of issues have been raised, including:
- (a) The frozen credit spread measurement method may have unknown or unintended consequences.
 - (b) Some derivative features that are embedded hybrid contracts with financial liability hosts would **not** be measured at fair value. This would be contrary to the long-standing position the Board has taken that all derivatives should be measured at fair value.
 - (c) The frozen credit spread measurement method would not apply to liabilities designated under the FVO and the FVO has been the source of many of constituents’ concerns in the past.
 - (d) Convergence will be difficult because the FASB’s proposed approach does not include a frozen credit spread measurement method, and the FASB has yet to discuss whether and if so, how, to address the long-standing concerns about the effects of changes .
- A8. As a result of those concerns, the staff recommends that the Board further consider whether final requirements for financial liabilities should be included as part of the forthcoming IFRS.
- A9. Some respondents to the ED recommended that the Board retain existing guidance for financial liabilities in the forthcoming IFRS for various reasons. The reasons given included the:
- (a) the complexity of the own credit risk issue and the interaction with other projects;

- (b) the possible impact of any decision on particular types of long-dated funding (including the related hedge accounting issues); and
- (c) the increased challenge that would result for any entity that wishes to apply the new IFRS for 2009 financial statements.

Staff recommendation

- A10. We recommend that the Board exclude financial liabilities from the scope of the forthcoming IFRS on classification and measurement. As a result, the IFRS would apply to financial assets. In the short-term, the requirements in IAS 39 would continue to apply to financial liabilities.
- A11. This would allow us to further analyze the frozen credit spread measurement method, including considering fully the comments on the discussion paper *Credit Risk in Liability Measurement*. Moreover, it would allow us more time to ensure that:
- (a) All liabilities that are held for trading are measured at fair value (this is non-controversial).
 - (b) All derivatives, including embedded derivative features, are measured at fair value.
 - (c) The concerns associated with the FVO are fully considered.
- A12. Moreover, it is consistent with the Board’s commitment to convergence with the FASB.
- A13. If the Board accept the staff recommendation, the staff will consider ways in which this issue might be addressed in the near-term.

Scope: financial liabilities
Does the Board agree with the staff recommendation that financial liabilities should be excluded from the scope of the forthcoming IFRS?
If not, what would you propose instead and why?

Appendix E – Agenda paper 6 of the October 2009 IASB main board meeting: *Comment letter analysis for the DP on credit risk in liability measurement*

Introduction

- A1. In June 2009 the Board published the discussion paper *Credit Risk in Liability Measurement* (DP). The comment period ended on 1 September 2009 and, by that date, the IASB had received 82 comment letters.
- A2. The DP and accompanying staff paper outlined the three most often-cited arguments in favour of including credit risk in liability measurement and the three most often-cited arguments against including it. The DP sought respondents' views on when and how credit risk should be included in liability measurement.
- A3. The staff presented a preliminary analysis of the 102 comment letters that had been received through 2 September at the September Board meeting.
- A4. A note on terminology before continuing. The staff paper focused on “credit risk,” which might be defined as the possibility that an entity will fail to pay an obligation according to its terms. FASB Statement 157, *Fair Value Measurements*, introduced the term “nonperformance risk.” The FASB intended the term to include credit risk, but also to include other failures to meet an obligation. Many of the respondents treated the terms as if they meant the same thing. The terms are interchangeable in many, but not all situations. We will describe one such in the final section of this paper.

Purpose of this paper

- A5. This paper provides a more detailed analysis of the 123 comment letters that were received by 5 October, along with staff recommendations on how the Board should address credit risk in other projects.

Overview of the comments received

- A6. Respondents agreed that Credit Risk is a complex and controversial issue which has to be addressed. However some respondents had concerns about looking at this issue in isolation and maintained that it should be addressed as a part of the Conceptual Framework project. Other respondents said that it was difficult to respond on this issue before the Fair Value (FV) project and the project to replace IAS 39 *Financial Instruments: Recognition and Measurement* have been completed. Respondents however generally supported the Board's effort to address this issue.
- A7. Respondents generally said that liabilities can or should be measured differently on initial measurement than on subsequent remeasurement. They also argued that a consistent measurement approach for different types of liabilities is not needed. In their view, different liabilities can or should be measured differently.
- A8. Respondents most often argued that decision usefulness should be the driver in liability measurement rather than consistency.

When assessing whether current measurements, subsequent to initial recognition, should incorporate the price of credit risk inherent in the liability, the objectives of quality of information and decision usefulness should be the guiding principles. (CL#71)

- A9. Respondents also seem to be more interested in eliminating obvious day one gain/loss than having a consistent approach to measuring liabilities. We use the word "obvious" here because any measurement on initial recognition that excludes credit risk builds in a "borrowing penalty" (see paragraph 30 of the staff paper). The penalty is obvious when the transaction includes a debit to cash, because debits have to equal credits.
- A10. A majority of the respondents addressed all types of liabilities, other respondents limited their answers to financial liabilities. A few of the respondents limited their answers to either pension or insurance liabilities.
- A11. The respondents who limited their responses to financial liabilities seemed to be more inclined to favour including credit risk both on initial measurement and on subsequent remeasurement. However, their answers were often limited further

to financial liabilities measured at FV. We will return to the interaction between comments about credit risk and fair value later in the paper.

- A12. Very few respondents identified the difference between a change in credit rating and a change in spread as an issue.
- A13. One of the objectives of the DP was to get users’ opinions on credit risk. Only three responses can be classified users, so the DP did not meet that objective. Whether this was due to the timing of the DP, the short comment period or the traditional pattern of receiving few comment letters from users is not clear.
- A14. We would summarize the respondents’ general conclusions in the following table (borrowed from the Ernst and Young comment letter):

	Measurement	Include own credit risk?	
		Initial recognition	Subsequent remeasurement
Financial liabilities	Fair value	Yes	Yes
	Other than fair value	Yes	No
Non-financial liabilities	Fair value	Yes	Yes
	Other than fair value - initial consideration exchanged	Yes	No
	Other than fair value - no initial consideration exchanged	No	No

- A15. The comment letters are summarized below by type of respondent and geographic region:

Respondent Type	Number of respondents	Percentage
Preparer	48	39%
Professional bodies	29	24%
National standard-setters	15	12%
Regulator	8	7%
Others eg NFPs, public sectors	8	7%
Accounting firms	6	5%
Individuals	4	3%
Investor/ Analyst/ User	3	2%
Academic	2	2%
Total	123	100%

Geographic region	Number of respondents	Percentage
West Europe	61	50%
North America	21	17%
International	14	11%
Asia Pacific ex ANZ	11	9%
Australia/NZ	11	9%
Africa	2	2%
East Europe	1	1%
Central/South America	1	1%
Total	122	100%

A16. In addition to responding to the questions in the DP, most respondents provided general comments about credit risk. First we will summarize those general comments and then we will address the responses to the questions in the DP.

Summary of general comments

A17. Some respondents have concerns about this DP and credit risk being taken on as a separate project. They are especially concerned about the interaction between this project and other ongoing projects on the Board's agenda.

Conceptual Framework

A18. Some respondents said that this issue should not be addressed in isolation and should be addressed in the measurement phase of Conceptual Framework Project. They also said generally that more work is needed on liability measurement before the issue of credit risk can be addressed.

The Joint Accounting Bodies appreciate the concerns expressed in the DP about the place of 'own credit risk' in liability measurement and support the need for guidance and clarity on the issue. However, it is our view that these concerns cannot be resolved before addressing measurement models. In particular, the issue of credit risk in liability measurement must be addressed in conjunction with the fair value measurement project and not in isolation of it, as the credit risk issue can only be resolved once fair value has been defined. We think this fundamental issue is more appropriately addressed within the conceptual framework and definition of fair value, rather than the approach taken in the DP. (CL #6)

Fair Value

A19. The staff found respondents' views on the interaction between fair value and credit risk difficult to analyse. Some respondents:

- (a) Appeared to be opposed to fair value measurement of liabilities in general, and used credit risk as a basis for arguing against fair value, or
- (b) Agreed that the Board's definition of fair value includes credit risk, and therefore would rarely favour its application to liabilities, or
- (c) Would like a definition of fair value that does not include credit risk.

A20. Many respondents said that it is difficult to answer the questions on the use of credit risk when the FV project has not been completed.

We would like to note that it is difficult to comment on the issue of when financial liability measurement should include consideration of credit risk separately to the related issues of how fair value should be determined and when financial instruments should be measured at fair value. The Board's conclusions on this DP clearly have potential impacts on exposure drafts already in issue, ED/2009/7 *Financial Instruments: Classification and Measurement* and ED/2009/5 *Fair Value Measurement*, which we will be commenting on separately. (CL #17)

A21. Many respondents said that FV should only be used in limited circumstances on subsequent remeasurement, namely for trading liabilities and other similar liabilities, or if the entity has the possibility to realise the changes in FV.

A22. Some respondents suggest using adjusted FV on subsequent measurement, in which effects of changes in own credit risk would be separated from other changes.

Therefore, we believe that it is premature to include subsequent changes in an entity's creditworthiness in the income statement. Such effects would be better suited to disclosure in the footnotes to the financial statements. (CL#99)

For fair value measurements of non-trading liabilities, as a practical solution rather than due to any conceptual argument, we support the recognition of gains or losses arising from changes in own credit risk through OCI. We believe that this approach would reduce volatility in the income statement and also meet the demands of various stakeholders. (CL#90)

The main argument raised here was that reporting changes in own credit risk in the income statement is misleading and the “counterintuitive” nature of recognized gains and losses when they cannot be realised. Many also argued that the gains and losses are not useful information, except when the entity can realise the gain by buying back its own debt.

- A23. A few respondents suggested separating the FV changes into changes for own credit risk which should not be presented in the income statement and all other changes which would be presented in the income statement. The changes related to own credit risk would be reported in Other Comprehensive Income.
- A24. Some letters remarked on the difficulties in separating credit risk from other elements of an interest rate. Some observed that extracting effects of own credit risk in level 1 FV measurement is very hard as the credit risk is implicit in the price used. They observed the opposite problem when inserting credit risk in level 3 FV measurement.

Conceptually, we do not disagree with the inclusion of credit risk where liabilities are measured at fair value but we do not believe that a single approach can be applied to all such liabilities. For example, from a practical point of view it may be appropriate to distinguish liabilities measured at fair value between those categorised at different levels of the fair value hierarchy. Accordingly, one would expect to reflect credit risk in the measurement of those at level 1 whereas this would not be the case for those at level 3 in the hierarchy. It would be practically difficult to exclude credit risk from a fair value determined higher up the hierarchy whereas a “mark to model” level 3 valuation would potentially experience the same difficulties including the credit risk element. (CL 63)

- A25. Many respondents also said that while the project to replace IAS 39, especially the first phase, *Financial Instruments: Classification and Measurement* has not been completed it is hard to give a definite answer now on credit risk without knowing when and to what extent FV will be used in measurement.
- A26. There are also some concerns about using FV especially on subsequent remeasurement as discussed above.

Other projects

- A27. The use of credit risk in the measurement of liabilities in other projects was also mentioned, especially the insurance and pension projects. There was little support for including own credit risk in the measurement of these liabilities. Respondents said that credit risk should only be included in measurement of a liability when it is priced into the (usually cash) transaction that gives rise to the liability. They also said that it is very difficult or even impossible to measure amount attributable to credit risk for these liabilities.

In the case of non-financial liabilities we do not believe it is possible for an entity to measure non-performance risk for no observable market price exists. Therefore non-performance risk should not be included in both initial and subsequent measurement. (CL 101)

Respondent also said that the same applies to liabilities within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the leases project.

Other comments

- A28. Many respondents said that decision usefulness of information on liabilities presented in financial statement should be the driver for measurement. Their view of decision usefulness overcomes any argument for a consistent measurement approach applied to all liabilities. They also said that measurement of the same liability should not necessarily include credit risk both on initial measurement and subsequent remeasurement.

The going concern assumption

A29. Many respondents argued against the inclusion of own credit risk, especially on subsequent remeasurement, because it violated their notion of the going concern basis.

A30. The staff has heard this argument many times, applied to many topics. We find it useful to revisit what the term “going concern” means in an IFRS context.

Paragraph 23 of the *Framework for Preparation and Presentation of Financial Statement* reads as follows:

The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

A31. Paragraph 23 of the Framework does not include or exclude any measurement objective, although going concern is often raised in objection to current measurements. We agree that most entities expect to pay their obligations when they are due. We also agree that adjustments for fair value and credit risk reverse when an obligation is paid according to its terms. Neither of those truisms has anything to do with the going concern notion described in the Framework. In the staff’s view, there are strong arguments against including credit risk in liability measurements. An appeal to the going concern notion is not one of them.

Summary of the responses to the questions in the DP

Initial measurement

A32. On initial measurement a majority of the respondents said that credit risk should *sometimes* be included in the measurement of liabilities. However, some of the respondents said that credit risk should *always* be included. It should however be noted that majority of those that support *always* including credit risk limit their answers to financial liabilities. Only four respondents said that credit risk should *always* be included in initial measurement of all liabilities. Very few respondents said that credit risk should *never* be included on initial

measurement. As discussed earlier, most respondents equated “sometimes” with “cash transaction.”

Subsequent remeasurement

A33. There are more divided views on subsequent remeasurement. The majority of the respondents said that credit risk should *sometimes* be included in subsequent measurement of liabilities. However, a substantial part of the respondents said that credit risk should *never* be included. Only a small number of the respondents said that credit risk should *always* be included. Again the majority of those which favoured *always* including credit risk limit their answers to financial liabilities measured at FV. Only two respondents said that credit risk should always be included in subsequent remeasurement of all liabilities.

Methods to determine the amount of change in market interest rates attributable to the price of credit risk

A34. Many respondents concluded that this question was not relevant as they would not measure this change. For others, the staff has concluded that this question was not clear. Given the number of respondents who opposed including credit risk in subsequent measurement, we expected more attention to the process of extracting credit risk from observed prices.

A35. A majority of those who answered this question thought that difference between the entities borrowing rate (or issuance rate) and a relevant market rate should be used, without explaining further what they meant by relevant rate.

A36. A few respondents pointed to the guidance in IFRS 7 *Financial Instruments: Disclosures* on how to determine this amount.

A37. There were also suggestions that a panel of industry experts should be convened to develop guidance on how the effect of changes in the price of own credit should be calculated.

Preferred approach to measure liabilities and credit standing

- A38. Approaches a) and b) suggested in paragraph 62 of the staff paper accompanying the DP did not get any support from the respondents. They were dismissed on the grounds that they would increase complexity and not provide decision useful information.
- A39. Most respondents favored approach c), that is the “frozen spread” approach, of the approaches presented in the paper to measure liabilities and credit standing in question 4 of the DP.

Measure borrowings and other liabilities that result from an exchange for cash at the amount of the cash proceeds. Measure liabilities that do not have a cash exchange at the present value of expected future cash flows, discounted at market rates that exclude the effect of credit risk. Subsequent current measurements should incorporate changes in market interest rates. Changes arising from the entity’s credit quality or the price of its credit should be excluded from the market interest rates. This would have the effect of fixing the credit spread at the original amount and incorporating all changes in the risk-free rate.

- A40. More than half of the respondents favoured approach c). However many respondents rejected all the approaches suggested without recommending an alternative.
- A41. Those respondents who rejected all the proposed approaches did so in most cases on the grounds that credit risk would have to be included in fair value measurement. They said that this approach would therefore not work for financial liabilities measured at FV, such as liabilities held for trading. They seemed to conclude that liabilities measured at FV would have to include changes in the entity’s own credit risk. It is not clear whether most of these respondents a) rejected the idea of an “adjusted fair value,” or b) did not see the proposed alternatives as appropriate adjustments.

Analysis and recommendations

General Recommendation

- A42. The natural first question following the Discussion Paper is “what next?” Neither the Board nor the staff started this exercise with a plan that it would

follow a normal project's trajectory. Instead, we wanted to focus our constituents' attention on a crosscutting issue. We hoped that their comments would provide useful input to a number of projects.

- A43. In the staff's view, the answer to "what next?" should be "nothing," at least in terms of continuing work on a quasi-project called Credit Risk. The discussion paper accomplished the Board's objective. Several respondents contended that the issues surrounding credit risk cannot be solved apart from a general concept of liability measurement. We agree with them, to a degree. It would be a mistake for the Board to try and articulate a principle on credit risk without having a principle on liability measurement. Any further work on credit risk as a general proposition should be part of the conceptual framework measurement phase.
- A44. But the Board still needs to make decisions about liability measurement in individual projects. We have some recommendations about how to approach that need.

Fair value

- A45. The credit risk team does not recommend any change in the role of credit/performance risk in the **definition** of fair value for liabilities. The staff proposed a different approach last December, and the Board rejected that proposal. Moreover, a fundamental change to the definition of fair value would be a major impediment to IASB/FASB convergence.
- A46. We recommend that the Board explicitly consider modifications to the **application** of fair value in every project. There is precedent for adopting a modified fair value, notably the use of "fair value less costs to sell," and "fair value less costs to distribute," in IFRS 5, *Noncurrent Assets Held for Sale and Discontinued Operations*. The Board's 2008 Discussion Paper on employee benefits adopted the phrase "fair value assuming the terms of the benefit promise do not change."
- A47. For example, the Board might decide that a particular class of liabilities should be measured:

- (a) At fair value on initial recognition, with a presumption that the cash proceeds of the liability approximate fair value. That measurement would include credit/performance risk to the extent that it is captured in the cash price, as one would expect it would be.
- (b) Using an approach similar to the “frozen spread” method described in the Credit Risk paper for subsequent measurements. The result might be described as “fair value excluding changes in credit risk.”

A48. We expect that defining the population of the class of liabilities to which this approach would apply will be difficult. It always is. We learned little from the comment letters that will help us with that. Many respondents said that subsequent measurement of liabilities should never include changes in credit standing. Their scope appears to have been all liabilities. Others allowed that fair value should include credit/performance risk when measuring some liabilities. Derivatives and liabilities in trading portfolios were common suggestions.

Other measurements

A49. In IFRS, most applications of fair value to liabilities occur in financial instruments. We have several other standards that *do not* require fair value but *do* require current information to be incorporated in liability measurement, including IAS 37 on provisions, IAS 19 on pensions, and potentially, standards on revenue recognition and insurance. Board decisions in those projects suggest that IFRS will have measurements that could be described as “current (or fresh-start) measurements that are not fair value” for the foreseeable future. All of those measurements are going to be based, to one degree or another, on the present value of future cash flows.

A50. In the credit risk staff’s view, there is no conceptual imperative in IFRS that requires a current measurement of a liability (other than fair value) to include credit risk. We are in a different position on this point than is the FASB. FASB Concepts Statement No 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, mandates fair value in paragraph 25, which says:

The only objective of present value, when used in accounting measurements at initial recognition and fresh-start measurements, is to estimate fair value. Stated differently, present value should attempt to capture the elements that taken together would comprise a market price if one existed, that is, fair value.

- A51. The FASB members who voted for Concepts Statement 7 intended that language to be absolute. Indeed, the two dissenters raised only this point in their dissent. In its entirety, the dissent reads:

Messrs. Larson and Trott dissent from this Statement because of its adoption of fair value as the sole objective of using cash flow information and present value in accounting measurements at initial recognition and fresh-start measurements. They agree with the guidance in the Statement for using cash flow information and present value if the objective is to estimate fair value. However, they believe that cash flow information and present value used in cost-accumulation and other measurements also produces relevant information.

- A52. A considerable majority of the respondents maintained that credit risk should not be incorporated in either initial or subsequent measurement of nonfinancial liabilities. Few, if any, commented on the inconsistency between this view and their views on initial measurements that result from cash transactions. That is, excluding credit standing at initial recognition builds a “borrowing penalty” into any liability measurement (refer to paragraph 30 of the staff paper). Most argued instead that credit risk should not be incorporated when it is not explicitly priced in a transaction.

Credit risk meets performance risk

- A53. There is another dimension to the role of credit (or performance) risk in liabilities with uncertain cash flows; a dimension that we should have spent more time describing in the staff paper. We usually think of credit risk as the possibility that a borrower will fail to pay a fixed amount on a fixed or determinable date. That is a two-dimensional problem. But nonfinancial liabilities usually have more dimensions of uncertainty.
- A54. Consider a liability with possible cash outflows that range from CU 5,000,000 to CU 5,000,000,000. Any cash outflow that exceeds CU 1,000,000,000 will bankrupt the entity. The company knows that if the cash outflow nears CU 1 billion, it will either default or attempt to renegotiate its contract. Do the

expected cash flows for a measurement other than fair value include the possibilities exceeding CU 1 billion? The fair value exposure draft seems to define a market participant as one with the same capacities as the entity, so possible outcomes exceeding CU 1 billion are assigned a probability of zero. It is not clear whether the same analysis applies in measurements that are not targeted on fair value.

A55. A similar problem, though not of the same black-swan¹² magnitude, caused the Board to adopt a modified fair value (fair value assuming the terms of the benefit promise do not change) in its discussion paper on employee benefits.

A56. We think that this is an (admittedly extreme) example of what the FASB was thinking about when they described performance risk. The distinction between credit and performance is important only because it reveals something that respondents may not have considered, and that we did not ask them to consider. Many respondents took the view that measurement of nonfinancial liabilities should never include credit risk. Many went a step farther and used the term performance risk. If we follow their argument, then a present value measurement of a nonfinancial liability must use:

- (a) All of the cash flow scenarios, including the black-swan possibilities. Excluding the cash flow scenarios over CU 1 billion would incorporate performance risk in the measurement.
- (b) A risk free interest rate. Any rate other than risk free would incorporate some credit risk in the measurement.

A57. We suspect that many of the constituents who objected to credit risk in their comment letters would also object to the measurement that applying (a) and (b) would produce. However, the problem illustrates that any present value measurement is a product of assumptions about cash flows and interest rates. Variability in possible outcomes can be incorporated in either, but should only be counted once. We tend to focus too often on the interest rate when describing credit risk.

¹² A *black-swan* event is one with low probability but very large magnitude. The name comes from a popular 2007 book by Nassim Nicholas Taleb.

A58. We recommend that the Board acknowledge that it will consider the question of credit (and performance) risk in every project that involves a current measurement of liabilities that is not fair value. We should not ask constituents to answer it on their own.

Staff recommendations and question for the Board

The staff recommends:

- (a) That the Board stop work on credit risk as a free-standing work stream;
- (b) That the Board not reach a general conclusion on credit risk at this time, but instead incorporate the topic in the conceptual framework measurement project;
- (c) That the Board not change the role of credit/performance risk in the definition of fair value;
- (d) That the Board consider the application of that definition in measurements that would otherwise be at fair value, and
- (e) That the Board state that it will consider the question of credit risk in every project that involves a current measurement of liabilities that is not fair value.

Do you agree?

Appendix F – Relevant paragraphs from IFRS 7 for identifying changes in fair value due to changes in own credit risk

10 If the entity has designated a financial liability as at fair value through profit or loss in accordance with paragraph 9 of IAS 39, it shall disclose:

- (a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability determined either:
 - (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (see Appendix B, paragraph B4); or
 - (ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.

Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund.

- (b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

11 The entity shall disclose:

- (a) the methods used to comply with the requirements in paragraphs 9(c) and 10(a).
- (b) if the entity believes that the disclosure it has given to comply with the requirements in paragraph 9(c) or 10(a) does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.

B4 If an entity designates a financial liability as at fair value through profit or loss, paragraph 10(a) requires it to disclose the amount of change in the fair value of the financial liability that is attributable to changes in the liability's credit risk. Paragraph 10(a)(i) permits an entity to determine this amount as the amount of change in the liability's fair value that is not attributable to changes in market conditions that give rise to market risk. If the only relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, this amount can be estimated as follows:

- (a) First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.
- (b) Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in (a).
- (c) The difference between the observed market price of the liability at the end of the period and the amount determined in (b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be disclosed.

This example assumes that changes in fair value arising from factors other than changes in the instrument's credit risk or changes in interest rates are not significant. If the instrument in the example contains an embedded derivative, the change in fair value of the embedded derivative is excluded in determining the amount to be disclosed in accordance with paragraph 10(a).

Financial liabilities at fair value through profit or loss (paragraphs 10(a)(i) and B4)

- IG7 The following example illustrates the calculation that an entity might perform in accordance with paragraph B4 of Appendix B of the IFRS.
- IG8 On 1 January 20X1, an entity issues a 10-year bond with a par value of CU150,000 and an annual fixed coupon rate of 8 per cent, which is consistent with market rates for bonds with similar characteristics.¹³
- IG9 The entity uses LIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, LIBOR is 5 per cent. At the end of the first year:
- (a) LIBOR has decreased to 4.75 per cent.
- (b) the fair value for the bond is CU153,811, consistent with an interest rate of 7.6 per cent.¹⁴
- IG10 The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.
- IG11 The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:

<p>[paragraph B4(a)]</p> <p>First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period.</p> <p>It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.</p>	<p>At the start of the period of a 10-year bond with a coupon of 8 per cent, the bond's internal rate of return is 8 per cent.</p> <p>Because the observed (benchmark) interest rate (LIBOR) is 5 per cent, the instrument-specific component of the internal rate of return is 3 per cent.</p>
<p>[paragraph B4(b)]</p> <p>Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in accordance with paragraph B4(a).</p>	<p>The contractual cash flows of the instrument at the end of the period are:</p> <ul style="list-style-type: none"> • interest: CU12,000^a per year for each of years 2–10. • principal: CU150,000 in year 10. <p>The discount rate to be used to calculate the present value of the bond is thus 7.75 per cent, which is 4.75 per cent end of period LIBOR rate, plus the 3 per cent instrument-specific component.</p> <p>This gives a present value of CU152,367.^b</p>
<p>[paragraph B4(c)]</p> <p>The difference between the observed market price of the liability at the end of the period and the amount determined in accordance with paragraph B4(b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be disclosed.</p>	<p>The market price of the liability at the end of the period is CU153,811.^c</p> <p>Thus, the entity discloses CU1,444, which is CU153,811 – CU152,367, as the increase in fair value of the bond that is not attributable to changes in market</p>

¹³ In this guidance monetary amounts are denominated in 'currency units (CU)'.

¹⁴ This reflects a shift in LIBOR from 5 per cent to 4.75 per cent and a movement of 0.15 per cent which, in the absence of other relevant changes in market conditions, is assumed to reflect changes in credit risk of the instrument.

	conditions that give rise to market risk.
a	$\text{CU}150,000 \times 8\% = \text{CU}12,000$
b	$\text{PV} = [\text{CU}12,000 \times (1 - (1 + 0.0775)^{-9})/0.0775] + \text{CU}150,000 \times (1 + 0.0775)^{-9}$
c	$\text{market price} = [\text{CU}12,000 \times (1 - (1 + 0.076)^{-9})/0.076] + \text{CU}150,000 \times (1 + 0.076)^{-9}$

Appendix G – Summary of the discussion paper *Credit Risk in Liability Measurement*

- A1. The DP discusses three arguments in favour and three against the inclusion of credit risk in the measurement of liabilities. The discussion was not limited to financial liabilities.
- A2. Arguments in favour (summary):
- (a) **Consistency at initial recognition**

Accountants accept that the initial measurement of a liability incurred in an exchange for cash includes the effects of the borrower's credit risk, adjusted for collateral, guarantees and other features of the contract. Barring evidence to the contrary, the cash exchange represents fair value in that market. There is no reason why subsequent current measurements should exclude changes in factors that were included in the initial measurement. Similarly, there is no reason why the initial measurement of some liabilities should include the effects of credit risk and others should not.
 - (b) **Wealth transfer**

Liabilities and equity represent the two classes of claims* against the entity. A change in the credit risk of the entity's liabilities represents a transfer of wealth between those two classes. Lenders' interests are usually senior to those of equity holders and their potential gains and losses are bounded by the terms of a contract. Equity holders of an entity are not required to make any additional investment to cover losses incurred by the entity except to the extent that the equity holders have a binding obligation to do so. As the entity's ability to pay its liabilities diminishes, the effect on owners' claims is limited to the amount of their investment. Therefore, the apparent gain to the borrower can be seen as an allocation of claims between the borrower's owners and its lenders.
 - (c) **Accounting mismatch**

The failure to include changes in the credit risk of liabilities can result in an accounting mismatch between asset and liability measurements. If an entity's assets are measured at fair value, then changes in credit spreads on those assets will affect their fair value and either profit or loss or other

comprehensive income. If the measurement of liabilities does not incorporate changes in credit spreads, then there is an accounting mismatch and the amounts of profit or loss or other comprehensive income will be distorted by the mismatch.

A3. Arguments against (summary):

(a) **Counter-intuitive results**

When liability measurement includes credit risk, an entity reports a gain from a decline in the credit quality of its liabilities. This gain (or loss, in the case of improving credit quality) is counter-intuitive. Gains should result from improvements in an entity's financial position, not declines. Reporting a gain from a decline in credit quality is potentially misleading and can mask a deteriorating situation.

(b) **Accounting mismatch**

Including changes in credit risk is likely to increase the mismatch between assets and liabilities. A decline in an entity's credit quality usually signals a decline in the value of assets that may not be measured on a current basis (like fixed assets and goodwill), unrecognized intangible assets, and confidence in the entity's management. Because changes in those items are not recognised in financial statements, changes in credit quality should be similarly excluded.

(c) **Realisation**

One of the major arguments in favour of fair value is that realisation is not a critical event in accounting for some assets. Unless a financial asset is pledged or otherwise restricted, an entity can sell an asset whenever management wishes to do so. Assets are sold every day, but liabilities are seldom transferred. A transfer usually requires permission of the counterparty, and some liabilities cannot be transferred in any practical way. The relevant measurement of some liabilities clearly requires inclusion of current information. It does not follow, however, that accounting measurement of the liabilities should mirror the measurement of assets.

A4. The discussion paper also discusses possible alternatives to including credit risk:

- (a) Measure all liabilities using the risk-free rate of interest and expected future cash flows, excluding any expectations about default. Any difference between the resulting amount and cash proceeds (if any) should be charged to income immediately.
- (b) Measure all liabilities using the risk-free rate of interest and expected future cash flows, excluding any expectations about default. Any difference between the resulting amount and cash proceeds (if any) should be charged to equity and amortised over the life of the liability.
- (c) Measure borrowings and other liabilities that result from an exchange for cash at the amount of the cash proceeds. Measure liabilities that do not have a cash exchange at the present value of expected future cash flows, discounted at market rates that exclude the effect of credit risk. Subsequent current measurements should incorporate changes in market interest rates. Changes arising from the entity's credit quality or the price of its credit should be excluded from the market interest rates. This would have the effect of fixing the credit spread at the original amount and incorporating all changes in the risk-free rate.

A5. The DP contains simplified examples showing the effects of these alternatives (p. 21-24 of the DP).