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**International  
Accounting Standards  
Board**

*This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.*

*These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

### **INFORMATION FOR OBSERVERS**

**Board Meeting:** 13 December 2006, London

**Project:** Financial Instruments – Due Process Document (DPD)

**Subject:** Recognition and Measurement (Agenda Paper 12C)

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### **CONTENTS OF PAPER**

1. This paper discusses the fair value measurement of liabilities with a demand feature.
2. This paper does not consider how such liabilities should be measured on initial recognition; the Boards do not have a preliminary view on how financial instruments should be measured on initial recognition, but whatever decision is eventually reached would also apply to demand liabilities.

### **BACKGROUND**

3. Some financial instruments allow the holder of the instrument to seek repayment of the instrument, with little or no notice to the issuer of the instrument – a *demand* feature. (Some such instruments carry no stated maturity).
4. Examples of such instruments include debt instruments that are puttable to the issuer at the option of the instrument holder and some types of bank deposit

liabilities. Examples outside the scope of the DPD include some insurance contracts that may be surrendered at the option of the policyholder.

5. As mentioned above, some types of bank deposit liabilities have such a demand feature; many banks accept deposits that are payable on demand or with very short contractual maturity dates. An example is a current (or chequing) account. The customer can demand settlement by various means (such as withdrawing cash).
6. A significant proportion of a population of such deposits can be observed to remain on deposit for a period of time. Historical withdrawal statistics are available for depositors with different demographics in different geographical areas and for different deposit types. Banks often manage their liabilities (and hence assets) taking into account expected replacements for existing deposits (that is, future transactions). However, before continuing, it is worth stressing that in this paper we are only seeking to measure existing liabilities. That is, we are not seeking to measure future possible liabilities (such as future deposits) that may or may not occur.
7. Banks also often have the right to return the depositor's money – although such a right is rarely, if ever, exercised (except in cases involving deposits that are suspected to be related to illegal activities).

#### **POSSIBLE WAYS TO MEASURE LIABILITIES WITH A DEMAND FEATURE**

8. There are two different ways to measure such existing liabilities. These are:
  - a. Immediate settlement value (that is, the cash outflow if payment of the liability was demanded at the earliest contractual date on which payment could be demanded), or the
  - b. Payment value based on the expected timing of cash outflows (that is, the probability weighted timing of the demand for repayment).

9. Any 'present value' approach to measurement would also require the discounting of any future cash flows.

## **THE FAIR VALUE OF LIABILITIES WITH A DEMAND FEATURE**

### **Fair value measurement**

10. The boards' long-term objective of fair value measurement for all financial instruments has been assumed in drafting the DPD. Based on the definition of fair value in Statement No. 157 *Fair Value Measurements*, the fair value of a liability with a demand feature is hence based on a transfer to another obligor (market participant) rather than on settlement with the counterparty.
11. An immediate settlement approach is therefore not relevant to the measurement of a liability with a demand feature unless market participants (other potential obligors) would be expected to use such an approach in pricing a portfolio, and all evidence indicates that they do not. (Of course, an immediate settlement approach may still provide decision useful information to be included in the financial statements).
12. An approach that is based on the expected timing of cash outflows is consistent with the transfer notion that lies behind fair value measurement. FASB staff have in previous projects consulted with bank and valuation experts, who confirmed that transfer prices for liabilities with a demand feature are based upon such information.
13. Adopting such an approach to measuring the fair value of liabilities with a demand feature is also consistent with the preliminary views reached by the IASB Board in the Insurance project; in that project the preferred 'current exit value' model is based on current estimates of future cash flows which results in no minimum floor for a surrender value.

## **Inputs required for fair value measurement**

14. In arriving at the fair value market of a contractual instrument, market participants take into account the expected timing and amount of any demand for repayment of the existing liability. Some cash flows could occur at the earliest possible date on which repayment could be demanded – but the probability of all or nearly all the cash outflows occurring at that date would be very low.
15. It should make little or no difference conceptually whether the timing of expected cash flows is determined on a contract by contract basis, or on a portfolio basis. However, some transactions involving the transfer of some liabilities with demand features (such as deposit liabilities – see later comments) involve portfolios – and hence from a practical viewpoint it may make sense to consider such items on a portfolio basis<sup>1</sup>.
16. In addition to assessing the expected timing of cash flows, the risk of nonperformance by the debtor should also be considered in measuring fair value.
17. Statement 157 states that a fair value measurement assumes that the liability is transferred to a market participant at the measurement date and that the nonperformance risk relating to that liability (which is the same as credit risk for a financial liability) is the same before and after its transfer<sup>2</sup>.
18. The discount rate to be used in measuring the fair value of a liability with a demand feature should be the interest rate used by market participants at the measurement date to price equivalent borrowings of similar risk and maturity.

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<sup>1</sup> At a previous meeting the IASB tentatively decided that the measurement objective should be to measure fair value at the individual instrument level. However, this requirement would not prevent an entity aggregating similar items into a portfolio and measuring the portfolio, as long as the objective in doing so was to ascertain the fair value of the individual instruments within that portfolio.

<sup>2</sup> Some liabilities with a demand feature may be guaranteed. The measurement of guaranteed liabilities (and specifically bank deposit insurance schemes) was discussed in paper 5A of the papers for November and is also discussed in paper 12D for this meeting. The outcome of that discussion will potentially impact how certain liabilities with a demand feature are measured.

19. In arriving at the fair value of a liability with a demand feature, if market participants expect to incur incremental servicing or other costs, these should be taken into account.
20. This would especially be the case for bank deposits. If the service (or product) offering varies between different banks (for example), one would expect this to be reflected in the estimated *incremental* servicing costs that market participants would incur if they assumed those particular liabilities.

### **Unobservable inputs**

21. Many of the inputs discussed in the preceding paragraphs may be unobservable (or at least, would be seldom observable) – especially in relation to bank deposits.
22. However, in some markets, deposit relationships occasionally are traded and such transactions may provide some evidence as to the inputs that market participants might use.
23. Hence, in arriving at the fair value of a deposit liability with a demand feature it is likely that the present value of the expected cash flows will have to be modeled rather than be observable from market transactions (but information useable to recalibrate the model may occasionally be available). This is, however, little different than for many other financial instruments with few observable inputs.

### **24. Questions to the Boards:**

- a. **Do you want to state a preliminary view about how liabilities with a demand feature should be remeasured? If so, is it appropriate to use face value or should the measurement consider market expectations about the timing and amounts of cash flows, the discount rate and incremental servicing costs?**
- b. **If you do not agree with the approach set out above for measuring liabilities with a demand feature, what alternative methods of**

**calculating the fair value of such liabilities would the Boards suggest we include in the DPD?**

- c. If you believe you could answer those questions if some additional information were provided, what additional information do you need?**