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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**16 November 2006, London**
Project:	**Financial Instruments – Due Process Document (DPD)**
Subject:	**Recognition and Measurement (Agenda Paper 5B)**

CONTENTS OF PAPER

1. This paper considers the following issues:

    a. Reporting of unrealized gains and losses

    b. Measurement of guaranteed liabilities

    c. Reporting of fair value changes arising from changes in an entity's own credit risk or own share price.

WHERE TO REPORT UNREALIZED GAINS AND LOSSES

2. The DPD needs to consider how unrealized gains and losses arising from the remeasurement of financial instruments might be reported to provide decision useful information to the users of financial statements.

3. Clearly unrealized gains and losses are a component of comprehensive income.

4. However, the DPD could either require that all unrealized gains and losses should be reported in profit or loss or other recognized income and expense/OCI.

5. Alternatively, the DPD could set out the alternatives but express no preliminary view.

6. A key factor to consider with regard to where unrealized gains and losses should be reported is which approach would maximize decision useful information to users (for both confirmatory and predictive purposes).

7. One of the main reasons why unrealized changes in the fair values of some financial instruments are required to be reported outside of profit or loss under current GAAP is the accounting mismatch (and the resulting 'unrepresentative' volatility) between financial assets measured at fair value but not related financial liabilities[1].

8. If all financial instruments were measured at fair value, this reason would no longer apply. Furthermore, the gains or losses reported in profit or loss would reflect the effects of economic events in each reporting period.

9. Requiring all financial instruments to be measured at fair value with all gains and losses reported in profit or loss would also eliminate any demand for fair value hedge accounting of financial instruments and cash flow hedge accounting of forecasted acquisitions of financial instruments.

10. There are also several other relevant factors to consider in deciding whether the Boards should attempt to reach a preliminary view on this issue in the DPD.

11. The Boards, in the joint project on Financial Statement Presentation, are currently discussing how to present the changes in assets and liabilities in an accounting period and the staff is expecting to issue a discussion paper on that project in 2007. Therefore, any preliminary views in the DPD as to where unrealized gains

[1] See paragraphs 93-94 of Statement No. 115 *Accounting for Certain Investments in Debt and Equity Securities.*

and losses on remeasurements of financial instruments should be reported need to be considered in the context of the Financial Statement Presentation project. Of course, the Boards may decide not to express a preliminary view in the DPD on this issue.

12. If the Boards decide that all unrealized gains and losses should be reported in profit or loss, then the Boards could also include detailed line requirements if they wished.

13. In addition, the staff has been working on a number of the display issues associated with fair value measurement of financial instruments. However, that work has not yet reached a stage where it is possible to decide whether (and if so, how) that research should be integrated into the DPD.

14. **Questions to the Boards:**

    a. Do the Boards wish to take a preliminary view as to where unrealized gains and losses on remeasurements of financial instruments should be reported? If so, what is that preliminary view?

    b. **If you are not prepared to answer this question, what additional information do you need?**

MEASUREMENT OF GUARANTEED LIABILITIES

15. Existing fair value measurement guidance is clear that the credit characteristics (or nonperformance risk) of a liability affects its measurement.

16. This section addresses whether (and if so, how) a financial guarantee affects the measurement of a guaranteed liability[2]. That is, should the guarantee be considered as:

[2] This issue is also related to (1) whether or not items should be linked together for recognition purposes and (2) the most appropriate unit of measurement. See paper 5A.

a. Separate from the liability (and hence not affect the fair value of the debtor's liability) or

b. As part of the liability (and hence should be taken into account in measuring the fair value of the debtor's liability).

Separate from the Liability

17. Financial guarantees typically require the guarantor to pay the creditor if a specific event (such as the default of the debtor) occurs. Some therefore argue that the existence of the guarantee does not affect the nature or amount of the debtor's obligation. The financial guarantee is a contract between the guarantor and the creditor and therefore the effect of the financial guarantee should not be considered in measuring the guaranteed liability's fair value for the debtor. So, if a guaranteed liability's fair value for the debtor is estimated using a present value approach, the discount rate or projected cash flows would **not** take into account the effect of the guarantee.

As Part of the Liability

18. An alternative approach is that the guarantee forms an integral part of the terms and conditions of the liability and should be taken into account in measuring the fair value of the guaranteed liability for the debtor. Effectively, a guarantee is a form of collateral that enhances the credit standing of the liability (albeit an unusual form of collateral that the debtor does not own). Therefore, if a guaranteed liability's fair value is estimated using a present value approach, the discount rate or projected cash flows **would** take into account the effect of the guarantee.

Debtor accounting

19. A related question is whether the debtor should separately recognize an asset for the financial guarantee. This would be consistent with the fact that other forms of collateral are recognized as an asset. Hence, if a guaranteed liability's fair value is

estimated using a present value approach, the discount rate or projected cash flows **would** take into account the effect of the guarantee, but arguably the value of the guarantee should also be recognized as an asset for the debtor.

Deposit insurance and similar forms of guarantees

20. In some circumstances, the question of how to treat a guaranteed liability is also related to an issue discussed in the first series of papers - the possible interaction between the law and the rights and obligations that form a contract.

21. One example is deposit insurance. That insurance is provided by a government or government agency and covers all liabilities that have specific characteristics (typically retail deposits up to a certain size). The deposit taking entities are, in exchange for this guarantee, subject to specific regulatory oversight. Typically, if such guaranteed liabilities are to be transferred, they may only be transferred to another entity whose deposits are also covered by the insurance scheme.

22. Such guarantees are different from the other types of guarantees previously discussed.

23. Deposit insurance is statutory in nature. It is therefore not a financial instrument because it is not a contract or an ownership interest. In addition, rather than simply paying out the guarantee if the deposit taking entity fails, the guarantor typically takes over the deposit-taking entity to ensure that the liabilities are partially or wholly satisfied.

24. Evidence suggests that interest rates on uninsured and insured deposits do not significantly vary. In reality, the value of such deposit insurance may actually be very low, given that there is a low probability that regulated entities covered by a deposit insurance scheme will default (and regulators typically step in before default occurs anyway). This might suggest that the Boards, for deposit and similar financial guarantees, should not require separate reporting but that the effect, to the extent it is material, should be included in the valuation of the

insured deposits. (This would still leave the question of whether the debtor should also recognize a non-financial asset for the deposit insurance guarantee.)

25. **Questions to the Boards:**

    a. **How does a financial guarantee affect the measurement of a guaranteed liability?**

    b. **How should financial guarantees issued by a government or government agency (such as deposit insurance) and the related liabilities be measured?**

    c. **If you are not prepared to answer those questions, what additional information do you need?**

REPORTING FAIR VALUE CHANGES ARISING FROM CHANGES IN AN ENTITY'S OWN CREDIT RISK OR OWN SHARE PRICE

26. The fair value of a liability includes the nonperformance risk relating to that liability. Nonperformance risk includes the entity's own credit risk.

27. Under current GAAP, many non-derivative financial liabilities are not measured at fair value. Respondents to the exposure draft that preceded Statement 157 stated that issues related to credit standing will become more pervasive as more liabilities are measured at fair value, especially in situations in which the reporting entity is experiencing financial difficulty and reports gains resulting from credit deterioration that cannot be immediately recognized. Some believe that reporting gains in such a situation is not relevant information to the users of the financial statements. However, the issue is broader than this.

28. Changes in fair value arising from changes in an entity's own credit risk occur because the market has reassessed the probability that the entity will be unable to meet its obligations when they fall due. Such a judgment requires an assessment of the entity's value and ability to turn that value into cash or other near liquid assets. An entity's value is driven by an assessment of many factors, including

items that are not recognized in the financial statements (such as many intangible assets). Hence, the issue is whether or not earnings should include the impact of changes arising from such an assessment of the value of items (such as internally generated intangible assets) that are not otherwise recognized or accounted for. Also, should it make any difference if such changes are realized or unrealized?

29. Similar issues arise regarding changes in fair values of financial instruments arising from a change in an entity's own share price. Should a gain arising from a financial instrument that results from an increase in an entity's own share price be reported in earnings? Would it make any difference if that gain was realized or unrealized?

30. **Questions to the Boards:**

    a. **Should gains and losses to an entity that result from changes in the market's assessment of the entity's own credit risk or own share price be reported in earnings? Does it matter if the gains or losses are realized or unrealized?**

    b. **If you are not prepared to answer those questions, what additional information do you need?**