



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

Purpose of this paper

1. This paper seeks your feedback on how the Board could address the issue of changes in own credit risk¹ in the classification and (re)measurement of financial liabilities.
2. This paper contains summary background information on the accounting for financial liabilities, and specific questions for you. Appendices A–H (distributed as a separate document) include relevant reference materials you may find useful.

Background

3. Financial liabilities are not in the scope of IFRS 9 *Financial Instruments*, as issued in November 2009.
4. ED/2009/7 *Financial Instruments: Classification and Measurement* (ED) proposed to apply the same classification model to both financial assets and financial liabilities within the scope of IAS 39. That ED cross-referenced the IASB discussion paper, *Credit Risk in Liability Measurement* (DP). (See Appendix H for an overview of that DP.)
5. In response to the comments received on these documents, the Board decided not to finalise the requirements for financial liabilities to be included in IFRS 9. Instead, the Board decided to address the accounting for financial liabilities

¹ The term *own credit risk* is used in this paper as it was used in the IASB discussion paper *Credit Risk in Liability Measurement*. Almost no respondents to that discussion paper differentiated between the price of credit and the credit standing of the issuing entity.

expeditiously after issuing IFRS 9 to meet the target date of the end of 2010 to replace IAS 39.

6. The Board tentatively decided that it would address the wide-spread view that recognising changes in own credit risk in profit or loss does not provide useful information for investors. The Board decided to address that concern for financial liabilities that are not eligible for amortised cost measurement other than those that are not managed on a contractual cash flow basis². However, the Board believed that it did not have sufficient information in order to be able to finalise how to address that issue. Therefore, the Board decided to consider the issue further and analyse possible approaches to address the concerns raised by respondents.

Possible approaches

7. The following ways of addressing the issue of own credit have been identified.
8. Under all of the approaches described below, amortised cost would be calculated in a manner consistent with the exposure draft *Financial Instruments: Amortised Cost and Impairment*.

Approach 1: Fair value measurement with separate presentation in OCI of fair value changes arising from changes in own credit risk

9. Under this approach, an entity would apply the classification requirements in paragraphs 4.1–4.4 of IFRS 9 to determine whether the financial liability must be measured at fair value or amortised cost.
10. If the liability is **not** eligible for amortised cost measurement, the entity would measure it at fair value and present in OCI changes in fair value related to changes in own credit risk **if** the financial liability meets the condition described in paragraph 4.2(a) of IFRS 9—ie the financial liability is held within a business model whose objective is to hold financial liabilities in order to pay contractual cash flows.

² This means that financial liabilities that are held for trading and derivatives would still be measured at fair value.

11. Under this approach, those liabilities would be subsequently measured at fair value but the changes 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).

Approach 2: An adjusted fair value measurement method (or ‘frozen credit spread’ measurement method)

12. This approach incorporates own credit risk only on initial measurement.
13. On subsequent measurement, particular financial liabilities would be measured at an adjusted fair value. That adjusted fair value amount is a current measurement that excludes changes in own credit risk. It is computed by determining the credit spread at initial recognition and “freezing” it (similar to the approach used in IFRS 7 *Financial Instruments: Disclosures* to disclose the amount of change in the fair value of a financial liability that is attributable to changes in the liability’s credit risk – see paragraph B4 of IFRS 7). Subsequent measurement would reflect changes in all **other** market risks.
14. This approach would apply only to the financial liabilities described above in paragraph 10. That is, a financial liability would be subsequently measured at an adjusted fair value only if the liability is not eligible for amortised cost measurement but meets the condition described in paragraph 4.2(a) of IFRS 9—ie the financial liability is held within a business model whose objective is to hold financial liabilities in order to pay contractual cash flows.

Approach 3: Bifurcation

15. Under this approach, financial liabilities would be separated into components and those components would be separately classified and measured. There are two main sub-approaches:
 - (a) Approach 3a—the subsequent measurement requirements in IAS 39 would be maintained for financial liabilities. That is, paragraph 47 in IAS 39 would remain (and thus the ‘default’ subsequent measurement

method for financial liabilities would be amortised cost). An embedded derivative would be separated from a financial liability host if the conditions in paragraph 11 of IAS 39 were met. The derivative and liability host would be classified and measured separately in accordance with the requirements in paragraph 47.

- (b) Approach 3b—a bifurcation approach that is aligned with the classification approach in IFRS 9 would be required. Under this approach, an entity would first analyse the entire financial liability to determine whether it meets the conditions in paragraph 4.2 of IFRS 9. If the entire liability does **not** meet those conditions (and thus is not eligible for amortised cost in its entirety), the entity would determine whether a **component** of the financial liability meets both of those conditions. If so, that component would be measured at amortised cost. All of the other components, which may be derivatives or other features, would be measured at fair value through profit or loss.

Approach 4: Parenthetical presentation of fair value for some liabilities measured at amortised cost

- 16. Under this approach a financial liability would be measured at fair value if it does **not** meet the condition in paragraph 4.2(a) of IFRS 9 (ie it is not held within a business model whose objective is to hold financial liabilities in order to pay contractual cash flows).
- 17. A financial liability would be measured at amortised cost if it meets the condition in paragraph 4.2(a) (ie it is held within a business model whose objective is to hold financial liabilities in order to pay contractual cash flows).
- 18. However, if an entity measures a financial liability at amortised cost but the liability does not meet the condition in paragraph 4.2(b) (ie it does not give rise to contractual cash flows that are solely principal and interest), the entity would be required to present the fair value of the liability in brackets on the face of the statement of financial position.

Other issues

19. Two issues to consider in conjunction with the possible approaches set out above are:
- (a) Derivatives being measured at fair value—The Board has a long-standing policy that derivatives (including embedded derivatives) should be measured at fair value. That would be the case under Approach 1 and Approach 3. However, under Approach 2, the financial liability (including any embedded derivatives) would be measured at **adjusted** fair value. However, the Board could require changes in own credit to be incorporated into the subsequent measurement of derivatives embedded in liabilities measured at adjusted fair value (ie the embedded derivatives would be measured at fair value and only the non-derivative component would be measured at an adjusted fair value). Under Approach 4, a hybrid contract with a financial liability host would be measured at amortised cost in its entirety if the entire hybrid contract is held within a business model whose objective is to hold financial liabilities in order to pay contractual cash flows.
 - (b) Symmetry between the classification of financial assets and financial liabilities—Approach 1 would result in symmetrical measurement for financial assets and financial liabilities. Assets and liabilities would be measured at either fair value or amortised cost on the basis of the two classification conditions set out in IFRS 9. However, Approaches 2–4 would not result in symmetrical measurement. That asymmetry is illustrated in the table on the following page.

Comparison of the approaches

20. The table on the next page summarises how a financial liability would be measured under the approaches.

	Meets the condition in paragraph 4.2(a)		Does <u>not</u> meet the condition in paragraph 4.2(a)
	Meets the condition in paragraph 4.2(b)	Does <u>not</u> meet the condition in paragraph 4.2(b)	
Approach 1	Amortised cost	Fair value with separate presentation in OCI of fair value changes arising from changes in own credit risk	Fair value
Approach 2	Amortised cost	Adjusted fair value	Fair value
Approach 3			
Approach 3a	N/A—classification is based on the requirements in IAS 39.		
Approach 3b	Amortised cost (in its entirety)	Look to see if a component of the financial liability meets the two conditions in paragraph 4.2	Look to see if a component of the financial liability meets the two conditions in paragraph 4.2
Approach 4	Amortised cost	Amortised cost with fair value in brackets on the face of the statement of financial position	Fair value

Discussion questions

Question 1: Fair value measurement with separate presentation in OCI of fair value changes arising from changes in own credit risk

- (a) Do you think this approach provides decision-useful information to users? Why or why not?
- (b) Do you think this approach is operational? Why or why not?
- (c) What are the challenges of this approach?
- (d) Are there other consequences of this approach that the Board should consider? If so, what?

Question 2: An adjusted fair value measurement method (or 'frozen credit spread' measurement method)

- (a) Do you think this approach provides decision-useful information to users? Why or why not?
- (b) Do you think this approach is operational? Why or why not?
- (c) What are the challenges of this approach?
- (a) Are there other consequences of this approach that the Board should consider? If so, what?

Question 3: Bifurcation (please consider these questions separately for approaches 3(a) and 3(b))

- (a) Do you think this approach provides decision-useful information to users? Why or why not?
- (b) Do you think this approach is operational? Why or why not?

- (c) What are the challenges of this approach?
- (a) Are there other consequences of this approach that the Board should consider? If so, what?

Question 4: Parenthetical presentation of fair value for some liabilities measured at amortised cost

- (a) Do you think this approach provides decision-useful information to users? Why or why not?
- (b) Do you think this approach is operational? Why or why not?
- (c) What are the challenges of this approach?
- (d) Are there other consequences of this approach that the Board should consider? If so, what?