



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

Background

1. Financial liabilities are not in the scope of IFRS 9 *Financial Instruments*, as issued in November 2009.
2. ED/2009/7 *Financial Instruments: Classification and Measurement* (ED) contained proposals for **all** items within the scope of IAS 39—ie the ED proposed the same classification approach for **both** financial assets and financial liabilities. That ED also drew attention to the IASB discussion paper, *Credit Risk in Liability Measurement* (DP), which was published in June 2009.
3. In their responses to the ED and the DP, almost all respondents expressed concerns about recognizing changes in an entity's own credit risk¹ in the remeasurement of liabilities. Also, some respondents to the ED pointed out that the Board accelerated its project on financial instruments because of the global financial crisis, which placed more emphasis on issues related to the accounting for financial assets than for financial liabilities. Respondents said that the Board should finalize classification and measurement requirements for financial assets, but retain the existing requirements for financial liabilities until the Board has more fully considered and debated the issues related to financial liabilities.
4. During its redeliberations, the Board decided not to finalize requirements for financial liabilities. The Board tentatively decided that it would address the

¹ The term *own credit risk* is used in this paper as it was used in the DP. Almost no respondents differentiated between the price of credit and the credit standing of the issuing entity.

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB.

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

Decisions made by the Board are reported in IASB *Update*.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

view that recognizing changes in an entity's own credit risk in the remeasurement of liabilities does not provide useful information for investors in some cases. The Board tentatively decided to address that concern as it relates to financial liabilities that are not eligible for amortized cost measurement **other than** those liabilities that are not managed on a contractual cash flow basis.²

5. The Board decided to address the accounting for financial liabilities expeditiously to meet its target to replace IAS 39 in its entirety by the end of 2010.

Purpose of this paper

6. This agenda paper describes our strategy for moving forward on financial liabilities. It summarizes the outreach activities that we have done to date—and that we plan to do in the upcoming weeks.
7. This paper is for informational purposes only and does **not** include a question for the Board. Furthermore, we are **not** asking the Board to discuss which classification approach(es) it wants to pursue for financial liabilities. We will begin those discussions at a subsequent meeting.

Outreach activities

8. Immediately following the issuance of IFRS 9, we began an extensive outreach programme to gather feedback about how the Board could address the issue of changes in own credit risk in the classification and remeasurement of financial liabilities. Consistent with the outreach programme for IFRS 9, our objective is obtain feedback from all types of constituents (investors, preparers, auditors, regulators, and others) from a range of industries across different geographic regions. We want to ensure that the Board has sufficient information to consider and debate the issues related to classifying and (re)measuring financial liabilities.

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

9. Over the last few weeks we have met with—or have scheduled to meet with:
 - (a) our Financial Instruments Working Group (FIWG)
 - (b) investors, including one-on-one meetings and small group meetings (eg CRUF)
 - (c) auditors (ie representatives from six of the global accounting firms)
 - (d) preparers (including representatives from financial institutions and insurance companies (we are in the process of setting up meetings with non-financial corporates))
 - (e) regulators
10. In the coming weeks, we will continue our outreach activities. We currently are reaching out to additional interested parties (focusing on users to discuss the decision-usefulness of various (re)measurement approaches) and scheduling follow-up meetings, as needed.
11. At the December IASB meeting we will provide an oral update on the feedback that we have received from our outreach so far.

Possible approaches

12. We think there is a spectrum of approaches that the Board could consider to address the issue of own credit in the remeasurement of financial liabilities. We have been discussing the following approaches during our outreach meetings. For each approach we are soliciting feedback on:
 - (a) whether the approach provides decision-useful information to investors;
 - (b) whether the approach is operational;
 - (c) what the challenges of the approach are; and
 - (d) if there are other consequences of the approach that the Board should consider.
13. The Board discussed some of these approaches during its redeliberations.

Fair value measurement with separate presentation of changes related to own credit or an “adjusted” fair value measurement attribute

14. The effect of changes in own credit risk could be addressed by presenting such changes outside of profit or loss (ie in other comprehensive income) **or** by using an “adjusted” fair value measurement attribute that does not reflect such changes.
15. An entity would apply the classification conditions in paragraphs 4.2 of IFRS 9 to determine whether the financial liability must be measured at fair value or amortised cost. If the liability is **not** eligible for amortised cost measurement but **is** held within a business model whose objective is to hold financial liabilities in order to pay contractual cash flows, the entity would:
 - (a) remeasure the liability at fair value and present in OCI changes in fair value related to changes in own credit risk; **or**
 - (b) remeasure the liability at an **adjusted** fair value, which is a current measurement that excludes changes in own credit risk.
16. In our outreach, we have been asking specifically for information on how the effects of own credit risk can be identified and measured, and how the requirements in paragraph 10 of IFRS 7 *Financial Instruments: Presentation* (to disclose the fair value change attributable to changes in the credit risk of a financial liability designated under the fair value option in IAS 39) are applied in practice, and the difficulties encountered—particularly for more complex contracts.

Bifurcation

17. Some financial liabilities would be separated into components and those components would be separately classified and measured. There are two main sub-approaches that we have discussed during our outreach:
 - (a) The subsequent measurement requirements in IAS 39, including those related to bifurcation of hybrid contracts, could be maintained for financial liabilities.
 - (b) A bifurcation approach would be developed that is aligned with the classification approach in IFRS 9. If the entire liability does **not** meet

those conditions in paragraph 4.2 of IFRS 9 (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 and all of the other components, which may be derivatives or other features, would be measured at fair value.

18. In our outreach we have specifically asked for information about how hybrid contracts with financial liability hosts are assessed, bifurcated and measured today under IAS 39—particularly the difficulties encountered for more complex contracts.

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

19. A financial liability would be measured at amortised cost if it is held within a business model whose objective is to hold financial liabilities in order to pay contractual cash flows. However, if an entity measures a financial liability at amortised cost but the liability 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.
20. In our outreach we have found it useful to compare (and differentiate between):
 - (a) the requirements in IAS 39 (and the proposals in ED/2009/12 *Financial Instruments: Amortised Cost and Impairment*) to (re)estimate expected cash flows for a financial liability measured at amortised cost, but to not update the discount rate (EIR)
 - (b) a ‘frozen credit spread’ measurement approach (when some but not all components of the discount rate are updated), and
 - (c) a fair value measurement approach (which updates all components).
21. This comparison of measurement approaches has been considered in the context of “vanilla” debt, own debt with interest and principal payments that also includes other contractual features, as well as own debt whose return reflects something

other than the time value of money and credit risk (for example, it is linked to the issuer's EBITDA or revenue³).

22. Such comparisons have been useful in ensuring that our discussions of the different measurement approaches are well understood, and the relative benefits or otherwise (in terms of useful information for investors) can be debated.

Other issues

23. In addition to discussing the approaches summarized above, we are also asking for feedback on two other relevant issues during our outreach meetings:
 - (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.
 - (b) Symmetry between financial assets and financial liabilities—The ED proposed a symmetrical approach for classification and (re)measurement—ie the same classification conditions and measurement attributes would be used for financial assets and financial liabilities. Some respondents to the ED said that creating symmetrical categories for financial assets and financial liabilities may be “superficially” attractive. There currently is no symmetry in IAS 39 and the respondents noted that they are not convinced that such symmetry is necessary or preferable.

Next steps

24. We will continue our outreach activities to better understand the operational (and other) challenges of these approaches and whether they result in decision-useful

³ Today, practice includes measuring some financial liability contracts that contain indexation features linked to non-financial variables that are specific to a party to the contract (for example, EBITDA-indexed own debt) at amortised cost in accordance with IAS 39. In such situations the estimates of future payments are updated in accordance with paragraph AG 8 of IAS 39 and are discounted at the originally calculated EIR.

IASB Staff paper

information. We plan to bring these approaches (and possibly others) to the Board in the coming months to discuss their mechanics (ie how they would work in practice) as well as the other feedback that we have received during our outreach. We may hold education sessions to ensure that Board members have sufficient opportunity to ask questions and gain an understanding of the approaches.