Staff Paper

IASB/FASB Joint Meeting – 14-16 December 2010

IASB Agenda reference **2A**

FASB ED Session – December 8, 2010

FASB Agenda reference **23**

Project **Fair value measurement**

Topic **Measuring the fair value of a liability issued with an inseparable third-party credit enhancement**

Purpose of this paper

1. This paper addresses the fair value measurement of a liability issued with an inseparable third-party credit enhancement (guarantee).[1]

2. This paper asks the boards to determine how an entity's credit standing affects the fair value of the entity's issued liability when that liability contains an inseparable third-party credit enhancement (ie the liability is issued as, for example, debt that is guaranteed by another party).

Background

US GAAP

3. EITF Issue No. 08-5 *Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement* (codified in Topic 820 *Fair Value Measurements and Disclosures*) addressed how to determine an issuer's unit of account for a liability issued with an inseparable third-party credit enhancement

[1] Note for IASB members—This paper addresses the accounting by the issuer of the *liability*. The guarantee may or may not be a financial guarantee contract (which is a contract that requires the issuer to make specified payments to reimburse the holder for a loss that it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument). This paper does not address the accounting by the issuer of the *guarantee*.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

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 FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

when it is measured or disclosed at fair value on a recurring basis. This situation arises when, for example, an entity purchases a guarantee from a third party, and then issues debt and combines it with the guarantee. Creating this combined security makes it easier for the entity to market its debt and to either reduce the interest rate paid to the investor or receive higher proceeds at issuance. The question arising in practice was about determining the unit of account for such liabilities.[2,3]

4. The Master Glossary defines a liability issued with an inseparable third-party credit enhancement as 'a liability that is issued with a credit enhancement obtained from a third party, such as debt that is issued with a financial guarantee from a third party that guarantees the issuer's payment obligation'.

5. When developing EITF 08-5, the FASB's Emerging Issues Task Force (EITF) concluded that for the issuer the unit of account for a liability measured or disclosed at fair value does not include the third-party credit enhancement. As a result, Topic 820 specifies that the issuer of such a liability may not include the effect of the credit enhancement when measuring the fair value of the liability.

6. Furthermore, the EITF concluded that in the situation envisaged by EITF 08-5 any payments made by the guarantor in accordance with the guarantee result in the issuer becoming obligated to the guarantor rather than to the investor (for the amount paid by the guarantor). **The issuer's resulting debt obligation to the guarantor has not been guaranteed.** Consequently, the fair value of the liability from the perspective of the entity that issued the liability considers its own credit standing and **not** the credit standing of the guarantor.

7. Topic 820 excludes the following instruments and transactions from that guidance:

   (a) a credit enhancement provided by a government (eg deposit insurance);

[2] See Appendix 1 of this paper for the relevant paragraphs of the FASB's exposure draft of a proposed Accounting Standards Update (ASU) *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*.

[3] EITF 08-5 was issued in 2008, after FASB Statement of Accounting Standards No. 157 *Fair Value Measurements* was published in 2006.

(b) a credit enhancement provided between a parent and subsidiary; and

(c) a credit enhancement provided between entities under common control.

8. Topic 820 requires an entity to disclose the existence of a third-party credit enhancement on its issued liability.

IFRSs

9. The IASB had previously discussed this issue, but IFRSs do not have explicit guidance for measuring the fair value of a liability with an inseparable third-party guarantee. In describing credit risk, paragraph BC92 in the basis for conclusions accompanying IAS 39 *Financial Instruments: Recognition and Measurement* states:[4]

> The [IASB] also noted that the fair value of liabilities secured by valuable collateral, guaranteed by third parties or ranking ahead of virtually all other liabilities is generally unaffected by changes in the entity's creditworthiness.

10. Paragraph BC92 (and IFRS 9.BCZ5.34) refers to the fair value of a liability from the *issuer's* perspective. It is in the section about credit risk and describes the notion of credit risk defined in IFRS 7 *Financial Instruments: Disclosures* (the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation).

11. The IASB discussed this issue in the fair value measurement project. Paragraph 27 of the IASB exposure draft *Fair Value Measurement* stated:

> If there is an active market for transactions between parties who hold debt securities as an asset, the observed price in that market also represents the fair value of the issuer's liability. **An entity shall adjust the observed price for the asset for features that are present in the asset but not present in the liability, or vice versa. For example, in some cases the observed price for an asset reflects a combined price for a package comprising both the amounts due from the issuer and a third-party credit enhancement. In such cases, the objective is to estimate the fair value of the issuer's liability, not the price of the combined**

[4] This paragraph was carried over to IFRS 9 *Financial Instruments* (see paragraph BCZ5.34).

> **package. Thus, the entity would adjust the observed price for the asset to exclude the effect of the third-party credit enhancement, a feature that is not present in the liability.** [Emphasis added.]

12. The IASB did not receive comments on this aspect of the proposed guidance for measuring the fair value of a liability. This might be because:

    (a) many such financial liabilities are not remeasured at fair value in the statement of financial position; and

    (b) if preparers are currently accounting for such liabilities as a combined package (when using the fair value option), they might have assumed that the wording in the exposure draft would be applicable only if they were accounting for such liabilities separately from the guarantee.

13. The boards discussed the measurement of liabilities at their January 2010 joint meeting (see Agenda Paper 2G from that meeting). At that meeting, the boards tentatively decided that an entity must determine whether the fair value of a liability held as an asset (the corresponding asset) represents the fair value of the liability. If an entity determines that the fair value of the corresponding asset does not represent the fair value of the liability, it must make adjustments to the fair value of the asset to the extent that its fair value does not represent the fair value of the liability.

14. Agenda Paper 2G gave an example of this being the case when the unit of account for the asset is not the same as for the liability (eg if the quoted price for the asset reflects a third-party credit enhancement, such as the guaranteed debt described in paragraph 3 above that is not accounted for as a combined package). Agenda Paper 2G and the boards' tentative decision are consistent with Topic 820, which includes ASU 2009-5 *Measuring Liabilities at Fair Value* and EITF 08-5, and paragraph 27 of the IASB exposure draft.

15. As a result, the IASB staff draft of a forthcoming IFRS on fair value measurement contains the following:[5]

> 35 An entity shall adjust the quoted price of a liability held by another entity as an asset for factors specific to the asset that are not applicable to the fair value measurement of the liability. Some factors that may indicate that the quoted price of the asset should be adjusted include the following:
>
> …
>
> (b) The unit of account for the asset is not the same as for the liability (eg in some cases the price for an asset reflects a combined price for a package comprising both the amounts due from the issuer and a third-party credit enhancement. In such cases, the objective is to measure the fair value of the issuer's liability, not the price of the combined package. Thus, the entity would adjust the observed price for the asset to exclude the effect of the third-party credit enhancement, because it is a feature that is not present in the liability).
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> 43 The issuer of a liability shall not include the effect of a third-party credit enhancement (eg a third-party guarantee of debt) in the fair value measurement of a liability. When measuring the fair value of a liability with a third-party credit enhancement, the issuer would consider its own credit standing and not that of the third-party guarantor.

16. With respect to disclosure requirements, paragraph 10 of IFRS 7 requires an entity to disclose 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. Paragraph 10 does not refer to the existence of third-party guarantees.

[5] The staff draft was posted to the IASB's website in August 2010 and is available at http://www.ifrs.org/Current+Projects/IASB+Projects/Fair+Value+Measurement/Staff+draft+FVM.htm.

Staff analysis and recommendation

Example

17. Entity A purchases a guarantee from Entity C for $75. Entity A then issues debt and combines it with the guarantee. Entity A issues the combined security (debt with a par value of $1000 and a five-year maturity that is guaranteed by Entity C) to Entity B and receives $1000. The debt has a fixed interest rate of 7%. (The present value of the interest and principal payments at 7% is $1000.)

18. Creating this combined security makes it easier for Entity A to market its debt and to either reduce the interest rate paid to the investor or receive higher proceeds at issuance. The market rate of interest for five-year debt without a guarantee is 9%. (The present value of the interest and principal payments at 9% is $925.)

19. If Entity A fails to meet its payment obligations to Entity B, Entity C becomes obligated to make the payments on Entity A's behalf. Entity A then becomes obligated to Entity C for those payments made.

20. Assume that there are no transaction costs for the debt issue and that Entity A has elected to use the fair value option.

What is the fair value of the liability?

21. Does the fair value of the liability from Entity A's perspective consider the guarantee, resulting in a fair value of $1000? Or does Entity A measure the fair value of the liability and the guarantee separately, resulting in a fair value of $925?

22. The answer depends on how the liability is accounted for and might differ depending on whether the entity applies US GAAP or IFRSs.

23. From Entity A's perspective, it is obligated to repay the principal amount plus interest to *somebody*. Entity A is not concerned with *which* counterparty receives those payments (whether Entity B or Entity C). If Entity A does not

repay Entity B, Entity A must compensate Entity C for any payments made on Entity A's behalf.

24. As a result, the liability issued by Entity A takes into account Entity A's credit standing. Entity C's credit standing is not relevant to Entity A after the issue of the debt because ultimately Entity A must repay the obligation, whether that is to Entity B or to Entity C. If Entity A must repay Entity C, that portion of the debt is not guaranteed. In other words, from the issuer's perspective, the only difference between paying back guaranteed debt and non-guaranteed debt is whom the entity might ultimately be obligated to pay.[6]

25. Topic 820 assumes that the guarantee is not an asset of the issuer (Entity A) while the liability is still outstanding. As a result, the proceeds received for the issue of a liability within the scope of EITF 08-5 represents consideration for both the liability and the guarantee purchased on the investor's (Entity B's) behalf. The proceeds from the issue of the liability are allocated to the premium for the guarantee and to the issued liability on the basis of their respective fair values.

26. Assume that the fair value of the debt was $925 when it was issued.[7] This excludes the effect of the guarantee (ie it assumes Entity A's credit standing).

27. Applying Topic 820, Entity A would record the following:

	Dr	Cr
Guarantee premium	$75	
Cash		$75

28. Entity A would also record the following for allocating the proceeds of the debt issue amongst the guarantee and the fair value of the debt:

	Dr	Cr
Cash	$1000	
Guarantee premium		$75
Debt		$925

[6] However, third-party guarantees would be a consideration in estimating the fair value of the liability from the perspective of a market participant who holds the liability as an asset (Entity B in this example).
[7] Using the 9% market interest rate.

29. The net effect is that Entity A recognises debt at $925 (liability) and cash at $925 (asset).

30. For subsequent measurement of the liability, assuming Entity A uses the fair value option to account for this liability, Entity A would take into account, for example, changes in *its own* credit standing and changes in market interest rates when measuring the fair value of the debt at each reporting period.

31. In the absence of explicit guidance under IFRSs, different approaches to the accounting for such liabilities might be used.[8] An entity that assumes that the liability is separate from the guarantee would account for them as described above. However, an entity that assumes that the liability is the combined package would record the following:

	Dr	Cr
Guarantee premium	$75	
Cash		$75

To record the guarantee asset.

	Dr	Cr
Cash	$1000	
Debt		$1000

To record the debt.

32. For subsequent measurement of the liability, assuming Entity A uses the fair value option to account for this liability, Entity A would take into account, for example, changes in *the guarantor's* credit standing and changes in market interest rates when measuring the fair value of the debt at each reporting period.

33. Today, under the US GAAP approach the fair value of the liability is $925, and under IFRSs the fair value of the liability might be $925 or $1000 depending on how the liability is accounted for.

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[8] It is important that the determination of the portion of the change in fair value that is attributable to changes in the issuer's credit risk in accordance with IFRS 9.5.7.7(a), as revised in 2010, is done consistently, regardless of whether the fair value of the liability is determined on the basis of the combined package or separately.

34. The staff thinks the requirements for measuring fair value in IFRSs and US GAAP should be consistent on this point and that the respective standards should use the same words to convey those requirements.

Scope

35. Topic 820 excludes the following from the scope of the guidance on inseparable third-party credit enhancements:

    (a) a credit enhancement provided by a government (eg deposit insurance)—this is because such guarantees are typically granted to, rather than purchased by, the reporting entity.

    (b) a credit enhancement provided between a parent and subsidiary—this is because once the subsidiary is consolidated, only the parent's non-performance risk is relevant. However, it should be noted that US GAAP preparers do not prepare separate financial statements. The staff thinks that when preparing an entity's separate financial statements, the guidance discussed in this paper with respect to the fair value of the subsidiary's liabilities would be relevant. The staff therefore suggests including this scope exception only for consolidated financial statements, but not for an entity's separate financial statements.

    (c) a credit enhancement provided between entities under common control—this is because once the entities are consolidated, only the parent's non-performance risk is relevant. In the US, the parent is ultimately responsible for repayment of its subsidiaries' debt. That is not always the case outside the US. In addition, US GAAP preparers do not prepare separate financial statements for entities under common control. The staff thinks that when preparing an entity's separate financial statements, the guidance discussed in this paper with respect to the fair value of the subsidiary's liabilities would be relevant. The staff therefore suggests including this scope exception only for

consolidated financial statements when, in the subsidiary's jurisdiction, the parent would be ultimately responsible for repayment of the subsidiary's debt. However, the staff thinks such a scope exception should not be allowed for an entity's separate financial statements.

36. The staff thinks these scope exceptions can be distilled into the following:
    (a) this guidance only applies to guarantees purchased by the issuer of the liability; and
    (b) this guidance does not apply to liabilities guaranteed by other group entities upon consolidation.

Disclosures about third-party credit enhancements

37. The staff notes that the disclosure in paragraph 10 of IFRS 7 relates to the credit risk of a liability. IFRS 7 does not require an entity to disclose the existence of a third-party credit enhancement on its issued liability.

38. The staff thinks that such information should be explicitly required because:
    (a) it would provide useful information to users of financial statements when assessing the credit risk of an entity's issued liabilities; and
    (b) it would be consistent with the disclosure requirement in US GAAP.

39. This is particularly important when a liability that subject to the credit enhancement is accounted for in two parts, because it would provide information about any differences between the fair value of a liability and the fair value of the corresponding asset.

Collateral vs guarantees

40. As noted above, the concept of credit risk in IFRS 9 considers the risk that non-payment by the issuer will cause loss to the holder. This would typically imply that the benefit of collateral and credit enhancements should be taken into account in the measurement of the liability because they reduce the risk that a liability would otherwise exhibit.

41. However, the staff thinks that collateral and guarantees are different in one important respect: collateral is posted so that it can be used to satisfy the obligation if the issuer fails to repay. If the issuer fails to repay, the lender can retain the collateral and the debt is no longer outstanding (to the extent that the value of the collateral covers the repayment of the debt).[9]

42. Guarantees, on the other hand, require a third party to satisfy the obligation if the issuer fails to repay. If the issuer fails to repay, it becomes obligated to the guarantor for repayment. As noted above, this means that the issuer's resulting debt obligation to the guarantor has *not* been guaranteed.

Staff recommendation

43. The staff thinks that the requirements for measuring the fair value of a liability with a third-party credit enhancement in IFRSs and US GAAP should be consistent.

44. The staff thinks that this can be done by specifying that the issuer of a liability must measure the fair value of that liability in a manner consistent with the unit of account used for accounting purposes. This would be as specified in other standards (eg IAS 39, IFRS 9 or Topic 825 *Financial Instruments*)).

45. Consequently, the staff recommends that the fair value measurement standard should state that the unit of account for an issued liability that is measured or disclosed at fair value might differ from the unit of account for the corresponding asset, as described in Agenda Paper 2G from the January 2010 meeting (which resulted in the wording used in the FASB's exposure draft and the IASB's staff draft). As a result, the issuer of a liability would not include the effect of a third-party credit enhancement in the fair value measurement of a liability if the unit of account for the liability does not include the effect of a third-party credit enhancement. In such cases, the issuer would consider its own credit standing and not that of the third-party guarantor.

[9] This would mean that the benefit of collateral would always be relevant to determining the credit risk for liabilities under IFRS 9 (eg for paragraph 5.7.7(a) of IFRS 9, as revised in 2010).

46. The staff makes this recommendation because the objective of the joint fair value measurement project is to ensure that the measurement guidance is consistent in IFRSs and US GAAP, not to address the accounting for items measured at fair value.

Question 1 – the effect of a third-party credit enhancement on the fair value of a liability
Do the boards agree with the staff recommendation in paragraph 45? If not, what do you propose and why?

47. If the boards agree with that recommendation in paragraph 45, the staff recommends that the financial instruments standards, not the fair value measurement standard, should address the unit of account for a liability. This is because the boards have agreed not to address the unit of account for items measured at fair value as part of the fair value measurement project.

Question 2a (for FASB) – unit of account
Does the FASB want to move the unit of account guidance for this specific situation to Topic 825? If not, what do you propose and why?

Question 2b (for IASB) – unit of account
Does the IASB want to include unit of account guidance for this specific situation in IAS 39 and IFRS 9? If not, what do you propose and why?

48. If the boards agree with that recommendation in paragraph 45, the staff recommends stating that this guidance:
    (a) only applies to guarantees purchased by the issuer of the liability; and
    (b) does not apply to liabilities guaranteed by other group entities upon consolidation.

Question 3 – scope
Do the boards agree with the staff recommendation in paragraph 48? If not, what do you propose and why?

49. The staff recommends that IFRSs should require an entity to disclose the existence of a third-party credit enhancement on its issued liability. Depending on whether the IASB agrees with the staff recommendation in paragraph 45, this could be done in the fair value measurement standard or in IFRS 7.

Question 4 (for IASB) – disclosure
Does the IASB agree with the staff recommendation in paragraph 49? If not, what do you propose and why?

50. If the boards agree with the staff recommendations, the result would be a change in the wording used in the FASB's exposure draft and the IASB's staff draft, but would be consistent with the principle in those documents with respect to the fair value measurement of liabilities.

Appendix 1: Excerpt from FASB's proposed ASU

Master Glossary

Liability Issued with an Inseparable Third-Party Credit Enhancement
A liability that is issued with a credit enhancement obtained from a third party, such as debt that is issued with a financial guarantee from a third party that guarantees the issuer's payment obligation.

Topic 820

820-10-35-18A: The issuer of a liability with an inseparable third-party credit enhancement shall not include the effect of the credit enhancement in the fair value measurement of the liability. For the issuer, the unit of accounting for a liability measured or disclosed at fair value does not include the third-party credit enhancement. This paragraph does not apply to the holder of the issuer's credit-enhanced liability.

820-10-35-18B: The guidance in the preceding paragraph does not apply to any of the following instruments or transactions:

a. A credit enhancement provided by a government or government agency (for example, deposit insurance)
b. A credit enhancement provided between a parent and its subsidiary
c. A credit enhancement provided between entities under common control.

820-10-50-4A: For a liability issued with an inseparable third-party credit enhancement, an issuer shall disclose the existence of the third-party credit enhancement on its issued liability. Paragraph 820-10-35-18A states that, for the issuer, the unit of accounting for a liability measured or disclosed at fair value does not include the third-party credit enhancement.

820-10-55-23C: Paragraph 820-10-35-18A specifies the guidance on accounting for and presentation of a liability issued with an inseparable third-party credit enhancement (for example, debt that is issued with a contractual third-party guarantee) when that liability is measured or disclosed at fair value on a recurring basis. That guidance does not address the accounting for a premium paid by the issuer for credit-enhanced liabilities that are not measured at fair value on a recurring basis, for example, if the issuer recognizes a credit-enhanced liability at amortized cost. However, that guidance (see paragraph 820-10-50-4A) does apply to the issuer's disclosure of fair value for that credit-enhanced liability.

820-10-55-23D: For the issuer, the unit of accounting for a liability measured or disclosed at fair value does not include the third-party credit enhancement (for example, a third-party guarantee of debt). Any payments made by the guarantor in accordance with the guarantee result in a transfer of the issuer's debt obligation from

the investor to the guarantor. The issuer's resulting debt obligation to the guarantor has not been guaranteed. Thus, the fair value of that obligation considers the issuer's credit standing and not the credit standing of the guarantor. For example, when measuring the fair value of a liability with a third-party guarantee, the issuer would consider its own credit standing and not that of the third-party guarantor.