IASB/FASB joint meeting

Staff Paper

IASB Agenda Paper No. **8**

Board meeting date **February 2010**

Project **Financial instruments: classification and measurement of financial liabilities**

Topic **Cover paper**

Background

1. At the joint meeting on 10 February 2010 we outlined the following three categories of financial liabilities:

   Category A—instruments that are **not** held to pay contractual cash flows (eg all standalone derivatives and all liabilities that are held for trading)

   Category B—instruments that **are** held to pay contractual cash flows and have **"non-vanilla"** (structured) contractual cash flow characteristics (eg own debt that the entity holds to maturity whose payments are linked to an equity index)

   Category C—instruments that **are** held to pay contractual cash flows and that have **vanilla** contractual cash flow characteristics

2. At that meeting both boards tentatively decided that liabilities in Category A should be measured at fair value through profit or loss.

3. The IASB tentatively decided that liabilities in Category B should be bifurcated into a host and the embedded features. Those components would be separately measured. That tentative decision responds to issues raised about recognizing gains or losses arising from changes in an entity's own credit risk.

4. The FASB did not vote on Category B. It decided to address Category B and Category C together at a subsequent FASB meeting because the issues about own credit risk apply to both categories (ie under the FASB's proposed approach, liabilities in both categories would be measured at fair value).

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

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 IASB or the FASB.

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

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

5. The issue of bifurcation (and how to do it) may become relevant to the FASB if it decides to bifurcate any financial liabilities. Likewise, the issue of whether (and if so, how) to address the effects of change in own credit might become relevant to the FASB, depending upon decisions it makes. Therefore, we believe that this session should be a joint discussion, although we will only be asking the IASB to make decisions.

Papers to be discussed at this meeting

6. The IASB will discuss three papers at today's session:

- AP 8A: Measuring liabilities in Category C
- AP 8B: Bifurcation methodology for liabilities in Category B
- AP 8C: The fair value option

Summary of issues

7. The table below summarizes the boards' tentative decisions to date and the timeline for further discussions:

<table>
<tr><th>Issue</th><th>IASB</th><th>FASB</th></tr>
<tr><td>Category A</td><td colspan="2">✓
Fair value through profit or loss
(10 Feb)</td></tr>
<tr><td>Category B</td><td>✓
Bifurcate
(10 Feb)</td><td rowspan="4">The FASB will discuss Category B and Category C together at a later FASB meeting</td></tr>
<tr><td>Bifurcation methodology for Category B</td><td>AP 8B for 17 Feb</td></tr>
<tr><td>Category C</td><td>AP 8A for 17 Feb</td></tr>
<tr><td>Fair value option</td><td>AP 8C for 17 Feb</td></tr>
<tr><td>Other issues, including effective date and transition</td><td>March</td><td>TBD</td></tr>
</table>

APPENDIX: Agenda paper 2A from the 10 February 2010 joint meeting– *Results of the user questionnaire on own credit*

Background

A1. We have been conducting an extensive outreach programme to gather feedback about how the boards could address the issue of changes in own credit risk in the remeasurement of financial liabilities. As part of the outreach programme, we created a questionnaire to solicit input on that topic from users of financial statements.

Purpose of this paper

A2. The purpose of this paper is to summarise the responses to the questionnaire. If board members would like copies of the responses, please let us know.

A3. This paper is for informational purposes only and does **not** include a question for the boards. However the responses described in this paper may help the boards answer the question in agenda paper 2 (ie how to proceed on the issue of own credit risk in the remeasurement of financial liabilities).

Questionnaire overview

A4. The questionnaire asked questions on two broad topics—(1) how users use the information about changes in own credit risk today (if at all) and (2) what their preferred method of accounting is for selected financial liabilities. Each question is discussed in more detail below.

A5. With the help of several banks, we sent the questionnaire directly to some of the analysts that follow each bank (the survey focuses primarily on banks and their analysts because generally only banks have used the fair value option in IAS 39 for their own debt and hence, provided the disclosures required by IFRS 7 of changes in fair value arising from changes in own credit risk). In addition, a link to the questionnaire was posted on the IASB project web page and an email was sent to all constituents who have registered to follow the IAS 39 replacement project. We distributed the questionnaire to relevant individuals in other organisations including members of the IASB's Analyst Representative Group and Financial Instruments Working Group and to users that we have met during

our outreach meetings. The CFA Institute also assisted us by advertising the survey on their website. The FASB staff sent the questionnaire to several U.S. users.

A6. As of 28 January 2010, we had received 84 responses to the questionnaire. Below is a summary of respondents by analyst type and geographic region.

Type	Number
Buy-side analyst	12
Sell-side analyst	18
Both	1
Other	6
Undisclosed	47
Total	84

Region	Number
Africa	4
Asia-Pacific	9
Europe	28
Middle East	4
North America	22
Undisclosed	17
Total	84

Feedback received

A7. There was one general message in the responses:

Information about changes in own credit risk should be included in profit or loss **only if** the entity has the ability and opportunity to buy back its own debt. If the liability will be repaid on the basis of its contractual terms, information about those contractual cash flows is more decision-useful than fair value information.

Question 1: When gains and losses arising from changes in own credit are included in net income, do you exclude such gains and losses for the purpose of deriving performance measures suitable for your analysis?

Response	Percentage
Yes	79%
No	7%
Other	14%

A8. While the vast majority of respondents exclude such gains and losses, a few noted that their response depends on whether the liabilities are funding assets that are measured at fair value—and indicated that they did not back out the amounts if those assets were so measured.

Question 2: If you exclude own credit gains and losses that are reported in net income from the performance measures used in your analysis do you nevertheless believe that these gains and losses have information content and therefore make use of them in other ways in your analysis? If so, please explain how below (e.g. statutory vs. underlying performance, benchmarking on a like basis).

A9. While most respondents exclude gains and losses arising from changes in own credit risk from their numerical analysis, about a third of the respondents said that such information is useful for other purposes.

A10. One user noted '[o]wn credit needs to be disaggregated because it communicates an important change in a company's standing. I believe this GAAP measure has meaning and should be clearly labelled as "own credit gain/loss". If analysts exclude it in pro forma earnings, that does not mean they are not using this number, it just means that it has more of a one-time nature that would be put aside in analysis of normalised earnings. Just because it does not make it into the normalised earnings number does not mean it is not being used.'

A11. Respondents said that they used this information for purposes including:

a. to provide information about the overall riskiness of the entity and to identify when the entity is in distress, including providing a measure of credit default risk for entities when credit default swap (CDS) information is not available;

b. to indicate that the entity's assets may be impaired;

c. to estimate the entity's financing costs going forward; and

d. to compare the entity to others in the same industry.

A12. However, some respondents noted that while the information may be useful, it can be obtained elsewhere (eg CDS pricing or other bond spreads).

Question 3: When evaluating net asset values or calculating price to book ratios do you make adjustments in respect of the book value of liabilities to exclude the effect of changes in own credit in cases where liabilities are included in the balance sheet at fair value? If yes, please explain what adjustment you make.

Response	Percentage
Yes	58%
No	42%

A13. Most of the comments indicated that, unless the entity has the ability and opportunity to repurchase the liabilities, the respondents attempt to either

a. remove the effects of own credit risk from the fair value measurement; or

b. compute amortised cost (or something similar).

A14. However, consistent with the responses to Question 1, a few respondents said that their response depends on how the entity's assets are measured. Also, a few respondents indicated that they feel that they **should exclude** the effects of changes in own credit risk but do not because the additional effort outweighs the incremental benefit.

Question 4: Many banks have liabilities that are measured at amortised cost in the balance sheet. However the fair values (including the effect of own credit) are disclosed in the notes. When calculating net asset values or price to book ratios, do you (or would you if the impact were material)

Response	**Percentage**
Make no adjustment?	49%
Adjust these liabilities to fair value using the information in the notes to the financial statements?	21%
Adjust to fair value except for the effects of own credit?	19%
Other	11%

A15. A few respondents commented that they would not adjust away from amortised cost unless the entity has the ability and opportunity to repurchase the liabilities—and that they preferred that fair value information be in the notes. Again, consistent with some of the responses mentioned above, a few respondents said that their response depends on how the entity's assets are measured—or how other banks were measuring similar liabilities. A few respondents noted that they would adjust if it were easier to do.

Question 5: Some banks elect to measure some issued debt at fair value in the balance sheet to (a) simplify the accounting; or (b) reflect in the financial statements the way that their debt is managed. Do any of your answers to Questions 1 to 4 depend on the reasons why own debt has been measured at fair value? If yes, please explain.

Response	**Percentage**
Yes	19%
No	81%

A16. Of those that responded to this question, the main reason given for an entity's own liabilities to be reported at fair value is if the entity is regularly trading its own debt.

Question 6: The effect of own credit as currently disclosed is typically determined as the change in market spread over a benchmark rate. Recognising that the change in spread above the benchmark rate may include other market factors (eg liquidity), do you think that this is an appropriate measure of own credit? If no, what alternative would you suggest and how could this be calculated?

Response	Percentage
Yes	62%
No	38%

A17. Most of the respondents that commented on this question said that the liquidity component should be excluded from the measure of own credit risk. However, many of those respondents noted the difficulty of separating those two factors.

A18. A few respondents noted the difficulty of developing a consistent and simple methodology for computing the effects of own credit risk—and at least one user expressed frustration about 'rooting around' in the notes for the relevant disclosure, which is computed differently for each company.

Question 7: Irrespective of the accounting requirements for own credit, would you like more disclosures in the footnotes around how own credit is determined? If yes, what additional information would you like and why?

Response	Percentage
Yes	55%
No	45%

A19. Those respondents who sought additional disclosures generally requested more information about how the entity computed the effects of own credit risk (eg the entity's methodology and the assumptions used). Some respondents said that it also would be helpful if the entity provided more commentary on any changes in own credit risk.

A20. Other respondents noted that since they do not think information on own credit risk is decision-useful, they do not think the benefits of additional disclosures outweigh the costs.

Question 8: Currently, if issued debt is measured at fair value, interest expense is not required to be reported separately in the income statement (rather, the total movement in fair value during the period may be reported in one line). Some banks impute an interest expense to report separately, but this is not a requirement. Should interest expense be imputed on such debt and reported separately in the income statement?

Response	Percentage
Yes	70%
No	27%
Don't know	3%

A21. The questionnaire did not ask for comments on this question.

Question 9: If interest expense is not reported separately on financial liabilities measured at fair value do you make an adjustment to impute an interest expense? If so, how do you make this estimate?

Response	Percentage
Yes	30%
No	70%

A22. Those that responded said that they use the following methodologies to impute interest expense:

a. compute amortized cost and the effective interest rate

b. use cash interest paid (coupon)

c. market-based interest or the entity's current cost of funding

A23. A few respondents said that while they do not impute an interest expense, they think that they should. However, they said that the difficulty of doing so outweighs the benefit.

Question 10: Please identify your preferred method of accounting for the following instruments. Note that in all cases the fair value of such instruments would be reported in the notes to the financial statements.

A24. The questionnaire provided the following alternative measurements, which are discussed in agenda paper 2:

a. amortised cost;

b. bifurcation of a host and embedded derivative features;

c. fair value with all changes in profit or loss;

d. fair value with changes in own credit in other comprehensive income (OCI) and all other changes in profit or loss; and

e. adjusted fair value whereby the effects of own credit risk are ignored (frozen credit spread method).

A25. Additionally, respondents had the opportunity to provide another measurement methodology.

A26. The table below summarised the responses:

	Amortised cost	**Bifurcation**	**Fair value through P&L**	**FV with own credit in OCI**	**Frozen credit spread**	**Other**
'Vanilla' coupon issued debt	75%	n/a	12%	8%	2%	3%
Structured issued debt that funds assets measured at fair value	20%	31%	20%	17%	6%	6%
Issued debt that contains structured features that funds assets measured at amortised cost	35%	30%	11%	13%	4%	7%
Issued debt where the issuer must defer interest payments in some cases	49%	21%	11%	14%	3%	2%

A27. The comments provided on these examples were generally consistent with the comments summarised above:

a. Amortised cost is appropriate because it reflects the legal obligation to pay the contractual amounts in the normal course (ie on a going concern basis). Based on the responses to the four examples, that is true even if the liability includes 'non-basic' features.

b. There was limited support for two methods that would require an entity to isolate the own credit risk component of the change in fair value. The 'frozen credit spread' method was the least favoured measurement alternative.

c. The accounting treatment of the liabilities should consider the accounting treatment of the assets that they fund.

d. To the extent that the liability is measured at amortised cost, fair value information should be in the notes. Also disclosures that describe the structured features would be helpful.