



Project	Financial instruments
Topic	Classification and measurement: financial liabilities

Background

1. The IASB and the FASB are committed to improve and simplify the reporting for financial instruments. At the December 2009 joint meeting, the boards reiterated their commitment to reaching a converged solution and confirmed that they would discuss jointly the issues related to the classification and measurement of financial liabilities (among other topics).
2. At the January 2010 joint meeting the boards reviewed their respective prior discussions about liabilities because they have not previously deliberated this topic jointly. That meeting was educational and the boards did not make any decisions.

Purpose of this paper

3. At this meeting, we will ask the boards how they would like to measure financial liabilities. Based on the boards' previous discussions, we have grouped financial liabilities into the following three categories (these categories are illustrated in a table in the appendix to this paper):

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.

Category A—instruments that are **not** held to pay contractual cash flows (eg all standalone derivatives and all liabilities that are held for trading)¹

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)²

Category C—instruments that **are** held to pay contractual cash flows and that have vanilla contractual cash flow characteristics³

4. **At this meeting, we will ask the boards:**

- (a) **to confirm that liabilities in Category A must be measured at fair value through profit or loss; and**
- (b) **to discuss whether, and if so how, to address the issue of own credit risk⁴ for liabilities in Category B.**

5. With regards to (b) above, we have laid out four broad alternatives in this paper. We hope that the boards can provide direction on which alternative they would like to pursue further—or whether the boards would prefer **not** to address the issue of own credit risk and instead measure these instruments at fair value with all changes in profit or loss (which would be consistent with the IASB’s exposure draft *Financial Instruments: Classification and Measurement* and FASB’s decisions to date). Based on the boards’ decision, we will bring more detailed papers to a subsequent meeting that further discusses issues specific to the boards’ preferred approach.

¹ For the IASB, Category A captures all liabilities that do not meet the condition in paragraph 4.2(a) of IFRS 9 (assuming for this purpose that IFRS 9 applies to financial liabilities). For the FASB, Category A captures all liabilities that do not have principal amounts or are not held for payment of contractual cash flows.

² For the IASB, Category B captures all liabilities that meet the condition in paragraph 4.2(a) of IFRS 9 but do not meet paragraph 4.2(b). For the FASB, Category B captures all hybrid financial instruments held for payment of contractual cash flows that contain embedded derivatives that do not meet the clearly-and-closely related criterion and require separate accounting under Accounting Standards Codification Topic 815, *Derivates and Hedging*.

³ For the IASB, Category C captures all liabilities that meet the conditions in paragraph 4.2(a) and 4.2(b) of IFRS 9. For the FASB, Category C captures all financial liabilities with principal amounts held for payment of contractual cash flows that do not contain embedded derivatives that require separate accounting under Topic 815.

⁴ 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 differentiated between (a) the price of credit and (b) the credit standing of the issuing entity; therefore we use the term in this agenda paper to reflect both.

6. At this meeting, we are **not** asking the boards to discuss:
 - (a) the instruments in Category C;
 - (b) the fair value option (FVO); or
 - (c) whether a “cost exception” should be maintained for particular derivative liabilities.
7. **Category C:** Based on the IASB’s decisions to date, the instruments in Category C would be measured at amortized cost (unless the FVO is elected). Under the FASB’s proposed approach, instruments in Category C would be measured at fair value through other comprehensive income (OCI) (unless the amortized cost option is applicable and elected). We will address this category at a later meeting.
8. **FVO:** Many IASB constituents have asked if the decisions about the liabilities in Category B will be extended to liabilities designated under the FVO. In general, those constituents think that the issue of own credit risk **should also be** addressed for liabilities under the FVO. We will address that issue at a later meeting.
9. **Cost exception:** IFRS 9 *Financial Instruments* does not have a cost exception for any investments in unquoted equity instruments (or any derivatives on those investments). All equity investments and derivative assets must be measured at fair value. That is consistent with the FASB’s tentative decisions to date. At a later meeting, we will ask the boards to confirm that there should **not** be a cost exception for any derivative liabilities on unquoted equity instruments.

Issue 1: Liabilities in Category A

10. This issue is not controversial. Both boards consistently have expressed the view that instruments should be measured at fair value through profit or loss if they are **not** held to pay contractual cash flows (eg all standalone derivatives and all liabilities that are held for trading).
11. The proposals in the IASB’s exposure draft reflected that view and almost all comment letters were supportive. Moreover, during our outreach activities, most constituents have continued to express this view.

12. Also, under the FASB's proposed approach, liabilities in Category A would be measured at fair value through profit or loss.
13. We recommend that the boards confirm their previous tentative decisions.

Differences between the IASB's and FASB's proposed approaches

14. It is important to note that there may be some differences between what would fall into Category A under the IASB's proposed approach versus what would fall into that category under the FASB's proposed approach. That is primarily because of slight differences in the wording of their respective "business model" conditions. Paragraph BC24 and BC25 in IFRS 9 describe that difference, which primarily relates to the FASB's additional explanatory text. At this point, we think that the boards should **not** attempt to resolve the differences between what would fall into Category A under the IASB's proposed approach versus what would fall into that category under the FASB's proposed approach. We think that the instruments in Category A are **similar enough** such that the boards can jointly discuss how to measure them. Moreover, the boards can ask for feedback in their respective exposure drafts.

Question 1

Do the boards agree that all financial liabilities that are not held to pay contractual cash flows should be measured at fair value through profit or loss? If not, how do the boards think those liabilities should be measured and why?

Issue 2: Liabilities in Category B

15. The liabilities in this category are more controversial. They have **non-vanilla** cash flow characteristics and, as a result, the proposals in both the IASB's exposure draft and the FASB's approach would measure them at fair value through profit or loss.
16. However, because the entity is holding the liabilities to pay the contractual cash flows, most respondents to the IASB's exposure draft and participants in our outreach activities **disagreed** with that proposal. This is consistent with the

long-standing concern raised by many (including users of financial statements) that recognizing the effects of changes in an entity's own credit risk in profit or loss does not result in useful information.

Differences between the IASB's and FASB's proposed approaches

17. Similar to our observation about Category A, there are some differences between what would fall into Category B under the IASB's proposed approach versus what would fall into that category under the FASB's proposed approach. That difference is primarily because
 - (a) the IASB's proposed approach looks to whether the contractual cash flows are **solely payments of principal and interest on the principal amount outstanding**; while
 - (b) the FASB's approach looks to whether a hybrid instrument **is required to be bifurcated under *FASB Accounting Standards Codification Subtopic 815-15 on embedded derivatives*** (originally issued as FASB Statement 133, *Accounting for Derivative Instruments and Hedging Activities*)
18. The differences described in paragraph 17 mean that, in some cases, an instrument will fall into Category B under the proposals in the IASB's exposure draft but will fall into **another category** under the FASB's proposed approach – and vice-versa. One example is an issued bond that pays interest of 1.5 X LIBOR. Under the IASB's proposals, that liability would fall into Category B. Under the FASB's proposals, it would fall into Category C.
19. **At this point, we think that the boards should not attempt to resolve the differences between what would fall into Category B under the IASB's proposed approach versus what would fall into that category under the FASB's proposed approach.** We do not think that the differences can be resolved quickly. Rather we think it would be advantageous for the boards to ask for feedback on that point in their respective exposure drafts. Moreover, we think that the instruments in Category B **are similar enough** such that the boards can jointly discuss how to measure them.

Alternatives for Category B

20. We have identified four broad alternatives for the instruments in Category B:
- (a) **isolate the effects of changes in own credit risk** and account for that amount differently than the other components of the fair value change
 - (b) **bifurcate** the instrument into a host and the embedded features
 - (c) **measure the entire instrument at amortized cost** and present its fair value on the face of the balance sheet in brackets
 - (d) **measure the entire instrument at fair value** and record the total fair value change in **OCI**
21. We have described those alternatives—and the feedback that we have received on them—in the paragraphs below. One benefit that is common to **all alternatives** is that changes in own credit risk would not affect profit or loss, which is responsive to constituents’ concerns. Alternatively, as mentioned in paragraph 5, the boards could decide **not** to address the issue of own credit risk and instead measure these instruments at fair value with all changes in profit or loss (consistent with the IASB’s exposure draft and FASB’s decisions to date).
- Alternative (a): Isolate the effects of changes in own credit risk*
22. There are at least two variants of this alternative—(1) present the change in own credit risk outside of profit or loss (ie in OCI) **or** (2) use an “adjusted” fair value measurement attribute that does not reflect changes in own credit risk (the “frozen credit spread” method).
23. **Present the change in own credit risk outside of profit or loss:** The liability would be remeasured at “full” fair value on the balance sheet but the portion of the fair value change attributable to changes in own credit risk would be presented in OCI while all other changes in fair value would be recognized in profit or loss.
24. **The “frozen credit spread” method:** The liability would be remeasured at a current value that ignores changes in the issuer’s own credit risk. This adjusted fair value measurement would be updated for all other fair value changes.
25. A benefit of both variants of Alternative (a) is that the complexities of bifurcation would be avoided.

26. A benefit that is specific to presenting changes in own credit risk in OCI is that a new measurement attribute would **not** be introduced on the balance sheet —“full” fair value would be presented. As a result, all derivative features would be remeasured at fair value (albeit with some changes presented in OCI), which is consistent with the boards’ long-held position. In contrast, the frozen credit spread method would introduce a new “adjusted” fair value measurement attribute, which may have unknown or unintended consequences. Furthermore, derivative features would not be remeasured at fair value (assuming that the credit risk of the **entire** instrument is frozen).
27. However, a benefit specific to the frozen credit spread method is that it would avoid the expanded use of OCI and, thus, would avoid increased volatility in OCI and questions about recycling. Those issues and questions would arise if changes in own credit were presented in OCI.
28. The most significant criticism of both variants of Alternative (a) is that isolating the “own credit risk” component of a fair value change is **very difficult**. That is because it is difficult, and perhaps impossible, to separate own credit risk from other components of the fair value change (eg liquidity or the market’s “appetite” for a particular instrument). Also it is difficult to be objective about own credit risk (as opposed to a counterparty’s credit risk).
29. Moreover, the effects of changes in own credit risk and changes in own share price or other equity-like features (and the correlation between the two) provide particular difficulties (for example, consider deeply subordinated liabilities issued with features such as mandatory deferral of interest or mandatory conversion into ordinary shares that are triggered if Tier 1 regulatory capital levels reach particular levels).
30. IFRS 7 *Financial Instruments: Disclosures* requires an entity to disclose for all liabilities designated under the FVO the amount of change (during the period and cumulatively) in the fair value that is attributable to changes in the credit risk of the liability. Topic 825, *Financial Instruments*, requires an entity to disclose for all liabilities designated under the FVO that have been significantly affected during the reporting period by changes in the instrument-specific credit risk the estimated amount of gains and losses from fair value changes included in

earnings that are attributable to changes in the instrument-specific credit risk and how those gains and losses were determined.

31. For IFRS 7 purposes, entities generally assume that the entire spread above the benchmark rate is attributable to own credit risk. For Topic 825 purposes, changes in instrument-specific credit risk are generally determined based on the changes in the reporting entity's own credit spreads. However, the approach can vary depending on the nature of the liability.
32. Many constituents noted during our outreach activities that in general only companies with sophisticated valuation capabilities (mainly banks) are applying the FVO to financial liabilities and, thus, are applying the disclosure requirements in IFRS 7. And even the companies with sophisticated valuation capabilities noted the complexity of determining the effects of changes in their own credit risk. Those constituents also noted that if the boards pursue Alternative (a), many more companies will have to compute own credit risk – and compute it for many types of liabilities – which will be very challenging.
33. Finally, both variants raise the question about whether the fair value change should be **further disaggregated** so that interest expense is imputed (and presented separately in the income statement) for liabilities that are measured at fair value (or adjusted fair value). As described below in paragraph 44 many users think that such information should be provided. However, both boards have struggled in the past (without reaching a conclusion) to decide how to disaggregate fair value changes. This further disaggregation could be difficult for the instruments in Category B given their non-vanilla contractual cash flow characteristics.

Alternative (b): Bifurcation

34. The liability would be separated into components and those components would be separately classified and measured. There are at least two variants of this alternative (1) maintain the existing bifurcation requirements in IFRS and US GAAP or (2) develop a bifurcation approach that is more aligned with the boards'

proposed classification approaches (that is, bifurcation would be based on the entity's business model and the liability's contractual cash flow characteristics)⁵.

35. The primary benefit of both variants of Alternative (b) is that the complexities of identifying own credit risk and imputing interest expense (described above in Alternative (a)) would be avoided. Moreover, many constituents have told us that practice has developed and the existing requirements are working well (and, in some cases, reflect how an entity manages its hybrid instruments). Those constituents have said that there isn't a need to change the existing requirements for liabilities because the criticisms of financial instrument accounting are primarily related to financial assets (ie the number of categories and the related impairment methodologies).
36. Also, under this alternative, derivative features would be remeasured at fair value, which is consistent with the boards' long-held position.
37. However, the existing requirements have been criticized by many for being complex, rules-based and internally inconsistent. Some entities currently use the FVO to avoid bifurcation. And if the boards decide to pursue bifurcation for liabilities, constituents will inevitably raise questions about why bifurcation was eliminated for hybrid contracts with financial asset hosts.

Alternative (c): Measure the entire instrument at amortized cost

38. A financial liability would be measured at amortized cost but the entity would be required to present the fair value of the liability in brackets on the face of the statement of financial position. Under an amortized cost approach, the cash flow estimates at initial recognition are used to determine an effective interest rate. Those cash flow estimates are constantly updated over the expected life of the instrument and discounted using the original effective interest rate – any difference is recognized in the income statement as a “catch up” adjustment.
39. The primary benefit is that the complexities of identifying own credit risk (described above in Alternative (a)) would be avoided. Also this alternative

⁵ For the FASB, (1) and (2) most likely would have the same bifurcation results. For the IASB, there would be some differences; however, we have not analyzed fully the magnitude of those differences.

would avoid the complexities of bifurcation. Moreover, a new measurement attribute would **not** be introduced on the balance sheet and, in fact, users would have both amortized cost **and** fair value information on the face of the balance sheet. Finally some say that amortized cost best reflects the value of the contractual obligations on a “going-concern basis” (ie on the basis that the issuer will pay the contractual cash flows as required by the terms of the contract).

40. However, many have criticized this alternative saying that amortized cost is hard to understand and difficult to compute for instruments with “non vanilla” features (eg an equity-linked note). In fact, some users have asked what the amortized cost figure means for such instruments. Moreover, derivative features would **not** be remeasured at fair value, which is contrary to the boards’ long-held position. Finally, a few constituents said that two balances on the balance sheet might create confusion (and perhaps a disconnect between the balance sheet and the income statement) and recommended that fair value information remain in the notes.

Alternative (d): Measure the entire instrument at fair value and record the total fair value change in OCI

41. The liability would be measured at “full” fair value on the balance sheet but the entire fair value change would be presented in OCI (rather than profit or loss).
42. The primary benefit is that the complexities of identifying own credit risk (described above in Alternative (a)) and bifurcation would be avoided. Moreover, a new measurement attribute would **not** be introduced on the balance sheet—“full” fair value would be used. As a result, all derivative features would be remeasured at fair value (albeit with changes presented in OCI), which is consistent with the boards’ long-held position.
43. However, this alternative would raise difficult questions about what (if any) amounts should be recognized in profit or loss, both:
- (a) during the life of the instrument (ie interest or other financing costs); and
 - (b) upon derecognition (ie recycling).
44. If the boards decide that a portion of the total fair value change should be recognized in profit or loss during the life of the instrument, determining **how**

much could be difficult for the instruments in Category B. Based on our recent user questionnaire (described in paragraphs 48-52 below), many users think that interest expense **should be** imputed and presented separately in the income statement for debt that is measured at fair value.

45. The boards have discussed the topic of disaggregating fair value changes on numerous occasions—without reaching any conclusions. For example in 2006 the staff performed extensive outreach with users to determine what disaggregated information would be decision-useful. While users agreed that some disaggregated information is required, the feedback varied on **what** would be useful. However, if the boards decide to pursue this alternative, one way to calculate an interest expense amount would be to apply the amortized cost methodology described in Alternative (c). That is, fair value would be presented in the balance sheet but interest expense could be computed using an amortized cost methodology.
46. Another criticism of this alternative is that it goes “over-board”. That is, the boards’ objective is to address issues related to own credit risk but this alternative would exclude the entire fair value change from profit or loss. Moreover, those amounts would create volatility in OCI.

Staff commentary and recommendation

47. We don’t think there is a simple or clear answer—each alternative has **significant** challenges.
48. In January 2010 we developed a questionnaire to solicit feedback from users on the issue of own credit risk. The questionnaire asked two broad types of questions—(1) how do users use information about changes in own credit risk today (if at all) and (2) what is their preferred method of accounting for selected instruments (the selected instruments in the questionnaire were vanilla debt, structured debt that funds assets measured at fair value, structured funding instrument (eg structured deposits that fund assets measured at amortized cost), and issued debt where the issuer must defer interest payments in some cases).

49. With the help of several banks, we sent that questionnaire directly to some of the analysts that follow each bank (we selected the banks partly on the basis of their use of the FVO in IAS 39 and, hence, their disclosures required by IFRS 7 of changes in fair value arising from changes in own credit risk). We also posted the questionnaire on the IASB's website and solicited input from other users. The FASB staff also sent the questionnaire to several U.S. users. By 28 January we received 84 responses. Agenda paper 2A discusses the feedback in detail, but the primary themes are set out below.
50. **The majority of users exclude the effects of changes in own credit risk from their analysis.** For example, when gains and losses arising from changes in own credit are included in net income, almost all respondents said that they **exclude** such gains and losses for the purpose of deriving performance measures suitable for their analysis. Similarly, when evaluating net asset values (or calculating price to book ratios), most respondents **exclude** the effect of changes in own credit risk in cases where the liabilities are measured in the balance sheet at fair value.
51. **The preferred method of accounting was either amortized cost (for vanilla debt, structured funding instruments, and issued debt where the issuer must defer interest payments in some cases) or bifurcation (for structured debt that funds assets measured at fair value).**
52. There was almost no support for measuring the selected instruments using the frozen credit spread method. That is consistent with the feedback that we received during our outreach activities—some users told us that they did not like that alternative because they thought that an “adjusted fair value” would be confusing.
53. Primarily on the basis of feedback from users—and our other outreach activities, we think the boards should pursue bifurcation. This is consistent with the feedback that the criticisms of financial instrument accounting are primarily related to financial assets (ie the number of categories and the related impairment methodologies) and there isn't a need to significantly change the existing requirements for liabilities. Also, under this alternative, derivatives would be

subsequently remeasured at fair value through profit or loss, which is consistent with the boards' long-held view.

54. As we mentioned above, many constituents noted during our outreach activities that in general only companies with sophisticated valuation capabilities (mainly banks) are applying the FVO to financial liabilities and, thus, are applying the disclosure requirements in IFRS 7 and Topic 825. Those constituents noted that if the boards pursue Alternative (a) and require entities to identify the own credit risk component of the total fair value change, many more companies will have to compute own credit risk – and compute it for many types of liabilities – which will be very challenging. In contrast, most entities are bifurcating structured instruments under existing requirements so by maintaining bifurcation, the boards would maintain the status quo for those entities. We question whether the challenges and cost of that computation exceed the benefits given that (1) the users don't seem to prefer Alternative (a) and (2) it will be difficult (and perhaps impossible) to specifically identify the own credit risk component.
55. We do not recommend Alternatives (c) and (d) based on the criticisms described in their respective sections.
56. It is important to note that our recommendation on the instruments in Category B does not prejudge what the boards will pursue for the instruments in Category C or instruments designated under the FVO. We acknowledge that our recommendation most likely would expand the use of the FVO compared to the other alternatives because some entities apply the FVO to avoid bifurcation. As we mentioned at the beginning of this paper, we think those are separate issues and will address those issues at a later meeting.

Question 2

Which alternative do the boards want to pursue for liabilities that are held to pay contractual cash flows and have “non-vanilla” (structured) contractual cash flow characteristics and why?

(a) isolate the effects of changes in own credit risk and account for that amount differently than the other components of the fair value change;

(b) bifurcate the instrument into a host and the embedded features:

(c) measure the instrument at amortized cost and present its fair value on the face of the balance sheet in brackets; or

(d) measure the entire instrument at fair value and record the total fair value change in OCI

If the boards do not want to pursue any of the alternatives above, do you want to measure these liabilities at fair value through profit or loss?

Appendix

A1. The following table illustrates the three categories of instruments described in paragraph 3 of this paper.

	Held to pay contractual cash flows?	Have “vanilla” contractual cash flow characteristics?	Example
Category A	No	N/A (would not affect classification)	derivative liabilities
Category B	Yes	No	equity-linked note that the entity holds to maturity
Category C	Yes	Yes	bond that pays a market-based interest rate that the entity holds to maturity