IASB/FASB joint meeting

Staff Paper

IASB Agenda Paper No.	**10A**
FASB Memo No.	**28A**
Date	**January 2010**

Project	**Financial instruments – Replacement of IAS 39**
Topic	**Classification and measurement: financial liabilities—summary of IASB discussion to date**

1. As described in the cover note, this agenda paper summarizes the IASB's discussion to date related to classification and measurement of financial liabilities. The appendices to this paper (distributed as a separate document) contain additional background reading—primarily agenda papers discussed during the deliberations that led to IFRS 9 related to the classification and measurement of financial liabilities.

Exposure draft ED/2009/7 *Financial Instruments: Classification and Measurement*

2. ED/2009/7 *Financial Instruments: Classification and Measurement* was published in July 2009 and contained proposals for **all** items within the scope of IAS 39—ie the exposure draft proposed a symmetrical classification approach for financial assets and financial liabilities. That approach would remeasure an item at either fair value or amortized on the basis of:
   (a) its contractual cash flow characteristics; and
   (b) the entity's business model for managing assets and liabilities.

3. A financial liability would be measured at amortized cost (unless the fair value option is elected) if the liability is held within a business model whose objective is to hold liabilities in order to pay contractual cash flows **and** the contractual cash flows of the liability are solely payments of principal and interest.

4. The exposure draft drew attention to the IASB discussion paper *Credit Risk in Liability Measurement*.

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.

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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.

The discussion paper *Credit Risk in Liability Measurement*

5. The discussion paper, which was published in June 2009, described the most common arguments for and against including "own credit risk"[1] in measuring liabilities (the discussion paper applied to both financial and non-financial liabilities). The IASB acknowledged that the issue of whether profit or loss resulting from changes in own credit risk should be recognized when a liability is measured at fair value has generated more comment and controversy than any other issue about the use of fair value, especially during the recent financial crisis. The discussion paper asked whether current measurements of fair value should incorporate the probability that an entity will fail to perform as required and, if not, what the alternatives are.

6. The discussion paper sought comment on three possible approaches to liability measurement. Those approaches identified possible ways to measure liabilities while excluding own credit risk.

Responses to the exposure draft and discussion paper

7. Almost all respondents to the exposure draft **and** the discussion paper expressed concerns about recognizing changes in an entity's own credit risk in the remeasurement of most financial liabilities. In general respondents thought that financial liabilities that are held for trading purposes (including derivatives) should be measured at "full" fair value. Appendix E to this agenda paper provides the detailed comment letter analysis to the discussion paper.

8. The responses to the exposure draft and discussion paper were consistent with long-standing concerns raised by many, including investors, that recognizing the effects of changes in an entity's own credit risk does not result in useful information.

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[1] The term *own credit risk* is used in this paper as it was used in the discussion paper. 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.

9. Also, some respondents to the exposure draft pointed out that the IASB 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 on financial liabilities. Respondents said that the IASB should finalize classification and measurement requirements for financial assets, but retain the existing requirements for financial liabilities until it has more fully considered and debated the issues related to financial liabilities. Respondents said that a symmetrical approach for financial assets and financial liabilities (ie having the same classification conditions and measurement attributes) is not necessary and, in some cases, does not result in useful information.

Redeliberations of the exposure draft

10. At the 29 September 2009 meeting the IASB tentatively decided that the scope of the IFRS should be the same as the exposure draft—that is, it should include financial assets **and** financial liabilities.

11. However, to address respondents concerns about reflecting changes in own credit risk in profit or loss, at the 6 October 2009 meeting the IASB tentatively decided to **require** a "frozen credit spread" remeasurement method for all financial liabilities that are:

    (a) not eligible for amortised cost, but

    (b) are managed with an objective to pay contractual cash flows.

12. Under this method, the liabilities described in paragraph 11 would be remeasured at an **adjusted** fair value, which is a current remeasurement that excludes changes in the issuing entity's own credit risk. The adjusted fair value measurement is updated for all other fair value changes.

13. Given the scope described in paragraph 11, the frozen credit spread measurement method **would not** apply to financial liabilities that are held for trading (including all stand-alone derivatives) or financial liabilities for which the entity has elected the fair value option (FVO). Those instruments would continue to be measured at fair value with changes recognized in profit or loss. In general, the frozen credit spread measurement attribute **would** be applied to structured or hybrid liabilities

(ie liabilities whose contractual cash flows are **not** solely payments of principal and interest) but that are held with an objective to pay the contractual cash flows.

14. The IASB tentatively decided not to prescribe a method for computing the frozen credit spread measurement method (but, consistent with the guidance in paragraph B4 of IFRS 7 *Financial Instruments: Disclosure*, provided a default method for simple financial liabilities). The IASB also tentatively decided to require disclosures about the methods and inputs used to isolate the initial credit spread and to continue to require "full" fair value disclosures in accordance with IFRS 7 for financial liabilities measured using a frozen credit spread measurement method.

15. At that meeting, in favour of the frozen credit spread measurement method, the IASB rejected alternatives approaches to addressing concerns about reflecting changes in own credit risk, such as

    (a) remeasuring the liability at fair value on the balance sheet but presenting the portion of the fair value change attributable to a change in own credit risk in other comprehensive income (OCI) while all other changes in fair value would be in P&L; or

    (b) retaining bifurcation requirements for hybrid contracts with financial liability hosts.

16. Subsequent to those tentative decisions, a number of issues were raised and considered, including:

    (a) The frozen credit spread measurement method may have unknown or unintended consequences because is it not applied today (other than for disclosure purposes for financial liabilities measured under the FVO).

    (b) Some derivative features that are embedded in hybrid contracts with financial liability hosts would **not** be measured at fair value. (This would be contrary to the long-standing position the IASB has taken that all derivatives should be measured at fair value.)

    (c) The frozen credit spread measurement method would not apply to liabilities designated under the FVO and the FVO has been the source of some constituents' concerns related to recognizing changes in own credit risk.

    (d) Convergence would be difficult because the FASB's proposed approach does not include a frozen credit spread measurement method.

IFRS 9

17. As a result of the concerns summarized in paragraph 16 (and others), at the October 2009 board meeting the IASB decided **not** to finalize requirements for financial liabilities. Instead it tentatively decided that it would further consider and analyze the issue of own credit risk in the remeasurement of particular liabilities.

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

Outreach performed subsequent to the issuance of IFRS 9

19. 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 own credit risk. Consistent with the outreach programme for IFRS 9, our objective is to obtain feedback from all types of constituents (investors, preparers, auditors, regulators, and others) from a range of industries across different geographic regions. We also held a meeting of the IASB's Financial Instruments Working Group (FIWG) to ask for their input.

Possible approaches

20. During those outreach discussions, we discussed a spectrum of approaches that the boards could consider to address the issue of own credit in the remeasurement of financial liabilities. As discussed above in paragraph 11, those approaches would be applied to financial liabilities that:

    (a) are **not** eligible to be measured at amortized cost; but

    (b) **are** managed with an objective to pay contractual cash flows.

21. During our outreach we discussed four primary possible approaches (some of the approaches are the same as the approaches discussed above in the "Redeliberations of the exposure draft" section):

(a) **Separate presentation of changes in own credit risk**: The liability would be remeasured at fair value on the balance sheet but the portion of the fair value change attributable to a change in own credit risk would be presented in OCI while all other changes in fair value would be recognized in profit or loss;

(b) **An adjusted fair value remeasurement (the "frozen credit spread" measurement method**): The liability would be remeasured at a current value that ignores changes in the issuer's own credit risk. The adjusted fair value measurement would be updated for all other fair value changes.

(c) **Bifurcation:** The liability would be separated into components and those components would be separately classified and measured. There are two main sub-approaches that we have discussed:

   (a) The subsequent measurement requirements in IAS 39, including those related to bifurcation of hybrid contracts, would be maintained.

   (b) A bifurcation approach would be developed that is aligned with the classification approach in IFRS 9 (that is, bifurcation would be based on the classification conditions in paragraph 2).

(d) **Parenthetical presentation of fair value:** A financial liability would be measured at amortised 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.

22. At the December 2009 IASB board meeting, we presented a detailed oral summary of the feedback received to date. However we realize that FASB board members did not attend that session so the main themes are set out below.

23. Feedback was varied. There was not a clear preference among the four alternatives and participants said that there is not a "silver bullet" with this issue. We received a few main messages:

(a) A symmetrical classification approach between financial assets and financial liabilities is not necessary and is unlikely to result in useful information about financial liabilities. This view is shared by almost all participants, including users of financial statements.

(b) If the boards pursue an approach that separately identifies own credit risk (Approaches 1 and 2), input from valuation experts will be necessary.

(c) The IFRS 7 disclosure requirements (paragraphs 10 and B4) related to identifying and calculating own credit risk are mainly applied by large financial institutions. And even they find the computations difficult and complex. Methodologies (whether for disclosure requirements in IFRS 7 or for other purposes) vary among entities.

(d) Bifurcation (Approach 3) is problematic to apply to many structured financial liabilities. Many financial institutions use the fair value option to avoid it.

(e) The effects of changes in own credit risk and changes in own share price, and the correlation between the two, provide particular difficulties in measuring particular types of liabilities. Differentiating between the two is impossible in some situations. For example, deeply subordinated liabilities issued with features such as mandatory deferral of interest or mandatory conversion into ordinary shares if Tier 1 regulatory capital levels reach particular levels (or similar triggers). Such liabilities have often been issued to qualify as regulatory capital.