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

Topic **The fair value option**

Background

Existing requirements

1. IAS 39 *Financial Instruments: Recognition and Measurement* permits entities to irrevocably elect the fair value option (FVO) on initial recognition if one (or more) of the following three conditions is met:

   (a) It eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch').

   (b) A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis.

   (c) The financial asset or financial liability contains one or more embedded derivatives and the entity elects to account for the hybrid (combined) contract in its entirety.

   [We have summarized these eligibility conditions. For the complete requirements, please refer to paragraphs 9 and 11A of IAS 39.]

Tentative decisions to date related to the FVO for financial liabilities

2. At the joint meeting on 17 February 2010 the IASB tentatively decided to retain the FVO for financial liabilities and carry forward the three eligibility conditions in IAS 39.

3. However, to respond to issues raised about recognizing gains or losses arising from changes in an entity's own credit risk[1], the Board also tentatively decided that for all financial liabilities designated under the FVO, an entity would be required to:

   (a) recognize the total fair value change in profit or loss; and

   (b) recognize the portion attributable to changes in own credit risk in other comprehensive income (OCI) (with an offsetting entry to profit or loss).

4. The Board tentatively decided that amounts recognized in OCI would never be recycled into profit or loss.

Other views discussed on particular aspects of the FVO

5. While the majority of the Board supported the tentative decisions described above, some Board members presented alternative views on particular aspects of those decisions:

   (a) Instead of recognizing changes in own credit risk in **OCI** as described in paragraph 3, that amount would be recognized in **equity**. [This was the staff recommendation in agenda paper 8C for the 17 February meeting.[2]]

   (b) Instead of the "two step" approach described in paragraph 3, changes in own credit risk would be recognized **directly in OCI** and only the other changes in fair value would be recognized in profit or loss.

   (c) The proposals described in paragraph 3 would apply **only** to liabilities that are designated under the FVO on the basis of the eligibility criterion described in paragraph 1(c)—ie to avoid bifurcation. If a liability is designated under the FVO on the basis of the eligibility criteria in paragraphs 1(a) and 1(b), the entire change in its fair value would be

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[1] 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.

[2] This has some similarities to an approach discussed in paragraph 29 and 62(b) of the IASB discussion paper *Credit Risk in Liability Measurement.* The approach described in the DP was published in an article 'Including Credit Standing in Measuring the Fair Value of Liabilities – Let's Pass This One to the Shareholders' by Lanny G Chasteen and Charles R Ransom in *Accounting Horizons*, 21/2 (June 2007). Under that approach, at contract inception the liability would be measured using the risk-free rate of interest and expected future cash flows (excluding any expectations about default). Any difference between the resulting amount and cash proceeds (if any) would be charged to equity and amortized over the life of the liability. If Board members would like a copy of this article, please let us know.

recognized in profit and loss (and the portion of that change attributable to changes in own credit would **not** be recognized in OCI).

Purpose of this paper

6. The purpose of this paper is to further discuss the views described above and ask the Board whether (and, if so, how) it wants to address them.

View (a): Recognize changes in own credit risk in equity (rather than OCI)

7. As mentioned above, our recommendation at the 17 February meeting was to recognize the effect of changes in own credit risk in **equity** (with an offsetting entry to profit or loss). That recommendation is discussed in paragraphs 27-34 of agenda paper 8C.

8. Compared to OCI, the benefits of recognizing those amounts in equity include:

   (a) The use of OCI would not be expanded, which is consistent with many responses to the exposure draft *Financial Instruments: Classification and Measurement*.

   (b) This approach is consistent with the argument described in the discussion paper on credit risk in liability measurement that a change in the credit risk of the entity's liabilities represents a transfer of wealth between liability holders and equity holders.

9. However, at the meeting on 17 February, the majority of Board members disagreed with the staff's recommendation—and instead favored using OCI—for the following reasons:

   (a) Under the staff's recommendation, the net amount recognized in the performance statement(s) would **exclude** the effects of own credit. The majority of board members noted that it is preferable to include those amounts in performance —albeit in OCI rather than profit or loss.

   (b) Existing IFRS uses OCI as a "parking lot" for other amounts. The staff's recommendation would create a new parking lot in equity. While expanding the use of OCI is not desirable, it is better than creating a new problem.

(c) The staff recommendation will make convergence difficult because the FASB's proposed approach does not recognize any fair value changes in equity (but does use OCI in particular circumstances).

(d) The staff's recommendation could raise problems in jurisdictions that have legal restrictions on what amounts can be recognized in equity.

Staff recommendation

10. We don't think there is a simple or clear answer—we think both of these are valid alternatives. Therefore we recommend that the Board propose its tentative decision (ie recognize changes in own credit in OCI) but **also** describe this alternative (ie recognize changes in own credit in equity) in the exposure draft and ask respondents for feedback on both. We think it would be very helpful to get specific feedback on both alternatives. This would be similar to the exposure draft *Financial Instruments: Classification and Measurement* where the Board described alternative classification approaches in the invitation to comment and asked for feedback.

Question 1: recognizing changes in own credit risk in OCI vs in equity
Does the Board agree with the staff recommendation in paragraph 10? If not, what does the Board want to do instead and why?

View (b): Recognize the effects of changes in own credit risk directly in OCI (with all other changes recognized in profit or loss)

11. At the 17 February meeting, we recommended the "two step" approach described in paragraph 3 for several reasons: [3]

(a) This approach would provide users of financial statements with all relevant information on the face of the income statement—the total fair value change and the amount attributable to changes in own credit.

[3] As noted earlier in this paper, we recommended recognizing the own credit component in equity but the Board tentatively decided to recognize it in OCI. However, our reasoning for the "two step" approach does not change based on whether that amount is recognized in equity or OCI.

(b) But consistent with the almost unanimous feedback from users, the portion of the fair value change attributable to changes in own credit risk would **not** have a “net” effect on profit or loss.

(c) The liabilities would be measured at “full” fair value on the balance sheet; therefore it would be consistent to recognize the entire fair value change in profit or loss.

12. The majority of the Board tentatively supported this “two step” approach. However some board members questioned whether it is too onerous. They expressed a preference for a “one step” approach whereby the effects of changes in own credit risk would be recognized **directly** in OCI and all other changes in fair value would be recognized in profit or loss.

Staff recommendation

13. The two approaches have the same net affect on the income statement. The only difference between these approaches is **how the amount gets to OCI**—ie whether (1) the change in own credit risk is first recognized in profit or loss and is then “transferred” to OCI **or** (2) the change in own credit is directly recognized in OCI.

14. Consistent with our recommendation in paragraph 10, we don’t think there is a simple or clear answer—we think both are valid alternatives. Therefore we recommend that the Board propose its tentative decision (ie the two step approach) but **also** describe this alternative (ie the one step approach) in the exposure draft and ask respondents for feedback on both. We think that feedback will be helpful when the Board re-deliberates this issue.

Question 2: A "two step" approach vs a "one step" approach
Does the Board agree with the staff recommendation in paragraph 14? If not, what does the Board want to do instead and why?

View (c): Treat liabilities differently if they are designated under the FVO to avoid bifurcation

15. At the 17 February meeting, we recommended that the Board address the issue of own credit risk for **<u>all</u>** liabilities designated under the FVO for the following reasons:

    (a) Users have consistently told us that the effects of changes in own credit risk should affect profit or loss **<u>only if</u>** the entity is regularly trading its own debt.

    (b) In the recent user questionnaire, we asked users whether their views on the usefulness of own credit risk information would change depending on **why** the entity is measuring a liability at fair value (eg to simplify its accounting or to reflect the way that it manages its debt). Over 80% of respondents said "no" – and reiterated the comment above in (a).

    (c) Comparability would be reduced if the recommendation was applicable to only one of the eligibility conditions. That would be the case if a particular liability met more than one of the FVO eligibility conditions—ie the accounting treatment would be different based on which condition the entity decided to use to support its FVO designation.

16. The majority of the Board tentatively agreed that all liabilities designated under the FVO should be accounted for in the same way.

17. However some board members disagreed and said that those proposals should apply **only** to liabilities that are designated under the FVO on the basis of the eligibility criterion described in paragraph 1(c)—ie to avoid bifurcation. If a liability is designated under the FVO on the basis of the eligibility criteria in paragraphs 1(a) or 1(b), the entire change in its fair value should be recognized in profit and loss (and the portion of that change attributable to changes in own credit would **<u>not</u>** be recognized in OCI).

18. Those board members said that because we have used the term *own credit* to include the price of credit (in addition to the credit standing of the issuer), our recommendation would **create** a mismatch in profit or loss. That is because the price of credit will affect the fair value measurement of related **assets**—and that effect will be recognized in profit or loss (not in OCI).

Outreach performed subsequent to the Board meeting on 17 February

19. Since the Board meeting on 17 February, we contacted several entities that currently use the FVO and asked for feedback on whether the Board's tentative decision would create a new mismatch in some cases.

20. Entities that supported the Board's tentative decision noted the following points:

    (a) Currently many liabilities meet more than one of the eligibility conditions for the FVO and the entity will use the condition that is the easiest to document. If the accounting for the eligibility conditions is different, an entity will be able to get different results in profit or loss on the basis of which condition it chooses to use. [We acknowledge that this choice would be available only at initial designation.]

    (b) Many entities use the FVO as an alternative to hedge accounting. While the price of credit will affect the derivative hedging instrument, that effect will be de minimus compared to the effect on the liability. In these circumstances, the entity has not elected the FVO to avoid bifurcation but recognizing in OCI the effects of changes in own credit risk on the liability would **not** create a mismatch.

21. However, other entities agreed that the Board's tentative decision **would** create a mismatch in cases where an entity is matching (or managing) a liability with a (non-derivative) asset. In that case, both items will be affected by changes in the price of credit—and a mismatch will arise when the entity recognizes the effects on the liability in OCI and the effects on the asset in profit or loss. In those cases, the entities would prefer to recognize the entire fair value change in profit or loss. Based on our outreach so far, we think this scenario will represent a relatively small subset of cases where the FVO is used. However, in some jurisdictions, this scenario is significant in particular industries (eg Danish mortgage banking).

22. Some asked about a case where an entity issues a liability whose re-payment is specifically linked to and secured by a particular asset (ie the re-payment of the

liability is based entirely on the performance of the asset). We do not think that liability has any issuer-specific credit risk, and therefore, the discussion in this paper is not relevant. [The derecognition project is discussing whether some non-recourse arrangements should lead to derecognition of the associated assets (refer to Agenda Paper 5B). If the Board agrees with the recommendation in that paper, some of the cases described in this paragraph will result in derecognition of the assets and no recognition of a liability.]

Staff recommendation

23. To address the concern in paragraph 21, the Board could propose that the entity:

    (a) Apply the "two step" approach to all liabilities designated under the FVO **unless** that approach would create a mismatch with related assets.

    (b) If that approach **would** create a mismatch with related assets, the entity would be required to recognize the liability's entire fair value change in profit or loss.

24. The determination of whether a mismatch would be created would be made at initial recognition and the entity would apply the same approach for the entire life of the instrument. The Board could require additional disclosures about how the entity made that determination.

25. Alternatively the Board could decide to carry forward the FVO as it is set out in IAS 39 (ie **not** address the issue of own credit risk). As a variant of this alternative, the Board could decide to recognize the entire change in fair value in profit or loss but present the effect of changes in own credit risk on the face of the income statement (rather than in the notes). [This is similar to the FASB's tentative decision, which is summarized in the appendix to this paper.]

26. Consistent with our recommendations above, we don't think there is a simple or clear answer—we think all of these are valid alternatives. Therefore we recommend that the Board propose its tentative decision (described in paragraph 3) but <u>**also**</u> describe the alternative described in paragraph 23 in the exposure draft and ask respondents for feedback on both. We think it would be very helpful to get specific feedback on both alternatives.

Question 3: The eligibility conditions for designating a liability under the FVO
Does the Board agree with the staff recommendation in paragraph 26? If not, what does the Board want to do instead and why?

Appendix—summary of FASB decisions at the 24 February 2010 board meeting (copied from the FASB website)

Accounting for financial instruments: liabilities

A1. The Board discussed the accounting for financial liabilities and how to address changes in an entity's own credit risk of financial liabilities measured at fair value.

A2. The Board affirmed their prior classification and measurement decisions on financial liabilities and decided to include separate presentation of significant changes in fair value related to changes in an entity's creditworthiness.

A3. Financial liabilities with a principal amount that are held for payment of contractual cash flows that do not contain embedded derivative features that would require bifurcation under Subtopic 815-15, Derivatives and Hedging—Embedded Derivatives, would be measured at fair value, with certain changes in fair value presented in other comprehensive income.

A4. Financial liabilities with a principal amount that are held for payment of contractual cash flows that contain an embedded derivative that would require bifurcation under Subtopic 815-15 would be measured at fair value, with changes in fair value presented in net income.

A5. For all financial liabilities measured at fair value, including financial liabilities without a principal amount and financial liabilities that are not held for payment of contractual cash flows, an entity would present on the face of the performance statement significant changes in fair value related to changes in the entity's credit standing. That information would be presented separately for financial liabilities for which certain changes in fair value are presented in other comprehensive income and financial liabilities for which all changes in fair value are presented in net income. The amount presented on the performance statement would reflect only the change in the entity's creditworthiness and not a change in the price of credit. The Board will discuss at a later meeting how changes in fair value related to an entity's creditworthiness should be measured.