Project **Fair value option for financial liabilities**

Topic **Effective date and transition**

Purpose of this paper

1. This paper discusses the effective date and transition requirements for the forthcoming amendments to IFRS 9 *Financial Instruments* for the changes to the fair value option (FVO) for financial liabilities.
2. Paragraphs 4 and 5 in the exposure draft *Fair Value Option for Financial Liabilities* (ED) set out the proposals related to effective date and transition. Questions 9 and 10 in the ED asked respondents for feedback.
3. This paper addresses effective date and transition separately. However, our recommendations for both topics are based on the requirements that currently exist in IFRS 9. To minimise complexity, we think it is important that the effective date and transition requirements related to the FVO for financial liabilities are as consistent as possible with the requirements in IFRS 9 related to financial assets.

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

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Effective date

Background

4. Entities must apply IFRS 9 for annual periods beginning on or after 1 January 2013.[1] Early application is permitted (paragraph 8.1.1 of IFRS 9).
5. The changes to the FVO for financial liabilities will be an amendment to IFRS 9 and thus will have the same mandatory effective date–1 January 2013. The ED proposed permitting early application of the finalised requirements. The ED also proposed that if an entity elects to apply these requirements early, the entity must at the same time apply all finalised requirements in IFRS 9 that it does not already apply (see paragraph 4 of the ED).
6. The Board proposed that because it was concerned that if an entity were permitted to adopt one phase early without also adopting early all of the preceding phases, there would be a period of significant incomparability among entities until all of the phases of the project become mandatorily effective. That is because there would be many different combinations of which requirements are adopted early and which are not. [As noted in paragraph BC50 of the ED, if an entity chooses to adopt a phase early, the Board would **not** require the entity to adopt **subsequent** phases early. The Board decided that it would be unfair to require an entity to anticipate the outcomes of unfinished phases in order to make a decision about adopting a phase early.]
7. Additional information on the Board's rationale for this decision is set out in paragraphs BC47-BC50 of the ED.

[1] As noted in BC93 of IFRS 9, the Board said it would consider delaying that effective date if the impairment phase of the project to replace IAS 39 makes such a delay necessary, or if the new IFRS on insurance contracts has a mandatory effective date later than 2013, to avoid an insurer having to face two rounds of change in a short period. This paper is not pre-judging that future discussion.

Feedback received

8. Almost all respondents agree with the proposal to permit early adoption. They believe that the proposals improve financial reporting and, thus, entities should be allowed to adopt them as soon as possible.

9. Some of those respondents also agree that if an entity elects to adopt these proposals early, it must adopt at the same time all of the other requirements in IFRS 9. They note that this proposal increases comparability among entities.

10. However, many respondents think that entities should be permitted to adopt the proposals in the ED **without** also adopting the rest of IFRS 9—and some suggest that the proposals in the ED could be finalised as an amendment to IAS 39 *Financial Instruments: Recognition and Measurement* (rather than IFRS 9). These respondents argue that the proposals in the ED are unrelated to the requirements in IFRS 9 because the former relates to the fair value option for financial liabilities and the latter relates to the measurement of assets. Many respondents point out that the Board decided to have different measurement models for financial assets and financial liabilities; therefore, early adoption of the respective requirements should not be 'linked'. Furthermore, respondents note that the adoption of IFRS 9 is far more complex and will take more time to implement than the proposals in the ED (ie the amendments are only a minor change while IFRS 9 introduced a new model).

11. In their responses to the user questionnaire, most users indicated that if an entity chooses to adopt the proposals in the ED early, it **should be required** to adopt the requirements for financial assets in IFRS 9. Comparability seemed to be users' primary concern.

Staff analysis and recommendations

12. We do not support the suggestion that the changes to the FVO should be finalised as an amendment to IAS 39 rather than IFRS 9. We think it would be

counter-productive to make amendments to IAS 39 while it is in the process of being replaced.

13. We recommend that the Board confirm the proposals in the ED to permit early application, but if an entity elects to early adopt these amendments, it must also early adopt all of the finalised requirements in IFRS 9 that it does not already apply.

14. Consistent with the rationale set out in the ED's basis for conclusions, we think that if entities are allowed to adopt one phase early without also adopting early all of the preceding phases, there will be a period of significant incomparability. Moreover, that period of incomparability will be quite lengthy because IFRS 9 will not be mandatorily effective before 1 January 2013. The proposal in the ED minimises that incomparability because it reduces the number of possible combinations of which requirements can be adopted early and which cannot.

15. Almost all users of financial statements shared the Board's concern about incomparability.

16. While we acknowledge that the Board decided to have different measurement models for assets and liabilities, we disagree with the respondents who suggested that those requirements are wholly unrelated. The transition requirements for assets in IFRS 9 require an entity to re-consider the population of **liabilities** designated under the FVO when it initially applies IFRS 9, discussed further in the next section of this paper (see paragraphs 8.2.9 and BC105 of IFRS 9). Therefore, we think it would be inappropriate and confusing to allow an entity to apply these amendments to the FVO before it reconsiders the population of liabilities designated under the FVO, as required by IFRS 9.

Question 1 – Early adoption
Does the Board agree with the staff recommendation in paragraph 13 that (a) early adoption is permitted and (b) if an entity elects to apply these amendments early, the entity must at the same time apply all finalised requirements in IFRS 9 that it does not already apply? If not, what would you propose instead and why?

Transition

Background

17. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that retrospective application results in the most useful information to users. Consistent with IAS 8, the ED proposed retrospective application. That proposal is consistent with IFRS 9, which also requires retrospective application (subject to specific transition requirements in particular circumstances).

18. Since the Board did not change the underlying classification and measurement approach for financial liabilities, including retaining the existing eligibility conditions for the FVO for financial liabilities, the ED did not allow entities to make new designations or revoke its previous designations as a result of the proposals.

19. The Board's rationale is explained in further detail in paragraphs BC51-BC53 of the ED.

Feedback received

20. Almost all respondents agreed with retrospective application. However, many respondents believe that the Board should allow entities to reassess their FVO

designations upon initial adoption of the proposals in ED. They note that some entities likely will want to de-designate some liabilities currently under the FVO or newly designate liabilities that are not currently under the FVO in light of the changes related to changes in the effect of a liability's credit risk.

21. Some respondents noted that the ability to reassess their designation is especially important if the Board does not address the issue of mismatches (this issue was described in agenda paper 5A for the September 2010 board meeting and, at that meeting, the Board **did** address that issue (as discussed below)). That is because if the proposals would create a significant mismatch in profit or loss (P&L), an entity likely would prefer to measure the liability at amortised cost—rather than retain the FVO designation.

Staff analysis and recommendations

Retrospective application

22. We recommend that the Board confirm the proposal in the ED and require retrospective application. That is consistent with the requirements in IAS 8, IFRS 9 and the feedback received.

23. Furthermore, we recommend that the Board confirm the proposal that an entity is **not** permitted to reassess its FVO designations. As noted in paragraph BC51 of the ED, the Board is not changing the underlying classification and measurement model for financial liabilities, including the eligibility criteria for the FVO. Therefore we do not think there is a compelling reason to permit entities to reassess their elections.

24. As noted above, some respondents were concerned that the Board would not address concerns about potential mismatches in P&L. Those respondents urged the Board to permit them to de-designate their liabilities currently designated under the FVO (and, thus, measure those liabilities at amortised cost) to avoid mismatches in P&L. However, at the Board meeting in September, the Board addressed those concerns and tentatively decided that the effects of changes in

own credit risk would **not** be presented in other comprehensive income (OCI) if such treatment would create an accounting mismatch in P&L. Therefore, this concern has been addressed.

25. If the Board does not agree with the staff's recommendation in paragraph 23 and decides to permit entities to reassess their FVO designations, the Board will need to consider additional transition guidance. Appendix A contains our suggestions and additional questions to the Board. We strongly discourage allowing reassessment, as this will add significant complexity to transition requirements with no associated improvement in financial reporting information. (Some board members may remember the transition requirements related to the 2005 amendments to the FVO – which were significantly longer and more complex than the actual amendment itself!)

26. One final note. As we mentioned above in paragraph 16, when an entity initially applies IFRS 9 to its assets, it is required to reassess particular liabilities designated under the FVO. That was necessary because IFRS 9 introduced a new classification and measurement approach for financial assets, which would change the classification of some (and perhaps many) financial assets. Changes to the classification of an entity's assets require an entity to reassess liabilities designated under the FVO to the extent that the FVO designation was originally elected to address an accounting mismatch—ie an accounting mismatch may no longer exist (or a new mismatch may have been created) as a result of the new classification and measurement approach for assets (see paragraph BC105 in IFRS 9).

27. However, we do not think a similar case can be made for these amendments to IFRS 9 because the underlying classification and measurement approach for liabilities has not changed. And, since IFRS 9 already requires reassessment of particular liabilities when an entity applies the new requirements to its assets, we think that permitting a second re-assessment upon adoption of these amendments would make transition unnecessarily complex, with no associated improvement in financial reporting information.

Question 2 – Retrospective application
Does the Board agree with the staff recommendation in paragraphs 22 and 23 that: (a) retrospective application is required and (b) an entity is not permitted to make new FVO designations or revoke its previous FVO designations when it applies these amendments? If not, what would you propose instead and why?

Other transition issues

28. The remaining paragraphs address associated transition requirements that the Board needs to consider. As we noted at the beginning of the paper, our objective was to maintain as much consistency as possible between the transition requirements in the forthcoming amendments and the existing transition requirements in IFRS 9 for assets.

29. The remainder of the paper addresses these issues:

    (a) Upon initial application of the forthcoming amendments, how should an entity assess whether presenting the effects of changes in own credit risk in OCI would create an accounting mismatch?

    (b) What should the ‘date of initial application’ be for these amendments?

    (c) Should the amendments be applied to liabilities that have been derecognised prior to the date of initial application of the amendments?

    (d) Is an entity required to restate prior periods (including interim financial reports)?

30. In addition, some of the transition requirements in this paper are relevant to first-time adopters and will be reflected in the consequential amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards.*

Determination of mismatches in P&L

31. The Board tentatively decided at the September board meeting that when an entity initially designates a liability under the FVO, the entity is required to determine whether an accounting mismatch would be created in P&L if the effects of changes in the liability's credit risk are presented in OCI. This determination will dictate whether the effects of changes in own credit risk are presented in P&L or OCI.

32. The Board did not discuss how an entity should make that determination at the date of initial application for existing liabilities designated under the FVO—ie whether the determination should be made on the basis of the facts and circumstances that existed when the liability was initially recognised (and designated under the FVO) or on the basis of the facts and circumstances that exist at the date of initial application.

33. We recommend that the Board require entities to make this determination on the basis of the facts and circumstances that exist at the date of initial application. (The 'date of initial application' for these amendments is discussed in further detail below.)

34. In almost all cases, we think the entity's conclusion will be the same regardless of how it makes the determination. Therefore we do not think there are significant benefits of requiring an entity to go back to historical data to make the determination. Moreover, basing such a determination on the facts and circumstances that exist at the date of initial application is consistent with the Board's transition requirements in IFRS 9 related to the FVO (ie designations are based on **current** facts and circumstances).

Question 3 – Determination of whether a mismatch would be created in P&L
Does the Board agree with the staff recommendation in paragraph 33 that an entity is required to make a determination as to whether a mismatch would be created in P&L on the basis of the facts and circumstances that exist at the date of initial application of the amendments? If not, what would you propose instead and why?

Date of initial application

35. If an entity adopts all phases of IFRS 9 on the mandatory effective date, all phases will have the same date of initial application. However, as a result of the phased approach to completing IFRS 9, if an entity chooses to early adopt some or all of the phases, each phase or some phases are likely to have a different date of initial application.

36. IFRS 9, paragraph 8.2.2 sets out the requirements for how an entity determines the 'date of initial application' if it early adopts IFRS 9. The guidance indicates that the 'date of initial application may be:

    (a) any date between the issue of this IFRS and 31 December 2010, for entities initially applying this IFRS before 1 January 2011; or

    (b) the beginning of the first reporting period in which the entity adopts this IFRS, for entities initially applying this IFRS on or after 1 January 2011'.

37. We have received questions about how to apply that paragraph—in fact, we have received more questions about that paragraph than any other transition requirement in IFRS 9. Therefore, we do not want to increase the complexity related to that transition guidance as a result of these amendments. Rather, our objective is to maintain as much consistency as possible between the transition for financial assets and the transition for financial liabilities. Therefore, we recommend that the finalised guidance for financial liabilities should use similar language as exists in IFRS 9.

38. That means that:

    (a) if an entity applies the amendments before 1 January 2011, the date of initial application can be any date between the issue of the amendments and 31 December 2010; and

    (b) if the entity applies the amendments on or after 1 January 2011, the date of initial application is the beginning of the first reporting period in which the entity adopts the amendments.

39. Paragraph 38 means that if an entity has already adopted IFRS 9, it will have a different date of initial application for the forthcoming amendments related to liabilities designated under the FVO. Furthermore, an entity is permitted to early adopt the requirements in IFRS 9 related to assets **without** early adopting the forthcoming amendments. That is true even after the forthcoming amendments have been finalised. Therefore, an entity may have two different dates of initial application **even if** it has not yet early adopted the requirements for assets, but chooses to adopt those requirements **before** adopting the amendments for liabilities designated under the FVO. We think these scenarios are unavoidable.

Question 4 – Date of initial application
Does the Board agree with the requirements outlined in paragraph 38 related to the date of initial application? If not, what would you prefer instead and why?

Items derecognised prior to the date of initial application

40. Paragraph 8.2.1 of IFRS 9 states that the requirements **shall not** be applied to financial assets that have been derecognised as of the date of initial application. This requirement responded to concerns from preparers that it would be very difficult to apply the requirements to derecognised assets. [Some preparers have since told us that they would have preferred that the Board made that sentence optional rather than mandatory—ie entities would be permitted to apply the requirements to derecognised assets, but not required to do so. However, the

Board explicitly decided that the sentence should be mandatory because optionality would create significant incomparability both within a single entity and among different entities.]

41. Consistent with the requirement in paragraph 8.2.1, we recommend that the forthcoming amendments are not applied to derecognised liabilities. As mentioned in paragraphs 16 and 26 of this paper, when an entity initially applies IFRS 9 to its assets, it is required to reassess particular liabilities designated under the FVO. However, that requirement is not applied to derecognised liabilities. Therefore it seems consistent that the forthcoming amendments should also not apply to those derecognised liabilities.

42. Moreover, at least one preparer noted in its comment letter that it does not track the effects of changes in own credit risk related to derecognised liabilities; therefore applying these amendments to such liabilities would be difficult. Finally, as the Board has discussed previously, if an entity holds the liability until maturity and repays the contractual amount, the cumulative effects of changes in own credit risk net to zero. Therefore, in many cases, applying the amendments to derecognised liabilities will have no effect on opening retained earnings or equity at the date of initial application.

Question 5 – Derecognised liabilities
Does the Board agree with the staff recommendation in paragraph 41 that the amendments shall not be applied to derecognised liabilities? If not, what would you propose instead and why?

Restatement of comparative financial statements

43. If an entity elects to adopt IFRS 9 before 1 January 2012, the entity is not required to restate prior periods (paragraph 8.2.12). That decision is discussed in paragraphs BC106 and BC107 of IFRS 9.

44. Consistent with that transition relief, we recommend that an entity is not required to restate prior periods if it elects to adopt the amendments for financial liabilities designated under the FVO before 1 January 2012.

45. As noted several times in this paper, when an entity initially applies IFRS 9 to its assets, it is required to reassess particular liabilities designated under the FVO. Therefore, the population of liabilities designated under the FVO could change. However, if the entity elects not to restate comparative periods when it initially applies IFRS 9, that 'change in population' will not be reflected in prior periods. Therefore, it seems illogical to require an entity to restate for the forthcoming amendments for financial liabilities designated under the FVO because, in some cases, the entity would apply the amendments to the wrong population of liabilities in comparative periods. That is, misleading rather than any useful information would be provided.

46. However, consistent with our rationale in paragraph 45, if an entity elects to restate comparative to reflect the amendments for financial liabilities designated under the FVO, it should also be required to restate its comparatives to reflect the new requirements for assets. That is, the restated periods must also reflect all preceding requirements.

Interim financial reports

47. If an entity prepares interim financial reports in accordance with IAS 34 *Interim Financial Reporting*, the entity need not apply the requirements in IFRS 9 to interim periods prior to the date of initial application if it is impracticable (paragraph 8.2.13). IAS 8 defines the term 'impracticable' and provides separate criteria if this condition is met.

48. We think that guidance is equally relevant to the forthcoming amendments.

Question 6– Restatement of comparative periods
Does the Board agree with the staff recommendation in paragraphs 44, 46 and 48: (a) An entity is not required to restate prior periods if it applies the amendments before 1 January 2012. However if the entity restates prior periods to reflect the amendments to financial liabilities designated under the FVO, those restated periods must also reflect the requirements in IFRS 9 that were finalised before these amendments. (b) If an entity prepares interim financial reports in accordance with IAS 34, the entity need not apply the amendments to interim periods prior to the date of initial application if it is impracticable? If not, what would you propose instead and why?

Appendix A – transition provisions if the Board's disagrees with the staff recommendation in paragraph 23 (Question 2)

1. This appendix contains suggested transition guidance if the Board decides to permit entities to make new designations or revoke its previous FVO designations when it applies these amendments. Therefore, this appendix is only relevant if the Board disagrees with the staff recommendation in Question 2(b).

2. If the Board decides to permit reassessment of FVO designations upon initial application of the amendments, it will have to provide re-classification guidance for four different scenarios. The first two scenarios apply when the entity had **not** previously designated a liability under the FVO but now elects to do so. The other two scenarios apply when the entity **had** previously designated a liability under the FVO but now elects to revoke that designation. The four scenarios are:

   (a) the liability had been bifurcated but will now be measured at fair value,

   (b) the liability had been measured at amortised cost but will now be measured at fair value,

   (c) the liability had been measured at fair value but will now be measured at amortised cost and

   (d) the liability had been measured at fair value but will now be bifurcated.

3. For scenarios (a)-(c), there is transition guidance in IFRS 9 that is applicable:

   (a) **Bifurcation to fair value**—Paragraphs 8.2.5 and 8.2.6 of IFRS 9 are applicable. If the fair value of the hybrid contract had not been determined previously, the fair value for comparative reporting periods shall be the fair values of the components (ie the non-derivative host and the embedded derivative) at the end of each reporting period. At the date of initial application of the amendments, any difference between the fair value of the entire hybrid contract and the fair value of the components shall be reported in opening retained earnings or P&L

(depending on whether the amendments were initially applied at the beginning of a reporting period or during a reporting period).

(b) **Amortised cost to fair value** – This scenario occurs in IFRS 9 if an item was measured at amortised cost under IAS 39 but IFRS 9 changes that classification. Paragraph 25 of IFRS 7 requires an entity to disclose the fair values of liabilities measured at amortised cost. Therefore, sufficient information is available for reclassification in this scenario.

(c) **Fair value to amortised cost** —Paragraph 8.2.10 of IFRS 9 is applicable. If it is impracticable (as defined in IAS 8) to retrospectively apply the effective interest method in IAS 39, the entity shall treat the fair value of the instrument at the end of each comparative reporting period as its amortised cost. The fair value at the date of initial application of the amendments shall be treated as the new amortised cost.

4. IFRS 9 does not address the fourth possible scenario (fair value to bifurcation). Because the combined instrument had been measured at fair value in its entirety in prior periods, entities likely will not have historical fair value information for the embedded derivative on a standalone basis. Therefore, entities may not be able to apply this scenario retrospectively.

5. In that case, the entity would apply the bifurcation requirements on the date of initial application of these amendments (ie the fair value of the combined instrument at initial application would be treated as its initial measurement as if the liability was newly acquired.)

Question A1 – Re-designation
Does the Board agree with the transition guidance set out in this appendix? If not, what would you propose instead and why?