Project **Fair value option for financial liabilities**

Topic **Recycling amounts from OCI to P&L**

Background and purpose of this paper

1. As noted in the cover paper for this session, the Board has tentatively decided that for all liabilities designated under the fair value option (FVO), the effects of changes in a liability's credit risk will be required to be presented in other comprehensive income (OCI) unless such treatment would create a mismatch in profit or loss (P&L). If such a mismatch would be created, the entire fair value change would be required to be presented in P&L. **This paper is only relevant to those scenarios where the effects of changes in a liability's credit risk are presented in OCI.**

2. The exposure draft *Fair Value Option for Financial Liabilities* (ED) proposed to prohibit reclassifying amounts from OCI to P&L ('recycling'). In the ED, the Board noted that if the entity repays the contractual amount, there would be no amounts to recycle because the cumulative effect of any change in the liability's credit risk will net to zero.

3. But if the entity repays an amount other than the contractual amount (eg if the entity settles the liability prior to maturity at its then fair value) there could be amounts in accumulated other comprehensive income, which would be realized when the liability is derecognized. Under the proposals in the ED, those amounts would **not** be recycled. But to provide users with information about how much of the accumulated other comprehensive income balance has been realized in the current reporting period, the ED proposed amendments to IFRS 7 *Financial Instruments: Disclosures* that would require disclosure of that amount.

4. The Board's rationale for these proposals is described in paragraph BC37-BC39 of the ED. Most notably, the Board noted that gains or losses should be recognized once only. Therefore, recognizing a gain or loss in OCI and subsequently reclassifying it to P&L is inappropriate.

5. Question 7 in the ED asked respondents for their views on this proposal.

6. This paper asks the Board whether it wants to confirm its proposal to prohibit recycling from OCI to P&L.

Feedback received

7. Many respondents disagreed with the proposal in the ED. They acknowledged that there would not be any amounts to recycle if the entity repays the contractual amount. However, they believe that if the entity repays an amount other than the contractual amount, the realized amounts in OCI should be recycled to P&L. These respondents view OCI as a 'temporary holding place' for unrealized gains or losses. They believe that realized and unrealized amounts are fundamentally different and, thus, should **not** be treated the same. The former have been crystallized and thus are backed by cash flows. The latter are still fluctuating and may never be crystallized.

8. Some of the respondents who supported recycling noted that it would be consistent with the guidance for liabilities measured at amortized cost, which requires all realized gains and losses to be presented in P&L. Some of those respondents noted that if the Board prohibits recycling, an entity might be encouraged to 'cherry pick' which liability to extinguish (ie a liability measured at amortized cost or a liability designated under the FVO) on the basis of the differing effects on P&L. They also noted that if the entity holds the liability until maturity and repays the contractual amount, the cumulative effect of any changes in the liability's credit risk would net to zero and, therefore, there would be no amounts left in accumulated OCI attributable to changes in the liability's credit risk. They think the same result should occur for liabilities settled at an

amount other than the contractual amount—ie there should no amounts left in accumulated OCI after the liability has been derecognized.

9. However, some respondents agreed with the Board's proposal to prohibit recycling, especially if the proposal for a single statement of financial performance with two sections (P&L and items of OCI) is finalized. These respondents agree that a gain or loss should only be recognized once and point out that recycling is a confusing notion.

10. Others noted that the Board should develop a principle for the use of OCI, including when amounts should be recycled. They note that without such guidance, any decision is arbitrary.

Staff analysis and recommendation

11. As noted above, without a clear principle for determining when amounts should be recycled from OCI to P&L, this is a difficult issue to analyze. However, we note the following items:

    (a) Most users of financial statements have told the Board that all realized amounts should be presented in P&L. Those users have said that the effects of changes in own credit risk should be included in P&L if the entity buys back its own debt and the amounts are crystallized (ie backed by cash flows). Users have said that the effects of changes in own credit risk should **not** affect P&L if those amounts are **not** realized (ie if the liability will be repaid on the basis of its contractual terms).

    (b) The Board's proposal in the ED is the same as its decision in IFRS 9 for investments in equity instruments that are measured at fair value through OCI (ie the amounts presented in OCI are never recycled). However, we think that the Board's rationale for using OCI in those two scenarios is different—and different rationales for using OCI could support different conclusions on recycling.

(i) As noted in paragraph BC83 of IFRS 9, the Board decided that presenting fair value gains and losses in P&L for some equity investments may not be indicative of the performance of the entity, particularly if the entity holds those equity instruments for non-contractual benefits rather than for increases in the value of the instrument.

(ii) As noted in paragraph BC7 of the ED, the primary message that the Board received from its outreach activities was that presenting the effects of changes in own credit risk in P&L does not provide useful information because the entity generally will not be able to realize those amounts.

12. We think the rationales in (i) and (ii) are different – and therefore it is understandable to reach different conclusions on recycling. Specifically, we agree that amounts in (i) should never be recognized in P&L because, in those cases, fair value gains and losses are not indicative of the entity's performance given the basis on which the Board decided to permit this presentation. However, if the rationale for presenting the amounts in (ii) in OCI is because those amounts likely are **not** going to be realized, we think those amounts **should** be presented in P&L if they **are** indeed realized.

13. For the reasons outlined in paragraph 11, we recommend that the Board require recycling if a liability is derecognized and the effects of changes in own credit risk are realized.

14. However, if the Board decides to prohibit recycling amounts from OCI to P&L, we recommend that the Board confirm the disclosure proposed in the ED – ie an entity would be required to disclose how much of the accumulated OCI balance (attributable to changes in own credit risk) was realized during the current reporting period. As noted earlier in this paper, users have told us that they think this information is useful.

Question 1
Does the Board agree with our recommendation to require recycling if a liability is derecognized and the effects of changes in own credit risk are realized? If not, when should recycling be required and why?

Question 2
If the Board decides to prohibit recycling, does it want to confirm its proposal to require entities to **disclose** how much of the accumulated other comprehensive income balance (attributable to changes in own credit risk) has been realized in the current reporting period? If not, what does the Board want to do instead and why?