Project	**Fair value option for financial liabilities**
Topic	**One-step vs. two-step approach**

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* (the ED) proposed that the effects of changes in a liability's credit risk be presented in the performance statement via a two-step approach. In the first step, the entity would present the entire fair value change in P&L. In the second step, the entity would 'back out' from P&L the portion of the fair value change that is attributable to changes in the liability's credit risk and present that amount in OCI.

3. The ED suggested an alternate one-step approach whereby the entity would present the portion of the fair value change that is attributable to changes in the liability's credit risk directly in OCI. All other portions of the fair value change would be presented in P&L.

4. The ED notes that both approaches have the same net effect on P&L and OCI. The only difference between the two approaches is how the change in the

liability's credit risk is presented in the performance statement. As noted above, the two-step approach would present those amounts first in P&L and then transfer them to OCI, whereas the one-step approach would present them directly in OCI.

5. The Board's rationale for its decision is explained in paragraphs BC23-BC32 of the ED. Primarily, the Board thought that the two-step approach would clearly present all of the relevant information in the primary financial statements—and would be useful for users of financial statements.

6. This paper asks the Board whether it wants to confirm the proposal in the ED to require the two-step approach.

Relevant questions in the ED

7. Questions 4 and 5, reproduced below, asked respondents whether they preferred a one-step or two-step approach to present the effects of changes in a liability's credit risk in the performance statement.

> **Question 4** – Do you agree that the two-step approach provides useful information to users of financial statements? If not, what would you propose instead and why?
>
> **Question 5** – Do you believe that the one-step approach is preferable to the two-step approach? If so, why?

Feedback received

8. Most of the respondents preferred the one-step approach. They pointed out that the one-step approach provides users with the same information as the two-step approach but is less complicated and more efficient (ie it requires fewer line items in the performance statement).

9. Those respondents said that the two-step approach is inappropriate because it introduces a new presentation method — ie a new interaction between P&L and OCI that requires an entity to present the entire fair value change in P&L and then subsequently to 'back out' from P&L the portion attributable to changes in

credit risk. They said that there is little (if any) added benefit of the 'gross' presentation in the two-step approach and the extra line items on the face of the performance statement result in unnecessary 'clutter'.

10. Some respondents also noted that the ED proposed that changes in a liability's credit risk should not affect P&L, therefore it would be inappropriate to present that amount in P&L (even though it has no ultimate effect on P&L because it is subsequently 'backed out'). Finally, some of the respondents who preferred the one-step approach pointed out that the two-step approach becomes increasingly unnecessary if the Board finalises the current proposal to present a single statement of financial performance with two sections (profit or loss and items of other comprehensive income) because the one-step approach would present all of the relevant information on that statement.

11. However, some respondents preferred the two-step approach. Those respondents said that it provides users with clearer information and enables a straight-forward reconciliation between the statement of financial position and the statement of financial performance.

12. Most users indicated that the two-step approach would **not** be more helpful to their analysis than the one-step approach. In general, users thought that presenting the entire change in P&L and then backing out the effects of changes in liabilities' credit risk would be too complicated and result in too much information on the face of the performance statement. Additionally, some users responded that changes in the liabilities' credit risk should have nothing to do with P&L. However, a few users noted a preference for the two-step method because it provides more information.

Staff analysis and recommendation

13. We recommend that the effects of changes in a liability's credit risk be presented in OCI via a **one-step approach**.

14. The two-step approach was proposed because the Board thought that approach would provide better and more complete information to users. However, feedback from the comment letters, the user questionnaire and other outreach activities did not support that view.

15. Instead, respondents (including users) preferred the one-step approach and noted that it has the following advantages:

    (a) creates less 'clutter' (fewer line items) on the performance statement;

    (b) does not present the effects of changes in a liability's credit risk in P&L, which has been a consistent message to the Board – that the effects of changes in a liability's credit risk should not affect P&L; and

    (c) does not introduce a new presentation method (ie whereby an amount is presented and then backed out).

16. Furthermore, respondents noted that no information is lost by using the one-step approach – ie the one-step approach provides the same information to users and has the same net effect on P&L and OCI.

Question 1 – One-step approach
Does the Board agree with the staff recommendation in paragraph 13 that the effects of changes in a liability's credit risk be presented in OCI via a **one-step approach**? If not, what would you want to do instead and why?