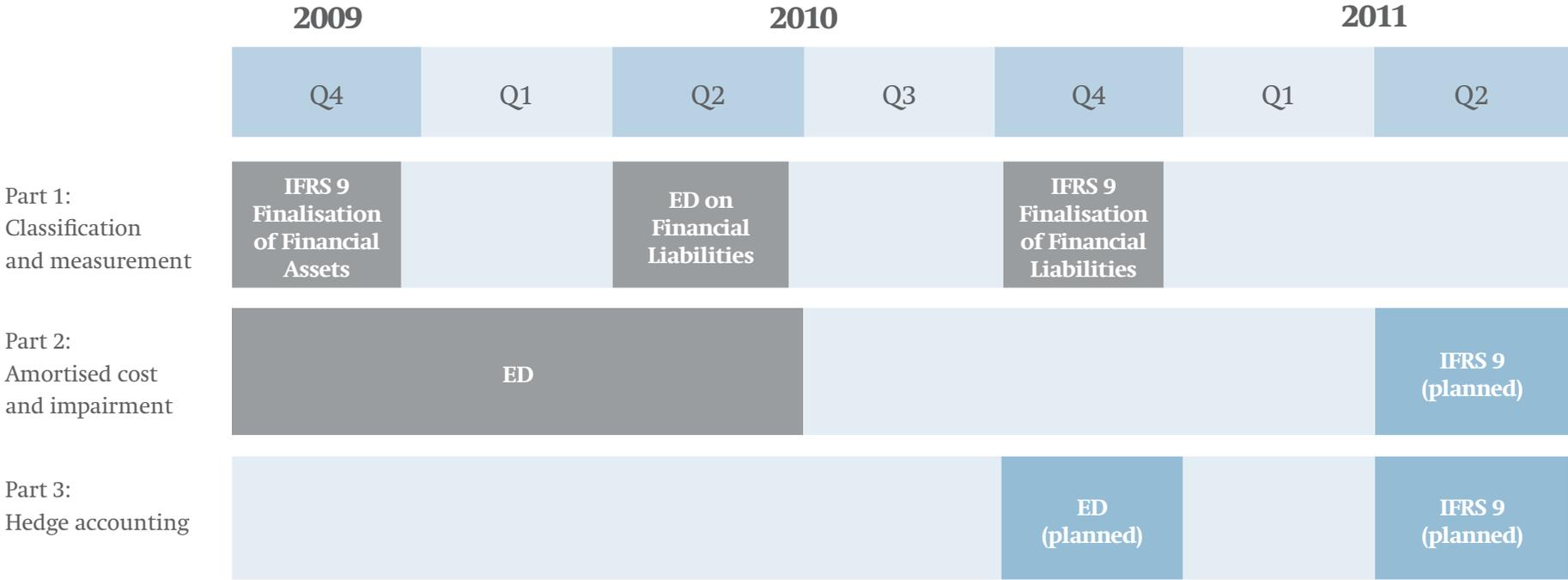


Financial Liabilities

Time line



At a glance

Responding to requests from the G20 and others to address urgent issues whilst also undertaking a comprehensive overhaul of the accounting for financial instruments we, the International Accounting Standards Board (IASB), have been publishing IFRS 9 *Financial Instruments* in phases.

In October 2010 we added requirements to IFRS 9 on the classification and measurement of financial liabilities.

When we issued IFRS 9 in November 2009, the new standard prescribed the classification and measurement of financial assets. These additions to IFRS 9 in October 2010 complete the classification and measurement phase of our project to replace IAS 39 *Financial Instruments: Recognition and Measurement*.

In July 2009 we published an exposure draft that proposed a symmetrical model for financial assets and financial liabilities. The feedback we received in response to that proposal was that the accounting requirements for financial liabilities in IAS 39 had worked well. Most respondents did not think that a fundamental change was needed to the accounting for financial liabilities. The only issue that we were told needed urgent attention was the volatility in net income (P&L) caused by changes in the credit risk of financial liabilities that an entity has elected to measure at fair value. Of particular concern to respondents was that an entity would recognise a gain on its liabilities it chooses to measure at fair value when its own creditworthiness ('own credit') deteriorates, and vice versa. Many investors and others found this result counter-intuitive and confusing. We decided that it would be better to publish IFRS 9 initially to address only the accounting for financial assets and to take more time to determine how to deal with own credit.

The requirements for the accounting for financial liabilities that have now been included in IFRS 9 address the own credit problem. The new requirements eliminate P&L volatility arising from own credit.

The new requirements apply to financial statements beginning on or after 1 January 2013. Entities are allowed to apply the new requirements in earlier periods but, if they do, they must also apply the requirements in IFRS 9 that relate to financial assets.

The additions to IFRS 9 carry forward the option in IAS 39 that permits entities to elect to measure financial liabilities at fair value through P&L provided that particular criteria are met. For example, an entity can choose to measure a structured financial liability at fair value in its entirety rather being required to account for its component parts. This is referred to as the fair value option (FVO).

The circumstances when the FVO is available for liabilities have not been changed in IFRS 9. However, whereas IAS 39 required the portion of the change in the fair value of a liability under the FVO that is due to own credit (the 'own credit amount') to be recognised in P&L, IFRS 9 requires (with one exception, which is set out below) this change to be presented in other comprehensive income (OCI).

At the same time as expanding the scope of IFRS 9 to cover the classification and measurement of financial liabilities we have also moved the derecognition requirements from IAS 39 across to IFRS 9. Those derecognition requirements have not been changed. Earlier in October 2010, as a separate project, we amended IFRS 7 *Financial Instruments: Disclosures* to improve the disclosure associated with derecognition transactions.*

The second and third phases of the project to replace IAS 39 address the accounting for the impairment of financial assets and hedge accounting. We aim to complete these two phases by 30 June 2011. Once this has been done IAS 39 will have been replaced in its entirety.

* Further information about the new disclosure requirements can be found in the Feedback Statement *Transfers of Financial Assets*.

Summary of main changes from the exposure draft

The exposure draft *Fair Value Option for Financial Liabilities* proposed that the own credit amount for financial liabilities an entity chooses to measure at fair value would ultimately be presented in OCI. However, the exposure draft proposed that this would occur through a two-step approach which required the own credit amount to be shown first in P&L and then, as a second step, as a transfer to OCI. IFRS 9 requires the own credit amount to be presented directly in OCI.

IFRS 9 includes one exception to the requirements for own credit amounts. That exception relates to those circumstances where recognising the own credit amount directly in OCI would create an accounting mismatch. That determination must be made when the financial liability is first recognised and is irrevocable. In such cases IFRS 9 requires the entire fair value change (including the own credit amount) to be recognised in P&L rather than in OCI.

IFRS 9 provides application guidance in addition to that proposed in the exposure draft. This guidance explains what components of the changes in the fair value of a liability under the FVO are considered to relate to own credit and clarifies how to measure the own credit amount.

IFRS 9 requires all derivatives that are liabilities to be measured at fair value through P&L, including those that are physically settled by the delivery of an unquoted equity instrument.

In all other respects the accounting requirements for financial liabilities are unchanged from the requirements in IAS 39. So, except for financial liabilities that are held for trading, financial liabilities continue to be measured at amortised cost or split into a derivative component (measured at fair value) and an amortised cost component unless an entity chooses to measure a liability at fair value.

Our consultation process

We undertook extensive outreach activities as part of the development of the exposure draft and in finalising the proposals on how to deal with own credit. This was a continuation of the outreach activities that we undertook in issuing IFRS 9.

Our work on own credit started well before the exposure draft *Fair Value Option for Financial Liabilities* was published. In June 2009 our staff prepared a discussion paper *Credit Risk in Liability Measurement*. The feedback we received on that document confirmed that most respondents believed that it was inappropriate for P&L volatility to arise as a result of the effect on the fair value of financial liabilities caused by changes in an entity's credit risk. In particular, respondents thought it inappropriate that gains on financial liabilities should be recognised in P&L when an entity's creditworthiness deteriorated. However, respondents did not provide much feedback about how to address this problem.

In July 2009 we published an exposure draft proposing a symmetrical model for the classification and measurement of financial assets and financial liabilities, and did not propose a solution to address the own credit problem. We received 245 comment letters in response to that document. Many respondents repeated their request that we deal with the own credit problem.

Responding to this feedback we decided not to address the accounting for financial liabilities when we published IFRS 9 in November 2009. However, we undertook to deal with the own credit problem in the near term and to get additional feedback and information to enable us to develop the best solution.

We undertook a significant amount of outreach both before and after publishing the exposure draft *Fair Value Option for Financial Liabilities* to determine the best approach to deal with the own credit problem. We discussed a number of alternative approaches with interested parties.

In particular, we spent time with preparers who already calculated the own credit amount to meet the disclosure requirements in IFRS 7 to help us understand the practical issues in calculating those amounts. We also drew on the expertise of, and met, our Financial Instruments Working Group and representatives of international accounting firms. We spoke to prudential regulators to understand how they deal with own credit amounts for regulatory purposes and to get their views on the alternative solutions we had identified.

We also spent a significant amount of time with users of financial statements to determine how best to address the issue of inappropriate P&L volatility while still providing decision useful information. In order to reach a broad range of users we supplemented our meetings with a survey about own credit that was targeted at the users of financial statements.

Based on the information we decided that the best way to deal with own credit was to maintain the current accounting for financial liabilities contained in IAS 39—and in particular to maintain bifurcation for financial liabilities. This meant that financial liabilities, other than those held for trading or those an entity chose to measure at fair value, would be measured at amortised cost or split into a derivative component measured at fair value and a component measured at amortised cost.

Our project team staff and some Board members held webcasts about the exposure draft proposing the solution to the own credit problem.

We received over 130 comment letters on our proposals for the treatment of own credit. We analysed these comment letters and used those comments along with the feedback from our outreach activities as the basis for reconsidering the exposure draft. We considered the responses we received during July to October 2010 at a series of regular and additional public meetings of the Board.

Feedback Statement

We received broad support from users of financial statements and others for our proposals to remove the effect of own credit from P&L.

Most respondents supported the overall proposal that the own credit amount should not affect P&L but instead should be presented in OCI. However, there was some disagreement with details of the exposure draft such as the Board's proposal to adopt the 'two-step' approach and the proposal that own credit amounts should not be recycled from OCI to P&L even when a liability is derecognised.

The final requirements reflect many of the suggestions made to us during the consultation process.

In the pages that follow we outline the more significant matters raised with us and how we responded.

The two-step approach

The proposal required the portion of the change in the fair value of liabilities measured at fair value under the FVO that is due to own credit (the 'own credit amount') to be removed from P&L.

It was proposed that this would be achieved using a two-step approach as follows:

- the entire fair value change of liabilities under the FVO would be presented in P&L;
- the portion of the fair value change due to own credit would be reversed out of P&L and transferred to, and presented in, OCI.

We proposed the two-step approach with the objective of giving more information to the users of financial statements.

Respondents' comments

While most respondents supported the proposal that the own credit amount should be presented in OCI rather than in P&L most, including users of financial statements, did not support the proposed two-step approach. They believed that it was an unnecessary extra step that increased presentation complexity and that while the information was elevated they did not think it provided extra information content. They also thought that it introduced a new form of recycling between P&L and OCI, without having had a broader discussion of the role of OCI.

Our response

In line with the views of most respondents, we agreed that there was insufficient incremental benefit obtained from the proposed two-step approach and we decided that the own credit amount should be presented directly in OCI rather than first being presented in P&L. By presenting the own credit amount directly in OCI the primary concern that own credit effects on P&L can result in information that is not decision useful is addressed. Own credit information is still useful for the users of financial statements but we decided that this information was sufficiently transparent through its presentation directly in OCI.

The following illustrates the presentation of the own credit amount as required by IFRS 9.

Requirement in IFRS 9	
Income Statement (P&L)	
Liabilities at FV (except derivatives and liabilities HFT)	
Change in fair value less own credit	90
Other Comprehensive Income	
Liabilities at FV (except derivatives and liabilities HFT)	
Change in fair value from own credit	10

Accounting mismatches

We proposed that for all liabilities measured at fair value under the FVO, the own credit amount should be required to be presented in OCI.

However, we were concerned that there would be cases where this requirement could create an *accounting* mismatch.

Our concern was that a relationship between an asset measured at fair value and an associated liability might be obscured by requiring a portion of the change in the fair value of the liability to be recognised directly in OCI while the entire change in the fair value of the associated asset is recognised in P&L.

We asked for information about such potential mismatches in the exposure draft.*

* Our concern was not about measurement mismatches that might arise because the default method of measuring the own credit amount in IFRS 7 captures effects other than just changes in the own credit amount of the liability being measured (see below).

Respondents' comments

Respondents stated that such *accounting* mismatches are rare. The examples identified by respondents were very limited and specific to particular jurisdictions. However, in the cases that were brought to our attention the effect on particular reporting entities could be material and would result in information being produced that would not be decision useful.

Our response

We were concerned that in those limited circumstances where an *accounting* mismatch arises, requiring the own credit amount to be presented in OCI would make the information less decision-useful.

We have therefore required that the full change in the fair value of financial liabilities an entity elects to measure under the FVO must be recognised in P&L if excluding the own credit amount from P&L would create or enlarge an accounting mismatch. To make this consistent with the FVO itself, this assessment must be made on initial recognition of the financial liability and is irrevocable.

A reporting entity that recognises the full change in fair value of a financial liability under the FVO is required to disclose its basis for determining why recognising the own credit amount in OCI would have created an *accounting* mismatch. They are also required to disclose the own credit amount in the notes to the financial statements.

Recycling of own credit amounts to P&L

We proposed that own credit amounts presented in OCI should not be transferred from OCI to P&L ('recycled') when the liability is settled or extinguished.

We proposed that entities should be required to disclose information about the own credit amounts that relate to financial liabilities that have been repaid during the current reporting period, for an amount different from the contractual amount due.

Respondents' comments

Some respondents disagreed with the proposal not to allow recycling. Respondents generally thought that it was only the effect of unrealised changes in the fair value of financial liabilities due to changes in own credit that should be excluded from P&L, although most respondents noted that realised amounts attributable to own credit would normally be insignificant. Also, some respondents observed that by preventing recycling an entity would get a different P&L effect if it bought back a financial liability for an amount other than its contractual amount depending on whether that liability is measured at amortised cost or at fair value under the FVO.

Our response

Having considered the various arguments presented we decided to retain the prohibition on recycling of own credit amounts from OCI to P&L. The FVO does not apply to financial liabilities that are held for trading. Most financial liabilities under the FVO are therefore expected to be held to maturity and to be repaid at their contractual amounts. In this case, the own credit amount in OCI would be zero at the time that the liability matures and the issue of recycling does not arise. In the rare cases when the liability is repaid for an amount other than the contractual amount users of the financial statements would be able to obtain information about the realisation of those amounts through the required disclosure of own credit amounts in OCI that relate to financial liabilities that have been derecognised.

We also noted that many respondents to these, and other, proposals have urged us to clarify the role of OCI and the principles behind recycling in IFRSs. We agree that we need to devote time to addressing this important issue, which affects financial reporting generally, and we believe that it would be inappropriate to apply recycling more broadly until that work has been undertaken satisfactorily.

Alternatives to fair value

We proposed that when an entity has chosen to measure a liability under the FVO it should be measured at fair value, as is required by IAS 39.

When we considered the comments we received about the proposals in the exposure draft that preceded IFRS 9 in July 2009 we considered ways to exclude the own credit amount from P&L. One approach was to measure these liabilities each period to take into account all changes in fair value except those related to the change in the credit spread of the liability being measured. We called this the ‘frozen credit spread’ approach.

However, during our outreach we learnt that most constituents, including almost all users of financial statements, did not want us to introduce a new measurement attribute for financial liabilities.

While most respondents thought it was inappropriate for own credit amounts to be presented in P&L they still wanted those liabilities to be measured at fair value if an entity had elected to use the FVO.

On the basis of that feedback we proposed that financial liabilities measured under the FVO should continue to be reported at fair value.

Respondents’ comments

Most respondents agreed that if an entity has chosen to measure a financial liability at fair value all changes in fair value, including the own credit component, should be accounted for. However, some respondents expressed a preference for the frozen credit spread approach as they felt that it was inappropriate to recognise the own credit amount at all. Those respondents were concerned about the potential volatility in OCI that could arise under the approach we proposed and questioned the usefulness of this information.

Our response

We confirmed that if an entity chooses to measure a financial liability at fair value under the FVO it should continue to measure and report those financial liabilities in the balance sheet at fair value. We understand the concerns raised about introducing a new measurement attribute for financial liabilities. Also, while users of financial statements generally considered it inappropriate to have P&L volatility arising due to own credit amounts, almost all users confirmed to us that own credit information is still useful and should be included in the primary financial statements. Given the importance of this information we decided that the own credit amount should be included in the primary financial statements rather than simply being retained as a note disclosure as was previously the case.

Measuring the own credit amount

IFRS 7 already requires disclosure of the own credit amount in the notes to the financial statements, for those who choose to measure financial liabilities at fair value. IFRS 7 sets out a method for calculating the own credit amount (the 'default method') but also allows preparers to use a different method if that more faithfully estimates the own credit amount.

Before we issued the proposals we discussed with preparers the calculations they currently use to comply with this requirement in IFRS 7. We were told that the own credit calculation can be complex and that it is helpful that IFRS 7 provides the default method, while giving preparers the flexibility to select the method that achieves a more accurate measurement. We were given a strong message that it would not be appropriate to introduce more prescriptive measurement requirements.

As a result of this feedback the exposure draft proposed that the definition of credit risk used to determine the own credit amount in IFRS 7 should be retained and that the guidance on measurement should be retained and not be changed.

Respondents' comments

While most respondents agreed with this proposed approach a number commented that because the own credit information would now affect the primary financial statements rather than be just a note disclosure, additional guidance should be provided.

However, almost all users of financial statements agreed that a more prescriptive approach to the measurement of own credit would not result in improved or more comparable information.

A number of respondents also raised concerns that the definition of credit risk in IFRS 7 is unclear. In particular, some thought it was unclear whether the effect on a financial liability's fair value that may arise because of an associated asset was intended to be included in the own credit amount—eg when the payments due on a financial liability are calculated on the basis of the performance of a linked asset.

Our response

We were persuaded by the concerns raised by respondents about the clarity of the concept of credit risk. IFRS 9 introduces additional guidance to explain what the definition of credit risk is intended to encompass—eg the difference between asset risk and credit risk is explained.

Also, although the default method is still available, additional emphasis has been made in the guidance about the necessity to isolate components of the change in fair value of a financial liability from the own credit calculation—such as when the financial liability includes embedded derivative features.

Transition and location of changes

We proposed that an entity that chooses to apply the changes to the treatment of own credit amounts before 1 January 2013 also be required to apply the requirements for the accounting for financial assets in IFRS 9. We proposed this because we wanted to reduce the number of different combinations of accounting for financial assets and financial liabilities that could be produced in the financial statements. Having many different combinations would reduce comparability for the users of financial statements.

We also proposed implementing these changes by adding new sections to IFRS 9 rather than amending IAS 39.

Respondents' comments

Some respondents said that they would prefer to be able to adopt the changes to the treatment of own credit amounts without adopting IFRS 9 as a whole. This was because it would be a relatively straightforward change to implement compared with changing the classification and measurement of financial assets. They also viewed the treatment of financial assets and financial liabilities to be sufficiently separate that it would be appropriate to only adopt one part in isolation.

However, most users preferred the approach that was suggested in the proposals because it improved comparability.

Some respondents suggested that it would be appropriate to make changes to IAS 39 rather than amending IFRS 9. These respondents felt that because the change to the accounting for financial liabilities was limited to only addressing the treatment of own credit amounts for financial liabilities under the FVO, changing IAS 39 was a more appropriate approach.

Our response

We have confirmed our proposal that entities applying the new requirements for own credit amounts before 1 January 2013 also be required to apply the IFRS 9 accounting for financial assets at the same time.

We are concerned about the lack of comparability if we allowed entities to choose to apply early only some parts of IFRS 9. Also, in some cases, changes to the accounting for financial assets will result in a change to which financial liabilities would be measured under the FVO. This interaction means that it is preferable that changes to the accounting for financial liabilities occur at the same time that changes are made to the accounting for financial assets.

We have also confirmed that the own credit changes will be implemented by adding new sections to IFRS 9, rather than by amending IAS 39.

We are undertaking a fundamental review of the accounting for financial instruments and these changes form part of that review. Although our deliberations resulted in us making only a small change to the accounting for financial liabilities, which is consistent with the requests made by the vast majority of our constituents, the resulting requirements are part of the new financial instruments accounting model.

As we complete each phase of the project and create new sections in IFRS 9 we are deleting the equivalent provisions from IAS 39.

When the final phase of the project is completed IAS 39 will have been superseded in its entirety. Given this overall approach we decided that it was not appropriate for us to make amendments to IAS 39.

International convergence

The US Financial Accounting Standards Board (FASB) has approached its project to improve the accounting for financial instruments in a different way from ours. In order to meet our international timetable commitments we have approached our project in phases. In contrast, the FASB published an exposure draft in May 2010 addressing the classification and measurement of financial assets and financial liabilities, impairment (provisioning) and hedge accounting. That exposure draft proposed a symmetrical model for financial assets and financial liabilities.

Compared with our decisions on the accounting for financial liabilities the FASB's exposure draft proposed that more financial liabilities should be measured at fair value. In addition, they proposed that for all financial liabilities measured at fair value (including derivatives and financial liabilities held for trading), the portion of the change in fair value due to own credit should be shown separately. For financial liabilities measured at fair value through P&L this would mean that the own credit amounts would be transparent but remain in P&L.

The comment period for the FASB's exposure draft closed on 30 September 2010.

The boards are concerned that the difference in timetables is creating a risk that they will develop different requirements for accounting for financial instruments. However, the project to replace IAS 39 is a joint one with the FASB. Once the FASB has reconsidered its proposals on classification and measurement we will consider any remaining differences between our models and determine what steps, if any, should be taken to reconcile any remaining differences. Any changes considered as a result of that comparison would be subject to the normal due processes of each board.

International Accounting Standards Board (IASB)

The IASB is the independent standard-setting body of the IFRS Foundation

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