IFRS Accounting

Staff paper

Agenda reference: AP3A

IASB® meeting

Date	**November 2022**
Project	**Post-implementation Review of IFRS 9—Classification and Measurement**
Topic	**Financial liabilities and own credit**
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Introduction

1. The IASB has been discussing feedback on the *Request for Information Post-implementation Review (PIR) of IFRS 9—Classification and Measurement* (the RFI) since March 2022.

2. This paper provides a summary of the feedback on the RFI and staff analysis on financial liabilities and own credit (Question 5 of the RFI).

3. At this meeting, the IASB will be asked to decide whether to take further actions to respond to the matters identified on this topic.

4. This paper is structured as follows:

   (a) staff recommendation and a question for the IASB;

   (b) a reminder of the requirements for assessing matters identified in a PIR;

   (c) a reminder of the IFRS 9 *Financial Instruments* requirements applicable to financial liabilities and own credit;

   (d) a summary of general feedback on this topic; and

   (e) staff analysis on the key application questions.

Staff recommendation and a question for the IASB

5. Feedback on the RFI indicated that there are no fundamental questions about the clarity and suitability of the requirements for financial liabilities, including the presentation of own credit changes in Other Comprehensive Income (OCI) for financial liabilities designated at fair value through profit or loss. Therefore, the staff recommend that no further action is taken on the matters identified in relation to financial liabilities and own credit.

Question for IASB
Do you agree with the staff's recommendation as summarised in paragraph 5 of this paper?

A reminder of the requirements for assessing matters identified in a PIR

6. At its June 2022 meeting, the Trustees of the IFRS Foundation considered the recent revisions to the description of PIRs (including the prioritisation of PIR findings) in the Due Process Handbook. These principles were discussed and finalised by the IASB in September 2022.

7. The IASB considers whether to take any action on matters identified in PIRs if there is evidence that:

   (a) there are fundamental questions (ie 'fatal flaws') about the clarity and suitability of the core objectives or principles in the new requirement;

   (b) the benefits to users of financial statements of the information arising from applying the new requirements are significantly lower than expected (for example, there is significant diversity in application); or

   (c) the costs of applying some or all of the new requirements and auditing and enforcing their application are significantly greater than expected (or there is a significant market development since the new requirements were issued for which it is costly to apply the new requirements consistently).

A reminder of the IFRS 9 requirements

References
Paragraphs 4.2.2 and 5.7.7–5.7.9 of IFRS 9
Paragraphs B5.7.16–B5.7.20 of IFRS 9
Paragraphs BCZ5.29–BCZ5.34, BC5.34A, and BC5.35–BC5.64 of the Basis for Conclusions on IFRS 9
Paragraphs BC16–BC22 of the Basis for Conclusions on IFRS 7

8. The requirements for financial liabilities in IFRS 9 are largely carried forward from IAS 39 *Financial Instruments: Recognition and Measurement*.

9. The only issue the IASB identified as requiring amendment related to changes in the fair value attributable to an entity's own credit risk for financial liabilities designated at fair value through profit or loss.

10. Changes in a financial liability's credit risk affects its fair value. This means that when an issuer's creditworthiness deteriorates, the fair value of that entity's issued debt will decrease

(and vice versa) resulting in a gain (loss) which was—prior to the issuance of IFRS 9—recognised in profit or loss. Many stakeholders shared the view that this effect did not provide useful information to users of financial statements. To address concerns for financial liabilities designated at fair value through profit or loss, IFRS 9 requires changes in the fair value attributable to a financial liability's credit risk to be presented in OCI rather than in profit or loss (unless this treatment would create or enlarge an accounting mismatch in profit or loss[1]).

A summary of general feedback

11. Respondents did not provide a significant amount of feedback on this topic. Most respondents that provided feedback said:

    (a) the requirements for financial liabilities generally worked well; and

    (b) the requirement to present own credit risk in OCI is a welcome change compared to IAS 39 and works as intended.

12. However, a few respondents said that:

    (a) it is difficult to separate fair value changes resulting from changes in own credit risk from fair value changes associated with other risks, particularly for complex financial instruments with embedded derivatives and other features. Respondents' views on potential actions needed were mixed, with some suggesting that the IASB provide illustrative examples while others suggested that all fair value changes should be recognised in OCI; and

    (b) the requirements for separating fair value changes resulting from changes in own credit risk should be extended to all financial liabilities that are measured at fair value through profit or loss (instead of applying only to financial liabilities designated at fair value through profit or loss).

Staff analysis

Determining the effects of changes in own credit

13. Before IFRS 9 was issued, IFRS 7 *Financial Instruments: Disclosures* required an entity to disclose the amount of change in fair value that is attributable to changes in the financial liability's credit risk. In the Basis for Conclusions on IFRS 7, the IASB acknowledged that quantifying the change in a financial liability's credit risk might be difficult in practice[2].

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[1] Paragraph 5.7.7 of IFRS 9

[2] Paragraph BC5.58 of the Basis for Conclusions on IFRS 9 and paragraph BC19 of the Basis of Conclusions on IFRS 7.

Paragraphs B5.7.16–B5.7.20 of IFRS 9 provide application guidance—largely carried forward from IFRS 7—to help entities separate the amount of change in fair value that is attributable to the credit risk of that liability.

14. In particular, paragraph B5.7.18 of IFRS 9 describes an estimation method that can be applied if the only significant relevant changes in market conditions for a financial liability are changes in an observed (benchmark) interest rate.

15. In other cases, an entity is required to use an alternative method that would more faithfully represent the amount of change in the financial liability's fair value that is attributable to changes in its credit risk[3]. Such an alternative measurement method is not prescribed, allowing management to apply judgement in measuring the change in fair value attributable to credit risk.

16. When developing the own credit requirements in IFRS 9, the IASB discussed an alternative approach to address the effect of changes in a financial liability's credit risk on profit or loss which would avoid the difficult question of how to measure the effects of changes in credit risk. Under this approach, the entire change in fair value of the financial liability would be presented in OCI. However, the IASB rejected this approach because it believes that at least some of the change in fair value should be presented in profit or loss. Presenting the entire change in fair value in OCI would not meet the IASB's objective of addressing the effect of changes in some financial liabilities credit risk.[4]

17. Paragraph B5.7.20 of IFRS 9 requires that an entity's measurement method make maximum use of relevant observable inputs and minimum use of unobservable inputs as with all fair value measurements. IFRS 13 *Fair Value Measurement* sets out a framework for measuring fair value, however, the requirements for measuring fair value in IFRS 13 are outside the scope of this PIR.

18. In the staff's view, IFRS 9 provides principle-based application guidance to help entities establish a measurement method for calculating the amount of change in fair value that is attributable to its own credit risk. The guidance was largely carried forward from IFRS 7 to IFRS 9. We also note that the questions around how to determine the changes in fair value attributable to a financial liability's credit risk, are similar to the questions the IASB received

[3] Paragraphs B5.7.16(b) and B5.7.19 of IFRS 9

[4] Paragraph BC5.44(b) of the Basis for Conclusion on IFRS 9

on the 2010 Own Credit Risk Exposure Draft. The IASB responded to questions received on that exposure draft by:

(a) clarifying, in paragraph B5.7.13 of IFRS 9, the difference between creditworthiness of the entity and the credit risk of a liability; and

(b) confirming, in paragraphs B5.7.14 and B5.7.15 of IFRS 9, that a change in a liability's credit risk does not include changes in asset-specific performance risk.

19. Based on the feedback on the RFI, the staff is of the view that there are no fundamental questions about the suitability and clarity of the requirements for financial liabilities, including the presentation of changes in own credit risk in OCI. Furthermore, the feedback did not indicate that the benefits to users of financial statements or the costs of applying the requirements are significantly different from what the IASB expected. The staff therefore recommend that no further action is taken on this matter.

Requests to broaden the scope

20. A few respondents to the PIR suggested that the requirements for presenting fair value changes resulting from changes in own credit risk in OCI should be extended to all financial liabilities that are measured at fair value through profit or loss rather than limited to those *designated* as at fair value through profit or loss.

21. Paragraph 4.2.1 of IFRS 9 requires a financial liability to be subsequently measured at fair value through profit or loss only if:

(a) it is a financial liability at fair value through profit or loss as defined in Appendix A of IFRS 9. Setting aside those financial liabilities that can be designated as measured at fair value through profit or loss, this only leaves financial liabilities that are either a derivative or meet the definition of held for trading; or

(b) it is contingent consideration recognised in a business combination to which IFRS 3 *Business Combinations* applies.

22. The IASB noted in paragraph BC5.53 of the Basis for Conclusions on IFRS 9 that if an entity repays the contractual amount, the cumulative effect over the life of the instrument of any changes in the liability's credit risk will net to zero because its fair value will equal the contractual amount. However, for financial liabilities that are held for trading, an entity will generally realise the effects of changes in the liability's credit risk when that instrument is

transferred.[5] Therefore, the staff continues to agree with the IASB's rationale in developing the requirements of IFRS 9 that it would not be appropriate to present fair value changes on financial liabilities that are held for trading in OCI.

23. When developing IFRS 3, the IASB observed that many obligations for contingent consideration that qualify for classification as liabilities meet the definition of derivative instruments in IFRS 9. To improve transparency in reporting particular instruments, the IASB concluded that all contracts that would otherwise be within the scope of IFRS 9 (if not issued in a business combination) should remain subject to those requirements (ie measured at fair value through profit or loss). When considering the subsequent accounting for contingent payments that are liabilities but are not derivatives, the IASB concluded that all liabilities for contingent payments should also be accounted for at fair value through profit or loss as this would faithfully represent the fair value of the liability.

24. Changes in the fair value of contingent consideration do not typically result from changes in the acquirer's own credit risk, but occur when[6]:

    (a) the acquirer obtained information after the acquisition date about facts and circumstances that existed at the acquisition date; or

    (b) a contingent event occurs, such as meeting an earnings target, reaching a specified share price or reaching a milestone.

25. The staff therefore recommend that no further action is taken on this matter.

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[5] Paragraph BC5.35 of the Basis for Conclusion on IFRS 9
[6] Paragraph 58 of IFRS 3