July 2010

Investor Perspectives

Patricia McConnell: Is our proposal the best fix for the own credit problem under the fair value option?

In May we published an exposure draft, *Fair Value Option for Financial Liabilities* (ED), as part of our project to improve the accounting for financial instruments. The ED comment deadline is 16 July 2010, so there is still time for investors to weigh in on our proposals. One way to do so would be to write a comment letter; another is to complete the questionnaire specifically designed for financial statement users to provide feedback on the ED, or you can respond to this article by clicking on the feedback button below. The ED proposes a limited change to the accounting for issued debt to deal specifically with the issue of P&L volatility caused by 'own credit' changes.

How are liabilities accounted for now?

Before I describe what we are proposing in the ED let's look briefly at the current accounting for financial liabilities.

At the moment most liabilities are measured at amortised cost under our literature. This is the case for vanilla liabilities and the vanilla component that is typically split out of more structured liabilities through bifurcation. All liabilities that are held for trading and derivative liabilities are required to be measured at fair value with the fair value changes being recognised in P&L.

Entities can however choose to measure liabilities at fair value that would otherwise be at amortised cost by using 'the fair value option'. This option is available in three circumstances: if the liability is managed on a fair value basis, if measuring the liability at cost would give rise to an accounting mismatch or if the liability is a structured liability that would otherwise need to be bifurcated.

What is the 'own credit' problem?

When a liability is measured at fair value, one of the things that cause a change in that fair value is a change in the credit quality of the issuer. If it becomes more likely that an issuer cannot meet its payment obligations, the value of the liability will fall. When that decline in fair value is recognised in P&L, it gives a counter intuitive result. The more that an issuer's credit quality declines, the greater the gain that it books in P&L!

Information is already available today about 'own credit'. When an entity uses the fair value option to measure its liabilities it must provide this information in the notes to the financial statements. Typically this amount is calculated based on the entire change in the margin on an issuer's debt over a benchmark rate such as LIBOR.

However, we have been told repeatedly that we need to do more. While there is useful information in 'own credit' measures, including the gain in P&L generally does not result in useful information. The particular liabilities that have caused concern are those that are not held for trading and that are not derivatives - liabilities that an entity chooses to measure at fair value under the fair value option. We are therefore proposing a solution that just focuses on these liabilities.

What we are not proposing

We decided not to comprehensively overhaul the accounting for financial liabilities. This is because we have been told that symmetrical measurement of financial assets and liabilities does not necessarily produce useful information, and that a new way of measuring financial liabilities was not necessary or desired. We were also told that generally the current accounting for financial liabilities works well. Consequently, in most cases, the proposed changes in the ED will leave the accounting for financial liabilities unchanged. Liabilities that are held for trading and derivative liabilities will still be accounted for at fair value, with changes in their fair value going to P&L. Plain vanilla debt will still be measured using amortised cost. Hybrid liabilities continue to be bifurcated using the existing methodology. In addition, the fair value option as described above will be retained with the same eligibility criteria that we have today.

What we are proposing to change

We are proposing to change the treatment of the ‘own credit’ portion of the fair value change in financial liabilities that have been measured at fair value under the fair value option. Liabilities measured using the fair value option will still be shown on the balance sheet at their full fair value. However, we propose a two-step approach in the P&L. First, the total change in fair value will be shown in P&L. Then, the portion of the change in fair value attributable to the change in the issuer’s own credit will be taken out and transferred to OCI. This is illustrated in the following exhibit.

FVO proposals

Profit or Loss (liabilities under FVO)	
Total change in FV	XX
Change in FV due to ‘own credit’	(X)
Profit for the year	XXX

Financial liability on balance sheet at (full) fair value

Statement of Comprehensive Income (liabilities under FVO)	
Other Comprehensive Income:	
Change in FV due to ‘own credit’*	X

* Not recycled

The ‘own credit’ amount will be calculated in the same way that it is today for disclosure purposes. In other words, the ED really only proposes that companies take the number that they already calculate for disclosure purposes, and use that number in the primary financial statements. This will generally eliminate P&L volatility caused by ‘own credit’, but it will still highlight ‘own credit’ information for your use in analysis and decision making.

The ED proposes that the transfer to OCI should be mandatory for all financial liabilities that have been measured at fair value under the fair value option. However, we are aware that there may be some circumstances, although we expect them to be uncommon, when this could give rise to a new accounting mismatch. This might arise, for example, if the credit risk of an issuer's assets was the same as the credit risk on its liabilities. In that case, if the full fair value change on the assets is recognised in P&L, a mismatch will occur if only a portion of the fair value change on the liabilities is recognised in P&L. Because of this potential issue, we are asking a question in the ED about whether the 'own credit' proposals should be mandatory, or whether we need instead to restrict the application to circumstances when leaving the effect of 'own credit' in P&L would cause an accounting mismatch. We are particularly interested in learning about situations where excluding 'own credit' from P&L might in fact cause a new accounting mismatch.

We propose prohibiting 'recycling' of the OCI amount back to P&L under any circumstances. In most cases, there would be no amount to recycle. This is because if a company settles its issued debt according to its contract, the cumulative effect of any changes in its credit will net to zero by maturity. However, if a company settles issued debt prior to maturity, there may be an amount realised that is attributable to 'own credit'. To provide you with information about how much of the accumulated 'own credit' effect has been realised during the reporting period when debt is settled prior to its maturity, we are proposing to require disclosure of that amount in the financial statement notes.

We have not created a new measurement attribute. We are still using full fair value in the balance sheet when the criteria for applying the fair value option are satisfied. However, there will be no P&L volatility caused by changes in 'own credit', except for items held for trading. Nevertheless, the 'own credit' information will still be prominent and readily available for you to use in decision making.

The FASB's proposals for own credit

After we published our ED on the treatment of 'own credit', the FASB issued its own proposals on financial instruments. Very briefly, with regard to 'own credit', the FASB is proposing that for all financial liabilities that are measured at fair value, the portion of the fair value change attributable to 'own credit' must be shown separately. The result of the FASB's proposal is that, for financial liabilities measured at fair value through the P&L, the 'own credit' effect will remain in P&L, but it will be presented separately.

Another difference is how the FASB has defined 'own credit'. We allow 'own credit' to be measured as the total change in an issuer's credit spread over a benchmark rate. In contrast, the FASB is proposing that companies should be required to isolate the effect of changes in their actual credit standing. This means that if, for example, a company issued debt at LIBOR plus 50 basis points last year, and this year that debt would be issued at LIBOR plus 75 basis points, the FASB would require the company to work out what part of the additional 25 basis points is due to a change in the issuer's own credit standing, and what part is due to a change in the price of credit generally. Consistent with our current disclosure requirements we would allow the company to treat the entire 25 basis point change as being due to a change in 'own credit', or to work out a more precise measure if it can do so.

We would like to hear from you

Instead of taking the 'own credit' effect to P&L, and then reversing it out into OCI (the proposed two-step approach discussed above), we could require that the own credit effect should go directly to OCI. Alternatively, we could leave the 'own credit' effect in P&L, but require it to be separately identified as proposed by the FASB. Yet another alternative would be to take the 'own credit' effect directly to equity. This would mean that the 'own credit' effect would be totally excluded from total comprehensive income. Which of these solutions do you think will be the most useful?

Do you think that the 'own credit' solution should be mandatory, or should its application be conditional depending on whether or not it would address an accounting mismatch?

As noted above, we propose to prohibit recycling of 'own credit' effects from OCI back into P&L. Do you think that this is appropriate?

We are proposing disclosure in the notes of any gain or loss relating to 'own credit' that might have been realised during the period as a result of early extinguishment of a company's own debt. Do you think that this is useful information?

Patricia McConnell is a Board member of the IASB.