



Memorandum

To:	AASB Members	Date:	2 June 2010
From:	Natalie Batsakis and Christina Ng	Agenda Item:	6.1
Subject:	Fair Value Option for Financial Liabilities	File:	

Action

Consider the matters that should be raised in the AASB's response to IASB ED/2010/4 *Fair Value Option for Financial Liabilities* and to the IASB's request for comment on the FASB Exposure Draft *Accounting for Financial Instruments, Revisions to the Accounting for Derivative Instruments and Hedging Activities* (FASB ED) as it relates to own credit standing.

Background

The IASB issued ED/2010/4 in May 2010 and comments are due by 16 July 2010. The AASB issued ED 196 *Fair Value Option for Financial Liabilities* incorporating ED/2010/4 for comment. No submissions have been received to-date.

AASB staff have been considering issues that could be used in the AASB and Asian Oceanian Standard Setters Group (AOSSG) submissions to the IASB, based on feedback from members of the Financial Instruments Project Advisory Panel and members of the AOSSG Financial Instruments Working Group.

Following this meeting, the plan is to finalise an AASB submission out-of-session. Staff will continue to liaise with members from the Financial Instruments Project Advisory Panel and consider responses from Australian constituents in developing responses to the specific questions in ED/2010/4 for consideration and approval by the Chairman and a small sub-committee of AASB members.

AASB staff will also be working with the AOSSG Financial Instruments Working Group and other AOSSG members to finalise an AOSSG response to the IASB on ED/2010/4 during the remainder of June.

Memorandum

ED/2010/4 is a further step in the project to replace IAS 39 *Financial Instruments: Recognition and Measurement* and follows on from ED/2009/7 *Financial Instruments: Classification and Measurement* that was published in July 2009 and the discussion paper *Credit Risk in Liability Measurement*. A number of concerns were raised in response to ED/2009/7 and the DP in respect of recognising gains in profit or loss resulting from changes in the credit risk of financial liabilities at fair value. As such, the IASB issued IFRS 9 *Financial Instruments* in December 2009 dealing only with financial assets and decided to defer addressing the requirements for accounting for financial liabilities until it had an opportunity to discuss the issues raised.

The main proposal of ED/2010/4 is to require gains or losses resulting from a change in credit risk on financial liabilities that are designated at fair value to be presented in other comprehensive income (OCI)¹ – and thereby, eliminate the perceived counter-intuitive impact of an entity recognising gains in profit or loss when it suffers a deterioration in its own credit risk.

The issues identified by AASB staff are discussed in the Appendix to this Memorandum.

Attachments

Agenda paper 6.2 AASB ED 196 *Fair Value Option for Financial Liabilities*

1 The presentation of fair value changes in OCI attributable to changes in credit risk is an abbreviated version of the proposal to present the entire change in fair value in the profit or loss and subsequently transfer the component associated with changes in credit risk to OCI.

Appendix

Issues

1. *Inconsistent accounting requirements for financial asset and financial liabilities*

- 1.1 Paragraph BC8(a) of the Basis for Conclusions to ED/2010/4 discusses the themes in the feedback received by the IASB from its outreach programme, and notes that:
- (i) it is not necessary to have symmetrical accounting for financial assets and financial liabilities;
 - (ii) symmetry often does not result in useful information; and
 - (iii) the IASB should not be constrained or biased by the requirements of IFRS 9 in developing requirements for financial liabilities.
- 1.2 As such, the IASB decided to retain the requirements in IAS 39 for financial liabilities, with the exception of the proposed amendments to the fair value option in ED/2010/4.
- 1.3 AASB staff are concerned with the proposed retention of the existing requirements for financial liabilities in light of the changed requirements for financial assets in IFRS 9. These would result in inconsistent accounting for financial assets compared with financial liabilities. For example, consider a loan liability with interest repayments indexed to the price of gold. The commodity-indexed interest embedded in the host debt instrument is not considered to be closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar (paragraph AG30(e) of IAS 39). Therefore, the borrower would be required to bifurcate the financial liability in accordance with IAS 39 and measure the host contract at amortised cost and separately measure the embedded derivative at fair value.
- 1.4 On the other hand, the lender would be required to assess the hybrid in its entirety in accordance with paragraph 4.2(b) IFRS 9. Since the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding and the interest amounts are not consideration for the time value of money on the principal amount outstanding, the loan receivable would be measured in its entirety at fair value through profit or loss.
- 1.5 Therefore, the issuer and the borrower will account for the debt instrument differently.

- 1.6 The FASB ED achieves a greater level of consistency in the accounting for financial assets and financial liabilities, especially in the treatment of embedded derivatives. The measurement basis of a hybrid instrument would be determined based on the features of the entire contract and embedded derivatives would not be bifurcated from their financial liability host.

Does the Board agree with AASB staff concerns regarding the inconsistent accounting for financial assets and financial liabilities?

2. *Presenting changes in own credit risk*

- 2.1 AASB staff do not support the proposal to separately present fair value changes arising from changes in credit risk in OCI for financial liabilities designated at fair value through profit or loss. Staff are of the view that if an entity elects to measure assets or liabilities at fair value, then the basis of measurement in both the balance sheet and the income statement should remain fair value and not be adjusted for the impact of credit risk. That is, if the entity adjusts fair value for the impact of credit risk the measurement basis is no longer fair value through profit or loss.
- 2.2 In addition, unless otherwise specified, financial statements are prepared on a going concern basis. Staff consider that a deterioration in an entity's own credit standing (excluding the price of credit) within reasonable bounds does not warrant separate presentation of fair value changes that result from changes in credit risk. Paragraph 25 of IAS 1 *Presentation of Financial Statements* requires an entity to disclose if the financial statements are not prepared on a going concern basis, together with the basis on which the financial statements are prepared and the reason the entity is not a going concern. Therefore, a significant deterioration in an entity's credit standing would justify an alternative basis of measurement which should be disclosed in accordance with IAS 1.
- 2.3 In the Basis for Conclusions to ED/2010/4, the IASB has acknowledged the difficulty in deducing the impact of credit risk, and also noted the views of some that the change in fair value of a liability due to credit risk should only reflect changes in the credit quality of the issuer and not the price of credit or liquidity risk. These concerns are consistent with the sentiments expressed in the FASB ED. Paragraph BC164 of the FASB ED notes that the FASB does not believe that the change in fair value attributable to the change in an entity's credit spread accurately reflects the change in an entity's own credit because "...it also

measures the change in the price of credit, which affects not just the individual entity, but also other entities in the industry and the economy.”

- 2.4 The IASB also notes that, whilst the methodology prescribed in IFRS 7 *Financial Instruments: Disclosures* does not deduce an exact measure of the impact of credit risk, it is a reasonable proxy. AASB staff has reservations with elevating the use of this methodology for determining adjustments to profit or loss. AASB staff believe that the requirement in IFRS 7 to disclose the impact of changes in credit risk on financial liabilities measured at fair value is sufficient to provide users with useful information and that the proposals in ED/2010/4 should not be progressed.
- 2.5 The FASB ED proposes presenting changes in an entity’s own credit risk in OCI when there is a significant change in the fair value of a financial liability due to changes in the entity’s credit risk (that is, excluding the price of credit). AASB staff believe that the FASB proposals will involve much less work for entities, because the impact of changes in own credit risk will only need to be determined when there is a significant change in the fair value of a financial liability that is attributable to changes in the entity’s own credit risk.
- 2.6 AASB staff consider that the FASB proposals are preferable to the IASB proposals, but would prefer that neither set of proposals were introduced.

Does the Board agree with AASB staff concerns regarding the presentation of changes in own credit risk?

3. Purpose and scope of ED/2010/4

- 3.1 AASB staff acknowledge the pressure for the IASB to respond to the G-20 recommendations and to address the findings raised in the report prepared by FCAG. However, we do not believe that the IASB has provided sufficient justification for the scope of the proposals. The report prepared by FCAG noted the following:

“...reporting gains in profit or loss seems counterintuitive and may not provide relevant, decision-useful information when the gain results from a change in the credit risk of the borrower rather than from the general price of credit, especially when the borrower lacks the ability to buy its own debt and actually realize the gain.”

- 3.2 FCAG’s thinking is consistent with the feedback received by the IASB on its questionnaire seeking comment from users. The results from that questionnaire were included in the

Appendix to IASB Staff Agenda Paper 8 for the IASB meeting held in the week beginning 19 April 2010.

- 3.3 AASB staff note that the comments made by FCAG that refer to entities having the ability and opportunity to buy back their own debt, are much narrower in scope than the ED proposals, which cover the gains or losses resulting from changes in credit risk of all financial liabilities designated at fair value through profit or loss under IFRS 9.
- 3.4 AASB staff note that if the scope were narrowed along the lines of the FCAG report, it would probably exclude the debt instruments issued by Australian public sector entities that are designated at fair value because they are widely traded.
- 3.5 In the staff's view, it is not clear why the IASB decided to focus on financial liabilities designated at fair value through profit or loss. The IASB could have developed the project in any number of ways – for example, the IASB could have considered the impact of credit risk on liabilities in a broader context given that credit risk plays a role in determining the value of all liabilities measured at fair value or a measurement basis commensurate to fair value, such as liabilities in IAS 37 *Provisions, Contingent Assets and Contingent Liabilities*, IAS 19 *Employee Benefits* and IAS 17 *Leases*.
- 3.6 Since we do not support the proposals, if they are to proceed, we believe it would be preferable for their focus to be as narrow as possible and would recommend that the IASB reconsider its proposals in light of the specific wording of the FCAG recommendation.
- 3.7 In addition to the above, AASB staff support the IASB's decision to not pursue any of the approaches to excluding the impact of credit risk from financial liability measurement that were included in the discussion paper *Credit Risk in Liability Measurement*, which included:
- Approach 1:* Fair value measurement of financial liabilities with separate presentation in OCI of fair value changes arising from changes in own credit risk where the entity holds the financial liability and its business objective is to pay contractual cash flows (that is, the financial liability meets paragraph 4.2(a) of IFRS 9 but not paragraph 4.3(b) of IFRS 9);
- Approach 2:* An adjusted fair value measurement method (or 'frozen credit spread' measurement method), that incorporates own credit risk only on initial measurement and subsequently measures particular financial liabilities at an adjusted fair value that excludes changes in own credit risk;

Approach 3: Bifurcation in accordance with IAS 39 or assess a hybrid contract with a financial liability host in accordance with the criteria in IFRS 9. For those hybrids that do not meet the criteria for amortised cost, determine whether any component of the hybrid contract is eligible for amortised cost; and

Approach 4: Presentation of fair value information on the face of the balance sheet in addition to the amortised cost of some liabilities.

Does the Board agree with AASB staff concerns regarding the purpose and scope of the ED?

4. *Two-step approach or one-step approach*

- 4.1 The ED identifies two approaches for presenting gains or losses resulting from the changes in a liability's credit risk. The two-step approach initially records the entire fair value movement in profit or loss, and subsequently transfers the portion of the fair value that relates to changes in credit risk to OCI – therefore, presenting the gains or losses in two locations – a 'what might have been' (in the profit or loss) and a 'what is' (in OCI). The one-step approach only presents the gains or losses associated with changes in credit risk once in OCI.
- 4.2 AASB staff believe there are arguments to support both approaches. The two-step approach is closer to recognising the full fair value change of financial liabilities in profit or loss rather than separating gains or losses arising from changes in own credit risk. On the other hand, it could be argued that the two-step approach does not provide any more useful information than the one-step approach and therefore that the one-step approach is a more efficient approach for presenting the same information.
- 4.3 AASB staff prefer the two-step approach. Given that AASB staff do not support the proposals to separately present gains or loss resulting from changes in credit risk, the two-step approach is closer to presenting the entire fair value change of financial liabilities designated at fair value through profit or loss in profit or loss.
- 4.4 Staff believe that the IASB should justify whichever approach it decides to use.

Does the Board agree with the AASB staff preference for the two-step approach?

5. *Recycling amounts to profit or loss*

- 5.1 AASB staff believe that recycling undermines the notion that items of revenue are ‘income’ and items of expense are ‘expenses’ regardless of where they are presented in the comprehensive income statement. Therefore, if the IASB pursues the proposals in this ED to separately present gains or losses resulting from changes in a liability’s credit risk in OCI, we believe that such amounts should not be reclassified to profit or loss. This is consistent with the presentation of gains or losses on equity instruments in OCI, where the instruments are not held for trading purposes (paragraphs 5.3.1 and B5.12 in Appendix B of IFRS 9).
- 5.2 In addition, AASB staff do not believe that it would be appropriate to recycle gains or losses arising from changes in a liability’s credit risk even if they were presented in equity. If the gains or losses are recorded in equity and do not impact performance when they arise, then it would not be appropriate for the gains or losses to impact performance at a later date.
- 5.3 However, AASB staff believe that the IASB should reconcile and explain its reasoning for retaining the existing requirements that recognise gains or losses in profit or loss that arise from changes in own credit and are ‘realised’ when amortised cost debt is repurchased (paragraph 56 of IAS 39), while proposing that changes in the fair value of financial liabilities designated at fair value through profit or loss arising from changes in an entity’s own credit standing be recognised in OCI and not be recycled to profit or loss.

Does the Board agree with AASB staff view regarding recycling of gains or losses?

6. *Appropriateness of IFRS 7 methodology in determining credit risk*

- 6.1 AASB staff note that there is an increasing need to reliably identify the impact of credit risk in the application of IFRSs. In ED/2010/4, the IASB is proposing to use the methodology in IFRS 7 that attributes the change in fair value of financial liabilities to changes in the benchmark rate and changes in the credit risk of the liability. The AASB submission in response to the IASB’s discussion paper *Credit Risk in Liability Measurement* noted the difficulty of determining the impact of credit risk on changes in the fair value of financial liabilities. The IASB also acknowledges these difficulties in the Basis for Conclusions to ED/2010/4.

- 6.2 However, the IASB notes that there is support for the methodology in IFRS 7 as a proxy for determining credit risk. Other than ‘noting’ support for the IFRS 7 methodology, there seems to have been no detailed analysis of whether the ‘simplified’ method is satisfactory in reflecting the actual credit risk.
- 6.3 In its deliberations, the FASB concluded that it does not believe that the IFRS 7 methodology accurately reflects the change in an entity’s own credit because it includes changes in the price of credit, which also affects other entities in the industry and the economy and that only the changes in the entity’s own credit risk are relevant. The FASB ED notes that there may be several different methods to determine the change in fair value excluding the change in the price of credit, and as such a method for determining the change in fair value attributable to a change in an entity’s own credit standing is not prescribed.
- 6.4 As discussed in Issue 2 above, AASB staff believe that the methodology prescribed in IFRS 7 for determining the impact of changes in credit risk on financial liabilities measured at fair value may be sufficient for disclosure purposes. However, for the reasons noted above, AASB staff are concerned with elevating the use of the IFRS 7 methodology for measurement purposes, particularly given the confusion about whether the IASB’s focus is on the impact of a change in credit risk generally or the impact of a change in credit risk specific to the entity.
- 6.5 In addition to the concerns with determining the entity’s credit risk, AASB staff believe that the IASB should provide more guidance regarding the appropriate benchmark rate that forms part of the IFRS 7 methodology. That is, whether the price of credit risk should be determined based on the issuer’s credit spread relative to:
- (i) an overall market benchmark rate;
 - (ii) the prevailing rate for a particular sector; or
 - (iii) the risk-free rate (such as a government bond rate).

Does the Board agree with AASB staff concerns regarding the appropriateness of the IFRS 7 methodology in determining credit risk?

7. Transition requirements

- 7.1 AASB staff are concerned that the interaction between the transition requirements in respect of financial liabilities in IFRS 9 and the proposed requirements in ED/2010/4 is unclear. AASB

staff believe that the transition requirements should be consistent for those that have already early adopted IFRS 9 and those that are yet to early adopt IFRS 9, but who would be required to do so if they elect to early adopt the proposed requirements in respect of financial liabilities.

Transition requirements for those that have early adopted IFRS 9

- 7.2 AASB staff are concerned about the impact that any new financial liability requirements may have on entities that have already early adopted IFRS 9. The transition requirements in IFRS 9 allow entities to designate or de-designate financial liabilities measured at fair value through profit or loss (paragraph 8.2.9 of IFRS 9). However, it is unclear whether entities will have the opportunity to reassess their accounting policy elections in respect of financial liabilities (that is, whether or not the entity wishes to designate or de-designate a financial liability at fair value through profit or loss based on the new requirements) even if the entity has already adopted IFRS 9.
- 7.3 Staff believe that entities should be provided with the opportunity to reassess whether, in light of new accounting requirements, their accounting policy elections for financial liabilities will provide useful information for users.

Transition requirements for those that have yet to early adopt IFRS 9

- 7.4 As discussed above, IFRS 9 allows an entity to retrospectively designate or de-designate a financial liability as at fair value through profit or loss based on the facts and circumstances at the date of initial application of IFRS 9. In contrast, ED/2010/4, paragraph BC51, states “...the exposure draft does not allow entities to make new designations or revoke its previous designations as a result of the proposals.” AASB staff believe that entities should be allowed to designate or de-designate financial liabilities if new requirements are issued by the IASB, because the new requirements may change an entities view on whether or not it wishes to use the fair value option in order to provide useful information for users.
- 7.5 Therefore, AASB staff believe that the transition requirements in the ED should be reconciled with the transition requirements for financial liabilities in IFRS 9 and should allow the designation or de-designation of financial liabilities if the proposals in the ED are progressed unamended.

Does the Board agree with AASB staff concerns regarding the proposed transition requirements?