New on the Horizon: Fair value option for financial liabilities

International Financial Reporting Standards
May 2010
Foreword

ED/2010/4 Fair Value Option for Financial Liabilities (ED) was published in May 2010. This is the third exposure draft of a phased project to replace the existing standard on financial instruments, IAS 39 Financial Instruments: Recognition and Measurement. The first chapters of the new IFRS 9 Financial Instruments were published in 2009 and cover the classification and measurement of financial assets. During the deliberations that led to IFRS 9, the IASB decided to address accounting for financial liabilities separately. This was driven by comments received that raised concerns about recognising the impact of changes in own credit risk in profit or loss when non-trading financial liabilities are measured at fair value.

To address those concerns, the IASB now intends to retain substantially all the requirements of IAS 39 in respect of the classification and measurement of financial liabilities but proposes removing from profit or loss the net impact of changes in the liability’s credit risk for financial liabilities designated under the fair value option.

The ED might therefore be considered noteworthy as much for what it does not seek to change as for what it does explicitly propose. In effect, it represents a stepping away from the more wide-ranging changes to financial liability accounting proposed in 2009. Requirements identical to those in IAS 39 would remain in place for most financial liabilities, in particular the current rules on separation of embedded derivatives that the IASB abolished for financial assets in IFRS 9.

Reform of financial instruments accounting remains a joint project between the IASB and the US Financial Accounting Standards Board (FASB). FASB will soon publish its own comprehensive proposals on financial instruments accounting. Although those proposals may be different from the IASB’s, the two Boards plan to continue to work together. Given the significance of financial instruments and the complexity of the associated accounting issues, together with the importance of co-ordinated and comparable standards for use across international capital markets, the benefits of achieving meaningful convergence are significant. However, it remains unclear how and to what extent that objective will ultimately be achieved.

In any event, completion of the IASB’s work on the classification and measurement of financial liabilities is an essential step in finalising a replacement standard on accounting for financial instruments under IFRSs. We hope that this publication will assist you in gaining a greater understanding of the proposals in ED/2010/4 and their context in relation to the overall financial instruments project. We encourage you to join in the debate and to provide the IASB with your comments prior to its deadline of 16 July 2010.

Andrew Vials
KPMG’s global IFRS Financial Instruments leader
KPMG International Standards Group
About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

We would like to acknowledge the efforts of the principal authors of this publication. Those authors include Dr Markus Fuchs and Chris Spall of the KPMG International Standards Group.

Content

Our New on the Horizon publications are prepared upon the release of a new proposed IFRS or proposed amendment(s) to the requirements of existing IFRSs. They include a discussion of the key elements of the new proposals and highlight areas that may result in a change of practice.

This edition of New on the Horizon considers the proposed requirements of ED/2010/4 Fair Value Option for Financial Liabilities (ED).

The text of this publication is referenced to the ED and to selected other current IFRSs in issue at 11 May 2010. References in the left-hand margin identify the relevant paragraphs.

Further analysis and interpretation will be needed in order for an entity to consider the potential impact of this ED in the light of its own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change.

The purpose of this publication is to summarise the key features of the proposals in the ED and highlight potential impacts and conceptual and application issues identified to date so as to facilitate informed debate and comment on the proposals.

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- New on the Horizon publications, which discuss consultation papers
- Newsletters, which highlight recent developments, including IFRS – Insurance Newsletter
- IFRS Practice Issue publications, which discuss specific requirements of pronouncements
- First Impressions publications, which discuss new pronouncements
- Disclosure checklist.

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## Executive summary

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<th>Item</th>
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<tbody>
<tr>
<td><strong>ED/2010/4 Fair Value Option for Financial Liabilities</strong> (the ED) is part of the IASB’s plan to replace IAS 39 <em>Financial Instruments: Recognition and Measurement</em> over the coming months.</td>
</tr>
<tr>
<td>The IASB proposes retaining substantially all the classification and measurement guidance in IAS 39 for financial liabilities. In particular, no changes are proposed to the accounting for financial liabilities with embedded derivatives.</td>
</tr>
<tr>
<td>The fair value option in IAS 39 under which an entity may designate financial liabilities on initial recognition as measured at fair value through profit or loss if certain eligibility criteria are met would continue. However, the ED proposes a “two-step approach” to the presentation of changes in the fair value of financial liabilities designated under the fair value option. The total fair value changes of these liabilities would be separately presented in profit or loss. At the same time, the portion of the fair value changes attributable to changes in the liabilities’ credit risk would be reclassified from profit or loss to other comprehensive income (OCI). The amount presented in OCI would never be recycled back to profit or loss. This means that the effect of changes in the liabilities’ credit risk would not impact reported net income.</td>
</tr>
<tr>
<td>The ED proposes retention of the guidance in IFRS 7 <em>Financial Instruments: Disclosure</em> on how to determine the amount of the change in fair value that is attributable to changes in the liabilities’ credit risk.</td>
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<tr>
<td>The IASB also asks for comments on some alternatives to the approach proposed in the ED.</td>
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<td>The ED additionally proposes eliminating the cost exception for certain derivative liabilities that will be settled by delivery of unquoted equity instruments.</td>
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<tr>
<td>The United States Financial Accounting Standards Board (FASB) is publishing its own different proposals on accounting for financial liabilities. The IASB requests its constituents to provide feedback to the FASB on its proposals.</td>
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2. Introduction

The IASB is revising its accounting requirements for financial instruments. The objectives of the project include improving the decision-usefulness of financial statements for users by simplifying the classification and measurement requirements for financial instruments. This project aims to replace the existing standard, IAS 39.

The IAS 39 replacement project, and in particular its timeline, is driven in part by requests for reform from the Group of Twenty (G20) and other constituents. Following the G20 summit in April 2009, the Leaders’ Statement called on accounting standard setters, including the IASB and the FASB, to work urgently with supervisors and regulators to improve standards on valuation guidance and loan loss provisioning and achieve a single set of high-quality global accounting standards. Following the conclusion of their September 2009 summit, the G20 leaders reiterated this message and called on the international accounting standard setters to complete their convergence project by June 2011.

The IAS 39 replacement project has three main phases:

- classification and measurement of financial instruments (the chapters of IFRS 9 Financial Instruments published on 12 November 2009 and ED/2010/4 Fair Value Option for Financial Liabilities (the ED) that is the subject of this publication);
- amortised cost and impairment of financial assets (ED/2009/12 Financial Instruments: Amortised Cost and Impairment published on 5 November 2009); and
- hedge accounting (an exposure draft is scheduled to be published in the second or third quarter of 2010).

A phased approach has been adopted in order to accelerate the replacement of IAS 39 and address the consequences of the financial crisis as speedily as possible, while giving interested parties an opportunity to comment on the proposals in accordance with the IASB’s commitment to due process.

In 2009 the IASB issued ED/2009/7 Financial Instruments: Classification and Measurement as the first phase in the IAS 39 replacement project and Discussion Paper (DP) 2009/2 Credit Risk in Liability Measurement. During its deliberations of responses to ED/2009/7 and the DP, the IASB decided to finalise the guidance on classification and measurement of financial assets first, with the issuance of the first chapters of IFRS 9, and to discuss further the classification and measurement of financial liabilities.

In particular, the IASB wished to consider more extensively the role of credit risk in financial liability re-measurement. Many constituents had concerns with recognising in profit or loss the effects of changes in the fair value of liabilities due to changes in the liability’s credit risk. During the financial crisis, some entities reported substantial gains on their financial liabilities measured at fair value as a result of increases in the liabilities’ credit risk.

The IASB has maintained its position that “own credit risk” is included in determining the fair value of liabilities. This is reflected in IAS 39 and in ED/2009/5 Fair Value Measurement, published in 2009.

The IASB discussed several models to address the issue of own credit risk for financial liabilities. It undertook an extensive outreach programme which included a questionnaire survey on own credit risk to gather opinions of users of financial statements on this issue.
At the time of this publication, the IASB has issued a number of other exposure documents that form part of, or are relevant to, the IAS 39 replacement project.

In March 2009 the IASB published exposure draft ED/2009/3 Derecognition, which proposed new guidance on when a financial asset should be removed from an entity’s statement of financial position, and increased disclosures about transfers of assets. The comment period closed on 31 July 2009. Following deliberation of the comments received, the IASB now is pursuing an alternative approach that was included in ED/2009/3 and which focuses on the specific rights and obligations acquired or assumed in a transfer of financial assets. Currently the IASB plans to issue a final standard in the fourth quarter of 2010 or the first quarter of 2011.

ED/2009/5 proposes new guidance on the principles to be applied in determining fair values when IFRSs require or permit use of fair values. The proposed guidance in ED/2009/5 also would apply to any measurements of fair values of financial instruments that would be required under the IAS 39 replacement project. The comment period closed on 28 September 2009. Currently, the IASB plans to issue a final standard in the fourth quarter of 2010.

ED/2009/12 proposes to replace the incurred loss method for impairment of financial assets with a method based on expected losses and to provide a more principles-based approach to establishing measurement requirements for amortised cost. The comment period closes on 30 June 2010. Currently the IASB plans to issue the final chapters on this phase of the project in the fourth quarter of 2010.

ED/2010/4 The IASB and the FASB reiterated their commitment to working together to develop a converged solution on financial instruments accounting and published a joint statement on 5 November 2009 detailing how they intend to fulfil this commitment. In their quarterly progress report to 31 March 2010, the Boards acknowledge that they have reached different conclusions in their financial instruments projects on some important technical issues and that addressing those differences in ways that foster convergence could affect the envisaged timetables. The FASB intends to publish its proposals on financial instruments accounting shortly in a comprehensive exposure draft that would address classification and measurement, impairment and hedge accounting. For financial liabilities, the FASB proposes generally to require fair value measurement (see section 6) whereas the IASB’s proposals result in a mixed measurement model with fair value and amortised cost categories, including bifurcation of embedded derivatives. Therefore, the IASB has asked its constituents to provide feedback to the FASB on the proposals in the FASB’s exposure draft. The IASB intends to use the feedback received when it considers how to reconcile any differences between IFRSs and US GAAP.

However, the IASB is not re-exposing any aspects of IAS 39 or IFRS 9 beyond the changes made to the fair value option. The invitation to comment explicitly states that the IASB does not seek comments on aspects of IAS 39 or IFRS 9 which are not addressed in the ED.
3. **Classification and measurement of financial liabilities**

3.1 **Background – financial assets**

**IFRS 9.2.1, 4.1, 4.2**

The chapters of IFRS 9 issued to date provide guidance on recognition, classification and measurement of financial assets. The standard contains two primary measurement categories: amortised cost and fair value. A financial asset qualifies for amortised cost measurement only if it meets both of the following conditions:

- the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

If a financial asset does not meet both of these conditions, then it is measured at fair value in profit or loss.

**Observation**

A similar approach based on the business model of the entity and the cash flow characteristics of the instruments was initially proposed for financial liabilities in ED/2009/7. The original idea was to align the classification and measurement of financial assets and financial liabilities. Under such a symmetrical approach, a financial liability that fails the “solely payments of principal and interest” test for amortised cost accounting would be required to be measured at fair value through profit and loss in its entirety. An example would be a structured note with an embedded equity feature. By contrast, under IAS 39, the embedded feature might be accounted for separately as a derivative measured at fair value through profit or loss while most of the liability might be allocated to a host liability measured at amortised cost. Thus, a symmetrical approach might have increased the extent to which fair value changes due to changes in own credit are recognised as gains and losses.

3.2 **Recent deliberations**

**ED/2010/4.BC6**

During its deliberations on the accounting for financial liabilities the IASB discussed several potential approaches to address own credit risk. The approaches comprised:

- **Recognition of fair value changes due to own credit risk in OCI**: Under this approach liabilities would be measured at fair value and the portion of the change in fair value that is attributable to changes in the liability’s credit risk would be presented in other comprehensive income.
- **Recognition of all fair value changes in OCI**: This can be seen as a variant of the previous approach under which the entire change in fair value of a liability would be presented in OCI.
- **Adjusted fair value**: Under this approach liabilities would be measured at an “adjusted” fair value that would reflect all changes in fair value except for the effects of changes in the liability’s credit risk. The IASB refers to this as “the frozen credit spread method.”
- **Amortised cost**: Under this approach liabilities would be measured at amortised cost. According to the IASB this approach would require estimating the cash flows over the life of the instrument, including those cash flows associated with any embedded derivative features.
- **Bifurcation**: Under this approach, liabilities would be bifurcated into host instruments and separable embedded features. The host contract would be measured at amortised cost while the embedded features (for example, embedded derivatives) would be measured at fair value through profit or loss. This approach could take either of two forms:
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- **IAS 39 model**: Under this approach, the IAS 39 model for bifurcation of embedded derivatives would be retained.
- **New model**: Under this approach, bifurcation would be based on the contractual cash flows criterion in IFRS 9 for amortised cost accounting, i.e. the host would be identified as a component involving solely payments of principal and interest and any other features contained in the liability would be separated and measured at fair value through profit or loss like a derivative.

**IASB staff FAQ** The IASB received feedback from users of financial statements from which it identified three principles which it used in formulating the proposals in the ED:

- if liabilities are re-measured they should be on the statement of financial position at full fair value (i.e. including the effect of changes in own credit);
- volatility in profit or loss arising from own credit risk does not provide useful information; and
- own credit risk information does still have information content.

**Observation**

Partly in order to address the issues arising from the inclusion of own credit risk in the measurement of financial liabilities at fair value, the IASB has decided to propose different principles for the classification and measurement of financial liabilities than those which apply to financial assets as set out in IFRS 9. The IASB’s survey indicated that users generally did not believe that symmetry between the accounting for financial assets and financial liabilities was important.

**ED/2010/4.BC10**

The IASB has decided to retain substantially all of the requirements in IAS 39 for the classification and measurement of financial liabilities. The IASB believes that the benefits of changing practice at this point would not outweigh the costs of the disruption that such a change would cause.

**ED/2010/4.BC11**

The IASB believes that largely retaining the IAS 39 model avoids the issue of own credit risk for most financial liabilities. Most would continue to be measured at amortised cost. Liabilities that are held for trading (including all derivative liabilities) would continue to be measured at fair value through profit or loss, which the IASB says “is consistent with the widespread view that all fair value changes for those liabilities should affect profit or loss.”

The following diagram provides an outline of the proposed requirements for the classification and measurement of financial liabilities based on the ED and those elements of the IAS 39 model that the IASB currently intends to retain. The overview does not cover financial liabilities that arise when the transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies, financial guarantee contracts and commitments to provide a loan at a below market rate of interest.
Financial liabilities in the scope of IAS 39

- Derivative or financial liability held for trading?
  - Yes
  - Measure at fair value through profit or loss
  - No
  - Designated under fair value option (If conditions are met)?
    - Yes
    - Separable embedded derivative(s) in financial liability?
      - Yes
      - Separate host and embedded derivative(s)
      - Host: Measure at amortised cost
      - Derivative(s): Measure at fair value through profit or loss
      - No
    - No
      - No

- No
  - Yes
  - Reclass fair value changes due to own credit risk from profit or loss to OCI
4. Proposed changes to the fair value option

4.1 Proposed changes

The option in IAS 39 to designate irrevocably a financial liability at fair value through profit or loss if particular eligibility conditions are met would be retained and integrated into IFRS 9. The eligibility conditions would remain as follows:

- The designation eliminates or significantly reduces a measurement or recognition inconsistency ("accounting mismatch") that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.
- A group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel.
- If a contract contains one or more embedded derivatives and the host is outside the scope of IFRS 9, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss unless:
  - the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or
  - it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

The proposed changes relate to the presentation and disclosure of gains and losses recognised on application of the fair value option to financial liabilities. Under IAS 39, all fair value changes are recognised in profit or loss. Under the ED, the IASB proposes to eliminate from profit or loss the effect of changes in fair value due to changes in own credit risk.

To achieve this outcome, the IASB proposes a two step approach:

- Step 1: Presentation of the total change in the fair value of the financial liability in profit or loss.
- Step 2: Presentation of the amount of the change in fair value that is attributable to changes in the liability’s credit risk in other comprehensive income - with an offsetting entry presented in profit or loss.

The amounts recognised under this approach would have to be presented separately in the statement of comprehensive income in the following line items:

(a) net gains or losses on financial liabilities designated as at fair value through profit or loss; and
(b) the portion of the amount in (a) that is attributable to changes in the liabilities’ credit risk.

Observation

The line item for the portion attributable to changes in credit risk would have to be presented twice – once within other comprehensive income and once as an offsetting entry to profit or loss.

Although the ED would require both the line items (a) and (b) to be separately presented in profit or loss, it does not state that they should be presented adjacently or that the net total of the two amounts should be presented as a third separate line item.
The amounts presented in OCI would never be recycled back to profit or loss. This would apply even if a gain or loss related to a change in the liability’s credit risk is realised by settling or repurchasing the liability at fair value. A transfer of the cumulative gain or loss within equity would be permitted. IFRS 7 would be amended to require the disclosure of the amount (if any) presented in other comprehensive income that was realised at derecognition of a financial liability designated as at fair value through profit or loss.

Observation
The general disclosure requirements of paragraph 10(a) of IFRS 7 would be retained. These require disclosure of the amount of change, both during the period and cumulatively, in the fair value of a designated financial liability that is attributable to changes in the liability’s credit risk as well as the difference between the financial liability’s carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

Furthermore the ED proposes that IAS 1 Presentation of Financial Statements would be amended so that the change in fair attributable to changes in the liability’s credit risk designated under the fair value option would be defined as a component of other comprehensive income. IAS 1 requires a reconciliation of the opening and closing balances of each component of equity, which includes the accumulated balance of each component of OCI.

Illustrative example
Assume on 1 January 20X1 Company X issues a bond at its fair value of 1,000 and with an interest rate of 10 percent payable annually. X incurs no fees and costs. The entity decides to apply the fair value option as the liability is held in a portfolio which is managed on a fair value basis. On 31 December 20X1 the fair value of the liability is 948. The fair value change is split into an amount attributable to changes in market interest rates of 36 and an amount attributable to changes in the liability’s credit risk of 16. On 1 January 20X2, X re-acquires the bond for its fair value of 948.

The entries are as follows under the proposed approach:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000</td>
</tr>
<tr>
<td>Financial Liability</td>
<td>1,000</td>
</tr>
<tr>
<td>To recognise issue of bond</td>
<td></td>
</tr>
<tr>
<td>Financial liability</td>
<td>52</td>
</tr>
<tr>
<td>Total change in fair value (profit or loss)</td>
<td>52</td>
</tr>
<tr>
<td>To recognise re-measurement of bond at 31 December 20X1</td>
<td></td>
</tr>
<tr>
<td>Change in fair value from own credit risk (profit or loss)</td>
<td>16</td>
</tr>
<tr>
<td>Change in fair value from own credit risk (OCI)</td>
<td>16</td>
</tr>
<tr>
<td>To recognise change in fair value relating to own credit risk in OCI</td>
<td></td>
</tr>
<tr>
<td>Financial liability</td>
<td>948</td>
</tr>
<tr>
<td>Cash</td>
<td>948</td>
</tr>
<tr>
<td>To recognise re-acquisition of the bond</td>
<td></td>
</tr>
</tbody>
</table>
ED/2010/4.
BC39

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value reserve (equity)</td>
<td>16</td>
</tr>
<tr>
<td>Retained earnings (equity)</td>
<td>16</td>
</tr>
<tr>
<td>To recognise reclassification within equity on re-acquisition (optional entry)</td>
<td></td>
</tr>
</tbody>
</table>

**Observation**

In the Basis for Conclusions it is noted 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 on repayment will equal the contractual amount. The IASB concluded that for many liabilities the issue of recycling is therefore irrelevant.

BC25

The IASB thinks that the two-step method proposed delivers useful information for the users of financial statements, namely:

- the fair value of the financial liability;
- the total fair value change of the financial liability; and
- the portion of the total fair value change that is attributable to changes in the liability’s credit risk.

This is in line with the criteria the IASB derived from its survey of users.

ED/2010/4.
BC39 A4, BC40, IFRS 7.10, B4

IFRS 7 already requires disclosure of the amount of change, during the period and cumulatively, in the fair value of a financial liability designated as fair value through profit or loss that is attributable to changes in the liability’s credit risk. The ED would retain the guidance in IFRS 7 on how to determine that amount. The IASB acknowledges that this determination may be difficult in practice. The “default method” carried forward from IFRS 7 as a “reasonable proxy” requires attribution of all changes in fair value, except for changes in a benchmark interest rate (and any other changes in market conditions that give rise to market risk), to changes in the liability’s credit risk. Nevertheless entities are permitted to use a different method if it provides a more faithful representation of the amount of the change in fair value attributable to changes in credit risk.

**Observation**

The ED proposes carrying forward, but not supplementing, the guidance from IFRS 7 on how to determine the portion of changes in fair value that is attributable to changes in credit risk. To date, the purpose of the determination has been to provide footnote disclosure of the portion whereas, under the ED, it would have a direct impact on reported profit or loss. Given this different impact, and the potentially more prominent effect of different approaches or any diversity in practice, some entities may request further clarification of the concepts and their application. Possible discussion issues include:

- **Benchmark interest rates:** The default method treats a benchmark interest rate as akin to a risk-free rate and excludes all changes in the benchmark rate as unrelated to and not part of changes in the liability’s credit risk. However, the ED does not define what a benchmark rate is. In practice, it is commonly understood to include inter-bank rates such as LIBOR for US dollar or sterling liabilities or EURIBOR for euro liabilities. However, some would argue that these rates may include a credit-risk premium above the highest-quality government bond rates for the same term and currency.
Credit-sensitive payments: Some debt agreements contain features that are intended to protect the creditor against increases in the issuer’s own credit risk by increasing the rate of contractual interest payable if the issuer’s credit rating deteriorates. The ED does not discuss how the effect of actual or expected changes in contractual cash flows arising from such clauses should be considered.

Interest stopper clauses: By contrast, some subordinated debt instruments or preference shares accounted for as liabilities may allow the issuer to avoid or defer payments of interest or principal if it fails to achieve some measure of financial health, e.g. a deficit of statutory reserves or inadequate regulatory capital. Again, the ED does not discuss whether consequent changes in contractual cash flows should be considered part of the own credit component.

Asset-backed securities and other pass-through-type and non-recourse arrangements: Entities, especially special-purpose entities, may issue instruments that are intended to “pass through” to an investor some or all of the cash flows of specified assets. Such instruments may have stated principal and interest amounts but the amount of the issuer’s obligation may be reduced if the specified assets fail to generate sufficient cash. Alternatively, the investor may have no recourse to other assets of the issuer in the event of the issuer’s default. Where such an instrument is accounted for as a liability, there might be difficult practical issues in identifying and measuring the own credit risk component.

4.2 Alternative approaches

In the ED, the IASB also asks for comments on alternatives to the proposed approach in the ED, being that changes in the liability’s credit risk would not affect (net) profit or loss.

Under one alternative, the proposals in the ED would be applied (i.e. changes in the credit risk of the liability would not affect profit or loss) unless this treatment would create a mismatch in profit or loss. If this were so, then the entire fair value change would be required to be presented in profit or loss. A possible example of such a scenario is where financial liabilities are managed together with financial assets that are measured at fair value through profit or loss (i.e. the entire changes in fair value of the assets, including that attributable to credit risk, is included in profit or loss). The determination of whether a mismatch would be created would be made at initial recognition of the liability and would not be reassessed. The IASB believes that such an approach would not be consistent with users’ preferences and would reduce comparability.

Observation

Although the ED states that some believe a “mismatch” could arise when related assets are measured at fair value through profit or loss, including the effect of changes in the assets’ credit risk, the ED does not provide any further discussion as to how an entity would evaluate whether there actually was a mismatch under this alternative approach. In a scenario of the type highlighted, the gains and losses on the assets would reflect the effect of changes in the credit risk of those specific assets. It is unclear whether the alternative approach would require any evaluation as to whether there was any actual or expected correlation between the effect of changes in the assets’ credit risk and changes in the liabilities’ credit risk and, if so, how this might be done.

Under another alternative, instead of the two-step approach described, a one-step approach would be applied under which the portion of the fair value change that is attributable to changes in the liability’s credit risk would be presented directly in OCI, i.e. without being simultaneously included in and removed from profit or loss. Some consider this more efficient and less complicated than
the two-step approach while both approaches give the same net result in profit or loss and other comprehensive income.

ED/2010/4, Question 6, BC33

The final alternative calls for presentation of the fair value change attributable to changes in the liability’s credit risk in equity rather than in OCI. Proponents of this alternative believe that the use of OCI should not be expanded until the IASB comprehensively addresses the issue of what items should be presented in OCI and whether they should be recycled. Also, they consider presentation in equity to be consistent with the view that a change in the liability’s credit risk represents a wealth transfer between liability holders and equity holders.
5. Other proposed changes

ED/2010/4.A8 The ED contains consequential amendments that would delete the current exception that requires measurement at cost of derivative financial liabilities linked to and settled by delivery of unquoted equity instruments whose fair value cannot be determined reliably. Such liabilities would be required under the ED to be measured at fair value through profit or loss, like other derivative liabilities. This aligns with the original proposals included in ED/2009/7 and with the requirements for derivative assets in IFRS 9.
6. Effective date and transition

The exposure draft does not specify an effective date. However, in the Basis for Conclusions, reference is made to the effective date of IFRS 9 which is 1 January 2013.

**Observation**

The IASB reiterates that it will consider delaying that effective date if the impairment phase of the project to replace IAS 39 makes such a delay necessary, or if a new IFRS on insurance contracts has a mandatory effective date later than 2013, to avoid an insurer having to face two rounds of change in a short period.

Early application of the guidance would be possible. If an entity applied the amendments early, it would have to apply at the same time any requirements in IFRS 9 that it did not already apply.

**Observation**

The wording that an entity has to apply any requirements in IFRS 9 it does not already apply upon early adoption of the amendments would contradict previous statements made by the IASB if any were interpreted as “all”. However, in the Basis for Conclusions the IASB clarifies that if an entity elects to apply early any finalised requirements that result from these proposals, the entity must also apply any “preceding” requirements in IFRS 9 that it does not already apply. This appears consistent with the IASB’s previously stated intention that any future additions to IFRS 9 as published in November 2009 could be applied only if “requirements published before them” were also applied, rather than all requirements whenever published.

An entity would have to apply the amendments to the fair value option retrospectively, in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

**Observation**

Since the ED would not generally change the guidance in IAS 39 for financial liabilities, it does not itself propose allowing new designations or revocations of previous designations under the fair value option on initial adoption.

The IASB also notes that entities should have the information about fair value changes attributable to changes in the liability’s credit risk designated under the fair value option, since this amount is required to be disclosed under IFRS 7. This would generally be the case for prior annual periods, to which IFRS 7 is applicable, but might not be the case for prior interim periods for which the IFRS 7 disclosure was not required. Additionally, the current chapters of IFRS 9 allow an entity at the date of its initial application of those chapters to designate a financial liability as at fair value through profit or loss to avoid an accounting mismatch. This designation is applied retrospectively. In this case, information about fair value changes attributable to changes in the liability’s credit risk may not be available since the entity would not have been required to disclose these amounts under IFRS 7 before.

IFRS 1 First-time Adoption of International Financial Reporting Standards allows a first-time adopter to designate an existing financial liability to be designated under the fair value option at its date of transition, provided the relevant criteria in IAS 39 are met. The ED would retain this exception. However, it does not discuss whether a gain or loss arising from a change in
the liability’s credit risk between its issuance and the date of transition should be identified and included in accumulated other comprehensive income at that time or recorded in retained earnings. Similarly, it does not specifically discuss whether reversal of such a gain or loss should be presented in profit or loss or other comprehensive income.
7. Outlook

The IAS 39 replacement project in relation to financial liabilities has been overshadowed by the discussions on own credit risk. A principal aim has been to meet the concerns of users about the presentation of own credit risk gains and losses on non-trading liabilities in profit or loss. This has led to a considerable narrowing of the scope of changes related to the classification and measurement of financial liabilities. The IASB aims to finalise the IAS 39 replacement project by the end of 2010. Several members of the IASB will be leaving in mid-2011. Wider changes to the accounting for financial liabilities would be difficult to fit into an already tight timetable, particularly with the challenges of dealing with other complex projects at the same time, such as the project on accounting for insurance contracts.

Further issues for the IASB’s consideration may arise from the proposed model for financial instruments accounting due to be published by the FASB. The FASB’s tentative decisions on financial liabilities include:

- All financial instruments, except for certain deposit liabilities and short-term receivables and payables, would be measured at fair value with all changes in fair value recognised in net income unless an entity’s business strategy is to hold debt instruments with principal amounts and that meet certain characteristics for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instruments with a third party.
- If the business strategy is to hold qualifying instruments to pay contractual cash flows, certain changes in fair value for those instruments may be recognised in OCI. The amount of the change in fair value recognised in OCI would equal the entire change in fair value, excluding current period interest accruals.
- Core deposit liabilities not measured at fair value would be measured at the present value of the average deposit amount discounted over the implied maturity of the deposits. Short-term receivables and payables not measured at fair value would be measured at amortised cost.
- For hybrid financial instruments containing embedded derivatives that do not meet the clearly and closely related criterion and would require separate accounting under current US GAAP, all changes in fair value for the entire hybrid financial instrument would be recognised in net income.
- An entity may irrevocably elect to measure a financial liability at amortised cost if the liability meets the criteria to recognise certain changes in fair value in OCI and if measurement of the liability at fair value would create or exacerbate an accounting mismatch of recorded assets and liabilities.

The financial instruments project is a joint project between the FASB and the IASB. In the ED, the IASB states that an objective is “increasing international comparability” and that it will use requested feedback from the IASB’s constituents in considering “how to reconcile any differences between IFRSs and US GAAP.” Accordingly, the FASB’s proposals may have an influence on the IASB’s final replacement standard. However, given the different proposals of the FASB and IASB, it is not possible to predict what the nature of this reconciliation may involve.