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Exposure Draft ED/2010/4

Fair Value Option for Financial Liabilities

Comments to be received by 16 July 2010



International
Accounting Standards
Board®

Exposure Draft
FAIR VALUE OPTION FOR
FINANCIAL LIABILITIES

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ED/2010/4

This exposure draft *Fair Value Option for Financial Liabilities* is published by the International Accounting Standards Board (IASB) for comment only. Comments on the exposure draft and the Basis for Conclusions should be submitted in writing so as to be received by **16 July 2010**. Respondents are asked to send their comments electronically to the IASB website (www.iasb.org), using the 'Open to Comment' page.

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BASIS FOR CONCLUSIONS

Introduction and invitation to comment

Reasons for replacing IAS 39

- 1 IAS 39 *Financial Instruments: Recognition and Measurement* sets out the requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. The International Accounting Standards Board (IASB) inherited IAS 39 from its predecessor body, the International Accounting Standards Committee.
- 2 Many users of financial statements and other interested parties have told the Board that the requirements in IAS 39 are difficult to understand, apply and interpret. They have urged the Board to develop a new standard of financial reporting for financial instruments that is principle-based and less complex. Although the Board has amended IAS 39 several times to clarify requirements, add guidance and eliminate internal inconsistencies, it has not previously undertaken a fundamental reconsideration of reporting for financial instruments.
- 3 Since 2005, the IASB and the US Financial Accounting Standards Board (FASB) have had a long-term objective to improve and simplify the reporting for financial instruments. This work resulted in the publication of a discussion paper, *Reducing Complexity in Reporting Financial Instruments*, in March 2008. Focusing on the measurement of financial instruments and hedge accounting, the paper identified several possible approaches for improving and simplifying the accounting for financial instruments. The responses to the paper indicated support for a significant change in the requirements for reporting financial instruments. In November 2008 the IASB added this project to its active agenda, and in December 2008 the FASB also added the project to its agenda.
- 4 In April 2009, in response to the input received on their work responding to the financial crisis, and following the conclusions of the G20 leaders and the recommendations of international bodies such as the Financial Stability Board, the boards announced an accelerated timetable for replacing their respective financial instruments standards. As a result, in July 2009 the IASB published an exposure draft *Financial Instruments: Classification and Measurement*, followed by IFRS 9 *Financial Instruments* in November 2009.

The IASB's approach to replacing IAS 39

- 5 The IASB and the FASB are committed to achieving a comprehensive and improved solution to the accounting for financial instruments that provides comparability internationally. However, the boards' efforts to achieve a common and improved financial instruments standard have been complicated by the establishment of different project timetables to respond to their respective stakeholder groups in the light of the financial crisis.
- 6 The IASB noted requests from interested parties that the accounting for financial instruments should be improved quickly. The G20 leaders recommended that the Board should take action by the end of 2009 to improve and simplify the accounting requirements for financial instruments. To achieve this, the Board divided its project to replace IAS 39 into three main phases.
- 7 As part of the first phase to replace IAS 39, in July 2009 the IASB published an exposure draft that contained proposals for the classification and measurement for all items within the scope of IAS 39. In that exposure draft the Board also drew attention to the IASB discussion paper *Credit Risk in Liability Measurement* that was published in June 2009.
- 8 In their responses to the exposure draft and discussion paper, many expressed concerns about recognising in profit or loss the effects of changes in the credit risk of financial liabilities. Many respondents to the exposure draft said that the Board should restrict any finalised requirements on classification and measurement to financial assets and retain the existing requirements for financial liabilities until the Board had more fully considered and debated the issues relating to financial liabilities. During its redeliberations on the classification and measurement of financial instruments the Board decided not to finalise the requirements for financial liabilities before considering those issues further and analysing possible approaches to address the concerns raised by respondents. Accordingly, in November 2009 the Board issued the chapters of IFRS 9 relating to the classification and measurement of financial assets.
- 9 The Board intends that IFRS 9 will ultimately replace IAS 39 in its entirety. As the Board completes each subsequent phase of its project to replace IAS 39, it will delete the relevant portions of IAS 39 and add new chapters to IFRS 9.

Contents of this exposure draft

- 10 During its deliberations leading to this exposure draft, the Board discussed several approaches for addressing the effects of changes in the credit risk of liabilities. On the basis of the feedback received from its Financial Instruments Working Group and from users, regulators, preparers, auditors and others, the Board decided that none of those approaches would be less complex or result in more useful information than the bifurcation requirements in IAS 39. As a result, the Board decided to retain the existing requirements for classifying and measuring financial liabilities, except for particular requirements related to the fair value option. To address the issue of credit risk, this exposure draft contains proposals for how gains and losses on liabilities designated under the fair value option should be presented in the statement of comprehensive income.
- 11 The result of the proposals in this exposure draft, along with the existing requirements in IAS 39, would be that changes in a liability's credit risk do not affect profit or loss unless the liability is held for trading. That is consistent with the almost unanimous feedback from users of financial statements.
- 12 For the convenience of the reader, the proposals in this exposure draft are presented as a self-contained issue rather than as an amendment to IFRS 9. However, any finalised requirements would be included in IFRS 9 in the chapter on classification and measurement of financial liabilities. Also, any guidance in IAS 39 or IFRS 7 *Financial Instruments: Disclosures* that is still relevant to the finalised requirements would be moved to IFRS 9. For example, paragraphs 9(b)(i) and (ii), 11A and AG4B-AG4K in IAS 39, which provide guidance on the eligibility conditions for the fair value option, would be added to IFRS 9 and deleted from IAS 39. Also, the paragraphs in IFRS 7 that provide guidance on how to determine the amount of change in the fair value of the liability that is attributable to changes in its credit risk would be added to IFRS 9 and deleted from IFRS 7.

Next steps

- 13 As mentioned above, the IASB chose to complete the project to replace IAS 39 in three phases to respond to requests from interested parties that the accounting for financial instruments should be improved quickly. The main phases are:
- (a) Phase 1: Classification and measurement—IFRS 9 was issued in November 2009 and contains new requirements for classifying and measuring financial assets. This exposure draft contains proposals

for presenting gains and losses on financial liabilities designated at fair value through profit or loss. The Board aims to finalise any requirements resulting from these proposals by the end of 2010.

- (b) Phase 2: Impairment methodology—An exposure draft, *Financial Instruments: Amortised Cost and Impairment* was published in November 2009 with a comment deadline of 30 June 2010.
- (c) Phase 3: Hedge accounting—The IASB expects to publish proposals resulting from its comprehensive review of hedge accounting requirements in the near term.

14 In addition to those three phases, the Board published in March 2009 an exposure draft *Derecognition* (proposed amendments to IAS 39 and IFRS 7) to replace the existing guidance on derecognition of financial assets and financial liabilities. Redeliberations are under way and the Board expects to complete this project in the first quarter of 2011.

15 As stated above, the Board plans to replace IAS 39 in its entirety.

16 The FASB expects to publish shortly a proposed Accounting Standards Update (ASU) on accounting for financial instruments that contains proposals for a new comprehensive standard on financial instruments, including proposals on the classification and measurement of financial assets and financial liabilities, impairment methodology and hedge accounting. Under the proposals almost all financial assets and liabilities would be measured at fair value in the primary financial statements. The proposals discuss separate presentation of significant changes in fair value attributable to changes in liabilities' credit risk. The FASB expects that the proposed ASU will have a comment deadline of 30 September 2010.

17 IFRS 9 and IAS 39 require some financial assets and financial liabilities to be measured at amortised cost if particular conditions are met.* The IASB has received widespread support for a measurement approach that requires reporting entities to classify financial instruments into two measurement categories—amortised cost and fair value (a 'mixed measurement' approach). Therefore, the IASB has asked its constituents to provide feedback to the FASB on the proposals in the FASB's exposure draft. This is particularly important because this is a joint project with an objective of increasing international comparability. Feedback from IFRS constituents will be helpful to the FASB when it redeliberates its proposals and finalises any requirements. Moreover, the IASB will use that feedback when it considers how to reconcile any differences between IFRSs and US GAAP.

* Unless the entity designates the financial asset or financial liability as at fair value through profit or loss.

Invitation to comment

The Board invites comments on all matters in this exposure draft, and in particular on the questions set out in the following paragraphs. Respondents need not comment on all of the questions. Comments are most helpful if they:

- (a) respond to the questions as stated
- (b) indicate the specific paragraph or paragraphs to which the comments relate
- (c) contain a clear rationale
- (d) describe any alternatives the Board should consider.

The Board is not seeking comments on aspects of IAS 39 or IFRS 9 not addressed in this exposure draft.

Comments should be submitted in writing so as to be received no later than **16 July 2010**.

Presenting the effects of changes in a liability's credit risk in profit or loss

For all liabilities designated under the fair value option, the exposure draft proposes that effects of changes in the credit risk of the liability would not affect profit or loss. That proposal responds to the long-standing concern raised by many, including users of financial statements, that recognising the effects of changes in the credit risk of a liability in profit or loss does not provide useful information unless the liability is held for trading. [Question 8 addresses how the effects of changes in the liability's credit risk should be determined.]

However, some have suggested that the proposals could create an accounting mismatch in profit or loss in some cases. That might be the case if the entity is managing liabilities designated under the fair value option with financial assets that are measured at fair value through profit or loss. A mismatch could arise because the entire change in the fair value of the assets would be presented in profit or loss but a portion of the change in the fair value of the liabilities (ie the portion attributable to the effects of changes in the liabilities' credit risk) would not.

To address that potential mismatch, an alternative approach would be to require the proposals in the exposure draft unless they would create a mismatch in profit or loss. If the proposals would create such a mismatch, the entity would be required to present the entire change in the fair value of those liabilities 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.

Question 1

Do you agree that for all liabilities designated under the fair value option, changes in the credit risk of the liability should not affect profit or loss? If you disagree, why?

Question 2

Or alternatively, do you believe that changes in the credit risk of the liability should not affect profit or loss unless such treatment would create a mismatch in profit or loss (in which case, the entire fair value change would be required to be presented in profit or loss)? Why?

Presenting the effects of changes in a liability's credit risk in other comprehensive income

Under the proposals, all liabilities designated under the fair value option would continue to be measured at fair value but changes in the liabilities' credit risk would not affect profit or loss.

The exposure draft proposes a two-step approach. In the first step, the entity would present the entire fair value change in profit or loss. In the second step, the entity would 'back out' from profit or loss the portion of the fair value change that is attributable to changes in the liability's credit risk and present that amount in other comprehensive income.

The Board believes this approach provides the following information that is useful to users:

- (a) the fair value of the financial liability;
- (b) the total fair value change of the financial liability; and
- (c) the portion of the total fair value change that is attributable to changes in the liability's credit risk.

Question 3

Do you agree that the portion of the fair value change that is attributable to changes in the credit risk of the liability should be presented in other comprehensive income? If not, why?

Question 4

Do you agree that the two-step approach provides useful information to users of financial statements? If not, what would you propose instead and why?

Some have suggested a one-step approach whereby the entity would present the portion of the fair value change that is attributable to changes in the liability's credit risk directly in other comprehensive income. All other portions of the fair value change would be presented in profit or loss.

Some think that the one-step approach is more appropriate because it is less complicated than the proposed approach and has the same net effect on profit or loss and other comprehensive income. The only difference between the two approaches is how the change in the liability's credit risk is presented. In the two-step approach, that amount is first presented in profit or loss but then 'backed out' and presented in other comprehensive income. Under the one-step approach the amount is presented directly in other comprehensive income.

Question 5

Do you believe that the one-step approach is preferable to the two-step approach? If so, why?

Under the proposals, the portion of the fair value change that is attributable to changes in the credit risk of the liability would be ultimately presented as an item of other comprehensive income.

Some believe it would be more appropriate to present that amount in equity (rather than in other comprehensive income). Those who prefer presenting the amount in equity believe that the use of other comprehensive income should not be expanded until the Board addresses that topic comprehensively (eg what items should be presented in other comprehensive income and whether those items should be recycled). Moreover, they believe that presenting the amount in equity is consistent with the view that a change in a liability's credit risk represents a wealth transfer between debt holders and equity holders. That view was described in the IASB's discussion paper *Credit Risk in Liability Measurement*.

Question 6

Do you believe that the effects of changes in the credit risk of the liability should be presented in equity (rather than in other comprehensive income)? If so, why?

Reclassifying amounts to profit or loss

The exposure draft proposes to prohibit reclassifying amounts from other comprehensive income to profit or loss ('recycling'). The Board noted that if the entity repays the contractual amount, there would be no amounts to recycle because the cumulative effect of any changes in the liability's credit risk will net to zero.

But if the entity repays an amount other than the contractual amount (for example, if the entity settles the liability prior to maturity at its then fair value), there could be amounts in accumulated other comprehensive income, which would be realised when the liability is derecognised. Under the proposals, those realised amounts would not be reclassified ('recycled') to profit or loss, which is consistent with the Board's view that a gain or loss should be recognised only once.

However, to provide users with information about how much of the accumulated other comprehensive income balance has been realised in the current reporting period, the exposure draft proposes amendments to IFRS 7 that would require disclosure of that amount.

Question 7

Do you agree that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income (or included in equity if you responded 'yes' to Question 6) should not be reclassified to profit or loss? If not, why and in what circumstances should they be reclassified?

Determining the effects of changes in a liability's credit risk

For the purposes of determining the amount of change in fair value of a liability that is attributable to changes in its credit risk, this exposure draft proposes to use the guidance in IFRS 7.

At present if an entity designates a financial liability as at fair value through profit or loss, IFRS 7 requires the entity to disclose the amount of the change in the fair value that is attributable to changes in the liability's credit risk. Paragraph B4 of IFRS 7 provides a default method for calculating that amount. That method attributes all changes in fair value, other than changes in a benchmark interest rate, to changes in the credit risk of the liability. In the Basis for Conclusions on IFRS 7, the Board noted that it believes that this method provides a reasonable proxy for the changes in the liability's credit risk. However, IFRS 7 permits entities to use a different method if it provides a more faithful representation of the changes in the fair value of the liability attributable to changes in its credit risk.

Also, the discussion paper *Credit Risk in Liability Measurement* used the term 'credit risk' broadly to include both the price of credit and the credit quality of the issuer. Almost no respondents differentiated those two items.

The proposals in this exposure draft would carry forward the default method but entities would continue to be permitted to use a different method if it provides a more faithful representation of the amount of the change in fair value that is attributable to changes in the liability's credit risk.

Question 8

For the purposes of the proposals in this exposure draft, do you agree that the guidance in IFRS 7 should be used for determining the amount of the change in fair value that is attributable to changes in a liability's credit risk? If not, what would you propose instead and why?

Effective date and transition

Entities must apply IFRS 9 for annual periods beginning on or after 1 January 2013 but, as noted in the Basis for Conclusions on that IFRS, the Board will consider delaying that effective date in particular circumstances.

However, the Board expects to permit early application of any finalised requirements resulting from this exposure draft. The Board is proposing that if an entity elects to apply these proposals early, the entity must at the same time apply any requirements in IFRS 9 that it does not already apply.

The Board chose to complete the project to replace IAS 39 in phases to respond to requests that the accounting for financial instruments should be improved quickly. The Board is concerned that if an entity is permitted to adopt a phase early without also adopting early all preceding finalised phases, there would be a period of significant incomparability among entities until all of the phases of the project are mandatorily effective.

Question 9

Do you agree with the proposals related to early adoption? If not, what would you propose instead and why? How would those proposals address concerns about comparability?

Consistently with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, the Board is proposing fully retrospective application. Also, the Board's proposal is consistent with IFRS 9, which requires retrospective application (subject to specific requirements that apply in particular circumstances).

Question 10

Do you agree with the proposed transition requirements? If not, what transition approach would you propose instead and why?

Proposals for the fair value option for financial liabilities

Option to designate a financial liability at fair value through profit or loss

- 1 If particular eligibility conditions are met at initial recognition, an entity may irrevocably designate a financial liability as at fair value through profit or loss. The eligibility conditions are described in paragraphs 9(b) and 11A of IAS 39 *Financial Instruments: Recognition and Measurement*. (See also paragraphs AG4B–AG4K of IAS 39.)

Gains and losses on a financial liability designated at fair value through profit or loss

- 2 Gains and losses on a financial liability designated at fair value through profit or loss shall be presented as follows:
- (a) the total change in the fair value of the financial liability shall be presented in profit or loss; and
 - (b) the amount of the change in fair value determined in (a) that is attributable to changes in the credit risk of the liability shall be presented in other comprehensive income (with an offsetting entry presented in profit or loss)

In IFRS 7 *Financial Instruments: Disclosures*, paragraphs 10(a) and B4 provide guidance on how to determine the amount of change in the fair value of the liability that is attributable to changes in the liability's credit risk.

- 3 The amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss. However, the entity may transfer the cumulative gain or loss within equity.

Effective date and transition

Effective date

- 4 An entity shall apply these [draft] amendments for annual periods beginning on or after [date to be inserted after exposure]. Earlier application is permitted. If an entity applies these [draft] amendments in

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its financial statements for a period before [date to be inserted after exposure], it shall disclose that fact and at the same time apply:

- (a) any requirements in IFRS 9 *Financial Instruments* that it does not already apply; and
- (b) the amendments set out in the Appendix.

Transition

- 5 An entity shall apply these [draft] amendments retrospectively, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Appendix

[Draft] Amendments to other IFRSs

The amendments outlined in this [draft] appendix shall be applied for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies the [draft] amendments for an earlier period, it shall apply the amendments in this [draft] appendix for that earlier period.

- A1 IFRS 7 *Financial Instruments: Disclosures* will be amended to add a disclosure requiring the following information:

If an entity derecognises a financial liability designated as at fair value through profit or loss during the reporting period, it shall disclose in the notes the amount (if any) presented in other comprehensive income that was realised at derecognition.

- A2 Paragraphs 10(a), 11 and B4 of IFRS 7 will be amended to reflect the fact that the amount of change during the period in the fair value of the financial liability that is attributable to changes in its credit risk is disclosed in the statement of comprehensive income (rather than disclosed in the notes as IFRS 7 currently requires). The cumulative amount of that change will continue to be disclosed in the notes as IFRS 7 currently requires.
- A3 Paragraph 20(a)(v) of IFRS 7 will be amended to reflect the fact that the net gains or losses on financial liabilities designated as at fair value through profit or loss will be disclosed in the statement of comprehensive income (see paragraph A6 below).
- A4 The following paragraphs will be moved to IFRS 9 *Financial Instruments* because they relate to financial liabilities designated as at fair value through profit or loss.

IFRS	Paragraph(s)
IFRS 7	B4
IAS 39	9(b)(i) and (ii), 11A, AG4B–AG4K

References to the relocated paragraphs will be updated in the following IFRSs.

IFRS 1 <i>First-time Adoption of International Financial Reporting Standards</i>
IFRS 7 <i>Financial Instruments: Disclosures</i>
IAS 39 <i>Financial Instruments: Recognition and Measurement</i>

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- A5 In paragraph 7 of IAS 1 *Presentation of Financial Statements*, the list of components of other comprehensive income will be amended to include the amount of the change in the fair value of a financial liability designated as at fair value through profit or loss that is attributable to changes in the liability's credit risk.
- A6 The following requirements will be added to paragraph 82 of IAS 1:
- (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.
- The requirement in (a) will be deleted from paragraph 20(a)(v) of IFRS 7 (see paragraph A3 above).
- A7 References to the requirements in IFRS 9 for financial liabilities designated as at fair value through profit or loss will be added to paragraphs 12 and 55 of IAS 39.
- A8 Paragraphs 53, 54, AG80 and AG81 of IAS 39 will be deleted and not carried forward to IFRS 9. Paragraphs 47(a) and 88(d) will be amended to remove references to derivative liabilities measured at cost.

[Draft] Amendments to guidance on other IFRSs

The following [draft] amendments to guidance on IFRSs summarised below are necessary in order to ensure consistency with the [draft] amendments and the related amendments to other IFRSs.

IGA1 IFRS 7 *Financial Instruments: Disclosures*, paragraphs IG7-IG11 will be moved to IFRS 9 *Financial Instruments* as an illustrative example.

References to the relocated paragraphs will be updated in IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

Approval by the Board of *Fair Value Option for Financial Liabilities* published in May 2010

The exposure draft *Fair Value Option for Financial Liabilities* was approved for publication by the fifteen members of the International Accounting Standards Board.

Sir David Tweedie Chairman

Stephen Cooper

Philippe Danjou

Jan Engström

Patrick Finnegan

Robert P Garnett

Gilbert Gélard

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John T Smith

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Wei-Guo Zhang

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the draft IFRS.

Introduction

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in developing the proposals in the exposure draft *Fair Value Option for Financial Liabilities*. Individual Board members gave greater weight to some factors than to others.
- BC2 The Board has long acknowledged the need to improve the accounting requirements for financial instruments. In the light of the global financial crisis and the urgent need to improve the accounting for financial instruments and to make it easier for users of financial statements to understand the financial reporting information, the Board proposes to replace IAS 39 *Financial Instruments: Recognition and Measurement* in several phases.
- BC3 In July 2009 the Board published the exposure draft *Financial Instruments: Classification and Measurement* as part of the first phase of its project to replace IAS 39. That exposure draft contained proposals for all items within the scope of IAS 39. However, some respondents to the exposure draft said that the Board should restrict any finalised requirements on classification and measurement to financial assets and retain the existing requirements for financial liabilities (including the requirements for embedded derivatives and the fair value option) until the Board had more fully considered and debated the issues related to financial liabilities. Those respondents pointed out that the Board accelerated its project on financial instruments because of the global financial crisis, which placed more emphasis on issues in the accounting for financial assets than for financial liabilities. They suggested that the Board should consider more fully issues that arise from recognising in profit or loss the effects of changes in the credit risk of liabilities before finalising the requirements for classification and measurement of financial liabilities.
- BC4 The Board noted those concerns and decided to finalise the proposals for financial assets only. The Board issued the chapters related to classification and measurement of financial assets in IFRS 9 *Financial Instruments* in November 2009. Accordingly, financial liabilities, including derivative liabilities, remain within the scope of IAS 39. Taking that course has enabled the Board to obtain further feedback on the accounting for financial liabilities, specifically how best to address accounting for the effects of changes in their credit risk.

Proposals

Background

- BC5 Immediately after issuing IFRS 9, the IASB began an extensive outreach programme to gather feedback on the classification and measurement of financial liabilities, in particular how best to address the effects of changes in the credit risk of financial liabilities. The Board obtained information and views from its Financial Instruments Working Group and from users, regulators, preparers, auditors and others from a range of industries across different geographical regions. The Board also developed a questionnaire to ask users of financial statements how they use information about the effects of changes in liabilities' credit risk today (if at all) and what their preferred method of accounting is for selected financial liabilities. The Board received over 90 responses to that questionnaire.
- BC6 During the outreach programme, the Board explored several approaches for subsequent measurement of financial liabilities that would exclude the effects of changes in a liability's credit risk from profit or loss, including:
- (a) measuring liabilities at fair value and presenting in other comprehensive income the portion of the change in fair value that is attributable to changes in the liability's credit risk. A variant of this alternative would be to present in other comprehensive income the entire change in fair value.
 - (b) measuring liabilities at an 'adjusted' fair value whereby the liability would be remeasured for all changes in fair value except for the effects of changes in its credit risk (ie 'the frozen credit spread method'). In other words, the effects of changes in its credit risk would be ignored in the primary financial statements.
 - (c) measuring liabilities at amortised cost. This would require estimating the cash flows over the life of the instrument, including those cash flows associated with any embedded derivative features.
 - (d) bifurcating liabilities into hosts and embedded features. The host contract would be measured at amortised cost and the embedded features (eg embedded derivatives) would be measured at fair value through profit or loss. The Board discussed either carrying forward the bifurcation requirements in IAS 39 for financial liabilities or developing new requirements.

- BC7 The primary message that the Board received from its outreach programme was that the effects of changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. That is because an entity generally will not realise the effects of changes in the liability's credit risk unless the liability is held for trading.
- BC8 In addition to that view, there were several other themes in the feedback that the Board received:
- (a) Symmetry between how an entity classifies and measures its financial assets and its financial liabilities is not necessary and often does not result in useful information. Most constituents said that in its deliberations on financial liabilities the Board should not be constrained or biased by the requirements in IFRS 9 for financial assets.
 - (b) Amortised cost is the most appropriate measurement attribute for many financial liabilities because it reflects the issuer's legal obligation to pay the contractual amounts in the normal course of business (ie on a going concern basis) and in many cases, the issuer plans to hold liabilities to maturity and pay the contractual amounts. However, if a liability has structured features (eg embedded derivatives), amortised cost is difficult to apply and understand because the cash flows can be highly variable.
 - (c) The bifurcation methodology in IAS 39 is generally working well and practice has developed since that Standard was issued. For many entities, bifurcation avoids the issue of own credit risk because the host is measured at amortised cost and only the derivative is measured at fair value through profit or loss. Many constituents were sceptical that a new bifurcation methodology could be developed that is less complex and provides more useful information. Moreover, a new bifurcation methodology would be likely to have the same classification and measurement outcomes as the methodology in IAS 39 in most cases.
 - (d) The Board should not develop a new measurement attribute. The almost unanimous view was that a 'full' fair value amount is more understandable and useful than an 'adjusted' fair value amount that ignores the effects of changes in the liability's credit risk.
 - (e) It is difficult to determine the amount of change in the fair value of a liability that is attributable to changes in its credit risk. Under IAS 39 and IFRS 7 *Financial Instruments: Disclosures*, only entities that elect to designate liabilities under the fair value option are

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required to determine that amount. If the Board were to extend that requirement to more entities and to more financial liabilities, many entities would have significant difficulty determining that amount and could incur significant costs in doing so.

- BC9 Although there were common themes in the feedback received, there was no consensus on which of the alternative approaches being explored by the Board was the best way to address the issue of the effect of changes in liabilities' credit risk. Many constituents said that none of the alternatives being discussed was less complex or would result in more useful information than the bifurcation requirements in IAS 39.
- BC10 As a result of the feedback received, the Board decided to retain almost all of the requirements in IAS 39 for the classification and measurement of financial liabilities. The Board decided that the benefits of changing practice at this point do not outweigh the costs of the disruption that such a change would cause.
- BC11 By taking that course, the issue of credit risk is addressed for most liabilities because they would continue to be subsequently measured at amortised cost or would be bifurcated into a host, which would be measured at amortised cost, and an embedded derivative, which would be measured at fair value. Liabilities that are held for trading (including all derivative liabilities) would continue to be subsequently measured at fair value through profit or loss, which is consistent with the widespread view that all fair value changes for those liabilities should affect profit or loss.
- BC12 The issue of credit risk would remain only in the context of financial liabilities designated under the fair value option. Thus, the proposals in this exposure draft address only those liabilities.
- BC13 Consistently with its decision to retain the requirements in IAS 39 for classifying and measuring financial liabilities (except for the proposed changes to the fair value option), the Board decided to retain the requirements in IAS 39 that prohibit reclassifying financial liabilities between amortised cost and fair value. The Board noted that IFRS 9 requires reclassification of assets in particular circumstances. However, in line with the feedback received during the Board's outreach programme, the classification and measurement approaches for financial assets and financial liabilities are different; therefore the Board decided that it is unnecessary and inappropriate to have symmetrical requirements for reclassification. Moreover, although the reclassification of financial assets has been a controversial topic in recent years, the Board is not aware of any requests or views that support reclassifying financial liabilities.

Elimination of the cost exception in IAS 39

- BC14 Also, consistently with the requirements for assets in IFRS 9, the Board decided that the cost exception in IAS 39 should be eliminated for derivative liabilities that will be physically settled by delivering unquoted equity instruments whose fair values cannot be reliability determined. That proposal was included in the exposure draft published in July 2009. The Board discussed the comments received on that proposal in September and October 2009 and in March 2010—and confirmed the view in the exposure draft. Therefore, the Board decided that its decision to eliminate the cost exception for derivative liabilities does not need to be exposed again.

Presenting the effects of changes in a liability's credit risk in profit or loss

Eligibility conditions

- BC15 IAS 39 permits an entity to elect irrevocably on initial recognition to measure a financial liability at fair value through profit or loss if one (or more) of three eligibility conditions is met. The exposure draft proposes to carry forward those three eligibility conditions. The Board considered whether it was necessary to propose any changes to those conditions. However, the Board decided that changes are not necessary because the Board has not changed the underlying classification and measurement approach in IAS 39 for financial liabilities.
- BC16 Some constituents would prefer an unrestricted fair value option. However, the Board acknowledged that an unrestricted fair value option has been opposed by many in the past and it is not appropriate to pursue it now.

Presentation of gains or losses

- BC17 If an entity designates a financial liability under the fair value option, IAS 39 requires the entire fair value change to be presented in profit or loss. As discussed above, many users and others have told the Board that changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading.
- BC18 To respond to that long-standing and widespread concern, the exposure draft proposes that changes in the credit risk of all liabilities designated under the fair value option would not affect profit or loss.

FAIR VALUE OPTION FOR FINANCIAL LIABILITIES

- BC19 However, in its deliberations leading to the exposure draft, the Board discussed whether the proposals could create an accounting mismatch in profit or loss in some cases. That might be the case if an entity is managing liabilities designated under the fair value option with financial assets that are measured at fair value through profit or loss. A mismatch could arise because the entire change in the fair value of the assets would affect profit or loss but only a portion of the change in the fair value of the liabilities would affect profit or loss. The portion of the liabilities' fair value change attributable to changes in their credit risk would not affect profit or loss.
- BC20 An alternative approach to address these potential mismatches would be to require the proposals in the exposure draft unless they would create a mismatch in profit or loss. If a mismatch would be created, the entity would be required to present the entire change in the fair value of the liabilities 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. Disclosures could be required to provide information about how the entity made that determination.
- BC21 While acknowledging that a mismatch might be created in a small number of circumstances (and that mismatch might be significant in particular industries in some jurisdictions), the Board decided to propose that all liabilities designated under the fair value option should be treated the same for the following reasons:
- (a) Users have consistently told the Board that changes in the credit risk of the liability ought not to affect profit or loss unless the liability is held for trading. No liabilities designated under the fair value option meet the definition of held for trading.
 - (b) In the user questionnaire conducted during the Board's outreach programme, the Board specifically asked users whether their views on the usefulness of information on the effects of changes in a liability's credit risk would change depending on why the entity is measuring a liability at fair value. Most respondents said 'no'—and reiterated their comment in (a).
 - (c) Comparability would be reduced if the proposals applied only to some liabilities designated under the fair value option. That would be the case if a particular liability met more than one of the eligibility conditions because the accounting would differ depending on which of the eligibility conditions the entity decided to use to support its decision to designate a liability under the fair value option.

BC22 However, the Board decided to ask respondents for comments on the alternative approach described in paragraph BC20. The Board also considered a variant of the alternative approach that would permit the alternative approach, rather than require it, if a mismatch in profit or loss would be created. However, the Board rejected that variant because it could result in significant incomparability.

Presenting the effects of changes in a liability's credit risk in other comprehensive income

BC23 Under the proposals in the exposure draft, all liabilities designated under the fair value option would continue to be measured at fair value in the statement of financial position. But the exposure draft proposes a 'two-step approach' for presenting the liability's credit risk in the statement of comprehensive income, with the result that those changes would not affect profit or loss.

BC24 In the first step, the entity would present the entire fair value change in profit or loss. In the second step, the entity would 'back out' from profit or loss the portion of the fair value change that is attributable to changes in the liability's credit risk and present that amount in other comprehensive income.

BC25 The Board believes that this approach provides useful information to users, namely:

- (a) the fair value of the financial liability;
- (b) the total fair value change of the financial liability; and
- (c) the portion of the total fair value change that is attributable to changes in the liability's credit risk.

BC26 Measuring the liability at fair value is consistent with the strong message received during the Board's outreach activities that the Board should not create a new measurement attribute—ie an adjusted fair value amount that ignores the effects of changes in the liability's credit risk.

BC27 And although almost all users told the Board that changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading, many users said that information about the effects of changes in the liability's credit risk is useful. They use it for purposes such as determining the overall riskiness of the entity, identifying when the entity is in distress, indicating when an entity's assets may be impaired, estimating the entity's future financing costs and comparing the entity with others in the same industry.

- BC28 The Board thinks that the proposed two-step approach would present clearly all of the relevant information in the primary financial statements.
- BC29 Some would have preferred a 'one-step approach', which would present the portion of the fair value change that is attributable to changes in the liability's credit risk directly in other comprehensive income. All other portions of the fair value change would be presented in profit or loss. Those individuals believe that the one-step approach is more efficient and less complicated than the two-step approach and they point out that both approaches have the same net result in profit or loss and other comprehensive income.
- BC30 The Board acknowledged that the only difference between the approaches is how the effects of changes in the liability's credit risk are presented. The two-step approach would present those amounts first in profit or loss and then transfer them to other comprehensive income, whereas the one-step approach would present them directly in other comprehensive income.
- BC31 The Board decided to ask respondents for views on whether the proposed two-step approach or the alternative one-step approach would provide more useful information.
- BC32 Under the proposals, an entity may transfer the cumulative gain or loss within equity. In the light of jurisdiction-specific restrictions on components of equity, the Board decided not to propose specific requirements related to that transfer. That is consistent with the guidance in IFRS 9 for particular investments in equity instruments (see paragraphs 5.4.4 and B5.12 of IFRS 9). Some would have preferred that the proposals explicitly prohibit an entity from transferring the cumulative gain or loss to particular components of equity (eg additional paid in capital). The Board will consider in its redeliberations of the proposals in the exposure draft whether such a restriction is necessary.

Presenting the effects of changes in a liability's credit risk in equity

- BC33 The exposure draft proposes that the effects of changes in a liability's credit risk should be presented in other comprehensive income. However, some believe that it would be more appropriate to present that amount in equity. Those individuals believe that the use of other comprehensive income should not be expanded until the Board addresses that issue comprehensively (eg what items should be presented in other comprehensive income and whether those items should be recycled).

Moreover, they believe that presenting the amount in equity is consistent with the view that a change in the liability's credit risk represents a wealth transfer between liability holders and equity holders. That view was described in the IASB's discussion paper *Credit Risk in Liability Measurement*.

- BC34 The Board decided to propose that the effects of changes in a liability's credit risk must be presented in other comprehensive income instead of equity for the following reasons:
- (a) Changes in the liability's credit risk ought to affect the entity's performance. If those amounts were presented in equity, they would never be presented in the entity's statement of comprehensive income.
 - (b) IFRSs do not provide a clear objective for other comprehensive income. Expanding its use before the Board addresses that issue is not desirable but it is preferable to creating a new problem by causing confusion or creating inconsistencies in what items are presented directly in equity (eg remeasurements of assets and liabilities should not be presented directly in equity because remeasurements are not transactions with equity holders).
- BC35 The Board decided to ask respondents for feedback on whether presenting the effects of changes in credit risk in equity is more appropriate than the proposal to present those amounts in other comprehensive income.
- BC36 The Board also considered another alternative that would require the entire change in fair value of liabilities designated under the fair value option (not just the portion attributable to changes in the liabilities' credit risk) to be presented in other comprehensive income. The Board did not pursue that approach because it believes that at least some of the change in fair value should be presented in profit or loss. The Board's objective was to address issues related to the effects of changes in liabilities' credit risk; therefore, presenting the entire change in fair value in other comprehensive income is not appropriate. Moreover, this alternative would raise difficult questions about what (if any) amounts should be recognised in profit or loss during the life of the liability (eg interest or other financing costs). The Board has discussed the topic of disaggregating finance costs from other fair value changes on numerous occasions without reaching any conclusions.

Reclassifying amounts to profit or loss

- BC37 The proposals prohibit reclassification of gains or losses to profit or loss (on derecognition of the liability or otherwise). That proposal is consistent with the Board's view that gains or losses on those liabilities should be recognised only once. Therefore, recognising a gain or loss in other comprehensive income and subsequently reclassifying it to profit or loss is inappropriate.
- BC38 To provide users with information about how much of the accumulated other comprehensive income balance has been realised during the current reporting period (ie how much would have been reclassified if the Board had required recycling upon derecognition), the exposure draft proposes amendments to IFRS 7 that would require entities to disclose that amount.
- BC39 The Board also noted that if the 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. Therefore, for many liabilities, the issue of recycling is irrelevant.

Determining the effects of changes in the liability's credit risk

- BC40 Currently, if an entity designates a financial liability under the fair value option, IFRS 7 requires the entity to disclose the amount of the change in fair value that is attributable to changes in the liability's credit risk. Paragraph B4 of IFRS 7 provides a default method for determining that amount. That method attributes all changes in fair value, other than changes in a benchmark interest rate, to changes in the credit risk of the liability. In the Basis for Conclusions on IFRS 7, the Board acknowledged that quantifying the change in a liability's credit risk might be difficult in practice. It noted that it believes that the default method provides a reasonable proxy for changes in the liability's credit risk, in particular when such changes are large, and would provide users with information with which to understand the effect on profit or loss of such a change in credit risk. However, IFRS 7 permits entities to use a different method if it provides a more faithful representation of the changes in the liability's credit risk.

- BC41 During the outreach programme, preparers told the Board that the default method in IFRS 7 is appropriate in many circumstances but a more sophisticated method is sometimes needed to reflect faithfully the effects of changes in the liabilities' credit risk (eg when the volume of liabilities outstanding significantly changed during the reporting period).
- BC42 In the user questionnaire conducted during the Board's outreach programme, the Board specifically asked users whether the default method in IFRS 7 was appropriate for determining the change in a liability's credit risk. Most of the respondents said that it was an appropriate method. Many users noted the difficulty in determining that amount more precisely.
- BC43 The IASB discussion paper *Own Credit Risk in Liability Measurement* used the term 'credit risk' broadly to include both the price of credit and the credit quality of the issuer. Almost no respondents differentiated those two items.
- BC44 Therefore, for the purposes of measuring the effects of changes in the credit risk of a liability, the exposure draft proposes to use the guidance in IFRS 7. Under the proposals, the default method would be carried forward but entities would be permitted to use a different method if it provides a more faithful representation of the amount of the change in fair value that is attributable to changes in the liability's credit risk.
- BC45 Some think that the effects of changes in a liability's credit risk should be determined more precisely and should reflect only changes in the credit quality of the issuer. Those individuals believe that including items such as changes in the price of credit and changes in liquidity is inappropriate.
- BC46 The Board decided to ask respondents for comments on whether the guidance in IFRS 7 should be used to quantify the change in a liability's credit risk or whether another method is more appropriate.

Effective date

- BC47 Entities must apply IFRS 9 for annual periods beginning on or after 1 January 2013. However, as noted in the Basis for Conclusions on IFRS 9, the Board will consider delaying that effective date if the impairment phase of the project to replace IAS 39 makes such a delay necessary, or if the 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.

- BC48 The Board expects to permit early application of any finalised requirements resulting from the exposure draft. The exposure draft proposes 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.
- BC49 The Board chose to complete the project to replace IAS 39 in phases to respond to requests that the accounting for financial instruments should be improved quickly. However, the Board is concerned that if an entity is permitted to adopt one phase early without also adopting early all of the preceding phases, there would be a period of significant incomparability among entities until all of the phases of the project are mandatorily effective. That is because there will be many possible combinations of which requirements are adopted early and which are not. Moreover, the period of incomparability would be significant because the phases will not be mandatorily effective before 1 January 2013.
- BC50 However, if an entity chooses to adopt a phase early, the Board would not require the entity to adopt subsequent phases early. The Board decided that it would be unfair to require an entity to anticipate the outcomes of unfinished phases in order to make a decision about adopting a phase early.

Transition

- BC51 The Board has not changed the classification and measurement approach in IAS 39 for financial liabilities. Also, the Board is proposing to retain the existing eligibility conditions in IAS 39 for the fair value option for financial liabilities. Therefore, the exposure draft does not allow entities to make new designations or revoke its previous designations as a result of the proposals.
- BC52 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that retrospective application results in the most useful information to users because the information presented for all periods is comparable. Therefore, the exposure draft proposes retrospective application.
- BC53 The Board noted that IFRS 7 requires disclosure of the amount of the change in fair value that is attributable to changes in the credit risk of the liability. Therefore, entities are already calculating the information necessary to apply the proposals in the exposure draft.