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IASB issues proposals on the fair value option for financial liabilities

The IASB in May published ED/2010/4 *Fair Value Option for Financial Liabilities* ('the ED') setting out their proposals on the presentation of gains and losses on liabilities designated under the fair value option. These proposals are part of the IASB's plan to improve and simplify the accounting for financial instruments. If finalised, entities that have designated financial liabilities at fair value through profit or loss (FVTPL) under the fair value option will no longer present in profit or loss a gain from a deterioration in own credit risk or loss from an improvement in own credit risk. Instead, gains and losses arising from changes in an entity's own credit risk will be presented in other comprehensive income (OCI). The Board is responding to the criticisms voiced by many constituents that recognising the effects of changes in an entity's own credit risk in profit or loss does not provide useful information and is counter-intuitive as an entity will recognise gains that it has limited ability to realise at times when its performance is worsening.

The ED, once finalised, would conclude the first phase of the IASB's comprehensive project to replace its financial instruments standard IAS 39 *Financial Instruments: Recognition and Measurement* (the other phases being impairment, hedge accounting and derecognition that have yet to be finalised). Any final guidance would be incorporated into IFRS 9, including any related disclosures that are currently required under IFRS 7. The comment period on the ED ends on 16 July 2010.

Proposals

The ED is limited in its impact. It focuses on the following two areas:

- The presentation of the effects of changes in an entity's own credit risk, and
- The elimination of the cost exception for derivative liabilities to be settled by delivery of unquoted equity instruments.

The presentation of the effects of changes in an entity's own credit risk

The ED distinguishes between financial liabilities held for trading and financial liabilities designated as at fair value through profit or loss using the fair value option. Financial liabilities held for trading would continue to be measured at fair value with all changes being recognised in profit or loss.

The ED proposes to change the presentation of the effects of changes in the credit risk of a financial liability designated at fair value through profit or loss using the fair value option. In an effort to increase transparency, the ED proposes a 'two-step approach' in recognising those changes. As a first step, an entity would present the full change in fair value in profit or loss. In the second step, the portion relating to changes in an entity's own credit risk would be presented as an offsetting entry in profit or loss and presented in OCI.

Example: Two-step approach

An entity designated a financial liability at fair value through profit or loss. At the beginning of 20X1, the liability's carrying amount was CU100 and at the end of 20X1 it was CU110. The change in fair value of CU10 is comprised of a change of CU2 which relates to a strengthening in the entity's own credit risk, and CU8 which relate to changes in other risk factors (e.g. a decline in interest rates). Under the ED, the entity would record the following journal entities to reflect the two-step approach:

	Dr	Cr
Dr: Loss on remeasurement (P&L)	10	
CR: Financial liability designated at FVTPL		10
Dr: Other comprehensive income	2	
Cr: Fair value change attributable to own credit risk (P&L)		2

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The Board acknowledges that the ED may create an accounting mismatch for a matched asset and liability position in that the entire change in the fair value of assets, but only a portion of the change in the fair value of liabilities, would affect profit or loss. However, the Board believes that these circumstances will likely be limited and it is preferable that fair value changes for own credit risk are treated consistently irrespective of whether a mismatch with the asset side may result.

The ED proposes to maintain the approach described in IFRS 7 in determining the amount of change in fair value of a liability that is attributable to changes in its credit risk. Under the default method in IFRS 7, changes in fair value that are not attributable to changes in market risks (generally the benchmark interest rate) are attributed to the credit risk of the financial liability. An alternative method would continue to be permitted if it results in a more faithful representation of the changes in the financial liability's credit risk.

It is proposed that recycling of amounts recognised in OCI will be prohibited, but transfers to other components of equity will be permitted. This is particularly relevant if an entity derecognised its financial liability prior to maturity at an amount different from the amount contractually due. In this situation, any residual amount in OCI may be transferred to other components of equity (e.g. retained earnings). Of course, if an entity repaid its debt under the contractual terms at maturity, there would be no amounts to recycle because the cumulative effect of any changes in the liability's credit risk would net to zero.

Paragraph 82 of IAS 1 would be amended to require separate line items in the statement of comprehensive income to be presented for:

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

In addition, an entity would be required to disclose the amount presented in OCI realised on derecognition of financial liabilities designated at fair value through profit or loss.

Financial liabilities that are *required* to be measured at FVTPL, for example derivatives such as foreign currency forwards or interest rate swaps, would continue to have all fair value movements recognised in profit or loss with no transfer to OCI.

The elimination of the cost exception for derivative liabilities

IFRS 9 removed the cost exception in IAS 39 for unquoted equity instruments and related derivative assets where fair value was not reliably determinable. The cost exception remained in place for derivative liabilities that will be settled by delivering unquoted equity instruments whose fair value cannot be determined reliably (e.g. a written option where, on exercise, an entity would deliver unquoted shares to the holder of the option). The ED proposes to remove the cost exception for derivative liabilities to ensure consistency with IFRS 9 for similar instruments that are derivative assets.

What would not change?

The ED concludes the IASB's deliberations on their proposals for classifying and measuring financial liabilities. As a result, the basic accounting model for financial liabilities under IAS 39 would remain unchanged.

Two measurement categories would continue to exist: fair value through profit or loss (FVTPL) and amortised cost. Financial liabilities held for trading would continue to be measured at FVTPL, and all other financial liabilities would be measured at amortised cost unless the fair value option is applied, using the existing criteria in IAS 39.

Proposed effective date and transition

The ED does not propose an effective date but it is the Board's stated intention to have the same effective date for all phases of the new financial instruments standard. Therefore, it is expected that the effective date will be 1 January 2013 (which is the effective date of IFRS 9). The Board proposes to permit early application of any finalised requirements resulting from this ED. 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 reason to require application of the earlier phases is to reduce the potential non-comparability among entities.

The ED proposes full retrospective application of the requirements in accordance with IAS 8.

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