IFRS Global office
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IFRS in Focus
IASB issues revisions to IFRS 9 for financial liability accounting

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The Bottom Line

- The classification criteria for financial liabilities contained in IAS 39 move to IFRS 9 unchanged and the IAS 39 classification categories of amortised cost and fair value through profit or loss are retained.
- For a financial liability designated as at fair value through profit or loss using the fair value option, the change in the liability's fair value attributable to changes in the liability's credit risk is recognised directly in other comprehensive income, unless it creates or increases an accounting mismatch.
- The amount that is recognised in other comprehensive income is not recycled when the liability is settled or extinguished.
- The meaning of credit risk is clarified to distinguish credit risk from asset-specific performance risk.
- The cost exemption in IAS 39 for derivative liabilities to be settled by delivery of unquoted equity instruments is eliminated.
- The effective date of the revised Standard is 1 January 2013.

Introduction

On 28 October 2010, the IASB published a revised version of IFRS 9 *Financial Instruments*. The revised Standard retains the requirements for classification and measurement of financial assets that were published in November 2009 but adds guidance on the classification and measurement of financial liabilities. As part of its restructuring of IFRS 9, the IASB also copied the guidance on derecognition of financial instruments and related implementation guidance from IAS 39 *Financial Instruments: Recognition and Measurement* to IFRS 9.

The guidance included in IFRS 9 on the classification and measurement of financial liabilities is unchanged from the classification criteria for financial liabilities currently contained in IAS 39. In other words, financial liabilities will continue to be measured either wholly, or in part, at amortised cost or at fair value through profit or loss (FVTPL). The concept of bifurcating embedded derivatives from a financial liability host contract also remains unchanged. 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.

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However, there are two differences compared to IAS 39:

- The presentation of the effects of changes in fair value attributable to a liability's credit risk; and
- The elimination of the cost exemption for derivative liabilities to be settled by delivery of unquoted equity instruments.

This revised guidance concludes the first phase of the IASB's comprehensive project to replace its financial instruments standard, IAS 39. The other phases, impairment and hedge accounting, have yet to be finalised.

The presentation of the effects of changes in a liability's credit risk

The revised guidance about a liability's credit risk does not apply to all liabilities measured as at FVTPL. Financial liabilities held for trading, such as derivative liabilities, as well as loan commitments and financial guarantee contracts that are designated under the fair value option would continue to be measured at fair value with *all* changes being recognised in profit or loss. For all other financial liabilities designated as at FVTPL using the fair value option, the revised guidance about a liability's credit risk applies, requiring the amount of change in the liability's fair value attributable to changes in the credit risk to be recognised in other comprehensive income (OCI) with the remaining amount of change in fair value being recognised in profit and loss.

Observation

One of the primary factors for the Board issuing this guidance is the often cited counterintuitive result that occurs when financial liabilities are measured at fair value. An entity experiencing credit deterioration generates a gain in profit or loss as the fair value of the liability is reduced (potentially offsetting losses the entity may be encountering that contribute to the credit deterioration) while improvement in creditworthiness results in recognition of losses in profit or loss (potentially obscuring income the entity is generating that may have led to the improvement in credit quality).

However, if recognising the changes in fair value attributable to credit risk within OCI creates or increases an accounting mismatch, an entity would present the entire change in fair value within profit and loss. In assessing any accounting mismatch, an entity should determine whether it expects that the effects of changes in the liability's credit risk will be offset in profit or loss by a change in the fair value of another financial instrument measured at FVTPL. Such an expectation must be based on an economic relationship between the characteristics of the liability and the characteristics of the other financial instrument. This determination is made by the entity at initial recognition and is not reassessed. An entity should disclose the methodology used to make its determination in the notes to the financial statements.

Observation

One example discussed by the IASB during the development of this part of the project related to mortgage funding where an accounting mismatch may arise. In that example, a mortgage bank lends to a customer and funds the loan by selling a bond with identical terms (i.e. outstanding balance, term, currency, and repayment terms) to that of the mortgage loan. The mortgage loan term permits borrowers to prepay their loan by retiring their specific outstanding bond at fair value. There is a contractual linkage between the effects of changes in credit risk of the bond and fair value changes in the mortgage loan. As a result of using the fair value option, if the bank recognises changes in the fair value due to changes in credit risk of the bond through OCI while recognising the full change in fair value of the loan through profit and loss, this would result in an accounting mismatch.

The Standard provides further guidance on differentiating credit risk from asset-specific performance risk (i.e. the risk that a single asset or a group of assets fail to perform and in doing so relieves the issuer of amounts under an obligation that is linked to those assets). The Standard provides examples of asset-specific performance risk.

Observation

One of the examples of asset-specific performance risk provided in the Standard are notes issued by a special purpose entity (SPE) where the assets of the SPE are legally isolated to fund the notes issued by the SPE. Amounts are only due to the investors of the notes if the ring-fenced assets generate cash flows. If the assets do not generate cash flows, the SPE is not obligated to pay the investors. The risk inherent in the notes is regarded as asset-specific performance risk as the performance of the assets determines the amount of the obligation under the liability. The difference between credit risk and asset-specific performance risk is subtle and therefore consideration of the terms of the liability will be critical. If the amount owed under the notes does not vary with the performance of the assets, the risk would be regarded as credit risk, not asset-specific performance risk.

The revised guidance prohibits recycling of amounts attributable to credit risk recognised in OCI, but transfers to other components of equity are permitted. This is relevant if an entity derecognises 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) with disclosure of the amounts transferred and the reason for the transfer. In contrast, 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.

The revised IFRS 9 retains the existing guidance in IFRS 7 *Financial Instruments*: Disclosures on how to isolate the change in fair value of a liability attributable to credit risk. IFRS 7 permits two techniques:

1) the change in fair value not attributable to changes in market risk (such as changes in a benchmark interest rate, the price of another entity's financial instruments, a commodity price, a foreign exchange rate, or an index of prices or rates); or

2) an alternative method that more faithfully represents credit risk.

The method used to measure changes in fair value due to changes in credit risk should be disclosed.

The elimination of the cost exemption for derivative liabilities

The part of IFRS 9 dealing with financial assets removed the cost exemption in IAS 39 for unquoted equity instruments and related derivative assets where fair value was not reliably determinable. When the financial assets part of IFRS 9 was published, the cost exemption 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) remained in place. However, the revised guidance now also removes this cost exemption so that all derivatives, whether assets or liabilities, are measured at fair value.

Effective date and transition

The revised version of IFRS 9 has the same effective date as the previous version of IFRS 9, i.e., 1 January 2013. The IASB has stated its intention to have the same effective date for all phases of the new financial instruments standard. The revised version permits early application but if an entity elects to apply the guidance related to classification and measurement of financial liabilities early, an entity must also apply any requirements in IFRS 9 that have been previously finalised at the same time. Currently, this would require an entity wishing to adopt early the guidance on financial liabilities in IFRS 9 also to adopt early the guidance on financial assets. The reason to require application of the earlier phases is to reduce the potential for non-comparability among entities. The revised Standard is to be applied retrospectively in accordance with IAS 8.

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