

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2010/11

FAIR VALUE OPTION FOR FINANCIAL LIABILITIES



Background

The International Accounting Standards Board (IASB) has issued an Exposure Draft (the ED) for public comment which sets out proposed changes to the accounting for financial liabilities where an entity has used the Fair Value Option (FVO) to measure a financial liability as at fair value through profit or loss (FVTPL).

The ED has been issued to address the accounting effect of changes in an entity's own credit risk, because changes in credit risk affect the fair value of an entity's financial liabilities. When an entity's creditworthiness deteriorates, the fair value of its own financial liabilities (such as issued debt) decreases due to the higher discount rate that is applied to contractual cash flows, meaning that where the FVO has been used, a gain will be recorded in the income statement. Many investors and other users of financial statements find this counter-intuitive and confusing.

In developing proposals to address the issue, the IASB obtained input from investors and other parties. Feedback indicated that volatility in profit or loss as a result of changes in an entity's own credit does not provide useful information (other than for derivatives and liabilities classified as held for trading). However, there was little support for the development of a new measurement method, and it was considered that information about the effect of changes in an entity's credit status can be useful.

STATUS

Exposure Draft

EFFECTIVE DATE

n/a

ACCOUNTING IMPACT

When the fair value option has been used for financial liabilities, eliminates effects of changes in own credit risk from profit or loss

Proposals

Scope and the fair value option

The proposals cover financial liabilities that are designated as at FVTPL using the fair value option in IAS 39 *Financial Instruments: Recognition and Measurement*. Therefore the proposals do not affect the accounting approach for derivative financial instruments or financial liabilities that fall into the Held for Trading category.

Financial liabilities that are not required to be measured as at FVTPL can be designated as such if they meet one of the following three conditions:

1. The instrument contains an embedded derivative;
2. The financial liability is managed on a fair value basis, either individually or within a group of financial instruments;
3. Designation as at FVTPL eliminates or significantly reduces an accounting mismatch (for example, where an entity has matched assets and liabilities where, under the standard requirements of IFRS, the assets are measured at FVTPL and the liabilities are measured at amortised cost).

Under the proposals, financial liabilities designated as at FVTPL would continue to be measured at fair value, including the effect of any changes in the reporting entity's credit status. The IASB received feedback which indicated that 'full' fair value would be a more understandable measurement than a new measurement category, that attempted to exclude changes in an entity's credit status and would be neither amortised cost nor fair value.

Presentation of gains and losses for financial liabilities designated as at FVTPL

A 'two step' approach has been proposed. The first step would be to measure the financial liability at its fair value, with the entire change in fair value being presented in profit or loss. The second step would be to determine the amount of the change in fair value that is attributable to changes in the reporting entity's credit risk. This second amount would be presented in Other Comprehensive Income, with an offsetting entry in profit or loss.

Guidance covering the measurement of the change in a financial liability as a result of changes in an entity's own credit risk is set out in IFRS 7 *Financial Instruments: Disclosure*, and this is carried forward unchanged. This guidance contains a 'default' approach whereby any changes in fair value, other than market risk factors such as a change in a benchmark interest rate, are regarded as being attributable to a change in the entity's credit risk. If another method is considered to represent more faithfully the change in fair value attributable to changes in an entity's credit status, that method can be used instead.

Gains and losses that are recorded in Other Comprehensive Income are not subsequently recycled to profit or loss, unless a financial liability is settled for an amount other than its contractual amount, although they may be transferred between categories of equity by way of a reserves transfer. The IASB has noted that many financial liabilities are held to their maturity, meaning that any amounts recorded in Other Comprehensive Income will reverse. However, if an entity does settle a financial liability at its fair value and that fair value has been reduced because of a decline in the entity's credit status, the amount recorded in OCI that becomes realised through the settlement is required to be disclosed.

Effective date and transition

It is anticipated that the proposals would become mandatory for accounting periods commencing on/after 1 January 2013. Earlier application would be permitted if all other finalised requirements of IFRS 9 *Financial Instruments* were also applied.

The proposed amendments would be required to be applied retrospectively. The exposure draft itself does not propose any permission to designate new, or revoke existing, designations of financial liabilities as at FVTPL, although this is possible on adoption of the first phase of IFRS 9.

How does this fit into the IASB's overall project to replace IAS 39?


In July 2009, the IASB issued an exposure draft which set out proposals for the classification and measurement of financial instruments. That exposure draft proposed a symmetrical treatment for both financial assets and financial liabilities, with two measurement categories (amortised cost and fair value). The proposals would have eliminated the separate accounting for embedded derivatives in IAS 39.

BDO, in common with a number of constituents, raised concerns that the proposed approach would result in many structured debt instruments being measured at fair value through profit or loss, with changes in fair value including the effect of changes in an entity's own credit status. It was suggested that the principal issues around accounting for financial instruments concerned financial assets, and that financial liabilities were less of a concern. For financial liabilities, the existing approach under IAS 39 worked satisfactorily in practice. In addition, it was noted that a symmetrical approach to accounting for financial assets and financial liabilities was not necessary.

As a consequence of these observations, when the IASB issued IFRS 9 in November 2009, its scope covered financial assets only. The IASB then sought feedback from constituents on the appropriate approach that should be taken when accounting for financial liabilities. Having considered the feedback obtained, the IASB decided to retain the existing requirements of IAS 39 for financial liabilities, except for a limited proposed amendment to address the own credit issue.

What about convergence with US GAAP?

Although the IASB and the FASB (the US standard setter) have accounting for financial instruments as a joint project, the conclusions that the two boards have reached to date have many differences. The IASB has indicated that it will take feedback from its constituents into account when it looks at how differences might be reconciled.



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