



ED/2010/4

Fair Value Option for Financial Liabilities

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Public Discussion

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Project Overview – Replacement of IAS 39

Project phases	Due process documents	Finalisation
1. Classification and Measurement	IFRS 9 published on 12 Nov 2009 ED on financial liabilities published on 11 May 2010	In time for year end financial statements 2009 for financial <u>assets</u> During 2010 for financial <u>liabilities</u>
2. Impairment	ED November 2009	During 2010
3. Hedge Accounting	Target: issue ED that allows finalisation in 2010	During 2010

Mandatory application not before 1 January 2013

In addition separate project '*Derecognition*' (ED/2009/3 issued March 2009)



ED/2010/4: Fair Value Option for Financial Liabilities

- Published 11 May 2010
- 60 days commenting period until 16 July 2010
- Objectives of the Exposure Draft:
 - Address the volatility in the income statement (P&L) caused by changes in the credit risk of a financial liability ('own credit')
 - In particular the ED proposes changes in the accounting for financial liabilities that an entity chooses to measure at fair value
 - The proposals form part of the IASB's response to the global crisis and recommendations made by the G 20, the Financial Stability Board and others



Financial liabilities – background

Feedback on ED Classification and Measurement

- Financial liabilities ‘not broken’
- Financial liabilities less urgent
- Need to address ‘own credit’



Excluded financial liabilities from the scope of IFRS 9 for 2009 year ends

To seek input on best way to
address ‘own credit’



Financial Liabilities – The issue of ‘own credit’

‘Own credit risk’: The accounting effect of changes in the credit risk of a financial liability

- For non-derivative financial liabilities measured at FV under the Fair Value Option (FVO):
 - Δ credit risk \rightarrow Δ FV
 - Entity’s creditworthiness \downarrow \rightarrow FV of its issued debt \downarrow (et vice versa)
 \rightarrow This causes a gain (or loss), which has to be recognised in the P&L (volatility)
- Reporting this effect does not provide useful information and can cause confusion



Classification and Measurement of Financial Liabilities (1)

To address 'own credit risk'

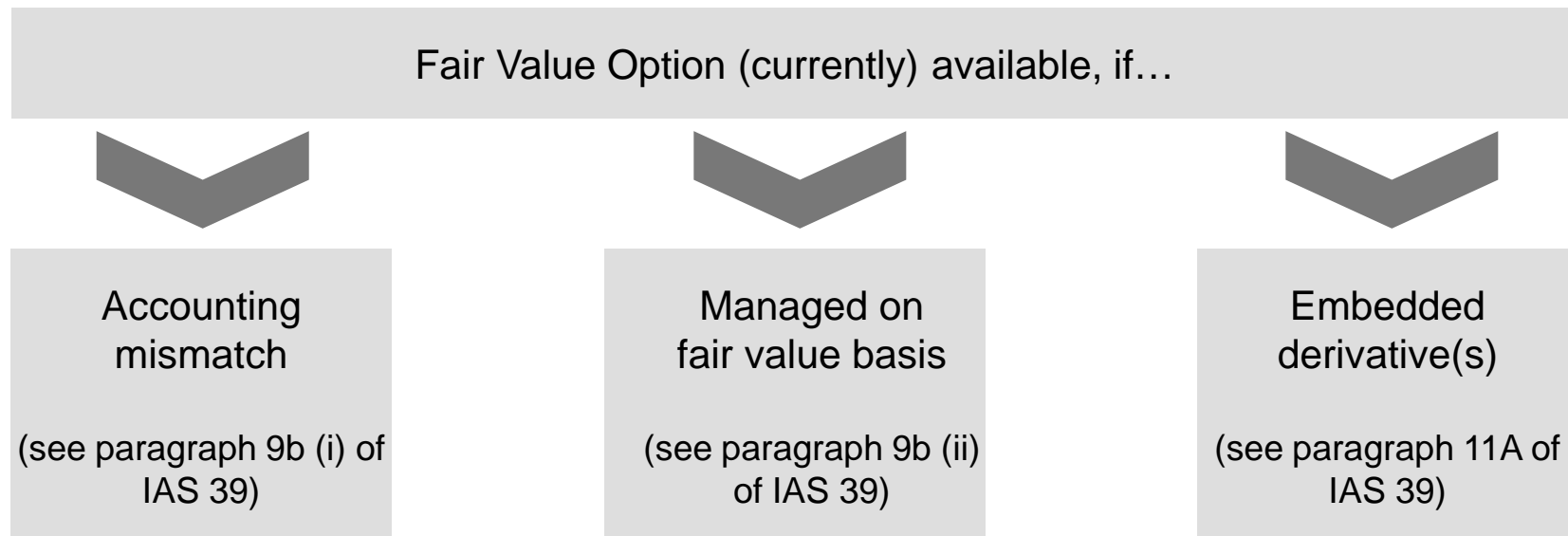
- Retain IAS 39 measurements for financial liabilities:
 - held for trading → fair value through P&L
 - hybrid liabilities → bifurcation requirements in IAS 39
 - 'vanilla' liabilities → amortised cost
 - maintain FVO (with current eligibility conditions, see next slide)

BUT

- Separate out 'own credit risk' for FVO
- 'Own credit risk' portion would be separated in a manner similar to that used in IFRS 7 for disclosure (IFRS 7 B4)



Classification and Measurement of Financial Liabilities (2)





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ED/2010/4: Presenting the Effects of changes in a liability's credit risk in profit or loss (1)

For all liabilities designated under the FVO:

- Effects of changes in the credit risk of the liability would not affect P&L

Reason:

does not provide useful information unless the liability is held for trading



ED/2010/4: Presenting the Effects of changes in a liability's credit risk in profit or loss (2)

Accounting mismatch

- Proposals could create an accounting mismatch in P&L in some cases
 - e.g. management of liabilities designated under the FVO with financial assets that are measured at FV through profit or loss
- Alternative approach to address that potential mismatch
 - Require the proposals in the ED unless they would create a mismatch
 - If there is a mismatch: Presentation of the entire change in the FV of those liabilities in P&L



ED/2010/4: Presenting the Effects of changes in a liability's credit risk in profit or loss (3)

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 presented in profit or loss)? Why?



ED/2010/4: Presenting the Effects of changes in a liability's credit risk in other comprehensive income (1)

The ED proposes a two-step approach

- Objective: eliminating P&L volatility resulting from changes in own credit while information on own credit is still available for investors
- Approach:
 1. The FV change of liabilities under the FVO would be recognised in P&L
 2. The portion of the FV change due to own credit would be reversed out of P&L and recognised in OCI



ED/2010/4: Presenting the Effects of changes in a liability's credit risk in other comprehensive income (2)

Proposed Two-step approach

Profit or Loss (liabilities under FVO)	
Total change in FV	XX
Change in FV due to 'own credit'	(X)
Profit for the year	XXX

Financial liability on balance sheet at (full) fair value

Statement of Comprehensive Income (liabilities under FVO)

<i>Other Comprehensive Income:</i>	
Change in FV due to 'own credit'*	X

* Not recycled



ED/2010/4: Presenting the Effects of changes in a liability's credit risk in other comprehensive income (3)

Information provided by the two-step approach:

1. FV of the financial liability,
2. Total FV change of the financial liability,
3. Portion of total FV change attributable to changes in the liability's credit risk.



ED/2010/4: Presenting the Effects of changes in a liability's credit risk in other comprehensive income (4)

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?



ED/2010/4: Presenting the Effects of changes in a liability's credit risk in other comprehensive income (5)

Suggestion of an alternative approach:

One-step approach:

- The portion of the FV change due to own credit would be recognised directly in OCI
- All other portions of the FV change would be presented in P&L

Question 5

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



ED/2010/4: Presenting the Effects of changes in a liability's credit risk in other comprehensive income (6)

Suggestion to present the effects of changes in 'own credit' in equity rather than in OCI

Reason:

- Use of OCI should not be expanded until the Board addresses that topic comprehensively
- Consistent with the view that a change in a liability's credit risk represents a wealth transfer between debt holders and equity holders

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?



ED/2010/4: Reclassifying amounts to profit or loss (1)

'Recycling':

- The ED proposes to prohibit reclassifying amounts from OCI to P&L
 - If the entity repays the contractual amount, there would be no amount to recycle
 - If the entity repays an amount other than the contractual amount, there could be amounts in accumulated OCI, which would be realised when the liability is derecognised

Disclosures:

- The ED proposes amendments to IFRS 7 to provide users with information about the amount included in OCI that was realised on derecognition of a financial liability



ED/2010/4: Reclassifying amounts to profit or loss (2)

Question 7

Do you agree that gains or losses resulting from changes in liabilities' 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?



ED/2010/4: Determining the effects of changes in a liability's credit risk (1)

- The ED proposes to use the guidance in IFRS 7 on the determination of changes in the FV attributable to changes in the entity's own credit risk
- Default method for calculating that amount (paragraph B4 of IFRS 7):
 - Method attributes all changes in FV, other than changes in a benchmark interest rate, to changes in the credit risk of the liability
- The use of a different method would be permitted, if it would represent more faithfully changes in the FV of the liability attributable to changes in its credit risk



ED/2010/4: Determining the effects of changes in a liability's credit risk (2)

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?



ED/2010/4: Effective date and transition (1)

- The proposals will ultimately form part of IFRS 9. Entities must apply IFRS 9 for annual periods beginning on or after 1 January 2013
- Earlier application would be permitted. Upon early application an entity would have to apply any requirements in IFRS 9 that it does not already apply and any consequential amendments to other standards
- The amendments would be applied retrospectively



ED/2010/4: Effective date and transition (2)

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?

Question 10

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



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