

FREQUENTLY ASKED QUESTIONS

Fair Value Option for Financial Liabilities (the 'ED')

Note: This Q&A has been prepared by the staff of the International Accounting Standards Board (IASB) to answer questions they are commonly asked. It does not represent the views of the IASB.

1. Why is this ED only dealing with financial liabilities?

- The exposure draft on financial instruments that preceded IFRS 9 dealt with both financial assets and liabilities.
- However the Board received feedback that financial liabilities were less urgent so IFRS 9 dealt only with the classification and measurement of financial assets. It excluded financial liabilities.
- The Board undertook to deal with classification and measurement of financial liabilities promptly, specifically addressing own credit.
- Of course, the Board already has an ED out on impairment, and is working towards an ED on hedge accounting.

2. So what is this issue of 'own credit'?

- The issue is for non-derivative financial liabilities measured at fair value under the fair value option.
- Changes in a liability's credit risk affects its fair value. This means that when an issuer's creditworthiness deteriorates, the fair value of that entity's issued debt will decrease (and vice versa). For financial liabilities measured using the FVO this change causes a gain (or loss) currently to be recognised in P&L.
- The Board has been told by many, including many investors, that reporting this effect does not provide useful information and can cause confusion.
- It is just this issue that the ED addresses.

3. So what feedback did you get from investors?

- We undertook extensive outreach with investors including a questionnaire, to which we got over 80 responses.
- Overall that feedback told us that:
 - i. if liabilities are remeasured they should be on the balance sheet at *full fair value* (ie including the effect of changes in own credit);
 - ii. they do not think the P&L volatility arising from own credit provides useful information;
 - iii. however, many think own credit information does still have information content.

- Many indicated that bifurcation of structured liabilities (splitting it into a derivative component that is measured at fair value through P&L and a vanilla host measured at amortised cost) is appropriate.

4. So what is the Board proposing?

- The Board is proposing a change to current requirements for financial liabilities only to address own credit.
- The ED proposes a two-step process for financial liabilities under the FVO:
 - i. The liability is measured at (full) fair value;
 - ii. The total change in fair value is recognized in P&L; **BUT**
 - iii. The change in fair value arising from own credit is reversed out of P&L and recognized in Other Comprehensive Income (OCI).
- The Board is not proposing any other changes to the accounting for financial liabilities and is not proposing a change to when the fair value option (FVO) is available for liabilities.

5. Why is the Board proposing amending the treatment of own credit in this way?

- It addresses the issue of own credit risk for liabilities in a focused way with the least disruption.
- It is consistent with the feedback from investors.

6. Why is the Board not proposing a broader change to the accounting for financial liabilities?

- Most believe that current requirements for financial liabilities work well, except for the effects of own credit for liabilities under the FVO.
- In our outreach we discussed a range of different approaches to deal with own credit.
- There was no clearly preferred approach.
- So the Board decided to propose retaining bifurcation and to focus only on addressing own credit for liabilities under the FVO.
- This causes the least disruption while addressing the problematic area of accounting for financial liabilities - own credit.

7. Why is the Board proposing the ‘two step’ approach to deal with own credit for financial liabilities under the FVO?

- Investors have told us they do not think P&L volatility due to own credit is useful but many investors still think own credit provides valuable information.
- This approach addresses both points – it removes the P&L volatility from own credit but still provides information on own credit to users.

8. Why not use a measurement that excludes changes in own credit (a ‘frozen credit spread’ approach)?

- It is difficult to do. Isolating the own credit risk component is very difficult for many types of liabilities (and, in some cases, impossible).
- By retaining bifurcation *only those preparers who choose to use the FVO need to isolate own credit.*
- Most investors don’t want it. Investors told us that they wanted structured liabilities to be measured at fair value if embedded derivatives were not separated. They did NOT want a new measurement method to be created.

9. Why are you keeping bifurcation for structured financial liabilities when it has been eliminated in IFRS 9 for structured financial assets? Shouldn’t the treatment be symmetrical?

- Own credit is not an issue for financial assets.
- Users showed support for bifurcation of financial liabilities, because of the effects of own credit for financial liabilities.
- In our user survey and investor outreach on own credit hardly any investors raised symmetry as an objective, or even an issue.
- However, many users in the past have stated support for structured financial assets to be measured at fair value.

10. Why did the Board decide to bifurcate based on IAS 39 rather than IFRS 9 (ie using the interest and principal as the host, and anything else being a ‘derivative’)?

- The benefits of using the same classification approach in IFRS 9 were outweighed by the significant disruption to practice.
 - i. Changing bifurcation to be based on IFRS 9 would require quite a fundamental change to practice.
 - ii. In almost all cases the accounting outcome would be the same.

11. Can amounts in OCI be recycled to P&L?

- The Board decided that the effect of own credit is still relevant to the assessment of performance – it just shouldn’t cause P&L volatility. This is why the ED proposes recognising it within OCI.
- However, the ED proposes that if a financial liability is settled for an amount other than its contractual amount, any amounts in OCI relating to own credit cannot be transferred to P&L (recycled) even if they are crystallised.
- Because the own credit amount is in OCI many board members believe it is not necessary to recycle to P&L.
- In addition, most financial liabilities will be held to maturity in which case the effect of own credit will reverse over time.

- Some board members believe that recycling just adds to complexity and does not improve financial reporting.
- However, the ED does include a question on this.