Fair Value Option

Extract, IFRS® Discussion Group Report on the Meeting – June 20, 2019

IFRS 9 *Financial Instruments* defines a financial liability at fair value through profit or loss (FVTPL) as a financial liability that meets the definition of held for trading or is designated by the entity in accordance with certain criteria in IFRS 9. This option to designate at FVTPL is referred to as the “fair value option.”

The Group considered a fact pattern in the context of an investment entity to discuss factors to consider in applying the fair value option, and the related measurement and presentation implications once that option is taken.

Fact Pattern

- Investment Entity A meets the definition of an investment entity and measures its investments on a fair value basis in accordance with IFRS 10 *Consolidated Financial Statements*. The entity reports fair value information to its key management personnel to evaluate the performance of substantially all of its investments and to make investment decisions. Investment Entity A has no equity.
- Investment Entity A issued a term loan for general borrowing purposes to finance the purchase of non-specific types of assets (e.g., real estate, private equities, and fixed income). The term loan is not managed as part of any portfolio for which there is evidence of a recent pattern of short-term profit-taking, nor is the term loan incurred with an intention to repurchase it in the near term due to changes in the loan’s fair value. The term loan is repayable at maturity and collateralized by Investment Entity A’s assets.
- The entity has a triple-A credit rating. Therefore, the term loan is issued to maximize the returns given the difference between the cost of borrowing and the expected return on the purchased assets.

Issue 1A: Is the term loan described in the fact pattern considered held for trading?

Analysis

Paragraph BA.7 of IFRS 9 provides guidance for assessing whether financial liabilities are held for trading, indicating that such liabilities include:

(a) derivative liabilities that are not accounted for as hedging instruments;

(b) obligations to deliver financial assets borrowed by a short seller (i.e., an entity that sells financial assets it has borrowed and does not yet own);

(c) financial liabilities that are incurred with an intention to repurchase them in the near term (e.g., a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and

(d) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

Based on the fact pattern, the term loan does not fit the characteristics of an instrument that is held for trading as contemplated in paragraph BA.7 of IFRS 9. The reasons are that the entity has no intention to repurchase the term loan in the near term and does not manage the term loan as part of a portfolio for short-term profit-taking purposes. The term loan is held to maximize the return between the purchased assets and the low cost of debt. Paragraph BA.8 of IFRS 9 goes on to state that “the fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.”

The Group’s Discussion

The Group agreed with the analysis above.

Issue 1B: Could the term loan be designated at FVTPL using the fair value option in IFRS 9?

Analysis

Paragraph 4.2.2 of IFRS 9 states:

> “An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss when permitted by paragraph 4.3.5, or when doing so results in more relevant information, because either:
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> (a) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29–B4.1.32); or
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> (b) a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures*), for example, the entity's board of directors and chief executive officer (see paragraphs B4.1.33–B4.1.36).”

Based on the fact pattern, Investment Entity A reports fair value information to its key management personnel to evaluate the performance of substantially all of its investments and to make investment decisions. Financial assets and financial liabilities are part of portfolios that have different risk profiles and are managed on a fair value basis. Since the term loan is part of a group of financial assets and liabilities that are managed on a fair value basis, the criterion in paragraph 4.2.2(b) of IFRS 9 is considered met such that the term is eligible for designation at FVTPL.

The Group's Discussion

Group members agreed with the analysis above and highlighted that a portfolio manager manages on a fair value basis, including looking at the borrowings and investments in evaluating performance on a net basis. One Group member pointed out that it is important to establish a strong correlation between the investment and the term loan. For example, if the general borrowing was not used for a long period of time, or only a portion is used for investment purposes, then that could make it more challenging to support that the financial instruments are managed together.

Issue 2: Assume the term loan is designated at FVTPL. Does the recognition in other comprehensive income of the fair value change of the term loan that is attributable to changes in credit risk of that loan create or enlarge an accounting mismatch in profit or loss?

Analysis

Paragraphs 5.7.7 and 5.7.8 of IFRS 9 provide guidance on where the fair value change of the financial liability that is attributable to changes in credit risk of that financial liability is presented in the statement of comprehensive income.

Paragraph 5.7.7(a) of IFRS 9 would require the fair value change of the term loan that is attributable to changes in credit risk of that loan to be recognized in other comprehensive income, unless the treatment of the credit risk component creates or enlarges an accounting mismatch in profit or loss. If this is the case, paragraph 5.7.8 of IFRS 9 would require all the fair value change of the financial liability to go through profit or loss (i.e., not necessary to present the credit risk component in other comprehensive income).

Furthermore, paragraphs B5.7.5-B5.7.20 of IFRS 9 provide application guidance for liabilities designated at FVTPL. To determine whether treatment of the credit risk component creates or enlarges an accounting mismatch, an entity needs to assess whether it expects the term loan's credit risk changes will be offset in profit or loss by another financial instrument's fair value change measured at FVTPL. The expectation must be based on an economic relationship between the characteristics of the liability and the characteristics of the other financial instrument.

In this fact pattern, while the credit risk of the term loan may be related to the total value of Investment Entity A's financial assets, the credit risk is also influenced by other factors, such as:

(a) the term loan's priority relative to other liabilities;

(b) whether the term loan is collateralized;

(c) whether the financial assets are available to be used for other purposes; and

(d) other assets, liabilities, activities and expenditures of Investment Entity A.

In addition, the term loan is issued for general borrowing purposes. It would be difficult to establish a sufficiently direct economic relationship between the term loan and another financial asset. As a result, treatment of the credit risk component in other comprehensive income in this fact pattern does not create or enlarge an accounting mismatch because the term loan's credit risk is not necessarily offset by the fair value change of another financial instrument measured at FVTPL.

The Group's Discussion

Group members agreed with the analysis above. One Group member emphasized that paragraph B5.7.6 of IFRS 9 specifically indicates that the economic relationship between the characteristics of the liability and the characteristics of the other financial instrument must be considered in determining whether the other comprehensive income treatment described in paragraph 5.7.7(a) of IFRS 9 would create or enlarge an accounting mismatch in profit or loss. This means that an entity would need to identify a feature of the other financial instrument that moves in tandem with the effects on the financial liability's fair value change attributable to the credit risk of that liability to support that such economic relationship exists.

Issue 3: Assume that an accounting mismatch is not created or enlarged in profit or loss as a result of recognizing the credit risk change of the term loan in other comprehensive income. What are some presentation considerations for Investment Entity A's financial statements relating to the credit risk component given it has no equity?

For investment entities, the most relevant information for a shareholder or unitholder is the net asset value on a fair value basis, which is total financial assets less total financial liabilities.

Some points to consider may include the following:

- The presentation format shown in Illustrative Example 7 of IAS 32 *Financial Instruments: Presentation* relating to the statement of comprehensive income and statement of financial position for entities with no equity. In summary, the statement of comprehensive income shows a total line item of "changes in net assets attributable to unitholders" and the statement of financial position shows "net assets attributable to unitholders" that comprises total assets less current and non-current liabilities.
- The magnitude of the changes in fair value of the term loan due to the credit risk of the loan. Paragraph B5.7.13 of IFRS 9 provides guidance in this area, contemplating how collateralization of a financial liability would affect whether the liability's credit risk would be significant or not.
- Guidance in IAS 1 *Presentation of Financial Statements* around the minimum line items to be presented in financial statements.

The Group's Discussion

Group members noted that paragraph 5.7.7(a) of IFRS 9 requires that the amount of change in the financial liability's fair value that is attributable to the change in that liability's credit risk must be presented in other comprehensive income when no accounting mismatch is created or enlarged in profit or loss. Therefore, entities need to develop an approach that would comply with this requirement. That said, Group members agreed with the presentation considerations described above.

One Group member noted that Illustrative Example 7 of IAS 32 and the presentation requirements in IAS 1 should be considered in developing an approach to separate net assets attributable to unitholders into its respective parts. Such parts may include the amount related to accumulated other comprehensive income. That said, another Group member noted that there are some questions in practice on applying Illustrative Example 7 of IAS 32.[1]

A few Group members shared that in their experience, the amount related to the change in the credit risk component from period to period is often not material for investment entities. Therefore, it is not separately presented in the statement of comprehensive income based on materiality. One reason for this could be that the investment entity's credit risk is influenced by the quality of the invested assets. If the financial liability is collateralized, the credit risk may be close to zero as acknowledged by paragraph B5.7.13 of IFRS 9.

One Group member also noted this issue is similar to thinking about how to present the cumulative translation adjustment when an investment entity has a Canadian-dollar functional currency but presents its financial statements in a different currency.

Overall, the Group discussed these issues to raise awareness on the application of the fair value option in IFRS 9. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).

[1] Refer to the AcSB's comment letter to the IASB's Discussion Paper, "Financial Instruments with Characteristics of Equity."