



MALAYSIAN INSTITUTE
OF ACCOUNTANTS



**MALAYSIAN INSTITUTE OF ACCOUNTANTS
FINANCIAL REPORTING STANDARDS IMPLEMENTATION COMMITTEE
("FRSIC")**

**FRSIC Issue No. 47 [2014]
*Adjustments for Credit Risks***

The issue:

MFRS 13 "Fair Value Measurement", effective for annual reporting periods beginning on or after 1 January 2013, requires an entity to "measure the fair value of an asset or a liability using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their in their economic best interest." [MFRS 13.22]

Where quoted prices in active markets are not available, market participants use valuation techniques to determine fair value. The most common is a discounted cash flow approach whereby probable future cash flows are estimated and then discounted to present value. The present value amount is adjusted for factors that a market participant would consider, for example for counterparty and own credit risk.

MFRS 7 defines credit risk as "the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation." The requirement to adjust for credit risk is made more explicit in the guidance for liabilities: "the fair value of a liability reflects the effect of non-performance risk ... [which] includes ... an entity's own credit risk." [MFRS 13.42].

The concept of credit risk adjustments is well known in the market place. Credit risks adjustments are commonly referred to as credit valuation adjustments (CVA) and debit valuation adjustments (DVA). In the case of a derivative, for example, CVA is the price of the default risk with a particular counterparty considering the effect of offsetting collateral. A DVA is an adjustment required for own credit risk.

Current accounting practice as observed by the Submitter:

The submitter observed that a number of international IFRS-compliant banks' financial statements indicate that CVA and DVA adjustments can have a significant impact on financial results. As at 31 December 2013, CVA adjustments ranged from 0.1% - 0.4% of the gross derivative asset position, and DVA adjustments ranged from 0.1% - 0.4% of the gross derivate liability position. In fact, the combined CVA/DVA/FVA (funding valuation adjustment) for one of the global banks represented 31.8% can be material to the financial statements and to users' understanding of the entity's underlying risk exposure.

The submitter also observed no similar disclosures of the impacts CVA and DVA were made to some of the local banks' 31 December 2013 financial statements.

Reasons for the FRSIC to address the issue:

A certain level of expertise and management judgement is required to ensure that CVA and DVA have been considered and appropriately applied. Entities may not be clear on the determination of the required credit adjustment. In light of this, it is important that the FRSIC raise awareness within the accounting profession of these new requirements in MFRS 13.

Submitter's proposal or recommendation to address the issue:

The submitter recommends the FRSIC issues a Consensus which emphasis the requirements of MFRS 13 including the specific requirement measured at fair value for which there is no quoted price available in an active market. We also recommend the FRSIC include in its Consensus, some commonly used techniques to determine adjustments for credit risk.

Submitted on:

4 April 2014

Corresponding Guidance:

PROJECT WAS DISCONTINUED.

A survey was carried out to better understand the current practices of financial institutions (FIs) in Malaysia in relation to this issue. The main findings of the survey are as follows:

- (a) the majority of respondents reflect CVA and DVA in the calculation of fair values of their derivatives;
- (b) the inputs used to calculate CVA and DVA includes both market and historical data;
- (c) CVA and DVA are mainly used for financial reporting rather than risk management purpose.

The survey findings were also shared with the FIs during an outreach session held in August 2016.

FRSIC has deliberated the issue and has taken into consideration the findings of the survey as well as responses from the FIs during the outreach session. FRSIC is of the view that paragraphs 42 to 44 of MFRS 13, as reproduced below, explicitly require entities to include CVA and/or DVA in measuring fair value.

MFRS13.42

The fair value of a liability reflects the effect of non-performance risk. Non-performance risk includes, but may not be limited to, an entity's own credit risk (as defined in MFRS 7 Financial Instruments: Disclosures). Non-performance risk is assumed to be the same

before and after the transfer of the liability.

MFRS 13.43

When measuring the fair value of a liability, an entity shall take into account the effect of its credit risk (credit standing) and any other factors that might influence the likelihood that the obligation will or will not be fulfilled. That effect may differ depending on the liability, for example:

- (i) whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a non-financial liability).
- (ii) the terms of credit enhancements related to the liability, if any.

MFRS13.44

The fair value of a liability reflects the effect of non-performance risk on the basis of its unit of account. The issuer of a liability issued with an inseparable third-party credit enhancement that is accounted for separately from the liability shall not include the effect of the credit enhancement (eg a third-party guarantee of debt) in the fair value measurement of the liability. If the credit enhancement is accounted for separately from the liability, the issuer would take into account its own credit standing and not that of the third party guarantor when measuring the fair value of the liability.

FRSIC decided that an article on the findings of the survey would adequately address the concern raised by the submitter. The article is published on FRSIC website and can be accessed at <http://www.mia.org.my/v1/frsic/>.