Stage 3—
Financial liabilities:
TooBigToFail Bank case study
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TooBigToFail Bank case study

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Background

TooBigToFail Bank (TBTF) has equity listed on the Artican Stock Exchange. All entities listed on the Artican Stock Exchange are required to prepare and file their financial statements in accordance with International Financial Reporting Standards (IFRS).

The Artican dollar (ART$) is TBTF’s functional currency and its presentation currency. TBTF’s debt is ART$-denominated. About half the listed debt TBTF issues is, when first recognised, deemed by TBTF to be at fair value through profit or loss. Mr Eden-Bro (Chief Financial Officer, TBTF) justifies this designation—to provide more relevant information to the primary users of TBTF’s financial information by avoiding ‘an accounting mismatch’. The designation is made irrevocably, at initial recognition, for particular financial liabilities issued by TBTF to be measured at fair value through profit or loss. Those debt instruments (financial liabilities measured at fair value through profit or loss), and other similar debt instruments issued by TBTF that are carried by TBTF at their amortised cost, are traded on the Artican debt market.

Rogue trader

On 29 December 20x1 a rogue trader (Mr P’Ariss) circumvents TBTF’s internal controls and enters TBTF into a number of speculative derivative transactions. On 15 January 20x2 the unauthorised trades are detected and TBTF immediately closes out the resulting derivative positions at a loss of ART$20 billion.

In its 20x1 statement of comprehensive income TBTF invokes the ‘fair presentation override’ so as to recognise the ART$20 billion loss in 20x1. On 31 December 20x1 the

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1 The names of individuals, entities and places in this case study are fictitious. Any resemblance to actual people, entities or places is purely coincidental.

2 See paragraph 4.2.2(a) of IFRS 9 Financial Instruments.

3 See paragraph 19 of IAS 1 Presentation of Financial Statements.
fair value of the unauthorised derivative instruments is an asset of ART$2 billion. However, Mr Eden-Bro cites the unauthorised actions of the rogue trader in 20x1 as the reason for invoking the fair presentation override to instead recognise a loss of ART$20 billion in 20x1.

Default and credit rating downgrade

The previously unforeseen losses arising from the unauthorised trades caused TBTF to contravene its regulatory capital requirements. In response to this, on 20 January 20x2 TBTF’s credit rating was downgraded from AA (‘high credit-quality investment grade’) to BB (‘junk bond’ grade) and other financial institutions now stop providing funds to TBTF. Consequently TBTF enters a liquidity crisis as a result of which, on 21 January 20x2, TBTF defaults on the redemption of its debt market-traded fixed-rate mandatorily redeemable two-year debentures when they reach maturity.

On 21 January, following the announcement of the downgrade, TBTF’s market capitalisation fell by ART$50 billion.

TBTF’s interim financial statements for the quarter ended 31 March 20x2 included:

- ART$10 billion income—decrease in the fair value of debenture liabilities carried at fair value as a result of the downgrading of its credit rating
- ART$8 billion expense—decrease in the fair value of assets carried at fair value because of an increase in counterparty credit spreads as an economic downturn takes hold in Artica
- ART$12 billion expense—asset impairment expense (primarily the impairment of goodwill and other intangible assets acquired in business combinations).

Some in the financial Press immediately expressed the view that the recognition of the ART$10 billion gain on its debenture liability is the counterintuitive result of an ‘accounting gimmick’, which effectively inflated TBTF’s reported income for the quarter.

Own debt repurchase

On 10 April 20x2 TBTF pays ART$7 billion to repurchase TBTF exchange-listed fixed-rate debt when it carried that debt at its amortised cost—ART$10 billion. In its financial statements for the quarter ending 30 June 20x2, TBTF reports ART$3 billion income on repurchasing this debt.
Part nationalisation

On 2 August 20x2 a financial crisis takes hold in Artica. On 3 August, citing the national interest, the Artican government intervenes in the market to prevent TBTF from being liquidated—TBTF receives ART$100 billion in exchange for ordinary shares that provide the Artican government with a major share of the equity of TBTF.

On 3 August 20x2 the disgraced Mr Eden-Bro is dismissed by TBTF and Ms Fixit is appointed to ‘turn around’ the company.

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<thead>
<tr>
<th>Some IFRS issues for class discussion</th>
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<tr>
<td>Does measuring debt at amortised cost or fair value provide financial information about TBTF that is more useful to primary users—existing and potential investors, lenders and other creditors who are not in a position to demand information from TBTF—in making decisions about providing resources to TBTF?</td>
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<td>Is it a counterintuitive ‘accounting gimmick’ that the downgrading of TBTF’s credit rating results in TBTF recognising income in the period of the downgrade?</td>
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<td>Does TBTF’s use of the fair presentation override contravene IFRS?</td>
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