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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**13 December 2007, London**
Project:	**IAS 39 Financial Instruments: Recognition and Measurement**
Subject:	**Scope of paragraph 11A of IAS 39 – Application of Fair Value Option (Agenda Paper 3B)**

BACKGROUND

1. The IFRIC was asked to consider whether the fair value option (FVO) available in paragraph 11A of IAS 39 can be applied to all contractual arrangements with one or more 'substantive'[1] embedded derivatives, including contractual arrangements that contain host contracts outside the scope of IAS 39. This issue relates to what is in the scope of IAS 39.

2. In May 2007 the IFRIC issued a tentative agenda decision that the fair value option available in paragraph 11A of IAS 39 is *not applicable* to contracts that are outside the scope of IAS 39 (because the scope of paragraph 11A should be consistent with the overall scope of IAS 39 set out in paragraphs 2-7).

3. However, at its September meeting, the IFRIC decided not to finalise this agenda decision because of diversity in practice. The IFRIC noted that the issue relates to some of the basic requirements of IAS 39 and that amendments

[1] The term 'substantive' is used in this context for embedded derivatives that meet the requirements of paragraph 11A(a) or 11A(b) of IAS 39.

to the standard might be required. Therefore, the IFRIC decided to refer the issue to the Board, with some recommendations for changes.

4. At the November IFRIC meeting, the staff set out a number of alternative approaches to eliminate diversity in practice that the IFRIC could recommend to the Board[2]. The IFRIC decided to recommend that paragraph 11A simply be amended.

THIS PAPER

5. This paper describes and analyses the two alternative interpretations of paragraph 11A and the staff's recommendation as to how paragraph 11A should be amended.

THE ISSUE

6. IAS 39 paragraph 11A states: 'Notwithstanding paragraph 11, if **a contract** contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset and financial liability at fair value through profit or loss unless:

   (a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or

   (b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.'

   [emphasis added]

View A: Paragraph 11A applies to all hybrid contracts

7. Proponents of this view argue that the FVO applies to all hybrid contracts even if, in the absence of such designation, the host would not be in the scope of IAS 39.

8. Paragraph 11A of IAS 39 refers specifically to circumstances where "**a contract** contains one or more embedded derivatives" such that "an entity may

[2] The staff IFRIC paper is attached as appendix 3 to Paper 3C. The IFRIC paper discussed both paragraph 11A of IAS 39 (the subject of this paper) and paragraph AG33(d) of IAS 39. Paragraph AG33(d) also relates to the scope of IAS 39 and is considered in paper 3C. The staff therefore recommends that board members read Paper 3C before reading the IFRIC paper.

designate the entire hybrid (combined) contract" as at fair value through profit and loss.

9. The only definition of a contract in the literature is in IAS 32. The term **"contract"** is defined in IAS 32 as "an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law." (Thus, the definition of a contract includes contracts that are not financial instruments).

10. Paragraph 10 of IAS 39 defines an embedded derivative as a component of a hybrid (combined) **instrument** that also includes a non-derivative host **contract**. That definition is somewhat confusing; it refers both to an instrument and the broader term contract. However, it is clear from paragraph 11 that hybrid (combined) instruments include arrangements that have non-financial host contracts.

11. The reference in paragraph 11A to "a contract" rather than "a financial instrument" suggests that paragraph 11A can be applied to a hybrid contract containing a non-financial host (or a financial host outside the scope of IAS 39).

12. Those in favour of this view note that paragraph 11A is not the only situation in which the standard allows or requires a hybrid contract, that contains a host contract that is outside the scope of IAS 39, to be fair valued in its entirety. Paragraph 12 requires that if "an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at a subsequent financial reporting date, it shall designate the entire hybrid (combined) contract as at fair value through profit or loss".

13. Proponents of View A also note the following reasons for paragraph 11A that are set out in AG33A and that would apply to all hybrid contracts:

> AG33A of IAS 39 states: '*When an entity becomes a party to a hybrid (combined) instrument that contained one or more embedded derivatives, paragraph 11 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial*

recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through profit or loss. For that reason this Standard permits the entire instrument to be designated as at fair value through profit or loss.'

[emphasis added]

14. In relation to View A, the staff notes that many executory contracts (for non-financial items) have the characteristics of a derivative as set out in paragraph 9 of IAS 39 when the contract is considered in its entirety. Therefore, logically, the staff struggles to see how paragraph 11A (which applies to host contracts with embedded derivatives) should be applied to a contract which in itself has all the features of a derivative.

View B: Paragraph 11A applies only to hybrid contracts with financial hosts in the scope of IAS 39

15. Although paragraph 11A uses the word "contract", it is clear that the designation of the contract is as "a financial asset or financial liability at fair value through profit and loss" rather than just 'a contract' at fair value through profit and loss (FVTPL). This is further underlined by the fact that the definition of a financial asset or financial liability at fair value through profit and loss in IAS 39 paragraph 9 is specifically framed in terms of "a financial asset or financial liability that meets either of the following conditions (…)" before later making reference to paragraph 11A. In other words, the host contract must already be in the scope of IAS 39 before considering whether the fair value option can be applied.

16. Futhermore, View A would allow the FVO to be applied to many types of contracts scoped out of IAS 39 that include a 'substantive' derivative – for example, leases (including operating leases), executory contracts and insurance contracts. This would override the measurement guidance of other standards. While proponents of View B concede that application of paragraph 12 does result in this happening, they argue that paragraph 12 of IAS 39 is essentially an anti-abuse provision (to prevent an entity claiming that the fair value of an embedded derivative cannot be measured).

STAFF ANALYSIS

17. The staff believes that the wording of paragraph 11A is ambiguous.

18. However, having researched the development of the FVO in IFRS, the staff believes that the Board discussed the FVO only in the context of financial hosts in the scope of IAS 39.

19. Prior to the Fair Value Option Amendment (June 2005) the FVO was not applied to non-financial hosts, as the previous unrestricted fair value option was restricted to financial assets and financial liabilities within the scope of the standard only.

20. The staff believes that the Board did not intend to introduce a change to the standard in this respect through the June 2005 Amendment and there is no evidence of such an intention in the Basis for Conclusions accompanying the Amendment. The objective of the restricted fair value option issued in June 2005 was to restrict an entity's ability to designate as at FVTPL compared to the previously unrestricted version, not to widen the scope of the fair value option to contracts not in the scope of IAS 39.

21. The staff notes that the Board did not discuss whether financial reporting might be improved if the FVO were to be applied to some or all non-financial items (both contractual and otherwise). For example, much of the diversity in practice arises from application of paragraph 11A to either:

    - non-financial contracts that are not net settled (see paragraph 6 of IAS 39) but contain an embedded derivative that is required to be separated, or to

    - net settled non-financial contracts that are entered into and continue to be held for the purposes of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (see paragraph 5 of IAS 39) but contain an embedded derivative that is required to be separated.

22. Financial reporting could arguably be improved and simplified by permitting a FVO for some or all such items. This was one of the alternatives in the staff paper to the IFRIC (see appendix 3 to paper 3C). However, the IFRIC decided not to recommend that alternative to the Board.

23. Assuming that the Board does not wish to revisit the broader issue of the scope of IAS 39, the staff recommends that the wording in paragraph 11A be

clarified to apply only to financial host contracts in the scope of IAS 39 (see appendix 1).

QUESTIONS FOR THE BOARD

24. Does the Board agree with the staff recommendation? If not, what alternative does the Board wish to pursue and why?

25. The staff believes this issue meets the criteria for inclusion in the annual improvements process (i.e. a minor and non-urgent issue). Does the Board agree that this issue should be included as part of the Annual Improvements process? If not, how would the Board like to proceed?

26. Does the Board agree with the draft amendments and Basis for Conclusion (see appendix 1)?

<u>Appendix 1</u>

DRAFTING

11A Notwithstanding paragraph 11, if a <u>financial instrument</u> ~~contract~~ <u>within the scope of the standard</u> contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) <u>financial instrument</u> ~~contract~~ as a financial asset or financial liability at fair value through profit or loss unless:

(a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or

(b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

Appendix 2

DRAFT BASIS FOR CONCLUSION

1. The Board was advised that there was diversity in practice regarding the application of the paragraph 11A of IAS 39. In particular, whether the fair value option available in paragraph 11A of IAS 39 can be applied to all contractual arrangements with embedded derivatives including those that contain host contracts outside the scope of IAS 39. The Board noted that the wording of paragraph 11A was not clear.

2. During the development of the fair value option, the Board discussed the fair value option only in the context of financial instruments within the scope of IAS 39. Prior to the Fair Value Option Amendment (June 2005) the fair value option was restricted to financial assets and financial liabilities within the scope of the standard. In amending the fair value option, the Board did not intend to expand the class of assets and liabilities to which the fair value option could be applied. The objective was to restrict an entity's ability to designate financial instruments as at fair value through profit and loss compared to the previously unrestricted version and not to widen the scope of the fair value option to contracts not within the scope of IAS 39.

3. Accordingly, the Board decided to clarify paragraph 11A in order to eliminate the diversity in practice by specifying that the fair value option in paragraph 11A applies only to financial instruments with embedded derivatives within the scope of IAS 39 (as originally intended by the Board).