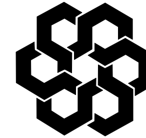

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
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:	**December 2008, London**
Project:	**IAS 39** ***Financial Instruments: Recognition and Measurement***
Subject:	**Background and Overview Fair Value Option (Agenda Paper 6B)**

INTRODUCTION

1. The IASB and the FASB held three public round tables in November and December. Many round table participants asked the boards to consider amending particular requirements related to the fair value option (FVO).

2. Participants raised three issues:

   (a) scope of FVO;

   (b) eligibility requirements for the FVO; and

   (c) ability to transfer out of the FVO category

3. This paper focuses on whether any of the accounting issues raised by participants require the urgent and immediate attention of the boards to improve financial reporting and help enhance investor confidence in financial markets. The paper addresses that objective by using the following structure:

(a) discussing participants' requests;

(b) summarizing the staff's views; and

(c) asking the board how to proceed.

ISSUE 1: SCOPE OF THE FVO

Existing requirements

4. Under IFRS, entities can elect the FVO for any financial instrument that is within the scope of IAS 39 if particular eligibility criteria are met. (Those eligibility criteria are discussed below in Issue 2.)

5. The scope of the FVO under US GAAP is different. For example, FASB Statement No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115* permits election of the FVO to some contracts that are outside of the scope of IAS 39 such as some insurance and warranty contracts that are not financial instruments. Also, SFAS 159 permits the fair value option to many investments in associates that are accounted for using the equity method.

Recommendation from Round Table Participants

6. Some participants stated that the IASB and FASB should reconsider the types of items that are eligible for the FVO. Those participants generally supported ensuring that the scope of the FVO is the same under both IFRS and US GAAP.

ISSUE 2: ELIGIBIILITY CRITERIA FOR THE FVO

Existing requirements

7. As discussed in Agenda Paper 11A for the November meeting, IAS 39 permits entities to elect the FVO upon initial recognition only if one (or more) of the following three conditions is met:

(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;

(b) a group of financial assets, financial liabilities or both 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; or

(c) the financial asset or financial liability contains one or more embedded derivatives (and particular other conditions described in paragraph 11A of IAS 39 are met) and the entity elects to account for the hybrid (combined) instrument in its entirety.

8. US GAAP does not have eligibility criteria.

Recommendation from Round Table Participants

9. Some round table participants noted that the eligibility criteria in IAS 39 should be reconsidered or eliminated.

10. They noted that such removal would simplify financial reporting and create convergence with US GAAP. Some participants who suggested removing the eligibility criteria also noted that the FVO should continue to be an election permitted only at inception and adequate disclosures should be required.

11. Furthermore, one participant noted that the eligibility criterion for a financial asset or a financial liability that contains one or more embedded derivatives (summarized in paragraph 7(c) of this paper and described in detail in paragraph 11A of IAS 39) is costly to assess and thus is inconsistent with one of the objectives of the FVO.

12. The board provides a basis for that requirement in paragraph BC78 of IAS 39. That paragraph notes that the board sought to strike a balance between reducing the costs of complying with the embedded derivatives provisions of IAS 39 and the need to respond to the concerns expressed regarding possible inappropriate use of the fair value option. The board determined that allowing the fair value option to be used for *any* instrument with an embedded derivative would make other restrictions on the use of the option ineffective, because many financial instruments include an embedded derivative. In contrast, limiting the use of the fair value option to situations in which the

embedded derivative must otherwise be separated would not significantly reduce the costs of compliance and could result in less reliable measures being included in the financial statements.

ISSUE 3: ABILITY TO TRANSFER OUT OF THE FVO CATEGORY

13. In October the IASB issued amendments to IAS 39 and IFRS 7 *Reclassification of Financial Assets* that permit reclassification out of the held-for-trading category (HFT) in particular circumstances. Some participants suggested that those amendments should be extended to instruments classified under the FVO.

14. One participant noted that the IFRS criteria for designation as HFT are more stringent than US GAAP. As a result, that participant argued that the recent amendments did not create a "level playing field" because more instruments can be designated as HFT under US GAAP (and, thus, are eligible for reclassification out of HFT).

15. Paragraph 9 of IAS 39 states that a financial asset or financial liability is classified as HFT if it is:

    (a) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;

    (b) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

    (c) a derivative (with particular exceptions).

16. Paragraph 12 of SFAS 115 *Accounting for Certain Investments in Debt and Equity Securities* states that

> …securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as *trading securities.* Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price.

17. Thus, US GAAP does not have a criterion similar to paragraph 15(b) above, which requires that in order for a portfolio to be classified as HFT there must be evidence of a **recent actual pattern of short-tern profit-taking**.

18. However, SFAS 115 only applies to financial instruments that meet the definition of a *security*. The scope of IAS 39 does not include such a definition.

19. Some participants also stated that entities should be able to transfer out of the FVO category when the conditions that permitted its application at initial recognition no longer exist (for example, if an entity no longer manages an instrument on a fair value basis).

20. However, most user participants were not supportive of permitting such reclassifications. They argued that reclassifications permit losses to be hidden. In addition, many users stated that they simply reconstruct earnings to try to eliminate the effect of any reclassification, to the extent that disclosed information permits them to do so (and if an entity did not provide sufficient detailed information at every reporting date, investors suffered a significant loss of overall information about the performance of the entity).

21. It was noted that forcing investors to do this difficult exercise was costly because of the time and effort involved, and also because it reduced the confidence that an investor had in reported earnings. One user noted that, because of this, such reclassifications actually probably harmed a company in terms of share price and investor confidence much more than any illusory accounting benefit that might appear to have been created.

22. Moreover, some participants noted that if reclassifications are permitted, the board will have to develop robust rules to prevent abuse. That is consistent with paragraph BC 73 of IAS 39, which notes that to impose discipline on the FVO, the board decided that financial instruments should not be reclassified into or out of the category. Some participants noted that such a move would *increase* complexity and would not be seen as an improvement to financial reporting.

23. Some participants also noted that, in some cases, entities had not thought carefully enough about their use of the FVO (and, in fact, more generally about how they classified many of their financial instruments). It was noted this lack of thought was now being clearly illustrated by the requests from some to be able to reclassify instruments out of the FVO.

24. The more general point that was made by some was that the problems regarding the use of the FVO illustrated the difficulty from the complex classification system in IAS 39 and US GAAP – and that the boards should move as quickly as possible to address the classification issue broadly (and not just in the context of the FVO).

REQUEST FOR VIEWS ON THE INAPPROPRIATE USE OF THE FVO

25. Agenda paper 11A for the November IASB meeting provided a brief history of the FVO (for convenience, that paper is attached to this paper as an appendix). As noted in that paper, IAS 39 (as revised in 2003) permitted entities to elect irrevocably on initial recognition to use the FVO for any financial instruments. Following the issuance of that amendment, the board became aware that some constituents (including some prudential supervisors of banks, some central banks, some securities companies and insurers) were concerned that the FVO might be used inappropriately. Moreover, the version of IAS 39 adopted by the European Commission carved-out the FVO requirements.

26. Given that background and the complexity of this accounting area, the IASB has formally asked for the views of some of the constituents that were closely involved in the revised FVO in IAS 39. Specifically, the IASB has asked for views about how inappropriate use of the FVO can be prevented (especially in the context of the eligibility criteria and the irrevocable designation).

27. In the request for those views, it was noted that the IASB is anxious to ensure that any actions taken are generally supported and have taken all factors into account.

28. As of the date that this agenda paper was posted, we had not yet received a response to our request.

STAFF RECOMMENDATION

29. We think that if the board decides to consider amending the requirements related to FVO, it is important to consider those requirements in their entirety (as a "package") rather than address only particular aspects on a piecemeal basis.

30. We think that only considering particular aspects of the FVO would not improve financial reporting or enhance investor confidence because that would result in a rules-based "patch". That patch could have unintended consequences, such as inappropriate use of the FVO.

31. Moreover, we acknowledge that convergence with US GAAP is a priority. We are already converged on irrevocable designation, but not the eligibility criteria or scope. Convergence on this issue would also be consistent with the boards' commitment to a global approach to enhancing market confidence.

32. As noted in paragraph 26-28 of this memo, the staff is awaiting responses to the formal request for views about how inappropriate use of the FVO can be prevented (especially in the context of the eligibility criteria and the irrevocable designation). We think that it is important that any actions that the IASB may take have taken all factors into account.

33. If the board agrees with our recommendation to only consider addressing the FVO as a package, we will update the board in January about any responses to our request for views on the FVO.

34. **<u>Question for the board</u>: The staff recommends that the board only consider the FVO as a "package", and that making piecemeal amendments will not enhance financial reporting or improve investor confidence. Does the board agree with that conclusion and recommendation? If not, which particular aspect of the FVO should be considered on a standalone basis and why would that improve financial reporting and enhance investor confidence?**

APPENDIX

NOVEMBER 2008 AGENDA PAPER 11A *Fair Value Option (FVO)*

INTRODUCTION

1. Some have asked the IASB to consider amending some of the restrictions around use of the FVO.

2. This paper

   (a) summarizes and provides a brief history of the IFRS requirements related to the FVO; and

   (b) for comparative purposes, provides a summary of the US GAAP requirements related to the FVO.

3. As noted in the cover paper for this session (AP11), we prepared this paper for background information only. We are not providing a technical recommendation nor are we asking the board for a decision in this paper.

IFRSs

Accounting Requirements

4. Paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement* states that a financial instrument is a *financial asset or financial liability at fair value through profit or loss* (FVTPL) if it meets either of two conditions:

   (a) it is classified as held for trading or

   (b) it is designated by the entity as at fair value through profit or loss upon initial recognition ("the fair value option")

5. This paper addresses (b) – the FVO. IAS 39 acknowledges that the decision to use the FVO is similar to an accounting policy choice although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions.

6. The FVO is **permitted upon initial recognition** only if one (or more) of the following three conditions is met:

   (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

   (b) a group of financial assets, financial liabilities or both 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

   (c) the financial asset or financial liability contains one or more embedded derivatives (and particular other conditions described in paragraph 11A of IAS 39 are met) and the entity elects to account for the hybrid (combined) instrument in its entirety.

7. Entities are prohibited from reclassifying any financial instrument into or out of the FVO category after initial recognition (IAS 39, paragraph 50). The amendments to IAS 39 and IFRS 7 *Reclassification of Financial Assets* issued in October 2008 do not apply to instruments in the FVO category. However, some interested parties recently have suggested that those amendments should be extended to such instruments.

Condition 1: eliminating or significantly reducing an accounting mismatch

8. Paragraphs AG4D-AG4G of IAS 39 provide application guidance related to electing the FVO to eliminate or significantly reduce an accounting mismatch.

9. Paragraph AG4E provides examples of when the FVO might be appropriate. One example is when an entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by IFRS 4, paragraph 24), and financial assets it considers related that would otherwise be classified as available for sale or measured at amortized cost. Another example is when an

entity has financial assets, financial liabilities or both that share a risk (such as interest rate risk) that gives rise to opposite changes in fair value that tend to offset each other (and the entity does not qualify for hedge accounting because none of the instruments is a derivative).

10. During the deliberations that resulted in the final requirements, the board discussed with its constituents whether prescriptive guidance was required as to the types, extents and timings of mismatches (including possibly some form of effectiveness test similar to hedge accounting). Constituents were almost unanimous that detailed prescriptive guidance should not be included and that the existing restrictions in place were sufficient to avoid accounting abuse. The board decided to require extensive disclosures regarding the use of the FVO rather than to develop detailed prescriptive guidance.

Condition 2: financial instruments that are managed and evaluated on a fair value basis

11. Paragraphs AG4H-AG4K provide the relevant application guidance.

12. The focus is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments. Accordingly, an entity that elects the FVO on the basis of this condition must so designate all eligible financial instruments that are managed and evaluated together. Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with the requirements in IAS 39. Such documentation is not required for each individual item, but may be on a portfolio basis.

13. Paragraph AG4I provide examples of when the FVO might be appropriate. An example could be an entity that has issued "structured products" containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments. Specifically, an entity could originate fixed interest rate loans and manage the resulting benchmark interest rate risk using a mix of derivative and non-derivative financial instruments.

Condition 3: financial instruments with embedded derivatives

14. Paragraphs AG33A and AG33B provide the relevant application guidance.

15. When an entity becomes a party to a hybrid (combined) instrument that contains one or more embedded derivatives, paragraph 11 of IAS 39 requires the entity to identify the 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 (initially and subsequently) at fair value.

16. 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 IAS 39 permits an entity to elect the FVO for the entire instrument. Such designation may be used whether paragraph 11 of IAS 39 would require the embedded derivatives to be separated from the host contract or prohibits such separation.

17. However, to qualify for the FVO, the hybrid instrument must meet particular conditions, which are set out in paragraph 11A. With those conditions, the board sought to strike a balance between reducing the costs of complying with the embedded derivatives provisions of IAS 39 and the need to respond to concerns expressed regarding possible inappropriate use of the FVO.

A Brief History of the FVO Designation

18. The requirements related to the FVO have been amended several times.

19. The original requirements in IAS 39 (as revised in 2000) did not permit an entity to measure particular categories of financial instruments at FVTPL (for example, some originated loans and non-derivative financial liabilities).

20. IAS 39 (as revised in 2003) permitted entities to elect irrevocably on initial recognition to use the FVO for **any** financial instrument. To impose discipline on that approach, the board decided that financial instruments could not be reclassified into or out of the FVTPL category (including the FVO category). This responded to comments received from respondents to the 2002 Exposure Draft that without such restrictions entities could use the FVO to recognize selectively changes in fair value in profit or loss.

21. Following the issuance of that amendment, the board became aware that some constituents (including some prudential supervisors of banks, some central banks, some securities companies and insurers) were concerned that the FVO might be used inappropriately. Some of those concerns are summarized in paragraph BC11C of IAS 39. The staff also notes that the version of IAS 39 adopted by the European Commission carved-out the FVO requirements. In a press release issued on 19 November 2004, the European Commission stated, "[t]he carve-out of the full fair value option is based on observations from the European Central Bank and prudential supervisors represented in the Basel Committee of banking supervisors."

22. In April 2004 the board issued another exposure draft proposing changes to the FVO. After extensive discussions with constituents and a series of public round-tables, the board issued an amendment to IAS 39 in June 2005.

23. That amendment permitted entities to elect irrevocably on initial recognition to use the FVO for **particular** financial instruments. Entities are permitted to apply the FVO only to financial instruments that meet one of three conditions (those conditions are summarized in paragraph 6 of this paper). The board stated that permitting the FVO is those circumstances results in more relevant information, reduces complexity, and increases measurement reliability.

24. The board has considered whether the FVO should be extended so that it could be applied to a component of a financial asset or financial liability (e.g., changes in fair value attributable to one risk such as changes in a benchmark interest rate) or a proportion (i.e., a percentage) of a financial asset or financial liability. For the reasons outlined in paragraphs BC85-86A of IAS 39, the board rejected extending the FVO to such items.

25. Also, as noted earlier in this paper, some interested parties have suggested that the recent amendments to IAS 39 and IFRS 7 should be extended to allow instruments in the FVO category to be reclassified to other categories in particular circumstances.

US GAAP

Requirements

26. The requirements relevant to the FVO are set out in FASB Statement No. 155 *Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140* and FASB Statement No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*.

SFAS 155

27. SFAS 155 was issued in February 2006. One of the primary objectives of that standard was to "simplify accounting for certain hybrid financial instruments by permitting fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation."

28. SFAS 155 amended paragraph 16 of FASB Statement No 133 *Accounting for Derivative Instruments and Hedging Activities* by permitting an entity that initially recognizes a hybrid financial instrument that would be required to be separated into a host contract and a derivative instrument to irrevocably elect to initially and subsequently measure that hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings). (SFAS 155 cannot be applied to hybrid instruments described in paragraph 8 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*.)

29. SFAS 155 states that an entity also may elect the FVO when a previously recognized financial instrument is subject to a remeasurement (new basis) event. Footnote 6bbb of SFAS 155 states that a *remeasurement event* is

> …an event identified in other authoritative accounting literature, other than the recognition of an other-than-temporary impairment, that requires a financial instrument to be remeasured to its fair value at the time of the event but does not require that instrument to be reported at fair value on a continuous basis with the change in fair value recognized in earnings. Examples of remeasurement events are business combinations and significant modifications of debt as defined in EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments."

SFAS 159

30. SFAS 159 was issued in February 2007 and permits entities to choose, at specified election dates, to measure many financial instruments and certain other items at fair value.

31. Entities may elect the FVO for all items in the scope of SFAS 159; there are not any qualifying conditions (such as those in IAS 39, which are summarized in paragraph 6 of this paper). The scope of SFAS 159 is set out in paragraph 8-9 of that standard. In summary, entities may elect the FVO for the following items:

    (a) most recognized financial assets and financial liabilities

    (b) a firm commitment that otherwise would not be recognized at inception and that involves only financial instruments

    (c) written loan commitments

    (d) some rights and obligations under an insurance contract that is not a financial instrument

    (e) some rights and obligations under a warranty contract that is not a financial instrument

    (f) some host financial instrument resulting from the separation of a nonfinancial hybrid instrument

32. The FVO is irrevocable and can be applied only to an entire instrument (not to specified risks, specified cash flows, or portions of that instrument).

Similarities between SFAS 159 and IAS 39

33. Paragraphs A51 and A52 of SFAS 159 summarize some of the similarities and differences between the provisions in that standard and those in IAS 39.

34. Paragraph A51 notes that the FVO in both pronouncements are similar in that they both require that the election:

    a. Be made at the initial recognition of the financial asset or financial liability

    b. Is irrevocable

c. Results in the changes in fair value being recognized in profit or loss as those changes occur.

35. Paragraph A52 notes that the differences between the provisions pertain principally to disclosures, scope exceptions, and whether certain eligibility criteria must be met to elect the FVO.