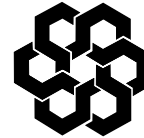

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

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: **November 2008, London**

Project: **Financial Instruments**

Subject: **Fair Value Option (FVO) (Agenda Paper 11A)**

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.