



Project	<b>Financial Instruments: Recognition and Measurement</b>
Topic	<b>Classification – fair value option</b>

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## Introduction

### *Background*

1. The Board discussed the classification of financial instruments at its meetings in May and early June 2009.<sup>1</sup> The Board adopted the working premise that a fair value option should be available.

### *Purpose of this paper*

2. This paper explains how a fair value option (FVO) fits into the context of the classification approach that the Board adopted as the working premise.
3. This paper includes staff recommendations and asks the Board for the following decisions:
  - (a) to confirm that the overall classification approach includes a FVO; and
  - (b) that the FVO is eligible if the designation eliminates or significantly reduces an accounting mismatch.

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<sup>1</sup> Agenda paper 5E of the May 2009 IASB meeting and agenda papers 2–2E of the 1 June 2009 IASB meeting.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB. The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

## Fair value option

### Scope

4. Classification can relate to different aspects:
  - (a) type of requirement:
    - (i) mandatory classifications; and
    - (ii) optional classifications (designations);
  - (b) point in time:
    - (i) initial classifications (ie on initial recognition); and
    - (ii) reclassifications (ie after initial recognition).
  
5. This paper on the FVO addresses only *initial optional* classification into the *fair value through profit or loss* category if financial instruments would otherwise have to be classified into the amortised cost category.
  
6. On the basis of the classification approach the Board adopted as its working premise this FVO would not apply to any designation of a financial instrument as at fair value through other comprehensive income (OCI). The latter category is only available for some equity investments, which do not qualify for amortised cost because of their characteristics. Consequently, the FVO cannot apply because it is only applicable to financial instruments that would otherwise have to be classified into the amortised cost category.

### Existing requirements

7. IAS 39 has three alternative eligibility criteria for use of the FVO. The FVO is available if at least one of the following conditions is met:

- (a) when designation as at fair value through profit or loss significantly reduces (or eliminates) an ‘accounting mismatch’ (ie a measurement or recognition inconsistency) that would otherwise arise;<sup>2</sup>
- (b) when a group of financial assets or liabilities is managed and its performance is evaluated on a fair value basis (in accordance with a documented risk management or investment strategy);<sup>3</sup> or
- (c) when a hybrid contract contains an embedded derivative unless that embedded derivative does not significantly affect the cash flows of the hybrid contract or it is clear that it is closely related to the host contract.<sup>4</sup>

***Implications of the new classification approach***

*Staff analysis*

8. The rationale for the first alternative to qualify for the FVO, which addresses accounting mismatches, is not affected by the new classification approach. Because of the mixed attribute model (ie fair value and amortised cost) the FVO would still provide a means of avoiding accounting mismatches. The staff notes that hedge accounting will be addressed in a future phase of this project. Because the FVO constitutes an alternative to hedge accounting in some circumstances it should be reconsidered as part of that phase of this project. The FVO is also important for many insurance companies that use it in order to avoid accounting mismatches between insurance liabilities and financial assets that exist, pending completion of the insurance project.
9. The new classification approach would affect the second alternative to qualify for the FVO. Financial instruments would be classified into the fair value

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<sup>2</sup> IAS 39.9–alternative (b)(i) of the definition of ‘financial asset or financial liability at fair value through profit or loss’.

<sup>3</sup> IAS 39.9–alternative (b)(ii) of the definition of ‘financial asset or financial liability at fair value through profit or loss’.

<sup>4</sup> IAS 39.11A.

category unless they were managed on a contractual yield basis (and have characteristics that qualify them for amortised cost). This new approach in effect makes the second alternative irrelevant.

10. The third alternative to qualify for the FVO, which allows avoiding bifurcation of a hybrid contract by designating the hybrid contract as at fair value through profit or loss in its entirety, would become obsolete if the Board decides to eliminate the notion of embedded derivative accounting for hybrid contracts with *financial* host contracts. Conversely, should the Board decide to retain embedded derivative accounting for all hybrid contracts (ie including those with financial host contracts) the third alternative to qualify for the FVO would remain relevant.

*Staff recommendations*

11. The staff recommends:
  - (a) retaining the FVO for scenarios in which designation as at fair value through profit or loss significantly reduces (or eliminates) an accounting mismatch because the FVO would continue to be useful in these circumstances, pending completion of the work on hedge accounting and other areas such as insurance contracts.
  - (b) eliminating the second alternative<sup>5</sup> because they would become obsolete under the new classification approach.<sup>6</sup>
  - (c) eliminating the third alternative<sup>7</sup> (but only) if the Board decides to also eliminate embedded derivative accounting for hybrid contracts with financial host contract (because then this alternative would become obsolete under the new classification approach).

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<sup>5</sup> See paragraph 7(b) above.

<sup>6</sup> Assuming that the new classification approach involves a business model criterion (as described in paragraph 9 above).

<sup>7</sup> See paragraph 7(c) above.

***Question to the Board***

**FVO if designation significantly reduces an accounting mismatch**

Does the Board agree with the staff recommendation to retain the FVO (only) if designation of a financial instrument as at fair value through profit or loss significantly reduces (or eliminates) an accounting mismatch?

If not, what does the Board prefer instead and why?