Project	**Financial Instruments: Replacement of IAS 39**
Topic	**Classification and measurement: fair value option (FVO)**

Purpose of the paper

1. Agenda paper 5 discusses what the measurement category should be if an instrument is not measured at fair value through profit or loss (FVTPL)—ie what the "other" measurement category should be. Our recommendation in that paper is that the other category should be amortized cost.

2. **This agenda paper builds on that recommendation and discusses whether an entity should be permitted to designate an instrument that would otherwise be measured subsequently at amortized cost, at FVTPL (the fair value option or FVO)—and if so, under what circumstance(s).**

3. If the Board disagrees with our recommendation in agenda paper 5, this paper is still relevant. Essentially we are asking the Board whether an entity should be permitted to subsequently measure an instrument at FVTPL if that instrument would otherwise be subsequently measured using some other measurement attribute. For simplicity, we have assumed in this paper that the Board agrees with our staff recommendation and the "other measurement attribute" is amortized cost.

Proposals in the exposure draft (ED)

4. IAS 39 permits entities the option to designate on initial recognition any financial asset or financial liability as measured at FVTPL 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) contract in its entirety.

5. The ED retains the eligibility condition described in paragraph 4(a). The Board's reasoning is summarized in paragraph BC50 of the ED.

6. Under the approach proposed in the ED, the eligibility conditions in paragraph 4(b) and 4(c) are not needed. That is because the proposals would:

(a) **require** any financial asset or financial liability that is managed on a fair value basis to be measured at fair value and

(b) classify hybrid contracts with financial hosts in their **entirety**, hence eliminating the requirement to identify and account for embedded derivatives separately.

Questions in the ED related to the FVO

7. Questions 5 and 6 in the ED asked respondents about the FVO:

Question 5

Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch?

If not, why?

Question 6

Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

Feedback received

8. Almost all respondents supported the proposal to retain the FVO if such designation eliminates or significantly reduces an accounting mismatch.

9. Some respondents preferred an unrestricted FVO (similar to existing US GAAP). However, some of those respondents acknowledged that an unrestricted FVO has been opposed by many in the past and that it may not be practical to pursue it now

10. The respondents who preferred retaining the requirements in IAS 39 for hybrid contracts generally supported retaining the FVO in cases where the hybrid contract must be separated.

11. A few respondents said that instruments designated under the FVO should be reclassified if the circumstances surrounding that designation no longer exist (ie there is no longer an accounting mismatch). However, many respondents argued that irrevocable designation is essential to the existence of the FVO.

FASB approach

12. The FASB has not yet discussed the need for a FVO under their proposed approach. According to the FASB's project plan, that topic will be analyzed and discussed in October.

13. However, based on the FASB's decisions to date, we do not think the FVO is relevant under their proposed approach. That is because FVTPL is the default measurement attribute. An entity may measure an instrument at FVTPL if that instrument otherwise qualifies to be measured at fair value through other comprehensive income or amortized cost.

Staff recommendation

14. The FVO will be discussed in the context of the hedge accounting phase. The Board's conclusions in phase II of the insurance project will also be relevant as to whether or not a FVO is necessary and should be retained. Therefore, the we think elimination of the FVO would be premature.

15. In addition, based on the feedback received, we think that the proposal in the ED should be carried forward to the IFRS. That is, we recommend that an entity is permitted to designate an instrument at FVTPL if such designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases.

16. If the Board carries forward the proposal to classify all hybrid contracts with financial hosts in their entirety, the condition in paragraph 4(c) is irrelevant. However, if the Board decides to retain embedded derivative accounting for some or all such hybrid contracts, we recommend that the condition described in paragraph 4(c) is retained. That is, we think that an entity should be permitted to designate an instrument at FVTPL if the financial asset or financial liability contains one or more embedded derivatives that would otherwise require separation and the entity elects to account for the hybrid contract in its entirety.

17. The condition discussed in paragraph 4(b) remains irrelevant under the proposed approach for the reason discussed in paragraph 6(a).

Question 1: FVO: accounting mismatches

Does the Board agree with the staff recommendation that an entity is permitted to designate an instrument at FVTPL if such designation eliminates or significantly reduces a measurement or recognition inconsistency?

If not, why?

Question 2: FVO: hybrid contracts

This question is relevant only if the Board decides to retain embedded derivative accounting for some or all hybrid contracts with financial hosts.

Does the Board agree with the staff recommendation that an entity is permitted to designate an instrument at FVTPL if the financial asset or financial liability contains one or more embedded derivatives that would otherwise require separation and the entity elects to account for the hybrid contract in its entirety?

If not, why?