STAFF PAPER

11 June – 15 June 2012

REG FASB | IASB Meeting

Project	**Financial instruments: classification and measurement**		
Paper topic	Fair value option		

CONTACT(S)	Jeff Lark	jlark@ifrs.org	+44 (0)20 7246 6932
	Yulia Feygina	yfeygina@ifrs.org	+44 (0)20 7332 2743
	Shahid Shah	sshah@fasb.org	+1 (203) 956-3478
	Trent Handy	tlhandy@fasb.org	+1 (203) 956-3466

This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or IASB. It does not purport to represent the views of any individual members of either board. Comments on the application of US GAAP or IFRSs do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRSs. The FASB and the IASB report their decisions made at public meetings in FASB Action Alert or in IASB Update.

Introduction

1. This paper assesses the fair value option (FVO) in the context of the boards' models for classifying and measuring financial instruments. Specifically, the paper discusses the current requirements in IFRS 9 and the FASB's tentative model, provides staff analyses and recommendations and asks the boards for decisions. The objectives of this paper are to consider:

   (a) whether the FASB would like to incorporate FVO requirements into its tentative model that are similar to those that are in IFRS 9 for financial assets and financial liabilities. This discussion excludes financial assets that are classified at fair value through other comprehensive income (FVOCI) because that topic is discussed separately (see (b) below); and

   (b) whether the IASB and FASB (if the FASB agrees to incorporate similar FVO requirements as are included in IFRS 9) would like to extend the eligibility condition in IFRS 9 for designating financial assets under the FVO (ie the 'accounting mismatch' eligibility condition) to debt

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

investments that are measured at FVOCI. Financial liabilities are discussed inasmuch as they could potentially result in an accounting mismatch with financial assets measured at FVOCI.

2. The staff is aware that the boards have different starting points in their respective classification and measurement models. The IASB is undertaking a project to consider limited modifications to IFRS 9. The FASB has developed a tentative classification and measurement model through redeliberations of its May 2010 proposed Accounting Standards Update[1]. Questions to the boards are designed to reflect those different starting points and provide the boards an opportunity to jointly deliberate a more converged position on the FVO.

Background

IFRS 9

Financial assets

3. IAS 39 *Financial Instruments: Recognition and Measurement* provided an irrevocable option to designate a financial asset or financial liability at initial recognition as measured at fair value through profit or loss (FVPL) if one or more of the following three eligibility conditions is met:

   (a) doing so eliminates or significantly reduces an accounting mismatch;

   (b) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis;

   (c) the financial asset or financial liability contains one or more embedded derivatives and the entity elects to account for the hybrid contract in its entirety.

[1] FASB Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities – Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*.

4. However, two of those eligibility conditions are unnecessary under IFRS 9[2]. Specifically, under IFRS 9:

   (a) any financial asset that is not managed within a business model that has an objective of collecting contractual cash flows is measured at FVPL, such that all financial assets managed on a fair value basis will be measured at FVPL (thus the eligibility condition in paragraph 3(b) is no longer relevant); and

   (b) hybrid contracts with financial asset hosts are classified in their entirety, hence eliminating the requirement to identify and account for embedded derivatives separately (thus the eligibility condition in paragraph 3(c) is no longer relevant).

5. However, the IASB retained the eligibility condition described in paragraph 3(a) for financial assets because it is still relevant under IFRS 9. It mitigates some anomalies arising from the different measurement attributes used for assets and liabilities. If assets and liabilities have an economic relationship, then accounting for the instruments using the same measurement criteria – FVPL – may provide the most relevant information for users. Most constituents supported the IASB's decision to retain the FVO if such a designation eliminates or significantly reduces an accounting mismatch. Although some would prefer an unrestricted FVO, they acknowledge that it has been opposed by many in the past and it would not be appropriate to pursue it now.

Financial liabilities

6. The IASB decided that is was unnecessary to make any changes to the three eligibility conditions for designating financial liabilities under the FVO because the IASB did not change the underlying classification and measurement approach for financial liabilities. Therefore, the IASB decided to carry forward from IAS

[2] The FVO requirements in IFRS 9 are reproduced in the appendix to this paper.

39 to IFRS 9 the three eligibility conditions for financial liabilities (reproduced in paragraph 3 above)[3].

7. Most constituents agreed with the IASB's decision although some constituents would have preferred an unrestricted FVO. But consistent with paragraph 5, they acknowledged that it has been opposed by many in the past and it would not be appropriate to pursue it now.

FASB's tentative model

8. Current US GAAP includes an unconditional FVO. In contrast, the FVO in the FASB's tentative classification and measurement model is not unconditional, but would permit an entity to measure a group of financial assets and financial liabilities at FVPL, if both of the following conditions are met:

   (a) The entity manages the *net exposure* relating to those financial assets and financial liabilities (which may be derivative instruments); and

   (b) The entity provides information on that basis to the reporting entity's management.

9. An entity would be permitted to elect that conditional FVO for a group of financial assets and financial liabilities only at initial recognition, and the election could not subsequently be changed.

10. Under the FASB's tentative model, an entity also would be able to elect at initial recognition a conditional FVO for both hybrid financial assets[4] and hybrid financial liabilities to avoid bifurcation and separate accounting for an embedded derivative feature. An entity would be allowed to measure a hybrid financial asset or hybrid financial liability at fair value in its entirety after determining an

[3] However the IASB decided that if a financial liability is designated under the FVO, the effects of changes in that liability's credit risk should be presented in OCI unless such treatment would create or enlarge an accounting mismatch in P&L.

[4] Based on decisions reached to date as part of joint deliberations, the FVO for embedded derivatives is no longer necessary for financial assets, as financial assets that do not meet the cash flow characteristics assessment are classified and measured in their entirety at FVPL.

embedded derivative feature exists that would otherwise require bifurcation and separate accounting.

Staff analysis – financial assets and financial liabilities measured at *amortised cost or FVPL* (FASB discussion only)

11. This section is relevant only to the FASB and compares the FVO requirements under the FASB's tentative model with those that are currently in IFRS 9.

12. The staff believes that the FVO provided under the FASB's tentative model (as discussed in paragraphs 8-10) results in similar outcomes as the FVO under IFRS 9. However, some differences exist, which are discussed below. Under both the FASB's tentative model and IFRS 9, the FVO is elected at initial recognition and is irrevocable.

Hybrid instruments (financial liabilities only)

13. The staff believes that the FVO related to hybrid financial assets that exists in the FASB's tentative model is no longer relevant, since on the basis of joint deliberations, hybrid financial assets are no longer subject to bifurcation requirements and will be measured in their entirety. However, since the tentative model still requires bifurcation for financial liabilities, the staff believes that a FVO is still needed for hybrid financial liabilities.

14. Related to hybrid contracts with financial liability hosts, paragraph 4.3.5 of IFRS 9 states:

> …an entity may designate the entire hybrid contract as at fair value through profit or loss unless:
>
> (a) the embedded derivative(s) do(es) 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 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.

15. As compared to the FASB's FVO for hybrid financial liabilities, which would revert to the guidance previously issued with Statement 155[5] and would require an entity to first determine whether an embedded derivative feature exists that would otherwise require bifurcation and separate accounting, the FVO under IFRS 9 for financial liabilities largely achieves the same outcome. While the outcomes would be similar, some U.S. GAAP constituents may be concerned that reverting from an unconditional FVO under existing U.S. GAAP to a more restrictive FVO similar to that issued with Statement 155 would increase costs for preparers while resulting in the same outcome. Other U.S. GAAP constituents may think that the guidance for the bifurcation of an embedded derivative and the related FVO election previously included in Statement 155 is well understood and thus, may not be costly to implement in comparison to the conditional FVO that would be required by IFRS 9.

16. IFRS 9's FVO is intended to achieve a balance between reducing costs of complying with embedded derivative guidance and constituents' concerns about the possible inappropriate use of the FVO. Specifically, the IASB determined that allowing the FVO 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 FVO 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. Therefore the IASB decided to specify situations in which an entity cannot justify using the FVO in place of assessing embedded derivatives – ie when the embedded derivative does not significantly modify the cash flows that would otherwise be

[5] FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140*

required by the contract or is one for which it is clear with little or no analysis when a similar hybrid instrument is first considered that separation is prohibited.

17. The staff believes that the use of the same terminology as included in IFRS 9 related to the FVO for hybrid financial liabilities will achieve the same outcome as intended by the FASB during its deliberations on its tentative model and help to reduce key differences that exist between IFRS 9 and the FASB's tentative model. Furthermore, the staff notes that the FVO for hybrid financial liabilities, as used in IFRS 9, does not result in an unconditional FVO because the entity is still required to determine that the financial liability is a hybrid instrument and cannot elect the option when the embedded derivative feature does not significantly modify the cash flows or when it is clear with little or no analysis that separation and separate accounting is prohibited.

Accounting mismatch (financial assets and financial liabilities)

18. IFRS 9 contains a FVO for financial assets **and** financial liabilities to address measurement inconsistencies (ie a mismatch from measuring some assets and liabilities at fair value and others at amortised cost) or recognition inconsistencies (ie a mismatch from recognising some gains or losses in P&L and others in other comprehensive income (OCI)). These inconsistencies are also referred to as accounting mismatches. The notion of an accounting mismatch involves two propositions. First, an entity has particular financial assets and financial liabilities that are measured, or on which gains and losses are recognised, inconsistently; and second, there is a perceived economic relationship between those assets and liabilities.

19. The staff believes that given the asymmetrical classification and measurement of financial assets and financial liabilities and the strict qualifying criteria for hedge accounting (under both U.S. GAAP and IFRSs), an eligibility condition to address accounting mismatches would assist in eliminating or significantly reducing a measurement or a recognition inconsistency. Therefore, this eligibility condition would result in relevant and useful information to the users of the financial statements if both the financial assets and financial liabilities are measured at FVPL.

20. Paragraph B4.1.30 of IFRS 9 provides examples of when the condition for an accounting mismatch would be met. Some of those examples are reproduced below:

    (b) 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. However, only some of the instruments would be measured at fair value through profit or loss (ie are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, for example because the requirements for effectiveness ... are not met.

    (c) 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. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses.

21. IFRS 9 also explains that it is not permissible to designate only some of the financial assets and financial liabilities that give rise to the inconsistency, if doing so would not eliminate or significantly reduce the mismatch. B4.1.32 of IFRS 9 states in part:

    For example, assume an entity has a number of similar financial liabilities that sum to CU100 and a number of similar financial assets that sum to CU50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (for example, individual liabilities with a combined total of

> CU45) as at fair value through profit or loss. However, because designation as at fair value through profit or loss can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (eg changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (ie percentage) of a liability.

22. The staff believes that given the asymmetrical model for financial assets and financial liabilities, an eligibility condition to address accounting mismatches for both financial assets and financial liabilities would provide useful information to users of financial statements.

Managed on a fair value basis (financial liabilities only)

23. The third eligibility condition for the FVO under IFRS 9 for financial liabilities relates to when an entity manages a group of financial liabilities **or** financial assets *and* financial liabilities and evaluates its performance on a fair value basis. This option is provided when the entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. For example, an entity that has issued structured products containing embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivatives and non-derivative financial instruments can elect to measure the group of structured projects at FVPL.

24. The staff believes that the FVO included in the FASB's tentative model associated with managing a group of financial assets and financial liabilities when an entity manages a net exposure related to those assets and liabilities (which may be derivative instruments) was developed to achieve a similar outcome as the eligibility condition included in IFRS 9. However, a difference between the FASB's tentative FVO and IFRS 9 is that under IFRS 9, the FVO eligibility criterion is only relevant for financial liabilities. That is, an entity may elect to measure a group of financial liabilities at FVPL, when an entity manages and

evaluates the performance of that group of financial liabilities or financial assets and financial liabilities on a fair value basis.

25. The staff believes that the objective of the FVO under the FASB's tentative model related to managing a net exposure was intended to provide a similar outcome as the example included in paragraph 23 above. Furthermore, during the FASB-only deliberations, another example that was noted was matched repo books, for which an entity could elect the FVO if the entity managed the net exposure arising from the matched repo book and provided information on that basis to the entity's management. The staff believes that if the FASB were to adopt the FVO under IFRS 9, a similar outcome could be achieved for a matched repo book, by electing the FVO related to managing on a fair value basis for repo liabilities and the accounting mismatch FVO for reverse repo receivables.

Staff recommendation

26. Therefore, the staff recommends that the FASB incorporate the following eligibility conditions for the FVO for financial assets and financial liabilities in its tentative model:

    (a) ***Financial Assets*** **– at initial recognition, irrevocably designate a financial asset as measured at FVPL if doing so eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.**

    (b) ***Financial Liabilities*** **–**

    (i) **at initial recognition, irrevocably designate a financial liability as measured at FVPL when doing so results in more relevant information, because either:**

    1. It eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or

2. **A group of financial liabilities or financial assets and financial liabilities 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.**

(ii) **at initial recognition, irrevocably designate a hybrid financial liability as measured at FVPL, unless**

1. **the embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract; or**
2. **it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited.**

Question 1 for the FASB
Does the FASB agree with the staff recommendation in paragraph 26?

Staff analysis – financial assets measured at *FVOCI* (joint discussion)

27. This section will be deliberated jointly by the IASB and the FASB (if the FASB agrees with the staff recommendation in Question 1). It discusses whether the boards would like to extend the eligibility condition in IFRS 9 for designating financial assets under the FVO (ie the 'accounting mismatch' eligibility condition) to debt instruments measured at FVOCI[6].

[6] The FVOCI measurement category was discussed by the boards at the May 2012 joint board meeting.

28. IAS 39, IFRS 9, and the FASB's tentative model utilise a mixed-measurement model such that some financial assets and financial liabilities are measured at fair value while others are measured at amortised cost. In addition, some gains and losses are recognised in profit or loss (P&L) while others are recognised in OCI. This combination of measurement and recognition requirements can result in inconsistencies, which some refer to as 'accounting mismatches' between an asset (or a group of assets) and liability (or a group of liabilities). As noted earlier in this paper, the notion of an accounting mismatch involves two propositions. First, an entity has particular financial assets and financial liabilities that are measured, or on which gains and losses are recognised, inconsistently; and second, there is a perceived economic relationship between those assets and liabilities.

29. In current IFRSs (both IAS 39 and IFRS 9), the FVO may be elected to eliminate or significantly reduce an accounting mismatch and thus produce more relevant information. This is accomplished by designating the financial asset, the financial liability or both **into** FVPL measurement from another measurement category (ie from available for sale or amortised cost under IAS 39 or from amortised cost under IFRS 9). The objective of this eligibility condition is to provide more useful information to users by reflecting the perceived economic relationship between the assets and liabilities.

30. IFRS 9 (issued in 2010) classifies financial assets and financial liabilities as measured at either amortised cost or FVPL. Therefore IFRS 9 discusses accounting mismatches only in the context of those two measurement categories. However, in June 2012 the IASB tentatively decided to introduce a FVOCI measurement category in IFRS 9 and the FASB's tentative model already includes a FVOCI measurement category ─ and accounting mismatches can arise as a result of measuring a financial asset at FVOCI. Consider the following two scenarios:

    (a) Scenario 1: If the asset is measured at FVOCI and the liability is measured at FVPL, an accounting mismatch arises because some of the gains or losses on the asset would be recognised in OCI whereas all of the gains and losses on the liability would be recognised in P&L.

(b) Scenario 2: If the asset is measured at FVOCI and the liability measured at amortised cost, an accounting mismatch would arise because the instruments are measured in the balance sheet on different bases. Moreover, while both instruments would have an amortised cost profile in P&L, the asset would have other gains or losses recognised in OCI.

31. If the eligibility condition for designating a financial asset into FVPL to avoid an accounting mismatch were eligible for financial assets measured at FVOCI, an entity could conclude that its financial statements would provide more relevant information if both the asset and the liability were classified at FVPL. As a result, the entity could designate the financial asset in both scenarios at initial recognition as measured at FVPL. Under the second scenario, the entity would also have to designate the financial liability under the FVO.

Staff recommendation

32. The staff recommend that:

(a) The IASB extend the current eligibility condition in IFRS 9 for designating financial assets under the FVO (ie the accounting mismatch condition) to financial assets in the FVOCI measurement category such that financial assets that would otherwise be measured at FVOCI may be measured at FVPL to eliminate or significantly reduce an accounting mismatch.

(b) The FASB extend the eligibility condition for designating financial assets under the FVO (ie the accounting mismatch condition as deliberated in Question 1) to financial assets in the FVOCI measurement category such that financial assets that would otherwise be measured at FVOCI may be measured at FVPL to eliminate or significantly reduce an accounting mismatch.

Question 1 for the IASB

Does the IASB agree with the staff recommendation in paragraph 32 to extend the ‘accounting mismatch’ FVO eligibility criterion as stated in IFRS 9 to financial assets in the FVOCI measurement category?

Question 2 for the FASB

Does the FASB agree with the staff recommendation in paragraph 32 to extend the ‘accounting mismatch’ FVO eligibility criterion for financial assets to financial assets in the FVOCI measurement category?

Appendix – Selections from IFRS 9 about the FVO

Option to designate a financial asset at FVPL

4.1.5. Despite paragraphs 4.1.1–4.1.4, an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so 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 (see paragraphs B4.1.29–B4.1.32).

4.1.6. IFRS 7 *Financial Instruments: Disclosures* requires the entity to provide disclosures about financial assets it has designated as at fair value through profit or loss.

Option to designate a financial liability at FVPL

4.2.2. An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss when permitted by paragraph 4.3.5, or when doing so results in more relevant information, because either:

(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 recognizing the gains and losses on them on different bases; or

(b) a group of financial liabilities or financial assets and financial liabilities 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 (as defined in IAS 24 Related Party Disclosures), for example the entity's board of directors and chief executive officer.

4.2.3. IFRS 7 requires the entity to provide disclosures about financial liabilities it has designated as at fair value through profit or loss.

Option to designate a hybrid financial liability at FVPL

4.3.5. Despite paragraphs 4.3.3 and 4.3.4, if a contract contains one or more embedded derivatives and the host is not an asset within the scope of this IFRS, an entity may designate the entire hybrid contract as at fair value through profit or loss unless:

(a) the embedded derivative(s) do(es) 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 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.

4.3.6. If an entity is required by this IFRS to separate an embedded derivative from its host, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at fair value through profit or loss.