

STAFF PAPER

11 – 12 December 2013

IASB Meeting

Project	Financial Instruments: Classification and Measurement		
Paper topic	Fair value option		
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Purpose and structure of paper

1. This paper considers the fair value option (FVO) for financial assets in the IASB's exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) (the 'Limited Amendments ED').
2. Because IFRS 9 *Financial Instruments* has two measurement categories—amortised cost and fair value through profit or loss (FVPL)—the FVO in that Standard applies only to financial assets that would otherwise be mandatorily measured at amortised cost. However, in the Limited Amendments ED, the IASB proposed to introduce a third mandatory measurement category—fair value through other comprehensive income (FVOCI)—and thus proposed to extend the FVO in IFRS 9 so that it **also** applies to financial assets that would otherwise be mandatorily measured at FVOCI. This paper asks the IASB if it would like to confirm that proposal.
3. This paper builds on the IASB's tentative decision in November 2013 to confirm its proposal in the Limited Amendments ED to introduce FVOCI into IFRS 9 as a mandatory and defined measurement category.
4. The paper covers the following:

- (a) background information providing an overview of the existing FVO requirements in IFRS 9 and the relevant IASB and FASB proposals (paragraphs 7-13);
 - (b) a summary of feedback on the FVO proposals from respondents to the IASB's Limited Amendments ED (paragraphs 14-21); and
 - (c) staff analysis and recommendation on the FVO for the IASB to consider (paragraphs 22-25).
5. This paper considers the FVO for financial assets generally. It does not specifically consider the interaction between the classification and measurement of financial assets and the accounting for insurance contract liabilities under the IASB's Insurance Contracts project. At a subsequent meeting the staff will bring a paper that discusses that interaction and considers the various related issues and alternatives raised in comment letters and outreach activities.
6. This paper does not discuss the FVO for financial liabilities in IFRS 9 because the IASB's Limited Amendments ED did not propose any changes to those requirements (other than proposing to permit the early application of the 'own credit' presentation requirements, which the IASB discussed in July 2013 and finalised in November 2013 (as part of IFRS 9 *Financial Instruments* (Hedge Accounting and amendments to IFRS 9, IFRS 7 and IAS 39)).

Background

The FVO in IFRS 9

7. 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 FVPL if one (or more) of the following three eligibility conditions are met:¹
- (a) doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch');

¹ These conditions in IAS 39 have been summarised for the purposes of this paper.

- (b) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis; or
 - (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.
8. However, under IFRS 9, two of those eligibility conditions are unnecessary for financial assets. Specifically, under IFRS 9:
- (a) Financial assets that are managed and whose performance is evaluated on a fair value basis are not held to collect contractual cash flows and thus are required to be measured at FVPL. As a result, the eligibility condition described above in paragraph 7(b) is no longer relevant.
 - (b) Hybrid contracts with financial asset hosts are classified in their entirety, hence eliminating the requirement to identify and separately account for embedded derivatives. As a result, the eligibility condition described above in paragraph 7(c) is no longer relevant.
9. However, the IASB retained the eligibility condition described above in paragraph 7(a) for financial assets because it is still relevant under IFRS 9. That condition mitigates some anomalies that result from the different measurement attributes used for assets and liabilities. In particular, it eliminates the need for fair value hedge accounting of fair value exposures when there are natural offsets. If assets and liabilities have an economic relationship, then accounting for them using the same measurement attribute—FVPL—may provide the most relevant information to users of financial statements.
10. Almost all the respondents to the exposure draft that preceded the issuance of IFRS 9 (2009) supported the IASB’s decision to retain the FVO for financial assets if such a designation eliminates or significantly reduces an accounting mismatch.

FVO proposals in the boards’ respective exposure drafts

11. The IASB’s proposals related to the FVO for financial assets in its Limited Amendments ED are different from the FASB’s proposals in its proposed

Accounting Standards Update *Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* (the ‘FASB’s proposed ASU’). However, the staff note that the FVO was not one of the key aspects of the boards’ respective classification and measurement models that the boards sought to align.

IASB’s proposals

12. As discussed earlier in this paper, the IASB proposed in its Limited Amendments ED to introduce a third mandatory measurement category for financial assets—FVOCI. The IASB decided that the FVO in IFRS 9, which applies to financial assets that would otherwise be measured at amortised cost, should **also** be available for financial assets that would otherwise be mandatorily measured at FVOCI. As noted in paragraph BC74 of the Limited Amendments ED, the IASB expressed the view that the rationale for permitting the FVO for assets measurement at amortised cost is equally applicable for financial assets measured at FVOCI (that rationale is discussed in paragraph 9 in this paper). Therefore, consistent with the guidance in IFRS 9 for financial assets measured at amortised cost, the IASB proposed that entities be permitted to designate financial assets that would otherwise be mandatorily measured at FVOCI as measured at FVPL under the FVO if such designation eliminates or significantly reduces an accounting mismatch. Consistent with the FVO in IFRS 9, the IASB proposed that such a designation would be available only at initial recognition and would be irrevocable.

FASB’s proposals

13. The FASB’s proposed ASU included the following proposals related to the FVO:
 - (a) All entities may apply the FVO to a financial asset that would otherwise be measured at FVOCI (ie an unrestricted FVO was available for financial assets otherwise measured at FVOCI) (FASB’s proposed ASU, paragraph 825-30-15-4); and
 - (b) All entities may apply the FVO to a group of financial assets and financial liabilities for which both of the following conditions are met:

- (i) The entity manages the net exposure relating to the financial assets and financial liabilities on a fair value basis.
- (ii) The entity provides information on a net exposure basis to its management.

(FASB's proposed ASU, paragraph 825-30-15-2).

Feedback from respondents to the IASB's Limited Amendments ED

14. Most of the comment letters received by the IASB in response to the Limited Amendments ED specifically commented on the proposals related to the FVO. A few respondents did not comment specifically on those proposals.
15. Of the respondents that commented on the FVO proposals:
 - (a) Most supported the proposals as set out in the IASB's Limited Amendments ED and agreed with the IASB's rationale.
 - (b) A few respondents advocated an unrestricted FVO; either
 - (i) **only** for financial assets that would otherwise be measured at FVOCI (ie consistent with the FASB's proposed ASU; refer to paragraph 13(a) above) or
 - (ii) for **both** financial assets that would otherwise be measured at FVOCI **and** financial assets that would otherwise be measured amortised cost.
 - (c) A few did not support the FVO.
16. **Support FVO as proposed**—As noted above, most respondents who commented on the FVO proposals supported them. This included a few respondents who disagreed with the introduction of the mandatory FVOCI measurement category—ie these respondents expressed support for the FVO proposals **if** the IASB decided to introduce that mandatory measurement category.
17. Respondents agreed that the FVO proposals would be consistent with the underlying logic for the existing FVO in IFRS 9 and would preserve an entity's ability to mitigate accounting mismatches.

18. **Unrestricted FVO**—Of the few respondents who expressed a preference for an unrestricted FVO, most thought that it should be available *only* for financial assets that would otherwise be measured at FVOCI. In making this suggestion, some specifically noted it would be consistent with the FASB’s proposals. A few respondents who opposed the introduction of the FVOCI measurement category as proposed noted that an unrestricted FVO would help alleviate their concerns. (The staff note that an unrestricted FVO would enable entities to reduce or even avoid the use of the FVOCI measurement category.)
19. Other respondents who advocated an unrestricted FVO expressed the view that it should apply to both financial assets that would otherwise be measured at amortised cost **and** assets that would otherwise be measured at FVOCI. Some of these respondents expressed the view that FVPL may provide more useful information to users of financial statements, particularly for entities in the financial services sector and, in such circumstances, entities should have flexibility to choose to measure financial assets at FVPL. They acknowledged the concerns raised by regulators in the past about an unrestricted FVO, but they thought those concerns could be mitigated by adequate disclosure.
20. **No FVO**—A few respondents suggested that the FVO should not be permitted for assets that would otherwise be measured at FVOCI. These respondents expressed the view that the FVO is inconsistent with the principle that the entity’s business model should affect how the financial asset is measured. (It was unclear whether these respondents also disagree with the FVO for financial assets that would otherwise be measured at amortised cost.)
21. **Interaction with insurance liabilities**—Several insurers and associations representing insurers commented on the interaction between the FVO and the proposed accounting treatment for insurance contract liabilities. Many of these respondents did not disagree with the proposed FVO as such, but most expressed a desire to better align the accounting treatment for insurance contract liabilities and the related financial assets. As noted above, the staff will bring a paper to a subsequent meeting that discusses that interaction and considers the various related issues and alternatives raised in comment letters and outreach activities.

Staff analysis and recommendation

22. As described above, most respondents supported the proposals in the Limited Amendments ED related to the FVO and agreed with the reasons set out in the ED's Basis for Conclusions.
23. The staff agree with those respondents and continue to support the IASB's rationale for the FVO proposals in the Limited Amendments ED. The IASB tentatively decided in November 2013 to confirm its proposal to introduce FVOCI into IFRS 9 as a mandatory and defined measurement category—and we note that accounting mismatches can arise as a result of measuring a financial asset at FVOCI (eg if that financial asset has an economic relationship with a financial liability that is measured at either amortised cost or FVPL). If the FVO in IFRS 9 is extended to financial assets that would otherwise be measured at FVOCI, an entity would be able conclude that its financial statements would provide more useful information if both the relevant assets and liabilities were measured at FVPL and thus be able to mitigate some anomalies that result from the different measurement attributes used for assets and liabilities. We believe that if assets and liabilities have an economic relationship that gives rise to an offsetting effect in their valuation, then accounting for them using the same measurement attribute—FVPL—may provide the most relevant information to users of financial statements.
24. Therefore we recommend that the IASB confirm its proposals in the ED related to the FVO and thus permit an entity to apply the FVO to a financial asset that would otherwise be mandatorily measured at FVOCI if such a designation eliminates or significant reduces a measurement or recognition inconsistency ('an accounting mismatch'). In accordance with the existing FVO in IFRS 9, such a designation would be performed at initial recognition and would be irrevocable. The FVO requirements and guidance in IFRS 9, as amended by the Limited Amendments ED, is given in Appendix A.
25. The staff notes that an unrestricted FVO—either for (a) **only** assets that would otherwise be measured at FVOCI or (b) **both** assets that would otherwise be measured at FVOCI **and** assets that would otherwise be measured at amortised cost—is inconsistent with the existing requirements in IFRS 9 and we believe that

such a change to the Standard would be much broader than that which the IASB contemplated when it decided to consider limited amendments to that Standard. An unrestricted FVO for financial assets otherwise measured at FVOCI is also inconsistent with the IASB's tentative decision in November 2013 to mandate a defined FVOCI category. Furthermore, consistent with the Basis for Conclusions on IFRS 9, the staff acknowledges that an unrestricted FVO has been opposed by many in the past and thus we do not think it is appropriate to pursue it now (in particular as part of **limited** amendments to IFRS 9).

Question for the IASB

Does the Board agree with the staff recommendation to confirm the proposals in the Limited Amendments ED to extend the FVO in IFRS 9 to financial assets that would otherwise be mandatorily measured at FVOCI; ie such designation would be permitted at initial recognition if doing so eliminates or significantly reduces an accounting mismatch and would be irrevocable?

Appendix A

Extract from IFRS 9 (2013)—Requirements and guidance relevant to the FVO for financial assets

Note: This text reflect IFRS 9, as issued in November 2013. Amendments proposed by the IASB’s Limited Amendments ED are shown as tracked changes. New text is underlined and deleted text is struck through.

Option to designate a financial asset at fair value through profit or loss

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 asset or financial liability as at fair value through profit or loss (sections 4.1 and 4.2)

Designation eliminates or significantly reduces an accounting mismatch

B4.1.29 Measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item’s classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an ‘accounting mismatch’) when, for example, in the absence of designation as at fair value through profit or loss, a financial asset would be classified as subsequently measured at fair value through profit or loss and a

liability the entity considers related would be subsequently measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were measured as at fair value through profit or loss.

B4.1.30 The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 4.1.5 or 4.2.2(a):

- (a) an entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by paragraph 24 of IFRS 4) and financial assets that it considers to be related and that would otherwise be measured at ~~amortised cost~~ fair value through other comprehensive income.
- (b) an entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, and 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 (for example, those that are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met because, for example, the requirements for hedge effectiveness in paragraph 6.4.1 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 none of the financial assets or financial liabilities qualifies for designation as a hedging instrument because they are not measured at fair value through profit or loss. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example, the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both

the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased.

- B4.1.31 In cases such as those described in the preceding paragraph, to designate, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through profit or loss may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to occur.
- B4.1.32 It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. 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.