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STAFF PAPER

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Project	Hedge Accounting (IFRS 9)		
Paper topic	Designation of 'own use' contracts as FVPL: transition		
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Introduction

1. One issue was raised regarding the effect of the draft transition requirements on entities' ability to use the new scope of IAS 39 *Financial Instruments: Recognition and Measurement* regarding the election of fair value through profit or loss (FVPL) accounting for 'own use' contracts[1].

2. This paper:

   (a) provides an analysis of the issue; and

   (b) asks the Board whether it wants to revisit its tentative decision.

Feedback received

3. The feedback received can be summarised as follows:

   (a) The draft transition requirements would result in 'phasing in' FVPL accounting over a potentially long period (which depends on the tenor of the own use contracts that an entity has).

   (b) Consequently, the comparative information would become confusing for a possibly long phasing-in period because the extent to which 'own use' accounting and FVPL accounting are applied to similar

[1] This paper refers to those contracts as 'own use' contracts that meet the scope exception of IAS 39.5.

contracts will change over that period. The information would only become comparable again after the last contracts accounted for as 'own use' have matured. This would make it very difficult for users of the financial statements to understand the information during that phasing-in period.

(c) The effect might be so severe that entities in effect cannot transition to the new accounting treatment, even though it generally provides more useful information, because there will never be 'the right time' *to phase in* the new accounting. Using non-GAAP information to address the issue would not be desirable.

Staff analysis

The issue

4. As part of the hedge accounting model, the Board tentatively decided to amend the scope of IAS 39. That scope amendment would allow entities to elect fair value through profit or loss accounting for contracts that otherwise would be 'own use' contracts (ie accounted for as executory contracts).[2]

5. The draft changes to IAS 39 do *not* include specific transition requirements for this scope change. That means by default retrospective application.[3] However, because the election of FVPL accounting can only be made *at inception* of a contract, the transition to the new scope of IAS 39 would *in effect* be 'prospective' in that the election would not be available for contracts that already exist on the date on which an entity applies the new scope for the first time. This would result in the effect on financial statements that the feedback describes as 'phasing in'.

6. The background of the Board's tentative decision was that for the 'own use' contracts that already exist on the date on which an entity applies the new scope for the first time, allowing entities to change the accounting from

[2] See IAS 39.5A (as amended by draft IFRS 9 *Financial Instruments*).

[3] See IAS 39.104.

executory contract accounting to FVPL accounting could lead to 'cherry picking'. This could result from the fact that entity would know what the fair value of an 'own use' contract on that date is and so for example select all contracts with a negative fair value for FVPL accounting[4] while not selecting those with a positive fair value.

Trade-off regarding the usefulness of information

7. The issue creates a trade-off regarding how transition affects the usefulness of the information between:

   (a) the danger of 'cherry-picking' and its effect on the financial statements until all 'own use' contracts that existed on transition will have matured; versus

   (b) the effect of 'phasing-in' the new accounting on the comparative information, which would be detrimentally affected by the co-existence of two different accounting treatments for similar contracts until all 'own use' contracts that existed on transition will have matured.

8. In the staff's view, the following considerations are relevant in evaluating this trade-off:

   (a) The danger of 'cherry-picking' could be mitigated by requiring that on transition an entity makes the FVPL election for all 'own use' contracts that already exist on that date on an '*all-or-none'* basis *for all similar contracts*. That means for entities that have a number of 'own use' contracts that are organised as portfolios the election would only be available for the entire portfolio or none of the contracts in that portfolio.[5]

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[4] This would allow a kind of 'big bath' accounting whereby the negative fair values are recognised as liabilities by adjusting retained earnings on transition (ie without affecting profit or loss) and the 'rebound' effect from the release of that liability over the remaining term of the contract would have a positive effect on profit or loss.

[5] A reference to "similar" has the advantage that this reference is already used by IAS 39 in the context of the 'own use' exception (see IAS 39.6(b) and (c)). It is already applied under IAS 39 as the criterion that drives the delineation of portfolios of contracts to buy or sell non-financial items that can be net cash

(b) Using a transition that changes the accounting to FVPL for all similar contracts at the same time would make the comparative information more useful[6] for users of financial statements compared with comparative information that has a mix of two different accounting requirements for similar contracts with that mix changing over time as FVPL accounting is 'phased-in' for new contracts. In particular, the new accounting treatment at FVPL was introduced because it will allow entities to better reflect their business in the financial reporting information. Hence, creating an artificial split in the information whereby solely because of the accounting transition some contracts can be accounted for at FVPL whereas other contracts that are part of the same business still have to use the previous off-balance-sheet accounting would be contrary to the intended improvement of the financial reporting information.

(c) One of the considerations of changing the scope of IAS 39 for 'own use' contracts was to provide a 'clean solution' for entities to apply FVPL accounting for 'own use' contracts. That was intended to eliminate an incentive for entities to use 'deliberate tainting'[7] in order to achieve FVPL accounting for contracts that otherwise would be 'own use' contracts. The transition requirement as drafted would create a significant incentive (or even pressure) to use 'deliberate tainting' to achieve the immediate change to FVPL accounting for 'own use' contracts that already exist on transition. In that sense, the transition requirements as drafted may have the effect of defeating

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settled. This delineation is necessary to be able to determine when similar contracts are settled net in cash and determines whether portfolios of contracts qualify as 'own use' (as well as which contracts that initially qualified as 'own use' are 'tainted' by the net cash settlement of a similar contract).

[6] In the *first year* of applying FVPL accounting the comparatives could not be restated because it would be impracticable on the grounds of hindsight that would have to be used for significant estimates (see IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraphs 5 and 23). Because 'own use' contracts are outside the scope of IFRS 7 *Financial Instruments: Disclosures* (see IFRS 7.5) entities do not have to measure the fair value of those contracts for disclosure purposes (unlike for financial instruments in the scope of IFRS 7).

[7] 'Deliberate tainting' refers to an entity intentionally settling net in cash a contract that is similar to 'own use' contracts with the consequence that the accounting for all those similar contracts changes to FVPL as a result of IAS 39.6(b) or (c). See also footnote 5.

(at least in part) the purpose of providing the new accounting for 'own use' contracts (ie a 'clean solution').

Staff recommendation and question to the Board

9. The staff analysis sets out the trade-off regarding how the two different transition requirements affect the usefulness of the information.

10. In the staff's view, the considerations set out in the staff analysis taken together outweigh the danger of 'cherry picking' and suggest that a transition to FVPL accounting at one point in time (ie on transition) instead of over a phase-in period would provide the more useful information.

11. Also, it would be odd to provide an accounting solution that the Board and commentators agree would improve the usefulness of the accounting information but tie it to a transition requirement that in effect results in that solution being unavailable.

12. If the draft transition requirements are changed so that an entity makes the FVPL election for all 'own use' contracts that already exist on that date on an 'all-or-none' basis for all similar contracts, a consequential amendment to IFRS 1 *First-time Adoption of International Financial Reporting Standards* should be made that provides the same approach on transition to IFRSs.[8]

Question: transition regarding new scope for 'own use' contracts
Does the Board agree with the staff recommendation to change the draft transition requirements so that an entity makes the FVPL election for all 'own use' contracts that already exist on that date on an '*all-or-none'* basis *for all similar contracts* and the consequential amendment to IFRS 1? If the Board does not agree, what does it want to do instead (if anything)?

[8] This is consistent with the specific transition requirements in IFRS 1 (see paragraphs D19 and D19A) regarding the fair value option under IFRS 9 *Financial Instruments*.