April 2004

EXPOSURE DRAFT OF PROPOSED

## Amendments to IAS 39 Financial Instruments: Recognition and Measurement

# The Fair Value Option

Comments to be received by 21 July 2004

International
Accounting Standards
Board®

**Exposure Draft of proposed**

**AMENDMENTS TO IAS 39**
**FINANCIAL INSTRUMENTS:**
**RECOGNITION AND MEASUREMENT**

# THE FAIR VALUE OPTION

*Comments to be received by 21 July 2004*

This Exposure Draft of proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as an amendment of IAS 39. Comments on the Exposure Draft and the Basis for Conclusions should be submitted in writing so as to be received by **21 July 2004**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org.uk** or addressed to:

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# Background

1. In July 2001 the International Accounting Standards Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. In June 2002 the Board published its proposed improvements as an Exposure Draft and in December 2003 it issued a revised version of the two Standards.

2. Among the revisions to IAS 39 was the introduction of an option that permits entities to designate irrevocably on initial recognition any financial asset or financial liability as one to be measured at fair value with gains and losses recognised in profit or loss (the 'fair value option'). The reason for introducing this option was to simplify the practical application of IAS 39, as is explained further in paragraphs BC5-BC8 of the Basis for Conclusions on this Exposure Draft.

3. A substantial majority of the respondents to the June 2002 Exposure Draft who commented on the proposed fair value option agreed with it. However, some, including prudential supervisors of banks, securities companies and insurers, expressed concerns that the fair value option might be used inappropriately. The dialogue with these constituents about their concerns continued after the revised version of IAS 39 was issued. In particular, they were concerned that:

   (a) entities might apply the fair value option to financial assets or financial liabilities whose fair value is not verifiable. If so, because the valuation of these financial assets and financial liabilities is subjective, entities might determine their fair value in a way that inappropriately affects profit or loss.

   (b) use of the option might increase, rather than decrease, volatility in profit or loss, for example if an entity applied the option to only one part of a matched position.

   (c) if an entity applied the fair value option to financial liabilities, it might result in the entity recognising gains or losses in profit or loss for changes in its own creditworthiness.

4. The Board decided to propose that the fair value option be amended so as to limit its use while preserving the key benefits of the option (these benefits are noted in paragraphs BC5-BC8 of the Basis for Conclusions on this Exposure Draft). The Board decided to achieve this by:

(a) limiting the types of financial assets and financial liabilities to which the option may be applied (see proposed amendments to paragraph 9), and

(b) requiring that the option may be applied only to financial assets and financial liabilities whose fair value is verifiable (see proposed new paragraph 48B). The proposal that fair value must be verifiable would apply only when the fair value option is used. It is a stricter test than that of 'reliably measured' contained in paragraphs 46(c) and 47(a) of IAS 39.

5. This Exposure Draft sets out the resulting proposed amendments to IAS 39.

# Invitation to Comment

The International Accounting Standards Board invites comments on the changes to IAS 39 proposed in this Exposure Draft. It would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, when applicable, provide a suggestion for alternative wording.

## The Board is not requesting comments on matters other than those set out in this Exposure Draft.

Comments should be submitted in writing so as to be received no later than **21 July 2004**.

**Question 1**

Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

**Question 2**

Are you aware of any financial instruments to which entities are applying, or are intending to apply, the fair value option that would not be eligible for the option if it were revised as set out in this Exposure Draft? If so:

(a) please give details of the instrument(s) and why it (they) would not be eligible.

(b) is the fair value of the instrument(s) verifiable (see paragraph 48B) and if not, why not?

(c) how would applying the fair value option to the instrument(s) simplify the practical application of IAS 39?

**Question 3**

Do the proposals contained in this Exposure Draft appropriately limit the use of the fair value option so as to address adequately the concerns set out in paragraph BC9? If not, how would you further limit the use of the option and why?

 

**Question 4**

Paragraph 9(b)(i) proposes that the fair value option could be used for a financial asset or financial liability that contains one or more embedded derivatives, whether or not paragraph 11 of IAS 39 requires the embedded derivative to be separated. The Board proposes this category for the reasons set out in paragraphs BC6(a) and BC16-BC18 of the Basis for Conclusions on this Exposure Draft. However, the Board recognises that a substantial number of financial assets and financial liabilities contain embedded derivatives and, accordingly, a substantial number of financial assets and financial liabilities would qualify for the fair value option under this proposal.

Is the proposal in paragraph 9(b)(i) appropriate? If not, should this category be limited to a financial asset or financial liability containing one or more embedded derivatives that paragraph 11 of IAS 39 requires to be separated?

**Question 5**

Paragraph 103A proposes that an entity that adopts early the December 2003 version of IAS 39 may change the financial assets and financial liabilities designated as at fair value through profit or loss from the beginning of the first period for which it adopts the amendments in this Exposure Draft. It also proposes that in the case of a financial asset or financial liability that was previously designated as at fair value through profit or loss but is no longer so designated:

(a) if the financial asset or financial liability is subsequently measured at cost or amortised cost, its fair value at the beginning of the period for which it ceases to be designated as at fair value through profit or loss is deemed to be its cost or amortised cost.

(b) if the financial asset is subsequently classified as available for sale, any amounts previously recognised in profit or loss shall not be reclassified into the separate component of equity in which gains and losses on available-for-sale assets are recognised.

However, in the case of a financial asset or financial liability that was not previously designated as at fair value through profit or loss, the entity shall restate the financial asset or financial liability using the new designation in the comparative financial statements.

 

Finally, this paragraph proposes that the entity shall disclose:

(a) for financial assets and financial liabilities newly designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the previous financial statements.

(b) for financial assets and financial liabilities no longer designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the current financial statements.

Are these proposed transitional requirements appropriate? If not, what changes do you propose and why? Specifically, should all changes to the measurement basis of a financial asset or financial liability that result from adopting the amendments proposed in this Exposure Draft be applied retrospectively by restating the comparative financial statements?

**Question 6**

Do you have any other comments on the proposals?

# Proposed Amendments to IAS 39

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|---|
| In the Introduction to IAS 39, paragraph IN16 is amended (new text is underlined; deleted text is struck through). |

IN16. The Standard permits an entity to designate ~~any financial asset or financial liability~~ specified financial assets or financial liabilities, on initial recognition, as ones to be measured at fair value, with changes in fair value recognised in profit or loss. To impose discipline on this categorisation, an entity is precluded from reclassifying financial instruments into or out of this category.

| |
|---|
| In the Standard, paragraphs 9 and 103 are amended (new text is underlined; deleted text is struck through) and paragraphs 48A, 48B and 103A are added. For ease of reference, paragraph 50 is also included, although no changes are proposed to it. |

**Definitions of Four Categories of Financial Instruments** (paragraph 9)

***A financial asset or financial liability at fair value through profit or loss is a financial asset or financial liability that meets either of the following conditions.***

***(a)*** ***It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:***

***(i)*** ***acquired or incurred principally for the purpose of selling or repurchasing it in the near term;***

***(ii)*** ***part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or***

***(iii)*** ***a derivative (except for a derivative that is a designated and effective hedging instrument).***

***(b)*** ***Upon initial recognition it is designated by the entity as at fair value through profit or loss.*** ***~~Any financial asset or financial liability within the scope of this Standard may be designated when initially recognised as a financial asset or financial liability at fair value through profit or loss except for investments in~~*** ***If elected, such designation shall be used only for a financial asset or financial liability that meets one of the following conditions.***

 

***(i) The item is a financial asset or financial liability that contains one or more embedded derivatives as described in paragraph 10, whether or not paragraph 11 requires the embedded derivative(s) to be separated.***

***(ii) The item is a financial liability whose cash flows are contractually linked to the performance of assets that are measured at fair value. This condition is met only if the contract specifies the assets to whose performance the cash flows on the liability are linked.***

***(iii) The exposure to changes in the fair value of the financial asset or financial liability (or portfolio of financial assets or financial liabilities) is substantially offset by the exposure to the changes in the fair value of another financial asset or financial liability (or portfolio of financial assets or financial liabilities), including a derivative (or portfolio of derivatives).***

***(iv) The item is a financial asset other than one that meets the definition of loans and receivables.***

***(v) The item is one that this or another Standard allows or requires to be designated as at fair value through profit or loss.***

***In the case of (ii) and (iii), the designation of a financial asset or financial liability as at fair value through profit or loss requires the identification of the offsetting exposure. In these two cases, if either the financial asset or the financial liability is to be designated as at fair value through profit or loss, the identified related financial liability or financial asset shall also be measured at fair value through profit or loss, either by designation or, when the definition is met, by classification as held for trading.***

***Because designation as at fair value through profit or loss is at the entity's election, such designation shall be used only if the fair value of the financial asset or financial liability to be so designated is verifiable (see paragraph 48B). ~~e~~Equity instruments that do not have a quoted price in an active market and whose fair value cannot be reliably measured shall not be designated as at fair value through profit or loss (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81).***

***Paragraphs 48, 48A, 48B and 49 and Appendix A paragraphs AG69-AG82 contain requirements for determining the fair value of a***

 

***financial asset or financial liability. For entities subject to prudential supervision such as banks and insurance companies, the powers of the relevant prudential supervisor may include oversight of the application of these requirements and of relevant risk management systems and policies.***

**Definitions Relating to Recognition and Measurement** *(also in paragraph 9)*

***Fair value** **is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.*** ~~*~~

~~* Paragraphs 48, 49 and AG69-AG82 of Appendix A contain requirements for determining the fair value of a financial asset or financial liability.~~

## Fair Value Measurement Considerations

48A. The best evidence of fair value is published price quotations in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique. The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs. It (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or based on any available observable market data.

 

48B. Paragraph 9 requires that a financial asset or financial liability may be designated as at fair value through profit or loss only if its fair value is verifiable. For the purposes of this requirement, the fair value of a financial asset or financial liability is verifiable if and only if the variability in the range of reasonable fair value estimates made in accordance with paragraphs 48, 48A and 49 and Appendix A paragraphs AG69-AG82 is low. This requirement is met if, for example, the fair value estimate is based on:

(a) observable current market transactions in the same instrument (ie without modification or repackaging);

(b) a valuation technique whose variables include primarily observable market data and that is calibrated periodically to observable current market transactions in the same instrument (ie without modification or repackaging) or to other observable current market data; or

(c) a valuation technique that is commonly used by market participants to price the instrument and has been demonstrated to provide realistic estimates of prices obtained in actual market transactions.

### Reclassifications

***50. An entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued.***

## Effective Date and Transition

***103A. An entity shall apply the [draft] amendments in paragraphs 9, 48A and 48B for annual periods beginning on or after 1 January 2005. An entity that applies this Standard to earlier periods as permitted by paragraph 103 may change which financial assets and financial liabilities are designated as at fair value through profit or loss from the beginning of the first period for which it applies the [draft] amendments in paragraphs 9, 48A and 48B. In the case of a financial asset or financial liability that was previously designated as at fair value through profit or loss but is no longer so designated:***

 

***(a) if the financial asset or financial liability is subsequently measured at cost or amortised cost, its fair value at the beginning of the period for which it ceases to be designated as at fair value through profit or loss is deemed to be its cost or amortised cost.***

***(b) if the financial asset is subsequently classified as available for sale, any amounts previously recognised in profit or loss shall not be reclassified into the separate component of equity in which gains and losses on available-for-sale assets are recognised.***

***In the case of a financial asset or financial liability that was not previously designated as at fair value through profit or loss, the entity shall restate the financial asset or financial liability using the new designation in the comparative financial statements. The entity shall also disclose:***

***(a) for financial assets and financial liabilities newly designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the previous financial statements.***

***(b) for financial assets and financial liabilities no longer designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the current financial statements.***

 

# Basis for Conclusions

## Background

BC1. In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. The objectives of the Improvements project were to reduce the complexity in the Standards by clarifying and adding guidance, eliminating internal inconsistencies and incorporating into the Standards elements of Standing Interpretations Committee (SIC) Interpretations and IAS 39 implementation guidance. In June 2002 the Board published its proposals in an Exposure Draft of Proposed Amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*.

BC2. Among the proposals in the June 2002 Exposure Draft was a proposal to permit entities to designate irrevocably on initial recognition any financial asset or financial liability as one to be measured at fair value with gains and losses recognised in profit or loss (the 'fair value option'). The Board proposed the fair value option in order to simplify the application of IAS 39, as explained further in paragraphs BC5-BC8, for example by helping entities to avoid some of the anomalies that can arise in IAS 39's 'mixed measurement model' (in which some financial instruments are measured at fair value and others at cost). The proposed fair value option was exactly that—an option—and did not require entities to measure more financial instruments at fair value.

BC3. Of the respondents to the June 2002 Exposure Draft who commented on the fair value option, a substantial majority agreed with it. This included a majority of each type of respondent except for banking, securities and insurance regulators. However, respondents made a number of comments on the proposed fair value option that the Board considered when finalising the Exposure Draft's proposals. These comments and the Board's conclusions on them are discussed in the Basis for Conclusions on IAS 39, paragraphs BC79-BC94.

BC4. After considering these comments, the Board decided to retain the fair value option in the revised IAS 39, but to require an additional disclosure when the option is used for a financial liability. (This disclosure is of the amount of the change in the fair value of the financial liability that is not attributable to changes in a benchmark interest rate.)

## Reasons why the Board introduced the fair value option

BC5. As noted above, the Board introduced the fair value option to simplify the practical application of IAS 39, in particular in those situations in which, without the option, IAS 39's mixed measurement model could result in an entity reporting volatility on positions that are economically matched.

BC6. More specifically, the Board had in mind three situations in which the option might be used:

(a) Financial instruments that contain embedded derivatives. IAS 39 requires embedded derivatives that are not closely related to their 'host' contract to be separated and measured at fair value. Such separation and measurement can be both difficult and subjective, and valuation of the entire instrument may be both easier and less prone to measurement error. In this case the fair value option can be used to measure the entire instrument, rather than separately measuring the embedded derivative, and without having to demonstrate that the embedded derivative cannot be reliably measured.

(b) When IAS 39 requires financial assets to be measured at fair value, but liabilities that are contractually related to them to be measured at amortised cost. An example is 'unit-linked' liabilities issued by insurers (in which the amount paid on the liability directly reflects the performance of a pool of specified assets). In this case, use of the option avoids reporting the volatility that would arise if the assets were measured at fair value but the offsetting liabilities were at amortised cost.

(c) Other 'natural offsets', ie when the entity's exposure to the change in the fair value of a financial asset is offset by its exposure to the change in the fair value of a financial liability (or vice versa). These are of two types:

(i) 'Natural offsets'—in particular those in which one of the items is a derivative—that could qualify for fair value hedge accounting in accordance with IAS 39. However, to obtain hedge accounting, the entity would have to meet various conditions, including detailed designation and documentation of the hedging relationship, and tracking the hedge to show that it is highly effective. This can require significant time, effort and systems, and therefore considerable expense. Because a similar accounting effect can be obtained by measuring both the hedged item and the hedging instrument at fair value through profit or loss, the fair value option can be used as an alternative to hedge accounting. It achieves a similar accounting result whilst avoiding the designation, tracking and assessing of hedge effectiveness that hedge accounting entails.

(ii) 'Natural offsets' that do not qualify for fair value hedge accounting because of IAS 39's restrictive conditions. Like US GAAP, IAS 39 permits hedge accounting to be used only when the hedge is undertaken using a *derivative*.* Accordingly, this category includes non-derivative financial assets that naturally offset—or 'hedge'—non-derivative financial liabilities. It also includes hedges that provide some protection against fair value exposure, but not enough to qualify for hedge accounting given IAS 39's stringent hedge effectiveness tests. Lastly, this category includes liabilities that fund, and whose risks match, assets that are classified as held for trading—for example, liabilities that fund the activities of a broker/dealer. In all of these cases, entities can use the fair value option to avoid reporting the volatility that arises if the asset is measured at fair value (eg because it is not a loan or receivable and the entity does not have the positive intention and ability to hold it to maturity) but the related liability is measured at amortised cost. Furthermore, to the extent the asset and liability do not perfectly offset one another (ie the hedge is ineffective), their fair values will differ, resulting in a gain or loss.

BC7. There are two other situations in which IFRSs permit use of the fair value option. These are:

* other than in a hedge of currency risk

(a) Loan commitments, other than those that can be settled net in cash or another financial instrument. Such loan commitments meet the definitions of both a financial instrument and a derivative. However, the Board excluded them from the scope of IAS 39 (and thereby from IAS 39's requirement to measure derivative financial instruments at fair value through profit or loss) to simplify the accounting treatment for both the holder and the issuer. Nevertheless, the Board was informed of cases when entities would want to measure such loan commitments at fair value through profit or loss, for example when they manage the risk exposures related to them on a fair value basis or hedge those exposures with credit derivatives (that are within the scope of IAS 39). Accordingly, the Board permitted entities to apply IAS 39 to such loan commitments provided they applied the fair value option to them.

(b) Investments in associates and joint ventures held by venture capital organisations or mutual funds, unit trusts and similar entities. IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures* allow such investments to be excluded from their scope provided the fair value option is used (or they meet the IAS 39 definition of held for trading). The Board's reasons for this decision were that measuring such investments at fair value through profit or loss would produce more relevant information than using equity accounting, and that fair value information is often readily available because fair value measurement is a well-established practice in these industries.

BC8. Some have questioned why the Board introduced the fair value option despite there not being an equivalent option in US GAAP. Two main points are worthy of note:

(a) Derivatives markets in the United States are significantly more developed than in other parts of the world. As a result, US entities are more able to hedge risk positions with derivatives. Conversely, entities located outside the US are more likely to offset risk positions using non-derivatives. Because IAS 39 permits hedge accounting only for hedges carried out with derivatives,* without the fair value option, such entities may be forced to buy derivatives to achieve hedge

* other than in a hedge of currency risk

 

accounting. The only available derivatives may be those traded in US markets, which may be a poorer economic hedge of the underlying risk positions than a hedge using a non-derivative, eg because of differences between domestic and US interest rates. In addition, derivatives traded in US markets are commonly denominated in US dollars, with the result that entities located outside the US will also need to hedge the exchange rate risk with an additional derivative, thereby incurring additional transaction costs.

(b) IAS 39 contains a tighter definition of held for trading than US GAAP, with the result that fewer financial assets and financial liabilities can be measured at fair value through profit or loss by being classified as held for trading.

**The rationale for the proposed amendments**

BC9. As a result of continuing discussions with some constituents on the fair value option, the Board became aware that some, including prudential supervisors of banks, securities companies and insurers, were concerned that the fair value option might be used inappropriately. In particular these constituents were concerned that:

(a) entities might apply the fair value option to financial assets or financial liabilities whose fair value is not verifiable. If so, because the valuation of these financial assets and financial liabilities is subjective, entities might determine their fair value in a way that inappropriately affects profit or loss.

(b) use of the option might increase, rather than decrease volatility in profit or loss, for example if an entity applied the option to only one part of a matched position.

(c) if an entity applied the fair value option to financial liabilities, it might result in the entity recognising gains or losses in profit or loss for changes in its own creditworthiness.

BC10. The Board decided to propose that the fair value option be amended so as to limit its use whilst preserving the key benefits of the option noted above. The Board proposes to do this by explicitly limiting the option to the three situations outlined in paragraph BC6 and by the proposals described in the next four paragraphs.

BC11. The Board decided to meet the concern set out in paragraph BC9(a) in two ways:

(a) The Board decided to emphasise that the fair value option can be used only for items whose fair value is verifiable and to give guidance on this (see paragraph 48B). The Board notes that the proposed requirement that fair value must be verifiable would apply only for the fair value option and not to financial assets or financial liabilities (including derivatives) that are classified as held for trading, or to available-for-sale financial assets. Also, 'verifiable' is a stricter test than that of 'reliably measured' contained in paragraphs 46(c) and 47(a) of IAS 39.

(b) The Board decided to note that, for entities subject to prudential supervision, such as banks and insurance companies, the powers of the relevant prudential supervisor may include oversight of the application of the requirements in IAS 39 on how to determine fair value and of relevant risk management systems and policies. The aim of making this statement is to alert entities subject to prudential supervision to the possibility that their supervisor may be concerned to ensure that they do not use inappropriate estimates of fair value. The statement merely notes powers that supervisors may already have and does not confer any additional powers on them. In particular, it does not give supervisors the power to amend or overrule the requirements of IAS 39.

BC12. To meet the concern set out in paragraph BC9(b), the Board decided to propose that if an entity measures one side of a matched position at fair value by using the fair value option, it must also measure the other side at fair value through profit or loss. This is to ensure that all of a matched position is recognised in the same way and that the option, in this case, is used to overcome rather than to exacerbate the limitations of a mixed measurement model.

BC13. Regarding the concern described in paragraph BC9(c), the Board decided when finalising the improvements to IAS 39 that the fair value of a financial liability is affected by the credit risk of that liability. The reasons for this decision are set out in paragraphs BC87-BC92 of the Basis for Conclusions on IAS 39. As noted in paragraph BC4 above, the Board also responded to this concern when finalising the improvements to IAS 39 by requiring an additional disclosure to be provided when the option is used for a financial liability. (This disclosure is of the amount of the change in the fair value of the financial liability that is not attributable to changes in a benchmark interest rate.)

BC14. In addition, the proposals to restrict the application of the fair value option to (a) the three situations described in paragraph BC6 and (b) items whose fair value is verifiable would further meet this concern whilst preserving the key benefits of the option. This is because these proposals would restrict the financial liabilities to which the option may be applied.

BC15. The Board also noted two other cases, in addition to those set out in paragraph BC6 in which entities may want to use the fair value option:

(a) Entities such as investment trusts and venture capital entities for which established industry practice in some jurisdictions is to measure all financial assets at fair value through profit or loss.

(b) Entities that hold financial assets whose fair value exposure offsets to some extent the fair value exposure of *non*-financial liabilities. An example is financial assets held by insurers whose fair value exposure offsets that of insurance liabilities that are measured using techniques that incorporate some market-consistent data but are not measured at fair value.

The Board noted that such entities may want to use the fair value option to measure the financial assets at fair value with changes in their fair value recognised in profit or loss. To preserve such uses of the option, the Board decided to propose that the option may be used for financial assets other than those that meet IAS 39's definition of loans and receivables.

BC16. The Board considered the following two ways to implement this decision (ie to permit use of the option for financial assets other than loans or receivables):

(a) to allow the fair value option to be applied, by designation on initial recognition, to any financial asset other than a loan or receivable, on an *asset-by-asset* basis.

(b) to restore the permission in the original IAS 39 for an entity to elect, as an accounting policy choice, to recognise gains and losses on *all* available-for-sale assets in profit or loss, but to require that loans and receivables cannot be classified as available for sale.

BC17. The Board noted that some entities may not want to recognise in profit or loss gains and losses on *all* available-for-sale assets other than loans and receivables. For example:

(a) a bank-assurance company may want to apply the option to assets held to back insurance liabilities, but not to available-for-sale assets held in its banking business.

(b) a bank with a venture capital subsidiary may want to apply the option to the assets held by the venture capital subsidiary, but not to available-for-sale assets held in its banking business.

(c) an insurer may want to apply the option to assets that fund insurance liabilities (such as with-profits contracts) on which the chosen accounting model recognises changes in profit or loss, but not to assets that fund insurance liabilities (such as non-participating fixed annuity contracts) that are often measured using a cost model.

BC18. Accordingly, the Board decided to propose the first approach in paragraph BC16, namely to allow the fair value option to be applied, by irrevocable designation on initial recognition, to any financial asset other than a loan or receivable, on an asset-by-asset basis. The Board noted that this proposal would continue to allow entities to account differently for different holdings of the same type of asset (ie to account for some using the fair value option and others not).

BC19 Lastly, the Board decided to clarify that the fair value option could continue to be used in cases when IAS 39 or another Standard explicitly permits or requires its use. Two examples of this are described in paragraph BC7.

## Other matters considered by the Board

*The proposed category for financial assets and financial liabilities containing embedded derivatives*

BC20. In developing the proposals in this Exposure Draft, the Board considered whether the first proposed category for which the fair value option may be used (financial instruments containing embedded derivatives) should apply only when IAS 39 requires the embedded derivative(s) to be separated or whether it should apply to all instruments containing embedded derivatives, regardless of whether IAS 39 requires the derivative(s) to be separated.

 

BC21. The Board decided to propose that this first category should be for all financial assets and financial liabilities that contain embedded derivatives, regardless of whether IAS 39 requires the derivative(s) to be separated for the following reasons:

(a) Informal discussions with constituents have indicated that one of the most common uses of the option is likely to be for structured products that contain embedded derivatives. IAS 39 requires some such embedded derivatives to be separated, whereas it requires other embedded derivatives not to be separated. It may take time and effort to identify all of the derivatives embedded in a structured product and to determine whether they have to be separated. Furthermore, the structured product will typically be hedged with derivatives that offset all (or nearly all) of the risks contained in it, regardless of whether the embedded derivatives that give rise to those risks are separated. Hence, the simplest way to account for such products is to apply the fair value option so that the entire product (and the derivatives that hedge it) is measured at fair value through profit or loss.

(b) Some investment contracts issued by insurers contain embedded derivatives, but these may be of a type that IAS 39 requires not to be separated. In some jurisdictions, insurers want to measure both investment contracts and related assets at fair value through profit or loss. This may enable some insurers to eliminate the mismatch in measurement attributes between the investment contract liabilities and the related assets (the latter being mainly measured at fair value).

BC22. However, the Board noted that a substantial number of financial assets and financial liabilities contain embedded derivatives and, accordingly, a substantial number of financial assets and financial liabilities would qualify for the fair value option under this proposal. It decided to ask respondents for their views on this matter and, in particular, on whether the proposal described in the previous paragraph would allow the fair value option to be used too broadly.

 

*The proposal that the fair value option may be used only for items whose fair value is verifiable*

BC23. The Board acknowledged the concern of some prudential supervisors that if the fair value option were to be used for items whose fair value is subjective, entities may determine fair value in a way that inappropriately affects profit or loss.

BC24. The Board discussed whether it should propose that the fair value option may be used only for items whose fair value is 'reliably measurable'. However, it decided not to make such a proposal for the following reasons:

(a) The *Framework*[*] uses the term 'reliability' to mean that information "is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could be reasonably expected to represent." In the *Framework*, reliability includes notions of faithful representation, substance over form, prudence and completeness. In the context of the fair value option, the Board wanted to convey a narrower meaning, namely that the variability in the range of reasonable fair value estimates made in accordance with IAS 39 is low. Hence, to use the term 'reliably measurable' could have been misleading.

(b) IAS 39[†] specifies that only unquoted equity instruments and derivatives that are linked to and must be settled in such unquoted equity instruments can fail to be measured at fair value on the grounds that fair value is not 'reliably measurable'. IAS 32 paragraph 90 contains the same very limited exemption from the disclosure of fair value. The Board decided that a wider range of instruments could fail to qualify for the fair value option.

[*] paragraph 31

[†] paragraphs 46(c) and 47(a)

 

(c) Because the *Framework*[*] uses the test of “can be measured with reliability” as a general recognition test for all items, the Board decided to use another term to avoid any implication that items covered by other Standards (eg share options) need not be measured at fair value if they do not meet the test proposed for the fair value option.

BC25. For these reasons, the Board decided to propose that the term ‘verifiable’ be used and that this be explained as meaning that the variability in the range of reasonable fair value estimates made in accordance with IAS 39 is low. Put another way, if several independent and knowledgeable observers were asked to estimate the fair value of a particular instrument in accordance with IAS 39, they would all arrive at approximately the same amount. The Board noted that this term is used with a similar meaning in the conceptual frameworks of other standard-setters.[†] The Board also noted that the proposed test of ‘verifiable’ is a stricter test than that of ‘reliably measured’ contained in paragraphs 46(c) and 47(a) of IAS 39. Accordingly, if this proposal is adopted, fewer items will qualify for the fair value option than are measured at fair value if classified as held for trading or available for sale in accordance with IAS 39’s requirements.

BC26. The Board also decided to add examples of when fair value is verifiable. Whilst these examples are not exhaustive, the Board decided that their inclusion would help entities to interpret the term ‘verifiable’.

## Effective Date and Transition

BC27. This Exposure Draft proposes to amend the revised IAS 39 that was issued in December 2003 and is effective for financial years beginning on or after 1 January 2005, with earlier application permitted.

BC28. When considering what the proposed effective date should be for the amendments proposed in this Exposure Draft, the Board noted the following points:

[*] paragraph 83(b)

[†] For example, the Concepts Statements issued by the US standard-setter, the Financial Accounting Standards Board, define verifiability as “The ability through consensus among measurers to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without error or bias.”

 

(a) Anecdotal evidence suggests that most first-time adopters of IFRSs (which is the largest group of entities applying the revised IAS 39) will not apply IAS 39 early (ie they will apply it only for financial years beginning on or after 1 January 2005) and will use the exemption in IFRS 1 *First-time Adoption of International Financial Reporting Standards* from applying IAS 39 to comparative amounts in the first year of adoption. The Board expects that the amendments proposed in this Exposure Draft will be finalised in late 2004. Accordingly, these entities will have time to plan for the amended version of the option before they apply IAS 39.

(b) For entities that are planning to adopt early the revised IAS 39 for an accounting period ending in late 2004, the amendments proposed in this Exposure Draft are likely to be finalised very close to the time when the financial statements to which IAS 39 is first applied are published and may be finalised after interim financial statements for those periods have been published.

(c) Those few entities that choose to adopt early the revised IAS 39 for an accounting period ending before mid-2004 might have applied the existing version of the fair value option before the proposals in this Exposure Draft are finalised.

BC29. In the light of these points, the Board decided that the amendments proposed in this Exposure Draft should apply for financial periods beginning on or after 1 January 2005. The Board decided that this proposal strikes an appropriate balance between giving entities sufficient time to prepare for the amendments and ensuring that as many entities as possible do not adopt the current version of the option and then change shortly afterwards.

BC30. The Board also considered whether those entities that had adopted the existing version of the fair value option should have the opportunity to change the financial assets and financial liabilities to which the option is applied when they adopt the amendments proposed in this Exposure Draft. For example, should an entity that had applied the existing version of the option to a financial liability that does not qualify for the amended option be given the opportunity to cease applying the option to any related financial assets? As another example, should an entity that had applied the existing version of the option to only one side of a substantially offsetting position be given the opportunity to apply the amended option to all of the position? The Board decided that because entities may want to apply the fair value option to related assets and liabilities, entities that had adopted the existing version of the fair value option should have the opportunity to change the financial assets and financial liabilities to which the option is applied when they adopt the amendments proposed in this Exposure Draft.

BC31. Under this proposal the issue arises of whether any change in the measurement basis of a financial asset or financial liability should be applied retrospectively, so that assets and liabilities would be measured in the comparative financial statements on the same basis as in the current year financial statements. The Board noted the following arguments in favour of retrospective application:

(a) the Board's general approach is to require retrospective application unless impracticable, because retrospective application provides the most comparable information to users of financial statements, and

(b) the revised version of IAS 39 issued in December 2003 requires retrospective application when an entity adopts the existing version of the fair value option.

BC32. However, the Board noted that the following arguments against retrospective application, in particular for assets and liabilities to which the existing version of the option has been applied but to which the amended version of the option is not applied:

(a) entities may have used the existing version of the option as a simplification to fair value hedge accounting. Had the option not been available, such entities might, instead, have gone to the effort of meeting the hedge accounting requirements. Hedge accounting cannot be applied retrospectively because of the need to designate the hedge at inception.

(b) requiring comparative amounts to be restated would permit entities to decide, with the benefit of hindsight, whether to cease designating an item as one to which the option is applied, so as to achieve a desired effect on profit or loss.

BC33. Bearing in mind the points in the previous two paragraphs, the Board decided to propose that:

(a) when the amended version of the option *is* applied to a financial asset or financial liability that was *not* previously designated as at fair value through profit or loss, the change should be applied retrospectively (ie the comparative financial statements should be restated).

(b) if the amended version of the option is *not* to be applied to a financial asset or financial liability that *was* previously designated as at fair value through profit or loss, the change should be applied only to subsequent accounting periods (ie the comparative financial statements should not be restated).

BC34. The Board also decided to ask respondents for their views on this proposal and, in particular, whether all changes to the measurement basis of a financial asset or financial liability that result from adopting the amended version of the option should be applied retrospectively by restating the comparative financial statements.

 

# Alternative views on Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement—The Fair Value Option

AV1. Three Board members voted against the publication of the Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement—The Fair Value Option.* Their alternative views are set out below.

AV2. First, these Board members note that the concerns expressed by prudential supervisors (see paragraph BC9 of the Basis for Conclusions on this Exposure Draft) were considered by the Board when it finalised IAS 39. At that time the Board concluded that these concerns were outweighed by the benefits, in terms of simplifying the practical application of IAS 39, that result from allowing the fair value option to be used for any financial asset or financial liability. In the view of these Board members, no substantive new arguments have been raised that would cause them to revisit this conclusion.

AV3. These Board members also note that the amendments are likely to have little effect on what instruments the option is applied to in practice. They understand that there are very few transactions to which entities could have applied the fair value option set out in the December 2003 version of IAS 39 that would not also qualify under the proposed amendments set out in this Exposure Draft. They believe that the Exposure Draft introduces a series of complex rules, with consequential costs to preparers of financial statements, in order to obtain substantially the same result as the much simpler and more easily understood fair value option that was included in the December 2003 version of IAS 39.

AV4. These Board members also note that one of the proposals in the Exposure Draft is to prohibit the fair value option being applied to items whose fair value is not verifiable. They believe that this gives rise to an undesirable dual standard, by adding a second tier threshold for fair value measurement, since IAS 39 requires available-for-sale assets and items that are held for trading to be measured at fair value without a verifiability test.

AV5. The Exposure Draft also proposes to prohibit the fair value option being applied to loans, receivables and financial liabilities, unless they qualify under one of the first three categories proposed in paragraph 9(b). These Board members note that the proposed requirements for category (iii) are very restrictive on initial recognition because they would require the identification of an existing substantially offsetting exposure to changes in fair value between the designated financial instruments similar to that required for hedge accounting. In addition, subsequently the proposed requirements fail to meet their stated objective of decreasing volatility in profit or loss because the fair value designation would be required to be continued even after one of the offsetting instruments has been derecognised. They note that category (ii) also requires that the fair value designation continues to apply in subsequent periods, irrespective of whether the initial conditions still hold.

AV6. The proposals to revise the fair value option will have another important consequence, namely to delay the finalisation of IAS 39. These Board members believe that such a delay is unhelpful to preparers and users of financial statements. In particular, the proposals will not be finalised until late 2004, which is very close to when entities that are required to apply IFRSs from 2005 will have to adopt them. Moreover, entities that are already using IAS 39 will currently be preparing to implement, or have already implemented, the fair value option that was included in the December 2003 version of IAS 39.

AV7. Lastly, two of the three Board members believe that financial reporting standards should deal only with the requirements of financial reporting and should not describe or endorse the powers of prudential supervisors or other regulators. They note that the IASB has no authority to endorse the powers of other regulators and any reference to such powers (such as is made in the Exposure Draft) may create a false impression that it does have such authority, even though the Board clearly states in paragraph BC11(b) of the Basis for Conclusions on this Exposure Draft that it does not give supervisors the power to amend or overrule the requirements of IAS 39.

 