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Amendment to IAS 39 – The Fair Value Option

The International Accounting Standards Board (IASB) issued the amendment to **IAS 39 Financial Instruments: Recognition and Measurement – The Fair Value Option** on 16 June 2005. The amendment limits the ability for an entity to designate any financial asset or financial liability as at “fair value through profit or loss” (FVTPL).

The amendment was developed after a number of commentators, including the European Central Bank, the Basel Committee and the EU Commission, raised concerns that the fair value option in the revisions to IAS 39 in December 2003, which permitted any financial instrument to be designated as at FVTPL on initial recognition, may be used inappropriately.

IAS 39's original fair value option was designed to address situations where the standard's mixed measurement model could result in an entity reporting volatility on positions that are economically matched. The objective of the June 2005 amendment is to limit inappropriate use of the fair value option, while preserving its key benefits.

Note, the ASB has not made any amendment to **FRS 26 Financial Instruments: Measurement** in respect of the fair value option and this newsletter does not address the impact for UK companies continuing to apply UK GAAP.

Criteria to be classified as at FVTPL

The amendment limits the classification of a financial instrument as at FVTPL to only those financial instruments falling into one of the following categories:

- those that are classified as held for trading (i.e. acquired principally for the purpose of selling or repurchasing in the near term; part of a portfolio for which there is evidence of recent short-term profit taking; or non-hedging derivatives);
- where designation as at FVTPL eliminates or significantly reduces a measurement or recognition inconsistency (“accounting mismatch”) that would otherwise arise from measuring assets or liabilities (not only financial assets and financial liabilities) or recognising the gains and losses on them on different bases;
- those that are part of a group of financial assets, financial liabilities or both that are managed, and their performance is evaluated by management, on a fair value basis in accordance with a documented risk management or investment strategy; or
- those that contain one or more embedded derivatives, except where the embedded derivative does not modify significantly the associated cash flows or it is clear with little or no analysis that separation is prohibited.

Classification of financial assets and financial liabilities

The FVTPL classification includes held for trading items as well as instruments that are designated as at FVTPL under this fair value option. If a financial asset is not classified as at FVTPL, and is not classified as loans and receivables or held-to-maturity, it will be classified as available-for-sale and consequently measured at fair value (provided that, for non-quoted financial instruments, fair value can be measured reliably) with the resultant gains and losses generally recognised directly in equity until disposal or impairment.

The measurement of financial liabilities that do not satisfy the criteria to be classified as at FVTPL automatically defaults to amortised cost.

“An entity may conclude that the financial statements provide more relevant information if both items are measured at FVTPL.”

Accounting mismatch

An accounting mismatch occurs when gains and losses on two items subject to the same fair value risk are not recognised consistently. This could occur where, in the absence of the fair value option, a financial asset would be classified as available-for-sale (with changes in fair value recognised directly in equity except for interest, impairment and foreign exchange differences) while a related liability is measured at amortised cost (with changes in fair value not recognised). An entity may conclude that the financial statements provide more relevant information if both items are measured at FVTPL. Designations as at FVTPL made on this basis shall be made at initial recognition. The entity need not enter into the assets and liabilities at the same time provided that the time gap is reasonable and the remaining transactions are expected to occur.

An accounting mismatch may also arise where a non-financial asset is measured at fair value and the related financial liability is measured at amortised cost. The amendment allows an entity to designate the related financial liability as at FVTPL provided that the entity concludes that the changes in fair value of both items are subject to the same risk and an accounting mismatch will be eliminated or significantly reduced by the designation.

Group of financial assets or financial liabilities managed on a fair value basis

Designation of financial instruments as at FVTPL under this criterion is based on the manner in which the entity manages and evaluates the performance of a group of financial assets or financial liabilities rather than the nature of those financial instruments. Designations as at FVTPL made on this basis shall be made at initial recognition and shall be in accordance with a documented risk management or investment strategy, where information about the group is provided internally on that basis to key management personnel as defined in **IAS 24 Related Party Disclosures** (e.g. board of directors or CEO). An entity shall designate all eligible financial instruments that are managed and evaluated together.

“... a hybrid instrument shall not be designated as at FVTPL if it is clear with little or no analysis that separation is prohibited.”

Embedded derivatives

When an entity becomes party to a hybrid instrument that contains an embedded derivative, IAS 39 requires the entity to assess whether to recognise the embedded derivative separately from the host contract and measure it at fair value. These requirements can be more complex or result in less reliable measures and, consequently, an entity is permitted to designate the entire hybrid instrument as at FVTPL provided that the embedded derivative does modify significantly the cash flows associated with the instrument. In addition, a hybrid instrument shall not be designated as at FVTPL if it is clear with little or no analysis that separation is prohibited.

“IFRS reporters that adopt the amendment early have until 1 September 2005 to designate any financial assets and financial liabilities that meet the criteria as at FVTPL at that date.”

Transitional provisions and first-time adoption

Entities shall apply the amendment for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. There are detailed transitional provisions for current IFRS reporters as well as an equally detailed consequential amendment to **IFRS 1 First-time Adoption of International Financial Reporting Standards** for first-time adopters.

IFRS reporters (with annual periods beginning prior to 1 September 2005) that adopt the amendment early have until 1 September 2005 to designate any financial assets and financial liabilities that meet the criteria as at FVTPL at that date. Cumulative gains and losses recognised in profit or loss on financial assets previously designated as at FVTPL that do not meet the criteria to be classified as at FVTPL and will be classified as available-for-sale on adoption of the amendment are required to be recognised as a separate component of equity until disposal.

For financial assets and financial liabilities previously designated as at FVTPL that do not qualify for such designation due to the amendment and will be measured at amortised cost, the date of de-designation is deemed to be the date of initial recognition (i.e. the instrument shall be deemed to have an amortised cost equal to fair value at the date of de-designation).

The amendment to IFRS 1 provides similar relief from the principle of retrospective application for first-time adopters. The amount of relief is dependent on the entity's date of transition to IFRSs and date of adoption of IAS 39. Where a first-time adopter's date of adoption for IAS 39 is prior to 1 September 2005, and the entity wishes to apply this fair value option early, for example in its annual financial statements at 31 December 2005, the entity has until 1 September 2005 to finalise the designation of its financial assets and financial liabilities as at FVTPL. Financial instruments designated as at FVTPL on first-time adoption that were previously designated as hedged items in fair value hedge relationships shall be de-designated from those relationships.

Entities that apply the amendment to annual periods beginning on or after 1 January 2006 that are not first-time adopters in 2006, shall only de-designate financial assets and financial liabilities that do not qualify for designation as at FVTPL. For financial assets and financial liabilities previously designated as at FVTPL that do not qualify for such designation that will be measured at amortised cost, the date of de-designation is deemed to be the date of initial recognition (i.e. the instrument shall be deemed to have an amortised cost equal to fair value at the date of de-designation). In addition the entity shall not designate, as at FVTPL any previously recognised financial assets and financial liabilities.

Disclosure requirements

The amendment includes a consequential amendment to **IAS 32 Financial Instruments: Disclosure and Presentation** that expands the disclosure requirements for financial assets and financial liabilities classified as at FVTPL. These amendments will also be included in **IFRS 7 Financial Instruments: Disclosure** which is due to replace IAS 32.

The additional disclosure includes, for financial assets or financial liabilities designated as at FVTPL, the criteria for such designation and how the entity has satisfied those criteria, the carrying amounts and gains and losses recognised in profit or loss. There is also a number of additional disclosure requirements primarily related to loans and receivables designated as at FVTPL.

The fair value option in the EU

The amendment received positive endorsement advice from the European Financial Reporting Advisory Group (EFRAG) as well as the Accounting Regulatory Committee (ARC) and it is expected that the EU Commission will replace the EU limitation on designating financial liabilities as at FVTPL (one of the "IAS 39 Carve Outs") with this amendment.

Given the importance of endorsement of IAS 39 in Europe, it is the EU Commission's intention (provided the European Parliament raises no objections) to adopt the amended fair value option by the end of September 2005.

Interim financial statements

The rules regarding early adoption of the amendment impact entities issuing interim financial statements before 1 September 2005. Where an entity elects to apply the amendment in their interim financial statements, the interim reporting date becomes the date of adoption of the amendment, hence designation of financial assets and financial liabilities at FVTPL must be completed by that date. Any subsequent redesignation of existing assets and liabilities is prohibited by the amendment. Entities not wishing to apply the amendment in their interim financial information should include appropriate disclosure in their interim report if they intend to apply the amendment early in their year end financial statements.

“The amendment includes a consequential amendment to IAS 32 that expands the disclosure requirements ...”

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