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GUIDANCE ON THE APPLICATION OF IAS 39 BY ENTITIES PREPARING THEIR FINANCIAL STATEMENTS IN ACCORDANCE WITH EU-ADOPTED IFRSs

This note has been prepared by the Accounting Standards Board. It provides guidance on the application of IAS 39 'Financial Instruments: Recognition and Measurement' for entities in the UK and the Republic of Ireland preparing their financial statements in accordance with EU-adopted IFRSs. It does not address the position of entities not preparing their financial statements in accordance with EU-adopted IFRSs. Text in bold sets out the main principles involved.

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INTRODUCTION

1 For accounting periods beginning on or after 1 January 2005, some UK[1] entities will be required[2] to prepare their financial statements in accordance with EU-adopted International Financial Reporting Standards (IFRSs) and many others will be permitted to do so. Such entities need to be aware of the implications of two recent, related events.

(a) Rather than adopt the version of IAS 39 'Financial Instruments: Recognition and Measurement' that the IASB has issued, the European Commission has deleted certain words from the standard and adopted that amended standard. (These deletions are commonly referred to as 'carve outs', a term this note also uses. The adopted version of the standard is referred to in this note as the 'amended' IAS 39 or standard.) The carve outs affect two parts of IAS 39: the hedge accounting requirements and the so-called 'fair value option'.

(b) It had been thought that UK entities preparing their financial statements in accordance with EU-adopted IFRSs had to comply only with the requirements of those standards; in other words, they had to comply with neither the requirements in the EU Accounting Directives nor the accounting requirements in the Companies Act 1985 (the Act). However, the European Commission has now explained that an effect of the fair value option carve out referred to in (a) is that certain accounting requirements in the Act continue to apply to entities following EU-adopted IFRSs.[3]

2 The purpose of this note is to help entities understand the implications of (a) and (b). It describes the position as it is expected to be at 1 January 2005.[4] The note will be updated or withdrawn as necessary.

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[1] For simplicity, 'UK' is used throughout this note in place of 'UK and the Republic of Ireland', and references to companies legislation should be taken to include the equivalent Northern Ireland and Republic of Ireland legislation.

[2] by Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002.

[3] See 'Explanatory memorandum of the Commission Services on the proposal for a regulation adopting IAS 39' (24 September 2004), which is available from www.europa.eu.int/comm/internal_market/accounting/docs/ias/explanatory-memo-2004-09-ias39-proposal_en.pdf. See also ' IAS 39 Financial Instruments: Recognition and Measurement – Frequently Asked Questions', which is available from www.europa.eu.int/rapid/pressReleasesAction.do?reference=MEMO/04/265&format=HTML&aged=0&language=EN&guiLanguage=en.

[4] See paragraph A1 of the Annex.

3 The main part of the note describes and discusses the requirements that apply to entities applying EU-adopted IFRSs. For those wishing to understand the background and analysis leading up to that description and discussion, further explanation is set out in the annex to the note.

HEDGE ACCOUNTING

4 The unamended version of IAS 39 (ie the version issued by the IASB) contains restrictions on the use that can be made of various hedge accounting techniques. The amended IAS 39 is less restrictive than the unamended standard because the Commission has deleted some of the restrictions.

5 The Commission has made it clear that there is nothing in the amended IAS 39 or in legislation that prevents an entity from complying in full with the unamended standard's hedge accounting requirements should it wish to do so.

6 It follows from this that, **if an entity wishes in 2005 to comply with both the amended standard and the unamended standard, it can do so—by applying the hedge accounting requirements of the unamended standard.**

7 Some entities may be thinking of taking advantage of the less restrictive provisions of the amended standard in 2005 with the intention of complying with the unamended standard from a later date. The Accounting Standards Board (the Board) believes that such an approach raises potential transition issues which, if material, could prove difficult and expensive for the entity to resolve.[5] The Board has recommended that **UK entities preparing their financial statements in accordance with EU-adopted IFRSs should prepare them in full compliance with the more restrictive hedge accounting requirements of the unamended standard.**[6]

THE FAIR VALUE OPTION

8 The European Commission's carve outs have no effect on an entity's ability to measure financial assets at fair value through profit or loss.[7]

[5] See 'Transition from the amended standard to the unamended standard', paragraphs 26 to 30 of this note.

[6] See ASB Press Notice 256 'ASB announces way forward on IAS 39', issued on 11 October 2004.

[7] When this note refers to an item being 'measured at fair value through profit or loss' it means the item is shown on the balance sheet at fair value and changes in that fair value are recognised immediately in the profit and loss account.

Financial liabilities required to be measured at fair value through profit or loss

9 The European Commission's carve outs do not change which financial liabilities are *required* to be measured at fair value through profit or loss. Under both versions of the standard, **a financial liability is required to be measured at fair value through profit or loss if:**

(a) it is held for trading. (See paragraphs 14 and 15 for a discussion of what 'held for trading' means); or

(b) it is a derivative, other than a derivative that is a hedging instrument in a cash flow hedge or a hedge of a net investment in a foreign operation that is accounted for using hedge accounting.

10 In certain circumstances, both versions of the standard also require part of a financial liability to be measured at fair value through profit or loss. In particular, if a risk arising from a financial liability is hedged and that hedge is accounted for as a fair value hedge, both versions of the standard require the hedged risk (that is, the part of the liability being hedged) to be measured at fair value through profit or loss.

Financial liabilities permitted to be measured at fair value through profit or loss

11 By contrast, the European Commission's fair value option carve outs do have implications for which financial liabilities are *permitted* to be measured at fair value through profit or loss. The unamended IAS 39 permits entities to use the fair value option to measure at fair value through profit or loss, if they wish, any financial liability that is not required to be accounted for in that way. The European Commission's carve outs delete that permission.

12 However, according to the European Commission, another effect of its carve out is to cause the requirements in the amended IAS 39 to be supplemented by certain of the accounting requirements in national legislation. The end result is that entities preparing their financial statements in accordance with EU-adopted IFRSs are *permitted* to measure a financial liability at fair value through profit or loss if such an accounting treatment would have been permitted by the Act were the financial statements not being prepared under EU-adopted IFRSs.[8] Thus, **a financial**

[8] See paragraphs A2-A7 of the Annex.

liability is permitted to be measured at fair value through profit or loss if:

(a) it would be permitted or required to be accounted for in that way, without needing to invoke the true and fair override, were the financial statements being prepared in accordance with the historical cost or alternative accounting rules of the relevant Schedule of the Act (see the discussion in paragraphs 16 and 17 that expand on this paragraph). As explained more fully in those paragraphs, this option is of no relevance to entities that would otherwise have been preparing their financial statements in accordance with Schedule 4 of the Act (because neither the historical cost accounting rules nor the alternative accounting rules of that Schedule permit or require financial liabilities to be measured at fair value through profit or loss). The option is relevant to entities that would otherwise have been preparing their financial statements in accordance with Schedules 9 or 9A of the Act;[9] **or**

(b) it qualifies as a hedged item under a fair value hedge accounting system that requires hedged items to be measured at fair value through profit or loss. (See the discussion in paragraph 18 that expands on this paragraph).

The 'fair presentation' override

13 Notwithstanding the detailed requirements to which an entity preparing its financial statements in accordance with EU-adopted IFRSs is subject, those financial statements are also subject to the overriding requirement of IAS 1 that they shall present fairly the financial position, financial performance and cash flows of an entity. IAS 1 requires that, in the extremely rare circumstances in which compliance with a requirement in a standard would conflict with the fair presentation objective, that requirement shall be departed from to the extent necessary to meet the fair presentation objective. Therefore, **a financial liability that is not otherwise required or permitted to be measured at fair value through profit or loss is required to be accounted for in that way if the financial position, financial performance and cash flows of the reporting entity cannot otherwise be**

[9] In Schedule 9A of the Act, the alternative accounting rules are referred to as the 'current value accounting rules'. For simplicity, however, they are referred to here as the 'alternative accounting rules'

presented fairly. (See the discussion in paragraphs 19-21 that expand on this paragraph.)[10]

The meaning of 'the reference to 'held for trading' in paragraph 9(a)

14 Paragraph 9(a) above explains that both versions of IAS 39 require financial liabilities that are classified as held for trading to be measured at fair value through profit or loss. 'Held for trading' is defined in exactly the same way in both versions of the standard. **A financial liability is held for trading if it is:**

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

(b) 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

(c) a derivative other than a derivative that is a designated and effective hedging instrument.

15 Although the notion of 'held for trading' (or 'held as part of a trading portfolio' or 'trading book') is not new, the above definition may be wider than definitions commonly used for such items. For example, subparagraph (b) would include some portfolios on which there is a practice of short-term profit-taking even if those portfolios are not formally designated as trading book portfolios for, say, capital adequacy purposes.

The reference in paragraph 12(a) to measuring at fair value through profit or loss under the Act

16 Paragraph 12(a) above explains that an implication of the European Commission's fair value option carve out is that entities complying with EU-adopted IFRSs are permitted to measure at fair value through profit or loss any financial liability that the historical cost or alternative accounting rules of the Act either require or permit to be accounted for in that way.

(a) Neither the historical cost accounting rules nor the alternative accounting rules of Schedule 4 of the Act require or permit any financial liabilities to be measured at fair value through profit or loss

[10] See also paragraphs A8-A10 of the Annex.

without invoking the true and fair override, so this option is of no relevance to entities that would have been reporting under Schedule 4 had they not been preparing their financial statements in accordance with EU-adopted IFRSs.

(b) Similarly, Schedule 9's historical cost accounting rules and alternative accounting rules do not explicitly state that they permit or require some financial liabilities to be measured at fair value through profit or loss. However, the Board understands that some entities believe that the rules implicitly permit such accounting and this option may therefore be of relevance to such entities.

(c) Schedule 9A's historical cost accounting rules and current value accounting rules clearly permit or require certain financial liabilities to be measured at fair value through profit or loss. For example, insurance companies are able to measure liabilities arising from unit-linked contracts[11] by reference to the value of the underlying units, assets, share index or reference value and take changes in that value through the profit and loss account.[12] The option is therefore of relevance to entities that would have been reporting under Schedule 9A had they not been preparing their financial statements in accordance with EU-adopted IFRSs.

17 In effect what paragraph 12(a) above means is that **an entity that prepared its 2004 accounts in accordance with the Act and, in doing so, measured a financial liability at fair value through profit or loss without needing to invoke the true and fair override can[13] continue, if it wishes, to apply that accounting treatment when applying EU-adopted IFRS**s.

The reference in paragraph 12(b) to a fair value hedge accounting system

18 The fair value accounting rules[14] contained in the Act in the main replicate the requirements in both versions of IAS 39 as to the financial liabilities that are required to be measured at fair value through profit or loss (ie the requirements discussed in paragraphs 9, 14 and 15 of this note). However,

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[11] ie contracts in which policyholders bear the investment risk or where benefits are determined by a certain index.
[12] See also paragraph 22.
[13] Subject to any relevant future amendments to Schedule 4, 9 or 9A.
[14] These rules were inserted into the Act by The Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004.

they also permit a financial liability to be measured at fair value through profit or loss if it qualifies as a hedged item under a fair value hedge accounting system that requires hedged items to be measured at fair value through profit or loss.

(a) This reference to 'fair value hedge accounting systems' is wider than 'fair value hedges that are accounted for as a fair value hedge under IAS 39' or even 'fair value hedges that are eligible to be accounted for as a fair value hedge under IAS 39'. Hedges that are accounted for as fair value hedges under IAS 39 will be accounted for in accordance with paragraph 10 of this note, which means that the reference in the fair value accounting rules to **'a fair value hedge accounting system' should be read, for the purposes of the discussion in this note, as being a reference to fair value hedges that may not be accounted for as fair value hedges under IAS 39.** For example, it may be that an entity is exposed to changes in the fair value of a financial asset or financial liability (or portfolio of financial assets or financial liabilities) that is substantially offset by an exposure to changes in the fair value of another financial asset or financial liability (or portfolio of financial assets or financial liabilities).

(b) The phrase "under a fair value hedge accounting system that requires hedged items to be measured at fair value through profit or loss" imposes an important restriction on the availability of this option because it is not common under current practice for the hedged item in a fair value hedge to be measured at fair value through profit or loss. However, in the probably limited circumstances in which that is the practice, the entity can choose to continue to account for the hedged item in that way, even if the hedge would not qualify for hedge accounting under either version of the standard.

The fair presentation override described in paragraph 13

19 Financial statements prepared in accordance with EU-adopted IFRSs are required, by paragraph 13 of IAS 1, to present fairly the financial position, financial performance and cash flows of the reporting entity. Paragraph 17 of IAS 1 states that "in the extremely rare circumstances in which management concludes that compliance with a requirement in a Standard or an Interpretation would be so misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall

depart from that requirement in the manner set out in paragraph 18 [of IAS 1] if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure." Paragraph 18 makes clear that an entity should depart from a standard only to the extent necessary to achieve a fair presentation, and paragraphs 15 and 16 make it clear that a fair presentation involves the use of appropriate accounting policies.

20 Paragraph 22 of IAS 1 states that, "for the purposes of paragraphs 17-21, an item of information would conflict with the objective of financial statements when it does not represent faithfully the transactions, other events and conditions that it either purports to represent or could reasonably be expected to represent and, consequently, it would be likely to influence economic decisions made by users of financial statements."

21 It is conceivable that this could mean that an entity would be required to measure at fair value through profit or loss a financial liability that would not otherwise be required or permitted to be accounted for in that way. As the expectation is that the 'fair presentation override' will be used extremely rarely, the circumstances that might merit its use are likely to be narrow and not generic to all types of entity. As such, it is difficult for the Board to provide guidance on the circumstances that might merit its use. The Board envisages though that:

(a) an example of where the override might need to be applied is where there would otherwise be potential for substantial artificial volatility to arise. 'Artificial volatility' in this context means that the value of some financial assets is either linked to or managed together with the value of some financial liabilities but, unless the override is applied, the assets and liabilities will be measured on different bases. It is the *potential* for volatility, rather than the existence of *actual* volatility, that is important, because consistency of appropriate accounting practice from year to year is important; and

(b) even if the potential for artificial volatility exists, it may not generally be appropriate to apply the override if the result would be the recognition in the profit and loss account of a *substantial* gain arising from a fall in the fair value of financial liabilities caused by a deterioration in the entity's own credit standing.

Linked liabilities and fair value

22 The Board understands that one of the concerns that has been raised in the light of the European Commission's adoption of the amended version of IAS 39 is that insurance entities will find their financial statements subject to artificial volatility because a financial asset will be required to be measured at fair value through profit or loss while a financial liability that is linked to the value of the asset will be required to be accounted for at a cost-based amount. Paragraphs 16(b) and (c) of the note may be of particular relevance here. The Board also notes that it is not always necessary to measure a financial liability at fair value through profit or loss in order to measure a liability that is contractually linked to changes in value of one or more assets at an amount that reflects the value of the linked assets. That is because, for those linked liabilities where the counterparty has the contractual right to demand payment of the liability at any time without penalty, the amortised cost of a linked liability could be viewed as the amount payable. Thus applying a cost basis may also result in the liability being measured at an amount that reflects the value of the linked asset.

Complying with both versions of the standard, albeit in different ways

23 UK entities have been preparing for the implementation of IAS 39 for some time now and some of those entities would have been relying on the ability to measure any financial liability at fair value through profit or loss to ease the burden of implementation. Some of those entities will wish both:

(a) to take advantage of the ability (described in paragraphs 11 and 12 of the note) to measure at fair value through profit or loss any financial liability that the Act would have permitted or required to be accounted for in that way had the entity not been preparing its financial statements in accordance with EU-adopted IFRSs; and

b) to be able to state that they have complied with the unamended version of the standard.

24 For example, if an entity chooses to use the option described in paragraph 12(a) to measure a financial liability at fair value through profit or loss but wishes also to comply with the unamended standard, it will need to ensure that it complies with the unamended standard's criteria for applying the fair value option. They require the item to be designated as 'measured at

fair value through profit or loss' on initial recognition (or on transition to IFRSs if later) and to remain so designated until it is derecognised.

25 It may be that the entity chooses, for the purposes of complying with EU-adopted IFRSs, to treat a financial liability as a hedged item under a fair value hedge accounting system of the type described in paragraph 12(b) above. However, to be able to state that it has complied with the unamended version of the standard, it needs to be able to apply the fair value option in the unamended standard to the financial liability.

(a) Such an approach will be satisfactory only if the accounting would be the same under both approaches.[15]

(b) It would also be necessary to comply both with the designation and other requirements of the fair value hedge accounting system (to comply with the EU-adopted standard) and the fair value option criteria (to comply with the unamended standard).

TRANSITION FROM THE AMENDED STANDARD TO THE UNAMENDED STANDARD

26 The transitional arrangements set out in the amended standard are identical to those set out in the unamended standard. IFRS 1 'First-time Adoption of International Financial Reporting Standards' also contains transitional arrangements, although they are available only to entities presenting their first set of annual financial statements that have been prepared in full compliance with IFRSs. IFRS 1 refers to such entities as 'first-time adopters of IFRSs'.

27 The European Commission has adopted IFRS 1 without amendment, but has nevertheless stated that entities applying the amended version of IAS 39 (in a way that does not comply with the unamended standard) can nevertheless regard themselves as a first-time adopter of IFRSs for the purposes of IFRS 1.

[15] For example, if a financial liability is a hedged item in a paragraph 12(b) fair value hedge, it might be that under the system of hedge accounting in use only the hedged risk part of the financial liability would be measured at fair value through profit or loss. However, applying the fair value option under the unamended standard would require the whole of the liability to be measured at fair value. Sometimes these different practices would result in numbers that do not differ materially; sometimes material differences might arise.

28 The Board is unsure of the status of the Commission's statement and is as a result not able to add to or expand upon it.[16] It notes though that enforcement agencies will need to form a view on whether an entity preparing financial statements in accordance with EU-adopted IFRSs *is* entitled to the relief available under IFRS 1 and those agencies may not necessarily treat the Commission's statement as authoritative.

29 Logically, an entity can be a first-time adopter of IFRSs only once. However, if an entity follows the Commission's advice and takes advantage of IFRS 1's relief even though it has not complied with the unamended version of IAS 39, it is not clear how it should proceed when the unamended and amended versions of IAS 39 are eventually brought into line. Some commentators argue that the entities should just treat the amendments to EU-adopted IFRSs involved like any other amendment; others argue that, in theory at least, the standards demand that the entities treat themselves as first-time adopters and, as a result, restate and rebase various amounts.

30 The Board notes that an entity can avoid these uncertainties arising by complying from the outset with both the amended and unamended versions of the standard, and its advice to entities is to do that.

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[16] See paragraphs A11-A14 of the Annex.

ANNEX
BACKGROUND AND ANALYSIS SUPPORTING THE NOTE'S EXPLANATIONS AND GUIDANCE

The position as it is expected to be at 1 January 2005 (paragraph 2)

A1 The note was finalised at the beginning of December 2004. It takes account of all information made publicly available by the end of November. It also makes two assumptions about what will happen after the end of November.

(a) The note assumes that the European Commission will adopt the December 2003 version of IAS 1 for application to accounting periods beginning on or after 1 January 2005. In fact, the standard has not yet been adopted,[17] although the Commission has indicated that it expects adoption in time for application to 2005 accounting periods.

(b) In April 2004 the IASB issued an exposure draft that has a bearing on the fair value option issue discussed in this note.[18] The European Commission has stated that it will reconsider the amendments it has made to IAS 39's fair value option as soon as the IASB finalises the amendments arising from that exposure draft. The note assumes that the IASB's work will not be finished by 1 January 2005 and that the European Commission's position will not have changed by that date. It remains possible nevertheless that, when the IASB has completed its work and the European Commission has considered the implications of that completed work, any resulting amendments to EU-adopted IFRSs will be applied to accounting periods beginning on or after 1 January 2005.

Continued relevance of parts of the Act to entities preparing financial statements in accordance with EU-adopted IFRSs (paragraphs 1(b), 12(a), and 16-18)

A2 Under the unamended standard, an entity can choose to measure at fair value through profit or loss any financial liability that is not required to be

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[17] The European Commission's Accounting Regulatory Committee voted on 30 November 2004 in favour of a Commission proposal to adopt the December 2003 version of IAS 1. This is an important step in the European adoption process, but is not the final step.
[18] 'Proposed Amendment to IAS 39 Financial Instruments: Recognition and Measurement—The Fair Value Option'

measured in that way, as long as the liability is designated on initial recognition as an item to be measured in that way and the liability continues to be measured in that way until it is derecognised. The Commission has deleted that provision from the standard, with the result that the amended standard does not in itself permit any financial liability that is not required to be measured at fair value through profit or loss to be accounted for in that way. However, the Commission has received legal advice that "a Member State can still require or recommend full application of IAS 39, to the extent that this is allowed under Community law." The Commission's explanation goes on:[19]

> "Article 42a which was introduced into the Fourth Company Law Directive by the Fair Value Directive (Directive 2001/65/EC) restricts the type of liabilities which may be subject to valuation at fair value. It does not allow a fair valuation of all liabilities of a company. The main category of liabilities excluded from fair valuation is that of own debt; this category can represent a major part of a company's balance sheet. Therefore, Member States cannot allow or require companies to fair value liabilities beyond what is specifically allowed under Article 42a or under other provisions in the EU Accounting Directives, such as Article 31 of the Insurance Accounts Directive (Directive 1991/674/EEC), which allows insurance companies in the case of unit-linked contracts to value liabilities—where policyholders bear the investment risk or where benefits are determined by a certain index—according to the value of the underlying units, assets, share index or reference value." [footnote omitted]

A3 In other words, although the amended version of IAS 39 itself does not permit the measurement at fair value through profit or loss of any financial liability that does not fall within the descriptions in paragraphs 9 and 10 of this note, if Community and national law would permit or require such an accounting treatment to be adopted were the financial statements involved prepared in accordance with national standards and requirements rather than EU-adopted IFRSs, entities applying EU-adopted IFRSs are permitted to measure a financial liability at fair value through profit or loss in those same circumstances.

A4 The reference in the Commission's statement to "Member States cannot allow or require companies to fair value liabilities beyond what is specifically allowed under Article 42a or *under other provisions in the EU Accounting Directives*" (emphasis added) makes clear the Commission's view that entities are permitted to measure financial liabilities at fair value

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[19] See 'Explanatory memorandum of the Commission Services on the proposal for a regulation adopting IAS 39' (24 September 2004), which is available from www.europa.eu.int/comm/internal_market/accounting/docs/ias/explanatory-memo-2004-09-ias39-proposal_en.pdf. 265&format=HTML&aged=0&language=EN&guiLanguage=en.

through profit or loss to the extent allowed under the existing EU Accounting Directives. Those directives have been fully implemented in the Act, so it follows that, if it is possible to measure a financial liability at fair value through profit or loss under the Act, it should still be possible if one is preparing financial statements in accordance with EU-adopted IFRSs.

A5 The relevant parts of the Act here are the measurement rules set out in Schedules 4, 9 and 9A. Until recently, those rules comprised the historical cost accounting rules and the alternative accounting rules. Paragraph 12(a) deals with those accounting rules.

A6 A third set of measurement rules—the so-called fair value accounting rules—has recently been inserted in the Schedules to implement Article 42a. Paragraph 12(b) deals with those rules. Article 42a clauses 1 and 2 require Member States to permit or require measurement at fair value through profit or loss of financial liabilities that are 'held as part of a trading portfolio' or are 'derivative financial instruments'. The Board believes that these terms have essentially the same meanings as IAS 39's 'held for trading' and 'derivatives', so that part of Article 42a merely repeats the requirements described in paragraph 9 of this note.

A7 Article 42a clause 5 permits any liabilities that qualify as hedged items under a fair value hedge accounting system, or identified portions of such assets or liabilities, to be valued at the specific amount required under that system. This is dealt with in paragraph 12(b) of the note.

The fair presentation override (paragraphs 13 and 19-21)

A8 The Commission's statement goes on to say that "a Member State [cannot] under the IAS Regulation "override" Article 42a by invoking the "true and fair view" concept. In other words, a Member State cannot apply a general override to the restrictions in the EU requirements (ie those contained in EU-adopted IFRSs, Article 42a and other provisions in the EU Accounting Directives) on the measurement at fair value through profit or loss of financial liabilities. However, that does not prevent an entity (as opposed to a Member State) from applying any overrides available to it if its particular circumstances require that override to be used.

A9 For entities preparing their financial statements in accordance with EU-adopted IFRSs, the true and fair requirement and true and fair override set out in the Act are replaced by the fair presentation requirement and override set out in IAS 1.

(a) This override permits an entity in certain rare circumstances to depart from the requirements of an adopted standard. Paragraphs 9 and 10 of this note describe such requirements.

(b) As noted in paragraphs 11 and 12, the European Commission has explained that the fair value option carve out has had the effect of making certain provisions set out in legislation mandatory for entities preparing financial statements in accordance with EU-adopted IFRSs. As far as the Board is aware, the legal advice the European Commission received did not clarify whether those provisions are subject to IAS 1's fair presentation override provisions or the Act's true and fair override provisions. The Board has therefore made what it believes to be a reasonable assumption: the fair presentation override in IAS 1 is the only override that entities preparing their financial statements in accordance with EU-adopted IFRSs can use.

A10 The note comments on the application of the override and suggests that, if the potential for substantial artificial volatility exists, the override might need to be applied. This suggestion has been made because it seems to the Board to be reasonable to suppose that, in making its amendments, the Commission was not seeking to prevent financial liabilities from being measured at fair value through profit or loss in circumstances in which it would be misleading to do otherwise. Different views exist as to what represents 'artificial' volatility. The Board has sought in the note to clarify that, in its view, for the volatility to be artificial it is necessary for there to be some linkage between the financial liability concerned and financial assets measured at fair value.

The applicability of IFRS 1 (paragraphs 26-30)

A11 On the application of IFRS 1 in the context of EU-adopted IFRSs, the Commission has stated:[20]

> IFRS 1, which was adopted under Commission Regulation No 707/2004, requires in principle companies to comply with each IAS/IFRS at the reporting

[20] See 'Explanatory memorandum of the Commission Services on the proposal for a regulation adopting IAS 39' (24 September 2004), which is available from www.europa.eu.int/comm/internal_market/accounting/docs/ias/explanatory-memo-2004-09-ias39-proposal_en.pdf. 265&format=HTML&aged=0&language=EN&guiLanguage=en.

date for its first IFRS financial statements, but grants limited exemptions in specified areas. This standard is therefore of major importance for the great majority of listed European companies which do not yet report according to IAS/IFRS before 2005. Those companies which apply IAS 39— as endorsed with the two carve outs under the present Regulation—can still make use of the exemptions under IFRS 1 because the reasoning is exactly the same: IFRS 1 should help "first time adopters" since the costs for complying with full IAS/IFRS will outweigh the benefits for the users of financial statements of such companies. As the two carve outs under IAS 39 are as limited as possible in substance and in time and the issues are likely to be resolved during 2005, it would be disproportionate in terms of costs for companies to take away the advantages granted under IFRS 1 whilst not offering any advantages to users of financial statements.

A12 It is understandable why the Commission would want this to be so, but not so clear how it can be so, bearing in mind that the Commission adopted IFRS 1 unamended earlier this year and the wording of IFRS 1 makes it clear that its relief is available only to entities that are fully compliant with IFRS.

A13 There are many cross-references within IFRSs to IAS 39, and it is generally accepted that, for the purposes of EU-adopted IFRSs, they should be read as referring to the adopted version of IAS 39 (ie the amended version). However, it is questionable whether this principle can be extended to IFRS 1's references to first-time adopters. According to IFRS 1, a first-time adopter is an entity that presents its first annual financial statements in which it adopts IFRSs "by an explicit and reserved statement of compliance with IFRSs." An entity that has complied with the amended IAS 39 but not the unamended version will be able to state that it has complied with EU-adopted IFRSs, but will not be able to provide the explicit and unreserved compliance statement referred to in IFRS 1, and therefore would appear not to be a first-time adopter.

A14 For that reason, the note reports that there is uncertainty as to how the Commission's statement should be treated.