

Amendments to
International Accounting Standard 39
**Financial Instruments:
Recognition and Measurement**
The Fair Value Option

These Amendments to IAS 39 *Financial Instruments: Recognition and Measurement—The Fair Value Option* are issued by the International Accounting Standards Board (IASB), 30 Cannon Street, London EC4M 6XH, United Kingdom.

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

This document sets out amendments to IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). The amendments relate to proposals that were contained in an Exposure Draft of Proposed Amendments to IAS 39—*The Fair Value Option* published in April 2004.

Entities shall apply the amendments set out in this document for annual periods beginning on or after 1 January 2006.

In paragraph 9, part (b) of the definition of a financial asset or financial liability at fair value through profit or loss is replaced, as follows.

Definitions

9. ...

Definitions of Four Categories of Financial Instruments

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) ...

(b) ***Upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when permitted by paragraph 11A, or when doing so results in more relevant information, because either***

(i) ***it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or***

(ii) ***a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to***

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the entity's key management personnel (as defined in IAS 24 Related Party Disclosures (as revised in 2003)), for example the entity's board of directors and chief executive officer.

In IAS 32, paragraphs 66, 94 and AG40 require the entity to provide disclosures about financial assets and financial liabilities it has designated as at fair value through profit or loss, including how it has satisfied these conditions. For instruments qualifying in accordance with (ii) above, that disclosure includes a narrative description of how designation as at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.

Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81), shall not be designated as at fair value through profit or loss.

It should be noted that paragraphs 48, 48A, 49 and Appendix A paragraphs AG69-AG82, which set out requirements for determining a reliable measure of the fair value of a financial asset or financial liability, apply equally to all items that are measured at fair value, whether by designation or otherwise, or whose fair value is disclosed.

Paragraph 11A is added, as follows.

Embedded Derivatives

- 11A. Notwithstanding paragraph 11, if a contract contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss unless:*
- (a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or*
 - (b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.*

Paragraphs 12 and 13 are amended (new text is underlined and deleted text is struck through), as follows.

12. *If an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at a subsequent financial reporting date, it shall ~~treat~~ designate the entire hybrid (combined) contract as a financial asset or financial liability that is held for trading at fair value through profit or loss.*
13. If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an unquoted equity instrument), the fair value of the embedded derivative is the difference between the fair value of the hybrid (combined) instrument and the fair value of the host contract, if those can be determined under this Standard. If the entity is unable to determine the fair value of the embedded derivative using this method, paragraph 12 applies and the hybrid (combined) instrument is treated as held for trading designated as at fair value through profit or loss.

Paragraph 48A is added, as follows.

Fair Value Measurement Considerations

- 48A. The best evidence of fair value is quoted prices 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 incorporates all factors that market

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participants would consider in setting a price and 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.

Effective Date and Transition

Paragraph 105 is amended (new text is underlined and deleted text is struck through) and paragraphs 105A-105D are added, as follows.

...

105. *When this Standard is first applied, an entity is permitted to designate a previously recognised financial asset ~~or financial liability as a financial asset or financial liability~~ as at fair value through profit or loss or available for sale despite the requirement in paragraph 9 to make such designation upon initial recognition. For any such financial asset ~~designated as available for sale,~~ the entity shall recognise all cumulative changes in fair value in a separate component of equity until subsequent derecognition or impairment, when the entity shall transfer that cumulative gain or loss to profit or loss. ~~For any financial instrument designated as at fair value through profit or loss or available for sale,~~ The entity shall also:*
- (a) ~~restate the financial asset or financial liability using the new designation in the comparative financial statements; and~~*
 - (b) ~~disclose the fair value of the financial assets or financial liabilities designated into each category at the date of designation and their classification and carrying amount in the previous financial statements.~~*
- 105A. *An entity shall apply paragraphs 11A, 48A, AG4B-AG4K, AG33A and AG33B and the 2005 amendments in paragraphs 9, 12 and 13 for annual periods beginning on or after 1 January 2006. Earlier application is encouraged.*
- 105B. *An entity that first applies paragraphs 11A, 48A, AG4B-AG4K, AG33A and AG33B and the 2005 amendments in paragraphs 9, 12 and 13 in its annual period beginning before 1 January 2006*

- (a) is permitted, when those new and amended paragraphs are first applied, to designate as at fair value through profit or loss any previously recognised financial asset or financial liability that then qualifies for such designation. When the annual period begins before 1 September 2005, such designations need not be completed until 1 September 2005 and may also include financial assets and financial liabilities recognised between the beginning of that annual period and 1 September 2005. Notwithstanding paragraph 91, any financial assets and financial liabilities designated as at fair value through profit or loss in accordance with this subparagraph that were previously designated as the hedged item in fair value hedge accounting relationships shall be de-designated from those relationships at the same time they are designated as at fair value through profit or loss.*
 - (b) shall disclose the fair value of any financial assets or financial liabilities designated in accordance with subparagraph (a) at the date of designation and their classification and carrying amount in the previous financial statements.*
 - (c) shall de-designate any financial asset or financial liability previously designated as at fair value through profit or loss if it does not qualify for such designation in accordance with those new and amended paragraphs. When a financial asset or financial liability will be measured at amortised cost after de-designation, the date of de-designation is deemed to be its date of initial recognition.*
 - (d) shall disclose the fair value of any financial assets or financial liabilities de-designated in accordance with subparagraph (c) at the date of de-designation and their new classifications.*
- 105C.** *An entity that first applies paragraphs 11A, 48A, AG4B-AG4K, AG33A and AG33B and the 2005 amendments in paragraphs 9, 12 and 13 in its annual period beginning on or after 1 January 2006*
- (a) shall de-designate any financial asset or financial liability previously designated as at fair value through profit or loss only if it does not qualify for such designation in accordance with those new and amended paragraphs. When a financial asset or financial liability will be measured at amortised cost after de-designation, the date of de-designation is deemed to be its date of initial recognition.*

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- (b) shall not designate as at fair value through profit or loss any previously recognised financial assets or financial liabilities.*
 - (c) shall disclose the fair value of any financial assets or financial liabilities de-designated in accordance with subparagraph (a) at the date of de-designation and their new classifications.*
- 105D.** *An entity shall restate its comparative financial statements using the new designations in paragraph 105B or 105C provided that, in the case of a financial asset, financial liability, or group of financial assets, financial liabilities or both, designated as at fair value through profit or loss, those items or groups would have met the criteria in paragraph 9(b)(i), 9(b)(ii) or 11A at the beginning of the comparative period or, if acquired after the beginning of the comparative period, would have met the criteria in paragraph 9(b)(i), 9(b)(ii) or 11A at the date of initial recognition.*

In Appendix A, paragraphs AG4B-AG4K are added, as follows.

Appendix A

Application Guidance

Definitions (paragraphs 8 and 9)

Designation as at Fair Value through Profit or Loss

- AG4B. Paragraph 9 of this Standard allows an entity to designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through profit or loss provided that doing so results in more relevant information.
- AG4C. The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 14(b) of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial

position, financial performance or cash flows. In the case of designation as at fair value through profit or loss, paragraph 9 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with paragraph 9, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

Paragraph 9(b)(i): Designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise

AG4D. Under IAS 39, measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence of designation as at fair value through profit or loss, a financial asset would be classified as available for sale (with most changes in fair value recognised directly in equity) and a liability the entity considers related would be measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were classified as at fair value through profit or loss.

AG4E. The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 9(b)(i).

- (a) An entity has liabilities whose cash flows are contractually based on the performance of assets that would otherwise be classified as available for sale. For example, an insurer may have liabilities containing a discretionary participation feature that pay benefits based on realised and/or unrealised investment returns of a specified pool of the insurer's assets. If the measurement of those liabilities reflects current market prices, classifying the assets as at fair value through profit or loss means that changes in the fair value of the financial assets are recognised in profit or loss in the same period as related changes in the value of the liabilities.

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- (b) An entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by IFRS 4 *Insurance Contracts*, paragraph 24), and financial assets it considers related that would otherwise be classified as available for sale or measured at amortised cost.
- (c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (ie are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, for example because the requirements for effectiveness in paragraph 88 are not met.
- (d) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and the entity does not qualify for hedge accounting because none of the instruments is a derivative. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example:
 - (i) the entity has financed a portfolio of fixed rate assets that would otherwise be classified as available for sale with fixed rate debentures whose changes in fair value tend to offset each other. Reporting both the assets and the debentures at fair value through profit or loss corrects the inconsistency that would otherwise arise from measuring the assets at fair value with changes reported in equity and the debentures at amortised cost.
 - (ii) the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased.

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- AG4F. In cases such as those described in the preceding paragraph, to designate, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through profit or loss may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to occur.
- AG4G. It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to CU100* and a number of similar financial assets that sum to CU50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (for example, individual liabilities with a combined total of CU45) as at fair value through profit or loss. However, because designation as at fair value through profit or loss can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (eg changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (ie percentage) of a liability.

* In this Standard, monetary amounts are denominated in 'currency units' (CU).

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Paragraph 9(b)(ii): A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy

AG4H. An entity may manage and evaluate the performance of a group of financial assets, financial liabilities or both in such a way that measuring that group at fair value through profit or loss results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments.

AG4I. The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 9(b)(ii).

- (a) The entity is a venture capital organisation, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest or dividends and changes in fair value. IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures* allow such investments to be excluded from their scope provided they are measured at fair value through profit or loss. An entity may apply the same accounting policy to other investments managed on a total return basis but over which its influence is insufficient for them to be within the scope of IAS 28 or IAS 31.
- (b) The entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. An example could be an entity that has issued 'structured products' containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments. A similar example could be an entity that originates fixed interest rate loans and manages the resulting benchmark interest rate risk using a mix of derivative and non-derivative financial instruments.
- (c) The entity is an insurer that holds a portfolio of financial assets, manages that portfolio so as to maximise its total return (ie interest or dividends and changes in fair value), and evaluates its performance on that basis. The portfolio may be

held to back specific liabilities, equity or both. If the portfolio is held to back specific liabilities, the condition in paragraph 9(b)(ii) may be met for the assets regardless of whether the insurer also manages and evaluates the liabilities on a fair value basis. The condition in paragraph 9(b)(ii) may be met when the insurer's objective is to maximise total return on the assets over the longer term even if amounts paid to holders of participating contracts depend on other factors such as the amount of gains realised in a shorter period (eg a year) or are subject to the insurer's discretion.

AG4J. As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial instruments as at fair value through profit or loss on the basis of this condition shall so designate all eligible financial instruments that are managed and evaluated together.

AG4K. Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 9(b)(ii). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for a department—as approved by the entity's key management personnel—clearly demonstrates that its performance is evaluated on a total return basis, no further documentation is required to demonstrate compliance with paragraph 9(b)(ii).

After paragraph AG33, a heading and paragraphs AG33A and AG33B are added, as follows.

Instruments containing Embedded Derivatives

AG33A. When an entity becomes a party to a hybrid (combined) instrument that contains one or more embedded derivatives, paragraph 11 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can

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be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through profit or loss. For that reason this Standard permits the entire instrument to be designated as at fair value through profit or loss.

AG33B. Such designation may be used whether paragraph 11 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 11A would not justify designating the hybrid (combined) instrument as at fair value through profit or loss in the cases set out in paragraph 11A(a) and (b) because doing so would not reduce complexity or increase reliability.

Basis for Conclusions

In the Basis for Conclusions, paragraph BC11C is added, as follows.

BACKGROUND

BC11C. After those amendments were issued in March 2004 the Board received further comments from constituents calling for further amendments to the Standard. In particular, as a result of continuing discussions with constituents, 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. 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) the 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 an entity recognising gains or losses in profit or loss associated with changes in its own creditworthiness.

In response to those concerns, the Board published in April 2004 an Exposure Draft of proposed restrictions to the fair value option. In March 2005 the Board held a series of round-table meetings to discuss proposals with invited constituents. As a result of this process, the Board issued an amendment to IAS 39 in June 2005 relating to the fair value option.

The heading after paragraph BC70 and paragraphs BC71-BC73 are amended (new text is underlined and deleted text is struck through), and paragraph BC73A is added, as follows.

Measurement

Fair Value ~~Measurement~~ Option (paragraph 9)

- BC71. The Board concluded that it could simplify the application of IAS 39 (as revised in 2000) for some entities by permitting the use of fair value measurement for any financial instrument. With one exception (see paragraph ~~BC829~~), this greater use of fair value is optional. The fair value option does not require entities to measure more financial instruments at fair value.
- BC72. ~~The previous version of~~ IAS 39 (as revised in 2000) did not permit an entity to measure particular categories of financial instruments at fair value with changes in fair value recognised in profit or loss. Examples included:
- (a) originated loans and receivables, including a debt instrument acquired directly from the issuer, unless they met the conditions for classification as held for trading in paragraph 9.
 - (b) financial assets classified as available for sale, unless as an accounting policy choice gains and losses on all available-for-sale financial assets were recognised in profit or loss or they met the conditions for classification as held for trading in paragraph 9.
 - (c) non-derivative financial liabilities, even if the entity had a policy and practice of actively repurchasing such liabilities or they formed part of an arbitrage/customer facilitation strategy or fund trading activities.
- BC73. The Board decided in IAS 39 (as revised in 2003) to permit entities to designate irrevocably on initial recognition any financial instruments as ones to be measured at fair value with gains and losses recognised in profit or loss ('fair value through profit or loss'). To impose discipline on this approach, the Board decided that financial instruments should not be reclassified into or out of the category of fair value through profit or loss. In particular, some comments received on the Exposure Draft of proposed amendments to IAS 39

published in June 2002 suggested that entities could use the fair value option to recognise selectively changes in fair value in profit or loss. The Board noted that the requirement to designate irrevocably on initial recognition the financial instruments for which the fair value option is to be applied results in an entity being unable to ‘cherry pick’ in this way. This is because it will not be known at initial recognition whether the fair value of the instrument will increase or decrease.

BC73A. Following the issue of IAS 39 (as revised in 2003), as a result of continuing discussions with 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 (as discussed in paragraph BC11C). In response to those concerns, the Board published in April 2004 an Exposure Draft of proposed restrictions to the fair value option contained in IAS 39 (as revised in 2003). After discussing comments received from constituents and a series of public round-table meetings, the Board issued an amendment to IAS 39 in June 2005 permitting entities to designate irrevocably on initial recognition financial instruments that meet one of three conditions (see paragraphs 9(b)(i), 9(b)(ii) and 11A) as ones to be measured at fair value through profit or loss.

Paragraph BC74 is replaced and paragraph BC74A is added, as follows.
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BC74. In the amendment to the fair value option, the Board identified three situations in which permitting designation at fair value through profit or loss either results in more relevant information (cases (a) and (b) below) or is justified on the grounds of reducing complexity or increasing measurement reliability (case (c) below). These are:

- (a) when such designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an ‘accounting mismatch’) that would otherwise arise (paragraphs BC75-BC75B);
- (b) when a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy (paragraphs BC76-BC76B); and
- (c) when an instrument contains an embedded derivative that meets particular conditions (paragraphs BC77-BC78).

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BC74A. The ability for entities to use the fair value option simplifies the application of IAS 39 by mitigating some anomalies that result from the different measurement attributes in the Standard. In particular, for financial instruments designated in this way:

- (a) it eliminates the need for hedge accounting for hedges of fair value exposures when there are natural offsets, and thereby eliminates the related burden of designating, tracking and analysing hedge effectiveness.
- (b) it eliminates the burden of separating embedded derivatives.
- (c) it eliminates problems arising from a mixed measurement model when financial assets are measured at fair value and related financial liabilities are measured at amortised cost. In particular, it eliminates volatility in profit or loss and equity that results when matched positions of financial assets and financial liabilities are not measured consistently.
- (d) the option to recognise unrealised gains and losses on available-for-sale financial assets in profit or loss is no longer necessary.
- (e) it de-emphasises interpretative issues around what constitutes trading.

After paragraph BC74A a new heading is added, paragraphs BC75-BC78 are replaced and paragraphs BC75A, BC75B, BC76A, BC76B, BC77A and BC77B are added, as follows.

Designation as at fair value through profit or loss eliminates or significantly reduces a measurement or recognition inconsistency (paragraph 9(b)(i))

BC75. IAS 39, like comparable standards in some national jurisdictions, imposes a mixed-attribute measurement model. It requires some financial assets and liabilities to be measured at fair value, and others to be measured at amortised cost. It requires some gains and losses to be recognised in profit or loss, and others to be recognised initially as a component of equity. This combination of measurement and recognition requirements can result in inconsistencies, which some refer to as ‘accounting mismatches’, between the accounting for an asset (or group of assets) and a liability (or group of liabilities). The notion of an accounting mismatch necessarily involves two propositions. First, an entity has particular assets and liabilities that

are measured, or on which gains and losses are recognised, inconsistently; second, there is a perceived economic relationship between those assets and liabilities. For example, a liability may be considered to be related to an asset when they share a risk that gives rise to opposite changes in fair value that tend to offset, or when the entity considers that the liability funds the asset.

BC75A. Some entities can overcome measurement or recognition inconsistencies by using hedge accounting or, in the case of insurers, shadow accounting. However, the Board recognises that those techniques are complex and do not address all situations. In developing the amendment to the fair value option, the Board considered whether it should impose conditions to limit the situations in which an entity could use the option to eliminate an accounting mismatch. For example, it considered whether entities should be required to demonstrate that particular assets and liabilities are managed together, or that a management strategy is effective in reducing risk (as is required for hedge accounting to be used), or that hedge accounting or other ways of overcoming the inconsistency are not available.

BC75B. The Board concluded that accounting mismatches arise in a wide variety of circumstances. In the Board's view, financial reporting is best served by providing entities with the opportunity to eliminate perceived accounting mismatches whenever that results in more relevant information. Furthermore, the Board concluded that the fair value option may validly be used in place of hedge accounting for hedges of fair value exposures, thereby eliminating the related burden of designating, tracking and analysing hedge effectiveness. Hence, the Board decided not to develop detailed prescriptive guidance about when the fair value option could be applied (such as requiring effectiveness tests similar to those required for hedge accounting) in the amendment on the fair value option. Rather, the Board decided to require disclosures in IAS 32 about:

- the criteria an entity uses for designating financial assets and financial liabilities as at fair value through profit or loss
- how the entity satisfies the conditions in this Standard for such designation
- the nature of the assets and liabilities so designated

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- the effect on the financial statement of using this designation, namely the carrying amounts and net gains and losses on assets and liabilities so designated, information about the effect of changes in a financial liability's credit quality on changes in its fair value, and information about the credit risk of loans or receivables and any related credit derivatives or similar instruments.

A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy (paragraph 9(b)(ii))

BC76. The Standard requires financial instruments to be measured at fair value through profit or loss in only two situations, namely when an instrument is held for trading or when it contains an embedded derivative that the entity is unable to measure separately. However, the Board recognised that some entities manage and evaluate the performance of financial instruments on a fair value basis in other situations. Furthermore, for instruments managed and evaluated in this way, users of financial statements may regard fair value measurement as providing more relevant information. Finally, it is established practice in some industries in some jurisdictions to recognise all financial assets at fair value through profit or loss. (This practice was permitted for many assets in IAS 39 (as revised in 2000) as an accounting policy choice in accordance with which gains and losses on all available-for-sale financial assets were reported in profit or loss.)

BC76A. In the amendment to IAS 39 relating to the fair value option issued in June 2005, the Board decided to permit financial instruments managed and evaluated on a fair value basis to be measured at fair value through profit or loss. The Board also decided to introduce two requirements to make this category operational. These requirements are that the financial instruments are managed and evaluated on a fair value basis in accordance with a documented risk management or investment strategy, and that information about the financial instruments is provided internally on that basis to the entity's key management personnel.

BC76B. In looking to an entity's documented risk management or investment strategy, the Board makes no judgement on what an entity's strategy should be. However, the Board noted that users, in making economic decisions, would find useful both a description of the chosen strategy and how designation at fair value through profit or loss is consistent with it. Accordingly, IAS 32 requires such disclosures. The Board also noted that the required documentation of the entity's strategy need not be on an item-by-item basis, nor need it be in the level of detail required for hedge accounting. However, it should be sufficient to demonstrate that using the fair value option is consistent with the entity's risk management or investment strategy. In many cases, the entity's existing documentation, as approved by its key management personnel, should be sufficient for this purpose.

The instrument contains an embedded derivative that meets particular conditions (paragraph 11A)

BC77. The Standard requires virtually all derivative financial instruments to be measured at fair value. This requirement extends to derivatives that are *embedded* in an instrument that also includes a non-derivative host contract if the embedded derivative meets the conditions in paragraph 11. Conversely, if the embedded derivative does not meet those conditions, separate accounting with measurement of the embedded derivative at fair value is prohibited. Therefore, to satisfy these requirements, the entity must:

- (a) identify whether the instrument contains one or more embedded derivatives,
- (b) determine whether each embedded derivative is one that must be separated from the host instrument or one for which separation is prohibited, and
- (c) if the embedded derivative is one that must be separated, determine its fair value at initial recognition and subsequently.

BC77A. For some embedded derivatives, like the prepayment option in an ordinary residential mortgage, this process is fairly simple. However, entities with more complex instruments have reported that the search for and analysis of embedded derivatives (steps (a) and (b) in paragraph BC77) significantly increase the cost of complying with the Standard. They report that this cost could be eliminated if they had the option to fair value the combined contract.

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- BC77B. Other entities report that one of the most common uses of the fair value option is likely to be for structured products that contain several embedded derivatives. Those structured products will typically be hedged with derivatives that offset all (or nearly all) of the risks they contain, whether or not the embedded derivatives that give rise to those risks are separated for accounting purposes. Hence, the simplest way to account for such products is to apply the fair value option so that the combined contract (as well as the derivatives that hedge it) is measured at fair value through profit or loss. Furthermore, for these more complex instruments, the fair value of the combined contract may be significantly easier to measure and hence be more reliable than the fair value of only those embedded derivatives that IAS 39 requires to be separated.
- BC78. The Board sought to strike a balance between reducing the costs of complying with the embedded derivatives provisions of this Standard and the need to respond to the concerns expressed regarding possible inappropriate use of the fair value option. The Board determined that allowing the fair value option to be used for *any* instrument with an embedded derivative would make other restrictions on the use of the option ineffective, because many financial instruments include an embedded derivative. In contrast, limiting the use of the fair value option to situations in which the embedded derivative must otherwise be separated would not significantly reduce the costs of compliance and could result in less reliable measures being included in the financial statements. Therefore, the Board decided to specify situations in which an entity cannot justify using the fair value option in place of assessing embedded derivatives—when the embedded derivative does not significantly modify the cash flows that would otherwise be required by the contract or is one for which it is clear with little or no analysis when a similar hybrid instrument is first considered that separation is prohibited.

After paragraph BC78 a new heading is added, paragraph BC79 is renumbered as BC80A and amended (new text is underlined and deleted text is struck through), paragraphs BC78A, BC79 and BC79A are added and paragraph BC80 is replaced, as follows.

The role of prudential supervisors

BC78A. The Board considered the circumstances of regulated financial institutions such as banks and insurers in determining the extent to which conditions should be placed on the use of the fair value option. The Board recognised that regulated financial institutions are extensive holders and issuers of financial instruments and so are likely to be among the largest potential users of the fair value option. However, the Board noted that some of the prudential supervisors that oversee these entities expressed concern that the fair value option might be used inappropriately.

BC79. The Board noted that the primary objective of prudential supervisors is to maintain the financial soundness of individual financial institutions and the stability of the financial system as a whole. Prudential supervisors achieve this objective partly by assessing the risk profile of each regulated institution and imposing a risk-based capital requirement.

BC79A. The Board noted that these objectives of prudential supervision differ from the objectives of general purpose financial reporting. The latter is intended to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. However, the Board acknowledged that for the purposes of determining what level of capital an institution should maintain, prudential supervisors may wish to understand the circumstances in which a regulated financial institution has chosen to apply the fair value option and evaluate the rigour of the institution's fair value measurement practices and the robustness of its underlying risk management strategies, policies and practices. Furthermore, the Board agreed that certain disclosures would assist both prudential supervisors in their evaluation of capital requirements and investors in making economic decisions. In particular, the Board decided to require an entity to disclose how it has satisfied the conditions in

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paragraphs 9(b), 11A and 12 for using the fair value option, including, for instruments within paragraph 9(b)(ii), a narrative description of how designation at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.

Other matters

- BC80. IAS 39 (as revised in 2000) contained an accounting policy choice for the recognition of gains and losses on available-for-sale financial assets—such gains and losses could be recognised either in equity or in profit or loss. The Board concluded that the fair value option removed the need for such an accounting policy choice. An entity can achieve recognition of gains and losses on such assets in profit or loss in appropriate cases by using the fair value option. Accordingly, the Board decided that the choice that was in IAS 39 (as revised in 2000) should be removed and that gains and losses on available-for-sale financial assets should be recognised in equity when IAS 39 was revised in 2003.
- BC80A. The fair value ~~measurement~~ option ~~enables~~ permits (but does not require) entities to measure financial instruments at fair value with changes in fair value recognised in profit or loss. Accordingly, it does not restrict an entity's ability to use other accounting methods (such as amortised cost). Some respondents to the Exposure Draft of proposed amendments to IAS 39 published in June 2002 would have preferred more pervasive changes to expand the use of fair values and limit the choices available to entities, such as the elimination of the held-to-maturity category or the cash flow hedge accounting approach. Although such changes have the potential to make the principles in IAS 39 more coherent and less complex, the Board did not consider such changes as part of this project to improve IAS 39.

Paragraphs BC81 and BC84 are amended (new text is underlined), as follows.

- BC81. Comments received on the Exposure Draft of proposed amendments to IAS 39 published in June 2002 also questioned the proposal that all items measured at fair value through profit or loss should have the descriptor 'held for trading'. Some comments noted that 'held for trading' is commonly used with a narrower meaning, and it may be confusing for users if instruments designated at fair value through profit or loss are also called 'held for trading'. Therefore, the Board

considered using a fifth category of financial instruments—‘fair value through profit or loss’—to distinguish those instruments to which the fair value option was applied from those classified as held for trading. The Board rejected this possibility because it believed that adding a fifth category of financial instruments would unnecessarily complicate the Standard. Rather, the Board concluded that ‘fair value through profit or loss’ should be used to describe a category that encompasses financial instruments classified as held for trading and those to which the fair value option is applied.

- BC84. The Board also decided to include in IAS 39 (as revised in 2003) the ability for entities to designate a loan or receivable as available for sale (see paragraph 9). The Board decided that, in the context of the existing mixed measurement model, there are no reasons to limit to any particular type of asset the ability to designate an asset as available for sale.

After paragraph BC84 the heading and paragraphs BC85 and BC86 are amended (new text is underlined and deleted text is struck through) and paragraph BC86A is added, as follows.

Application of the Fair Value Option to a Component or a Proportion (Rather than the Entirety) of a Financial Asset or a Financial Liability

- BC85. Some comments received on the Exposure Draft of proposed amendments to IAS 39 published in June 2002 argued that the fair value ~~measurement~~ option should be extended so that it could also be applied to a ~~portion~~ component of a financial asset or a financial liability (eg changes in fair value attributable to one risk such as changes in a benchmark interest rate). The arguments included (a) concerns regarding inclusion of own credit risk in the measurement of financial liabilities and (b) the prohibition on using non-derivatives as hedging instruments (cash instrument hedging).
- BC86. The Board concluded that IAS 39 should not extend the fair value option to ~~portions~~ components of financial assets or financial liabilities. It was concerned (a) about difficulties in measuring the change in value of the ~~portion~~ component because of ordering issues and joint effects (ie if the ~~portion~~ component is affected by more than one risk, it may be difficult to isolate accurately and measure the ~~portion~~ component); (b) that the amounts recognised in the balance sheet would be neither fair value nor cost; and (c) that a fair value

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adjustment for a ~~portion~~ component may move the carrying amount of an instrument away from its fair value. ~~The Board agreed to address separately the issue of cash instrument hedging.~~ In finalising the 2003 amendments to IAS 39, the Board separately considered the issue of cash instrument hedging (see paragraphs BC144 and BC145).

BC86A. Other comments received on the April 2004 Exposure Draft of proposed restrictions to the fair value option contained in IAS 39 (as revised in 2003) suggested that the fair value option should be extended so that it could be applied to a proportion (ie a percentage) of a financial asset or financial liability. The Board was concerned that such an extension would require prescriptive guidance on how to determine a proportion. For example if an entity were to issue a bond totalling CU100 million in the form of 100 certificates each of CU1 million, would a proportion of 10 per cent be identified as 10 per cent of each certificate, 10 million specified certificates, the first (or last) 10 million certificates to be redeemed, or on some other basis? The Board was also concerned that the remaining proportion, not being subject to the fair value option, could give rise to incentives for an entity to 'cherry pick' (ie to realise financial assets or financial liabilities selectively so as to achieve a desired accounting result). For these reasons, the Board decided not to allow the fair value option to be applied to a proportion of a single financial asset or financial liability. However, if an entity simultaneously issues two or more identical financial instruments, it is not precluded from designating only some of those instruments as being subject to the fair value option (for example, if doing so achieves a significant reduction in a recognition or measurement inconsistency, as explained in paragraph AG4G). Thus, in the above example, the entity could designate 10 million specified certificates if to do so would meet one of the three criteria in paragraph BC74.

After paragraph BC86A the heading and paragraphs BC87-BC90 are amended (new text is underlined and deleted text is struck through), as follows.

~~Own~~ Credit Risk of Liabilities

BC87. The Board discussed the issue of including changes in ~~own~~ the credit risk of a financial liability in ~~the~~ its fair value measurement ~~of financial liabilities~~. It considered responses to the Exposure Draft of proposed amendments to IAS 39 published in June 2002 that

expressed concern about the effect of including this component in the fair value measurement and that suggested the fair value option should be restricted to exclude all or some financial liabilities. However, the Board concluded that the fair value option could be applied to any financial liability, and decided not to restrict the option in the Standard (as revised in 2003) because to do~~ing~~ so would negate some of the benefits of the fair value option set out in paragraph BC74A.

BC88. The Board considered comments on the same Exposure Draft that disagreed with the view that, in applying the fair value option to financial liabilities, an entity should recognise income as a result of deteriorating credit quality (and a loan expense as a result of improving credit quality). Commentators noted that it is not useful to report lower liabilities when an entity is in financial difficulty precisely because its debt levels are too high, and that it would be difficult to explain to users of financial statements the reasons why income would be recognised when ~~an entity's~~ a liability's creditworthiness deteriorates. These comments suggested that fair value should exclude the effects of changes in ~~own~~ the instrument's credit risk.

BC89. However, the Board noted that because financial statements are prepared on a going concern basis, credit risk affects the value at which liabilities could be repurchased or settled. Accordingly, the fair value of a financial liability reflects the credit risk relating to that liability. Therefore, it decided to include credit risk relating to a financial liability in the fair value measurement of that liability for the following reasons:

- (a) entities realise changes in fair value, including fair value attributable to ~~own~~ the liability's credit risk, for example, by renegotiating or repurchasing liabilities or by using derivatives;
- (b) changes in credit risk affect the observed market price of a financial liability and hence its fair value;
- (c) it is difficult from a practical standpoint to exclude changes in credit risk from an observed market price; and

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- (d) the fair value of a financial liability (ie the price of that liability in an exchange between a knowledgeable, willing buyer and a knowledgeable, willing seller) on initial recognition reflects ~~the~~ its credit risk ~~relating to that liability~~. The Board believes that it is inappropriate to include credit risk in the initial fair value measurement of financial liabilities, but not subsequently.

BC90. The Board also considered whether the ~~portion~~ component of the fair value of a financial liability attributable to changes in credit quality should be specifically disclosed, separately presented in the income statement, or separately presented in equity. The Board decided that whilst separately presenting or disclosing such changes might ~~would~~ ~~often be difficult in practice, not be practicable because it might not be possible to separate and measure reliably that part of the change in fair value.~~ However, it noted that disclosure of such information would be useful to users of financial statements and would help alleviate the concerns expressed. Therefore, it decided to include in IAS 32 ~~to require~~ a disclosure to help identify ~~of~~ the changes in the fair value of a financial liability ~~that is not attributable to changes in a benchmark rate that arise from changes in the liability's credit risk.~~ The Board believes this is a reasonable proxy for the change in fair value that is attributable to changes in the liability's credit risk, in particular when such changes are large, and will provide users with information with which to understand the profit or loss effect of such a change in credit risk.

Appendix: Amendments to other Standards

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2006. If an entity applies the amendments to IAS 39 for an earlier period, the amendments in this appendix shall be applied for that earlier period.

Amendments to IAS 32 Financial Instruments: Disclosure and Presentation

Paragraph 66 is amended (new text is underlined and deleted text is struck through), as follows.

66. In accordance with IAS 1, an entity provides disclosure of all significant accounting policies, including the general principles adopted and the method of applying those principles to transactions, other events and conditions arising in the entity's business. In the case of financial instruments, such disclosure includes:
- (a) the criteria applied in determining when to recognise a financial asset or financial liability and when to derecognise it;
 - (b) the basis of measurement applied to financial assets and financial liabilities on initial recognition and subsequently; ~~and~~
 - (c) the basis on which income and expenses arising from financial assets and financial liabilities are recognised and measured; ~~and~~
and
 - (d) for financial assets or financial liabilities designated as at fair value through profit or loss:
 - (i) the criteria for so designating such financial assets or financial liabilities on initial recognition.
 - (ii) how the entity has satisfied the conditions in paragraph 9, 11A or 12 of IAS 39 for such designation. For instruments designated in accordance with paragraph 9(b)(i) of IAS 39, that disclosure includes a narrative description of the circumstances underlying the measurement or recognition inconsistency that would otherwise arise. For instruments designated in accordance with paragraph 9(b)(ii) of IAS 39, that

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disclosure includes a narrative description of how designation as at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy

- (iii) the nature of the financial assets or financial liabilities the entity has designated as at fair value through profit or loss.

Paragraph 94 is amended (new text is underlined and deleted text is struck through), as follows, and subparagraphs (g)-(j) are renumbered as (j)-(m).

94. ...

Financial assets and financial liabilities at fair value through profit or loss (see also paragraph AG40)

...

- (e) *An entity shall disclose the carrying amounts of ~~financial assets and financial liabilities that:~~*
- (i) financial assets that are classified as held for trading;
~~and~~
 - (ii) financial liabilities that are classified as held for trading;
 - (iii) financial assets that were, upon initial recognition, were designated by the entity as financial assets ~~and financial liabilities~~ at fair value through profit or loss (ie those that are not financial ~~instruments~~ assets classified as held for trading).
 - (iv) financial liabilities that, upon initial recognition, were designated by the entity as financial liabilities at fair value through profit or loss (ie those that are not financial liabilities classified as held for trading).
- (f) An entity shall disclose separately net gains or net losses on financial assets or financial liabilities designated by the entity as at fair value through profit or loss.

- (g) If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it shall disclose:**
- (i) the maximum exposure to credit risk (see paragraph 76(a)) at the reporting date of the loan or receivable (or group of loans or receivables),**
 - (ii) the amount by which any related credit derivative or similar instrument mitigates that maximum exposure to credit risk,**
 - (iii) the amount of change during the period and cumulatively in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in credit risk determined either as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or using an alternative method that more faithfully represents the amount of change in its fair value that is attributable to changes in credit risk.**
 - (iv) the amount of the change in the fair value of any related credit derivative or similar instrument that has occurred during the period and cumulatively since the loan or receivable was designated.**
- (fh) If the entity has designated a financial liability as at fair value through profit or loss, it shall disclose:**
- (i) the amount of change during the period and cumulatively in ~~its~~ the fair value of the financial liability that is ~~not~~ attributable to changes in ~~a benchmark interest rate (eg LIBOR)~~ credit risk, ~~and~~ determined either as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (see paragraph AG40); or using an alternative method that more faithfully represents the amount of change in its fair value that is attributable to changes in credit risk.**
 - (ii) the difference between ~~its~~ the carrying amount of the financial liability and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.**

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- (i) The entity shall disclose:
- (i) the methods used to comply with the requirement in (g)(iii) and (h)(i).
 - (ii) if the entity considers that the disclosure it has given to comply with the requirements in (g)(iii) or (h)(i) does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in credit risk, the reasons for reaching this conclusion and the factors the entity believes to be relevant.

...

Paragraph AG40 is amended (new text is underlined and deleted text is struck through), as follows.

AG40. If an entity designates a financial liability or a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it is required to disclose the amount of change in the fair value of the ~~liability~~ financial instrument that is not attributable to changes in a benchmark interest rate credit risk (eg LIBOR). Unless an alternative method more faithfully represents this amount, the entity is required to determine this amount as the amount of change in the fair value of the financial instrument that is not attributable to changes in market conditions that give rise to market risk. Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, commodity price, foreign exchange rate or index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of an internal or external investment fund. If the only relevant changes in market conditions for a financial liability are changes in an observed (benchmark) interest rate ~~For a liability whose fair value is determined on the basis of an observed market price~~, this amount can be estimated as follows:

- (a) First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.

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- (b) Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the start of the period and a discount rate equal to the sum of the observed (benchmark) interest rate at the end of the period and the instrument-specific component of the internal rate of return at the start of the period as determined in (a).
- (c) The amount determined in (b) is then ~~adjusted decreased~~ for any cash paid or received on the liability during the period and increased to reflect the increase in fair value that arises because the contractual cash flows are one period closer to their due date.
- (d) The difference between the observed market price of the liability at the end of the period and the amount determined in (c) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be disclosed.

The above example assumes that changes in fair value that do not arise from changes in the instrument's credit risk or from changes in interest rates are not significant. If, in the above example, the instrument contained an embedded derivative, the change in fair value of the embedded derivative would be excluded in determining the amount in paragraph 94(h)(i).

Amendments to IFRS 1 First-time Adoption of International Financial Reporting Standards

Paragraphs 25A and 43A are amended (new text is underlined and deleted text is struck through), as follows.

Designation of previously recognised financial instruments

25A. IAS 39 *Financial Instruments: Recognition and Measurement* (~~as revised in 2003~~) permits a financial ~~instrument~~ asset to be designated on initial recognition as available for sale or a financial instrument (provided it meets certain criteria) to be designated as a financial asset or financial liability at fair value through profit or loss ~~or as available for sale~~. Despite this requirement exceptions apply in the following circumstances,

- (a) any entity is permitted to make ~~such an~~ available-for-sale designation at the date of transition to IFRSs.
- (b) an entity that presents its first IFRS financial statements for an annual period beginning on or after 1 September 2006—such an entity is permitted to designate, at the date of transition to IFRSs, any financial asset or financial liability as at fair value through profit or loss provided the asset or liability meets the criteria in paragraph 9(b)(i), 9(b)(ii) or 11A of IAS 39 at that date.
- (c) an entity that presents its first IFRS financial statements for an annual period beginning on or after 1 January 2006 and before 1 September 2006—such an entity is permitted to designate, at the date of transition to IFRSs, any financial asset or financial liability as at fair value through profit or loss provided the asset or liability meets the criteria in paragraph 9(b)(i), 9(b)(ii) or 11A of IAS 39 at that date. When the date of transition to IFRSs is before 1 September 2005, such designations need not be completed until 1 September 2005 and may also include financial assets and financial liabilities recognised between the date of transition to IFRSs and 1 September 2005.

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- (d) an entity that presents its first IFRS financial statements for an annual period beginning before 1 January 2006 and applies paragraphs 11A, 48A, AG4B-AG4K, AG33A and AG33B and the 2005 amendments in paragraphs 9, 12 and 13 of IAS 39— such an entity is permitted at the start of its first IFRS reporting period to designate as at fair value through profit or loss any financial asset or financial liability that qualifies for such designation in accordance with these new and amended paragraphs at that date. When the entity's first IFRS reporting period begins before 1 September 2005, such designations need not be completed until 1 September 2005 and may also include financial assets and financial liabilities recognised between the beginning of that period and 1 September 2005. If the entity restates comparative information for IAS 39 it shall restate that information for the financial assets, financial liabilities, or group of financial assets, financial liabilities or both, designated at the start of its first IFRS reporting period. Such restatement of comparative information shall be made only if the designated items or groups would have met the criteria for such designation in paragraph 9(b)(i), 9(b)(ii) or 11A of IAS 39 at the date of transition to IFRSs or, if acquired after the date of transition to IFRSs, would have met the criteria in paragraph 9(b)(i), 9(b)(ii) or 11A at the date of initial recognition.
- (e) for an entity that presents its first IFRS financial statements for an annual period beginning before 1 September 2006— notwithstanding paragraph 91 of IAS 39, any financial assets and financial liabilities such an entity designated as at fair value through profit or loss in accordance with subparagraph (c) or (d) above that were previously designated as the hedged item in fair value hedge accounting relationships shall be de-designated from those relationships at the same time they are designated as at fair value through profit or loss.

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Designation of financial assets or financial liabilities

- 43A. An entity is permitted to designate a previously recognised financial asset or financial liability as a financial asset or financial liability at fair value through profit or loss or a financial asset as available for sale in accordance with paragraph 25A. The entity shall disclose the fair value of ~~any~~ financial assets or financial liabilities designated into each category at the date of designation and their classification and carrying amount in the previous financial statements.

Basis for Conclusions

In the Basis for Conclusions, paragraph BC63A is amended (new text is underlined and deleted text is struck through), as follows.

Designation of previously recognised financial instruments

BC63A IAS 39 ~~(as revised in 2003)~~ permits an entity to designate, on initial recognition only, a financial instrument as (a) available for sale (for a financial asset) or (b) a financial asset or financial liability at fair value through profit or loss (provided the asset or liability qualifies for such designation in accordance with paragraph 9(b)(i), 9(b)(ii) or 11A of IAS 39) or (b) available for sale. Despite this requirement, an entity that had already applied IFRSs before the effective date of IAS 39 (as revised in ~~March 2004~~2003) may (a) designate a previously recognised financial asset as available for sale on initial application of IAS 39 (as revised in March 2004~~2003~~), or (b) designate a previously recognised financial instrument as at fair value through profit or loss in the circumstances specified in paragraph 105B of IAS 39. ~~so designate a previously recognised financial instrument.~~ The Board decided ~~to treat~~ that the same considerations apply to first-time adopters in the same way as to entities that already apply IFRSs. Accordingly, a first-time adopter of IFRSs may similarly designate a previously recognised financial instrument in accordance with paragraph 25A, at the date of transition to IFRSs. ~~Such an entity is required to disclose the amount of previously recognised financial instruments that it so designates.~~ Such an entity shall disclose the fair value of the financial assets or financial liabilities designated into each category at the date of designation and their classification and carrying amount in the previous financial statements.

In paragraph IG56 of the Implementation Guidance, subparagraph (d)(iii) is amended (new text is underlined and deleted text is struck through) and (d)(iv) is added, as follows.

Measurement

IG56 ...

- (d) to comply with IAS 39, paragraph 50, an entity classifies a non-derivative financial asset or non-derivative financial liability in its opening IFRS balance sheet as at fair value through profit or loss ~~if, and only if,~~ the asset or liability was:
 - (i) ...
 - (iii) designated as at fair value through profit or loss at the date of transition to IFRSs, for an entity that presents its first IFRS financial statements for an annual period beginning on or after 1 January 2006.
 - (iv) designated as at fair value through profit or loss at the start of its first IFRS reporting period, for an entity that presents its first IFRS financial statements for an annual period beginning before 1 January 2006 and applies paragraphs 11A, 48A, AG4B-AG4K, AG33A and AG33B and the 2005 amendments in paragraphs 9, 12 and 13 of IAS 39. If the entity restates comparative information for IAS 39 it shall restate the comparative information only if the financial assets or financial liabilities designated at the start of its first IFRS reporting period would have met the criteria for such designation in paragraph 9(b)(i), 9(b)(ii) or 11A of IAS 39 at the date of transition to IFRSs or, if acquired after the date of transition to IFRSs, would have met the criteria in paragraph 9(b)(i), 9(b)(ii) or 11A at the date of initial recognition. For groups of financial assets, financial liabilities or both that are designated in accordance with paragraph 9(b)(ii) of IAS 39 at the start of the first IFRS reporting period, the comparative financial statements should be restated for all the financial assets and financial liabilities within the groups

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at the date of transition to IFRSs even if individual financial assets or liabilities within a group were derecognised during the comparative period.

Approval of Amendments to IAS 39 by the Board

These Amendments to International Accounting Standard 39 Financial Instruments: Recognition and Measurement—*The Fair Value Option* were approved for issue by eleven of the fourteen members of the International Accounting Standards Board. Professor Barth, Mr Garnett and Professor Whittington dissented. Their dissenting opinions are set out on the following page.

Sir David Tweedie

Chairman

Thomas E Jones

Vice-Chairman

Mary E Barth

Hans-Georg Bruns

Anthony T Cope

Jan Engström

Robert P Garnett

Gilbert Gélard

James L Leisenring

Warren J McGregor

Patricia L O'Malley

John T Smith

Geoffrey Whittington

Tatsumi Yamada

Dissenting Opinions

Dissent of Mary E Barth, Robert P Garnett and Geoffrey Whittington

- DO1. Professor Barth, Mr Garnett and Professor Whittington dissent from the amendment to IAS 39 Financial Instruments: Recognition and Measurement—*The Fair Value Option*. Their dissenting opinions are set out below.
- DO2. These Board members note that the Board considered the concerns expressed by the prudential supervisors on the fair value option as set out in the December 2003 version of IAS 39 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 and providing relevant information to users of financial statements, 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. Furthermore, the majority of constituents have clearly expressed a preference for the fair value option as set out in the December 2003 version of IAS 39 over the fair value option as contained in the amendment.
- DO3. Those Board members note that the amendment introduces a series of complex rules, including those governing transition which would be entirely unnecessary in the absence of the amendment. There will be consequential costs to preparers of financial statements, in order to obtain, in many circumstances, 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. They believe that the complex rules will also inevitably lead to differing interpretations of the eligibility criteria for the fair value option contained in the amendment.
- DO4. These Board members also note that, for paragraph 9(b)(i), application of the amendment may not mitigate, on an ongoing basis, the anomaly of volatility in profit or loss that results from the different measurement attributes in IAS 39 any more than would the option in the December 2003 version of IAS 39. This is because the fair value designation is required to be continued even if one of the offsetting instruments is derecognised. Furthermore, for paragraphs 9(b)(i),

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9(b)(ii) and 11A, the fair value designation continues to apply in subsequent periods, irrespective of whether the initial conditions that permitted the use of the option still hold. Therefore, these Board members question the purpose of and need for requiring the criteria to be met at initial designation.