

# IFRS News

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## Fair value option – frequently asked questions

**The amended fair value option in IAS 39, Financial Instruments: Recognition and Measurement, like the previous 2003 version, does not contain detailed prescriptive guidance about when the fair value option can be applied. It uses a principles-based approach, supported by examples. This supplement addresses some commonly-asked questions that have arisen from the practical application of these principles. By Sandra Thompson and Jeanine Pickering.**

The IASB published in June 2005 an amendment to the fair value option introduced by the 2003 revisions to IAS 39, Financial Instruments: Recognition and Measurement. The amendment addresses the concerns of some regulators that the original 'unrestricted' version of the fair value option might be applied inappropriately.

The amendment permits the irrevocable designation on initial recognition of a financial asset or financial liability as at fair value through profit or loss (FVTPL) only when the entity demonstrates that it falls within one (or more) of the following three criteria:

- 1) designation at FVTPL 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 (IAS 39.9(b)(i));
- 2) 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 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 (IAS 39.9(b)(ii)); or
- 3) the item proposed to be designated at FVTPL is a hybrid (combined) contract that contains one or more embedded derivatives unless:

- the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or
- 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 (IAS 39.11A).

This supplement addresses commonly asked questions about each of the above three criteria in turn.

### Criterion 1: accounting mismatch (IAS 39.9(b)(i))

#### Question 1

What is the meaning of 'significant' in the context of 'eliminates or significantly reduces a measurement or recognition inconsistency'?

#### Solution

The IASB has not established a percentage, or a 'bright line', for the interpretation of 'significant'. Management should look at the objective of the proposed designation as at FVTPL. Comparing the accounting impact – ie, the measurement basis and the recognition of gains and losses – of all relevant items (including, for example, any funding that it is not proposed to be designated at fair value through profit or loss) before and after the designation will give an indication of whether an accounting mismatch has been eliminated or significantly reduced. It is clear from IAS 39.BC 75B that an effectiveness test similar to that used for hedge accounting is not required to demonstrate that a

reduction in an accounting mismatch is significant. Further guidance is given in questions 2 and 3 below.

### Question 2

An entity is about to originate 100 of fixed rate assets that, if not designated as at FVTPL, will be classified as available-for-sale, and 50 of fixed rate liabilities that, if not designated as at FVTPL, will be measured at amortised cost. The assets and liabilities share the same interest rate risk, as they are at fixed rates. Can the entity designate the entire 100 of assets and 50 of liabilities at FVTPL to significantly reduce the accounting mismatch between them?

#### Solution

No. Designating the entire 100 of assets at FVTPL eliminates a mismatch with the 50 of liabilities, but it opens up a new mismatch for the other 50 of assets that do not have matching liabilities. However, we should ask why the entity wishes to use the fair value option in such a case. For example, is there a pre-existing derivative that offsets the other 50 of assets? Does the entity expect to issue a further 50 of liabilities with no more than a reasonable delay (and designate them at FVTPL) so as to eliminate the mismatch completely? Designation of the entire 100 of assets would be acceptable in such cases.

### Question 3

An entity is about to issue a 10-year liability that, if not designated as at FVTPL, will be measured at amortised cost, and a nine-year derivative that it regards as related to the liability and whose risks offset those of the asset. The entity wishes to designate the liability as at FVTPL to eliminate the measurement and recognition inconsistency with the derivative. Although the relationship does not completely eliminate the economic exposure, can the entity still designate the liability as at FVTPL?

#### Solution

Yes. The difference in maturities does not prevent the entity from designating the liability as at FVTPL, provided there is a perceived economic relationship between the derivative and the liability. The fair value option does not require the elimination of economic volatility; it requires the elimination or significant reduction of an accounting mismatch. The notion of an accounting mismatch between an asset and a liability involves two propositions, as described in IAS 39.BC 75. Firstly, the asset and liability are measured, or the gains and losses are recognised, inconsistently. In the above example, the liability is measured at amortised cost and the derivative is measured at fair value, hence the accounting mismatch. Secondly, there is a perceived economic relationship between the asset and liability – for example, they share a risk that gives rise to opposite changes in fair value that tend to offset.

### Question 4

An entity is about to issue a nine-year liability that, if not designated as at FVTPL, will be measured at amortised cost, and a 10-year derivative that it regards as related to the liability and

whose risks offset those of the asset. The entity designates the liability as at FVTPL to eliminate the measurement and recognition inconsistency that exists for the first nine years. At the start of year 10 (after the liability has been repaid), can the entity designate the derivative as a hedging instrument in a new hedge relationship?

#### Solution

Yes, provided the new hedge relationship meets all of the conditions for hedge accounting, including the expectation that it will be highly effective. IAS 39 permits the designation of pre-existing derivatives as hedging instruments.

### Question 5

A subsidiary is about to issue a liability to a third party and enter into a related interest rate swap with its parent. An accounting mismatch exists in the stand-alone accounts of the subsidiary, and it intends to designate the liability as at FVTPL. Can the group similarly designate the liability as at FVTPL in the consolidated accounts?

#### Solution

No. The swap cannot be used to designate the liability as at FVTPL in the consolidated accounts. The swap will be eliminated, and the 'mismatch' will not exist in the consolidated financial statements. However, if the entity can identify an external swap or other instrument that gives rise to an accounting mismatch on a consolidated basis, this may justify designating the liability as at FVTPL in the consolidated accounts.

### Question 6

It is necessary to demonstrate that there is an accounting mismatch in order to use the fair value option under IAS 39.9(b)(i). What is the extent of evidence that is required?

#### Solution

The evidence needs to identify the accounting mismatch for which the fair value option is to be used but, provided it meets this criterion, need not be extensive. It may be possible to use the same evidence for a number of similar transactions, depending on the circumstances – for example, by identifying a particular kind of accounting mismatch that arises from one of the entity's chosen risk management strategies. It is not necessary to have the extensive documentation required for hedge accounting, but the entity does need to provide evidence that the fair value option was designated at inception. Also, IAS 32/IFRS 7 require disclosure of the carrying amounts of assets and, separately, liabilities designated as at FVTPL. The evidence must therefore include precise identification of the assets and liabilities to which the fair value option has been applied.

### Question 7

An accounting mismatch exists on initial recognition and the entity applies the fair value option. If subsequently the accounting mismatch ceases to exist, can the entity de-

designate the fair value classification and change the measurement to amortised cost?

### Solution

No. The designation is irrevocable. Once designated, the entity cannot change from fair value measurement to amortised cost. Even if one part of the position that gave rise to the accounting mismatch is derecognised (for example, because it is sold), the remainder of the position must continue to be measured at FVTPL.

### Question 8

An entity originates a financial asset that is measured at fair value; it simultaneously issues a liability, which the entity considers related, that is measured at amortised cost. Six months later, the entity decides it wants to use the fair value option and designate the liability as at FVTPL to reduce the measurement inconsistency. Is the entity permitted to use the fair value option in this case?

### Solution

No. Designation as at FVTPL may be made only on initial recognition.

### Question 9

The fair value option does not require the entity to enter into all of the assets and liabilities at exactly the same time. A 'reasonable delay' is permitted as long as the remaining transactions are expected to occur (IAS 39.AG 4F). What is meant by 'reasonable delay'?

### Solution

Reasonable delay is assessed on a case-by-case basis, based on what is reasonable in the circumstances. For example, a 'reasonable delay' could be a fairly short period in the case of entering into a derivative to offset some of the risks of an asset. A longer period could be justified if the delay arises from the need to assemble a portfolio of similar assets and arrange their funding. However, all financial assets and liabilities designated as at FVTPL must be accounted for on this basis from their initial recognition (and not only from the time any offsetting position is entered into).

### Question 10

Some entities may consider using the fair value option in place of fair value hedge accounting to overcome measurement or recognition inconsistencies. If the entity were to use fair value hedge accounting (for example, for a hedge of the interest rate risk on a fixed rate loan), it would adjust the carrying amount of the hedged item (the loan) for only changes in its fair value that are attributable to the hedged risk (interest rate risk). If the entity chooses the fair value option, can it similarly adjust the

carrying amount of the designated item (the loan) only for changes in its fair value that are attributable to one risk (for example, interest rate risk)?

### Solution

No. When the fair value option is used, the designated financial asset or financial liability is measured at full fair value, and the entire change in its fair value is recognised in the income statement. The instrument cannot be split into different portions or components of risk only some of which are measured at fair value.

Using the fair value option may not therefore have the same effect as using fair value hedge accounting. The two accounting treatments will have the same effect only when:

- the hedge relationship covers the entire change in fair value and is not limited to selected risks;
- hedge accounting is applied from the initial recognition of the hedged item; and
- hedge accounting continues until the hedged item is derecognised.

### Question 11

Should all financial assets and financial liabilities in a portfolio giving rise to the measurement or recognition inconsistency be designated as at FVTPL, or can only some of the financial assets and liabilities in the portfolio be so designated? For example, an entity is about to originate 50 of assets and issue 100 of liabilities, all of approximately equal amount. Can it designate 25 of the assets and all 100 of the liabilities, assuming that a measurement inconsistency exists?

### Solution

The entity can choose some assets or liabilities, provided doing so reduces the measurement or recognition inconsistency, as explained in IAS 39.AG 4G:

'It would not be acceptable to designate only some of the financial assets and liabilities giving rise to the inconsistency as at FVTPL if to do so would not eliminate or significantly reduce the inconsistency...'

The fair value option would not be permitted, as the designation of 25 of the assets and all 100 of the liabilities creates an additional accounting mismatch. However, if the entity wanted to designate, say, 25 of the assets and 25 of the liabilities, this would be acceptable.

An entity may wish to designate some but not all of the financial assets and financial liabilities as at FVTPL for a number of reasons. For example, it might want to designate only those items that do not have significant credit risk. Or it might want to

take into account future funding plans for a portfolio of assets that will affect the extent of the accounting mismatch.

### Criterion 2: managed on a fair value basis (IAS 39.9(b)(ii))

The criterion in IAS 39.9(b)(ii) can be analysed in three parts:

- 1) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis;
- 2) in accordance with a documented risk management or investment strategy; and
- 3) information about the group is provided internally on that basis to the entity's key management personnel.

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### (1) A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis

#### Question 12

If entities are managing a portfolio using value at risk (VaR), is this sufficient to meet the requirement that it 'is managed and its performance is evaluated on a fair value basis'? Similarly, if a mutual fund or similar entity regularly publishes the fair value of the net assets in the fund, is this sufficient to meet the requirement?

#### Solution

No. VaR is a risk management technique. The portfolio's performance, however, is not evaluated on a fair value basis. Managing a portfolio using VaR is not therefore sufficient to meet the criterion in IAS 39.9(b)(ii). Similarly, merely publishing fair value information is not sufficient; the assets should be evaluated and managed on a fair value basis.

#### Question 13

Does management need to evaluate a portfolio on a full fair value basis or can it evaluate on a risk-by-risk basis? For example, an entity originates fixed interest rate loans and manages the interest rate risk of this portfolio based on the fair value attributable only to interest rate changes.

#### Solution

Management should evaluate the portfolio on a full fair value basis. The fair value concept is a broader notion than hedge accounting, such that evaluating the performance of the portfolio for only some risks is not sufficient. If an entity's risk management policy and the resulting management information looks at changes in fair value for only some risks rather than the

entire change in fair value, this will not be sufficient to justify use of the fair value option.

#### Question 14

IAS 39.AG4I gives examples of the application of IAS 39.9(b)(ii). AG4I(a) deals with venture capital organisations, as follows:

'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.'

IAS 39.AG4J states that:

'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' [emphasis added].

If a venture capital organisation chooses the IAS 28 exemption by designating its investment in associates as at FVTPL, should the venture capital organisation also designate at FVTPL its other investments (over which it has insufficient influence for them to qualify as associates) that are managed on a total return basis as part of the same portfolio?

#### Solution

Yes, if an entity chooses the fair value option, it must be applied to all the financial instruments that are managed and evaluated together. However, the entity need not apply the fair value option to other portfolios if it manages and evaluates investments in associates to which the IAS 28 exemption is applied as a separate portfolio.

### (2) In accordance with a documented risk management or investment strategy

#### Question 15

What extent of documentation is required to qualify as 'a documented risk management or investment strategy'? Is reference to a documented risk management strategy relating to other issues permitted?

#### Solution

The documentation does not need to be as extensive as is required for hedge accounting and may be on a portfolio basis rather than item by item. However, the documentation needs to

identify clearly the items for which the fair value option is to be used. If the documentation relies on several other pre-existing documents, there needs to be an overall document that references these other documents and clearly demonstrates that the entity manages and evaluates the relevant financial assets or financial liabilities on a fair value basis. The documentation also needs to be sufficient for the entity to meet the requirement in IAS 32.66(d)(ii) to disclose how the designation as at FVTPL is consistent with the entity's documented risk management strategy.

**(3) Information about the group is provided internally on that basis to the entity's key management personnel**

**Question 16**

What is meant by key management personnel? Does it imply that all of the entity's key management personnel should be provided with the information?

**Solution**

The term 'key management personnel' in IAS 39 has the same meaning as in the definition in IAS 24, Related Party Disclosures. That is:

'Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of the entity' (IAS 24.9).

It is acceptable for some and not all of key management to be provided with the required information about a group of financial assets/liabilities that is managed on a fair value basis.

**Question 17**

Can information provided to a subsidiary's key management personnel enable the fair value option to be used at the group level if the other requirements in IAS 39.9(b)(ii) are met?

**Solution**

It depends. Information provided to a subsidiary's key management personnel alone is not enough to enable the fair value option to be used at the group level. However, if those management personnel also include key management of the group – such as a main board director who is included in the IAS 24 disclosures given in consolidated financial statements – the fair value option could be used. The information could alternatively be reported separately (for example, in a summary report) to key management personnel of the group and therefore meet the IAS 39 criteria.

Even if these conditions are not met, information provided to a subsidiary's key management personnel can enable the fair value option to be used at the subsidiary level provided the other requirements in IAS 39.9(b)(ii) are met.

**Criterion 3: embedded derivatives (IAS 39.11A)**

**Question 18**

Is there an established percentage for the interpretation of 'significantly modify'?

**Solution**

No. There is no bright-line test. Management needs to look at the substance and objective of the transaction.

**Question 19**

For which of the following hybrid products that contain embedded derivatives is the use of the fair value option not permitted?

- Prepayment options in mortgages;
- Interest rate caps and floors in floating rate loans;
- Extension options;
- Embedded foreign currency derivatives; or
- An embedded derivative whose underlying might be a non-financial variable that is specific to a party to the contract.

**Solution**

This question should be answered on a case-by-case assessment. If management and auditors with a reasonable knowledge and understanding of the requirements of IAS 39 are not sure whether an embedded derivative is required to be separated from the host contract, it is not apparent with little or no analysis whether separation is required, and the fair value option is permitted.

The subject of this supplement is the accounting requirements of the fair value option set out in IAS 39. Banks and their auditors should also be aware of the regulatory guidance that is being developed by the regulators on the use of the fair value option by banks. For further information, refer to the draft guidance prepared by the Basel Committee: 'Supervisory guidance on the use of the fair value option by banks under International Financial Reporting Standards', issued in July 2005.

**For further help please contact:**

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