

20 June 2005

IAS 39: Fair value option

Status: Final**Effective date:** Annual periods beginning on/after 1 January 2006 (earlier adoption encouraged)**Accounting impact:** Restricts the availability of the option to carry any financial asset or liability at fair value through profit or loss

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Background

IAS 39: Financial Instruments: Recognition and Measurement (amended 2003) contained an option, on initial recognition, irrevocably to designate any financial asset or liability as being held at fair value with changes in value being recorded in profit or loss (the 'fair value option'). The purpose of this option was to simplify the application of the standard. However, concerns were raised that the fair value option might be used inappropriately. Because of those concerns, the EU-endorsed version of IAS 39, that will be applied by listed companies for accounting periods commencing on/after 1 January 2005, **excludes** the **option** to carry any financial **liability** at fair value through profit or loss.

The IASB has now amended IAS 39 to limit the use of the fair value option to financial instruments that meet certain specified conditions. It is anticipated that this will be endorsed for use in the EU.

Requirements

Financial assets and liabilities may be designated irrevocably on initial recognition to be measured at fair value through profit or loss when the following conditions apply:

- The designation eliminates or significantly reduces an accounting mismatch (for example, where a financial asset would otherwise be held at amortised cost and an associated liability would be held at fair value through profit or loss);
- A group of financial assets, financial liabilities or both are managed, and their performance is evaluated, on a fair value basis in accordance with a documented risk management or investment strategy; or
- A financial instrument contains an embedded derivative that meets certain conditions.

Effect

The fair value option may reduce the complexity of accounting in certain circumstances. For example:

- The complexity of hedge accounting for a fixed rate loan that is swapped into a variable rate might be avoided by carrying the loan at fair value through profit or loss. This will reduce, but not eliminate, mismatches as the fair value of the loan will be changed for all variables, including the credit rating of the hedging entity while the derivative (swap) will not; and
- In many cases, where an embedded derivative would otherwise need to be separated from a host contract and accounted for at fair value through profit or loss, an option will be available to classify the entire contract (host plus embedded) as at fair value through profit or loss.

Action required

Companies should review existing and new arrangements involving financial instruments (in particular those involving fair value hedge accounting and embedded derivatives). Consideration should be given to whether the extension of the fair value option to include financial liabilities, and the restrictions over the use of the option for financial liabilities, will have an impact. The transitional requirements are complex and careful analysis will be needed.