

COMMISSION REGULATION (EC) No 1864/2005

of 15 November 2005

amending Regulation (EC) No 1725/2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, as regards International Financial Reporting Standard No 1 and International Accounting Standards Nos. 32 and 39

(Text with EEA relevance)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community,

Having regard to Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards ⁽¹⁾, and in particular Article 3(1) thereof,

Whereas:

- (1) By Commission Regulation (EC) No 1725/2003 of 29 September 2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council ⁽²⁾ all international standards and interpretations that were extant at 14 September 2002 except International Accounting Standards (IAS) 32, IAS 39 and the related interpretations were adopted. In the cases of IAS 32 and IAS 39, the degree of amendment was considered so important that it was considered inappropriate to adopt the extant versions of these standards at that time.
- (2) On 17 December 2003 the International Accounting Standard Board (IASB) published revised IAS 39 Financial Instruments: Recognition and Measurement as part of the IASB's initiative to improve fifteen standards in time for them to be used by companies adopting IAS for the first time in 2005. The purpose of the revision was the further improvement of the quality and consistency of the body of existing IASs.
- (3) IAS 39 as revised in December 2003 introduced an option that permitted entities to designate irrevocably on initial recognition any financial asset or financial liability as one to be measured at fair value with gains and losses recognised in profit or loss (the full 'Fair Value Option'). However, the European Central Bank (ECB), prudential supervisors represented in the Basel Committee as well as security regulators expressed

concerns that an unrestricted fair value option might be used inappropriately, in particular for financial instruments relating to a company's own liabilities.

- (4) The IASB recognised these concerns and therefore published an Exposure Draft on 21 April 2004 proposing an amendment to IAS 39 in order to restrict the scope of the fair value option.
- (5) In order to have substantive accounting guidance on financial instruments in time for application in 2005, the Commission endorsed IAS 39 with the exclusion of certain provisions relating to the full Fair Value Option and hedge accounting, by Commission Regulation (EC) No 2086/2004 of 19 November 2004 amending Regulation (EC) No 1725/2003 on the adoption of certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards the insertion of IAS 39 ⁽³⁾. The Commission considered this exclusion as exceptional and of a temporary nature pending resolution of the outstanding issues by further consultation and discussion.
- (6) In the light of the comments received to the Exposure Draft published on 21 April 2004 and further discussions, in particular with the ECB and the Basle Committee, as well as a series of roundtables with interested parties in March 2005, the IASB published on 16 June 2005, *Amendments to IAS 39 Financial Instruments: Recognition and Measurement, The Fair Value Option*.
- (7) The revised IAS 39 Fair Value Option restricts application to situations where this results in more relevant information, because it either eliminates or reduces significantly a measurement or recognition inconsistency ('accounting mismatch'); or a group of financial assets or financial liabilities or both is managed in accordance with a documented risk management or investment strategy. In addition, the revised Fair Value Option permits an entire combined contract containing one or more embedded derivatives to be designated as a financial asset or financial liability at fair value through profit or loss in certain circumstances. Consequently, the application of the revised Fair Value Option is restricted to cases where certain principles or circumstances must be respected. Lastly, application should be supported by adequate disclosure.

⁽¹⁾ OJ L 243, 11.9.2002, p. 1.

⁽²⁾ OJ L 261, 13.10.2003, p. 1. Regulation as last amended by Regulation (EC) No 211/2005 (OJ L 41, 11.2.2005, p. 1).

⁽³⁾ OJ L 363, 9.12.2004, p. 1.

- (8) Therefore, the provisions relating to the application of the fair value option to financial liabilities, which were excluded under Regulation (EC) No 2086/2004 should be inserted. Furthermore, the full fair value option with regard to financial assets as endorsed by Regulation (EC) No 2086/2004 should also be subject to a principles based approach.
- (9) The IASB acknowledges that for the purposes of prudential supervision, the revised standard does not prevent prudential supervisors from evaluating the rigour of the fair value measurement practices of a regulated financial institution and the robustness of its underlying risk management strategies, policies and practices and from taking appropriate action. Furthermore, the IASB agrees that certain disclosures would assist prudential supervisors in their evaluation of capital requirements. This is particularly the case regarding the recognition of gains arising from deterioration in own credit standing which are to be further studied within the context of broader improvements to IAS 39. The Commission will therefore monitor the future effects of *Amendments to IAS 39 Financial Instruments: Recognition and Measurement, The Fair Value Option* and examine its application within the scope of the Review described at Article 10 of Regulation (EC) No 1606/2002.
- (10) The adoption of amendments to IAS 39 implies, by way of consequence, amendments to International Financial Reporting Standard (IFRS) 1 and IAS 32 in order to ensure consistency between the accounting standards concerned.
- (11) In the light of the new principles based approach to the fair value option and the need for first time adopters to provide more meaningful initial financial statements and comparative information, it is appropriate to provide for the retroactive application of this Regulation as from 1 January 2005.
- (12) The consultation with technical experts in the field confirms that International Accounting Standard (IAS)

Amendments to IAS 39 Financial Instruments: Recognition and Measurement, The Fair Value Option meets the technical criteria for adoption set out in Article 3 of Regulation (EC) No 1606/2002, and in particular the requirement of being conducive to the European public good.

(13) Regulation (EC) No 1725/2003 should therefore be amended accordingly.

(14) The measures provided for in this Regulation are in accordance with the opinion of the Accounting Regulatory Committee,

HAS ADOPTED THIS REGULATION:

Article 1

The Annex to Regulation (EC) No 1725/2003 is amended as follows:

1. International Accounting Standard (IAS) 39 is amended as set out in point A of the Annex to this Regulation;
2. The text of 'International Accounting Standard (IAS) *Amendments to IAS 39 Financial Instruments: Recognition and Measurement, The Fair Value Option*' as set out in point B of the Annex to this Regulation, is added to IAS 39.
3. International Financial Reporting Standard (IFRS) 1 and IAS 32 are amended as set out in point B of the Annex to this Regulation.

Article 2

This Regulation shall enter into force on the third day following that of its publication in the *Official Journal of the European Union*.

It shall apply from 1 January 2005.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 15 November 2005.

For the Commission
Charlie McCREEVY
Member of the Commission

ANNEX

A. International Accounting Standard No 39 Financial Instruments: Recognition and *Measurement* is amended as follows:

(a) in paragraph 35 the following text is inserted:

'If the transferred asset is measured at amortised cost, the option in this Standard to designate a financial liability as at fair value through profit or loss is not applicable to the associated liability.'

(b) in Appendix A, Application Guidance, the text of AG 31 is replaced by the following text:

'An example of a hybrid instrument is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a "puttable instrument"). Unless the issuer on initial recognition designates the puttable instrument as a financial liability at fair value through profit or loss, it is required to separate an embedded derivative (ie the indexed principal payment) under paragraph 11 because the host contract is a debt instrument under paragraph AG27 and the indexed principal payment is not closely related to a host debt instrument under paragraph AG 30(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.'

B. The following text is added to IAS 39:

INTERNATIONAL ACCOUNTING STANDARDS

IAS No	Title
IAS 39	<i>Financial Instruments: Recognition and Measurement</i> with the addition of the provisions on the use of the fair value option

AMENDMENTS TO INTERNATIONAL ACCOUNTING STANDARD 39

Financial Instruments: Recognition and Measurement**THE FAIR VALUE OPTION**

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 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, 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 designate the entire hybrid (combined) contract as 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 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 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 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 as available for sale. For any such financial asset 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. The entity shall also:

- (a) restate the financial asset using the new designation in the comparative financial statements; and**
- (b) disclose the fair value of the financial assets 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.
 - (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.
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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.
- (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.

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.

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 nonderivative financial instruments.

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

- (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 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.
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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, 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;
 - (c) the basis on which income and expenses arising from financial assets and financial liabilities are recognised and measured; 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 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, 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:*
- (i) *financial assets that are classified as held for trading;*
 - (ii) *financial liabilities that are classified as held for trading;*

- (iii) *financial assets that, upon initial recognition, were designated by the entity as financial assets at fair value through profit or loss (ie those that are not financial 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.*
- (h) *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 the fair value of the financial liability 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 (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 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.*
- (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, 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 financial instrument that is attributable to changes in credit risk. 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, 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.
- (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 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, as follows.

Designation of previously recognised financial instruments

25A. IAS 39 *Financial Instruments: Recognition and Measurement* permits a financial 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. Despite this requirement exceptions apply in the following circumstances,

- (a) any entity is permitted to make 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;
- (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.

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 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.
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