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International Accounting Standards Board

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **May 2007, London**

Project: **IAS 39 *Financial Instruments: Recognition and Measurement* - Scope of IAS 39 paragraph 11A (Agenda Paper 11(iv))**

ISSUE

1. IAS 39 paragraph 11A states: '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 a 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.'

2. The IFRIC has been asked whether or not IAS 39 paragraph 11A can be applied to all contractual arrangements that contain one or more embedded derivatives, in particular whether IAS 39 paragraph 11A can be applied to hybrid contracts that contain financial or non-financial hosts that are outside the scope of IAS 39.

3. An alternative view is that IAS 39 paragraph 11A can only be applied to hybrid contracts with hosts that are within the scope of IAS 39.

TWO DIFFERENT VIEWS

4. The submission sets out two different views:

- View A – IAS 39 paragraph 11A can be applied to all contractual arrangements that contain one or more embedded derivatives. Under View A, any hybrid contracts that contain one or more embedded derivatives can be designated as financial assets or financial liabilities at fair value through profit or loss provided that the conditions set out in IAS 39 paragraph 11A are met; and
- View B – IAS 39 paragraph 11A can only be applied to hybrid contracts that contain hosts that are within the scope of IAS 39. IAS 39 paragraph 11A should not modify the scope of IAS 39.

Arguments for View A

The introduction of IAS 39 paragraph 11A is to reduce complexity arising on the application of IAS 39 paragraph 11

5. Supporters of View A note, from paragraphs BC 77 – 78 of IAS 39, that IAS 39 paragraph 11A was introduced primarily to reduce complexity arising on the application of IAS 39 paragraph 11. A summary of those BC paragraphs is set out below:

- IAS 39 paragraph 11 requires an embedded derivative to be separated out from the host contract and accounted for as a derivative unless certain conditions are met.
- Such a requirement requires an entity to (a) identify whether the instrument contains one or more embedded derivatives and (b) determine whether each embedded derivative is one that must be separated from the host instrument.

- The Board acknowledged that, when an entity has complex hybrid instruments, the search for embedded derivatives and the determination whether embedded derivatives are closely related to the host contracts would significantly increase the cost of complying with IAS 39 paragraph 11.
- To reduce the cost of compliance with IAS 39 paragraph 11, the Board decided to allow the entire hybrid instrument to be designated as a financial asset or financial liability at fair value through profit or loss unless (a) the embedded derivative does not significantly modify the cash flows that would otherwise be required by the contract or (b) it is clear with little or no analysis when a similar hybrid instrument is first considered that separation is prohibited.

What contracts does IAS 39 paragraph 11 apply to?

6. Based on the above requirements, it appears that IAS 39 paragraph 11A was introduced to reduce the complexity arising from the application of IAS 39 paragraph 11. Consequently, supporters of View A believe that it is crucial to consider the contracts to which IAS 39 paragraph 11 applies.

7. IAS 39 does not provide specify whether a hybrid (combined) contract includes a contract that contains a financial or non-financial host outside the scope of IAS 39.

8. Therefore, proponents of View A refer to the following Application and Implementation Guidance to determine the scope of IAS 39 paragraph 11:

   - AG33(d) of IAS 39 states: 'An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract …'
   - AG33(f) of IAS 39 states: 'An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is …'
   - AG33(g) of IAS 39 states: 'A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to …'

- C.7 of the Guidance on Implementing IAS 39 uses an example relating to a contract to purchase or sell non-financial items to illustrate the circumstances in which a foreign currency embedded derivative should be separated out from the host contract.
- C.8 of the Guidance on Implementing IAS 39 illustrates whether an embedded foreign currency derivative is closely related to a host oil contract that is not within the scope of IAS 39 (because the contract was entered into and continues to be held for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements).

9. The above extracts from the Application and Implementation Guidance require an entity to identify derivatives embedded in hybrid contracts that contain financial or non-financial hosts outside the scope of IAS 39.

IAS 39 paragraphs 12 and 13

10. Furthermore, proponents of View A note that IAS 39 paragraphs 12 – 13 require that the entire hybrid contract should be designated at fair value through profit or loss (when an embedded derivative is required to be separately accounted for but the fair value of the embedded derivative cannot be measured reliably).

11. For the above reasons, supporters of View A believe that IAS 39 paragraph 11A can be applied to all contractual arrangements with one or more embedded derivatives.

Arguments for View B

IAS 39 paragraph 11

12. Supporters of View B believe that IAS 39 paragraph 11 is in *no way* related to the scope of IAS 39. IAS 39 paragraph 11 *only* sets out the requirements as to when embedded derivatives should be separately accounted from the relevant host contracts.

What is the scope of IAS 39?

13. The issue relates to the "scope" of IAS 39 paragraph 11A – i.e. whether IAS 39 paragraph 11A can be applied to all contractual arrangements with one or more embedded derivatives. Supporters of View B believe that the scope of IAS 39 paragraphs 11 and 11A (i.e. subsets of IAS 39) should be consistent with the overall scope of IAS 39. The scope of a subset of IAS 39 should not be broader than the overall scope of IAS 39.

14. Applying this general principle, IAS 39 paragraph 11A should only be applied to hybrid contracts with hosts that are within the scope of IAS 39.

15. IAS 39 generally applies to financial instruments only (see IAS 39 paragraph 2). The scope of IAS 39 is then adjusted to include:

- derivatives embedded in lease contracts. IAS 39 paragraph 2(b) explicitly scopes out rights and obligations under leases to which IAS 17 *Leases* applies;
- derivatives embedded in contracts within the scope of IFRS 4, if the derivatives are not themselves within the scope of IFRS 4. IAS 39 paragraph 2(e) clearly excludes rights and obligations arising under insurance contracts as defined in IFRS 4 *Insurance Contracts* subject to certain exceptions; and
- a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, <u>as if the contracts were financial instruments</u>, with the exception of contracts that that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (see IAS 39 paragraph 5).

16. Furthermore, IAS 39 allows an entity to designate a financial instrument as at fair value through profit or loss on its initial recognition provided that certain conditions are met. To designate a financial instrument as at fair value through profit or loss, the entity is required to meet the requirements in IAS 39 paragraph 11A (where the contract is a hybrid contract with one or more derivatives).

17. In other words, IAS 39 paragraph 11A is just *a condition* to qualify for the fair value option.

Significant implication of View A on contracts outside the scope of IAS 39

18. The potential implication of View A is that all hybrid contracts that include one or more embedded derivatives would be allowed to be designated as financial assets or financial liabilities at fair value through profit or loss. Examples are:

- Lease contracts under IAS 17 *Leases*;
- Pension arrangements under IAS 19 *Employee Benefits*;
- Share-based payment arrangements under IFRS 2 *Share-based Payment*;
- Insurance contracts under IFRS 4 *Insurance Contracts*; and
- Contracts to buy or sell non-financial items that are entered into to meet an entity's expected usage requirements.

19. In light of the above IAS 39 requirements, proponents of View B believe that, to designate a contract as a financial asset or financial liability at fair value through profit or loss, the contract should:

- be a financial asset or a financial liability within the scope of IAS 39 (or be deemed as a financial asset or a financial liability (see IAS 39 paragraph 5));
- meet the fair value option requirements set out in IAS 39 paragraph 9; and
- meet the requirement set out in IAS 39 paragraph 11A (in cases where the contract is a hybrid contract that contains one or more embedded derivatives).

STAFF RECOMMENDATION

20. The staff believes that the scope of a subset of IAS 39 should be consistent with the overall scope of IAS 39. And the scope of a subset of IAS 39 should *not* be broader than the overall scope of IAS 39. This is a general principle in applying all IFRSs.

21. In addition, IAS 39 paragraph 9 explicitly states that, to designate a financial instrument as at fair value through profit or loss, a number of conditions have to be met – one of which relates to the requirements set out in IAS 39 paragraph 11A (in cases where the contract contains one or more embedded derivatives).

22. [Paragraph omitted from observer note].

23. [Paragraph omitted from observer note].

24. For the above reasons, the staff recommends that the issue should *not* be taken onto the agenda. Wording for the proposed tentative agenda decision is set out below [Paragraph omitted from observer note].

QUESTIONS TO THE IFRIC

25. Does the IFRIC agree with the staff recommendation? If not, why not?