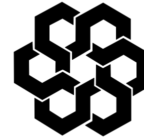

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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **December 2008, London**

Project: **IAS 39 *Financial Instruments: Recognition and Measurement***

Subject: **Assessment and Separation of Embedded Derivatives on Reclassification of a financial asset (Agenda Paper 6D1)**

Introduction

1. In October 2008 the Board issued *Reclassification of Financial Assets* (Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures)*.

2. At the public round table meetings on the global financial crisis in November and December, several accounting firms highlighted an issue related to the interaction between those recent amendments to IAS 39 and IFRIC 9 *Reassessment of Embedded Derivatives*. Those firms requested the Board consider further amendments to IFRS literature to prevent any practice developing whereby, following reclassification of a financial asset, embedded derivatives that should be separately accounted for are not.

3. This paper focuses on whether any of the accounting issues raised by participants require the urgent and immediate attention of the boards to

improve financial reporting and help enhance investor confidence in financial markets. The paper addresses this objective by using the following structure:

(a) an explanation of the issue

(b) a staff analysis of the issue

(c) some possible approaches

(d) the staff recommendation

The issue

4. An entity is permitted to reclassify some non-derivative financial assets out of the held-for-trading part of the fair value through profit or loss category (FVTPL) in the circumstances described in paragraphs 50B and 50D of IAS 39.

5. The issue described in this paper relates to hybrid (combined) financial assets – financial assets that contain features (an 'embedded derivative') that would have been separately accounted for as a derivative, if the entire contract had not been classified as held-for-trading and measured at fair value through profit and loss.

6. Paragraph 11(c) of IAS 39 does not allow separate accounting for an embedded derivative in a hybrid financial instrument classified as FVTPL, irrespective of whether the economic characteristics and risks of that embedded derivative are closely related to the economic characteristics and risks of the host contract. This is because the entire contract is measured at fair value with changes in fair value recognised in profit or loss in the period in which they occur.

7. However, the reclassification of a hybrid financial asset out of FVTPL means that the reason that originally prevented the separation of the embedded derivative no longer applies.

8. Therefore, particular accounting firms have requested an amendment that would ensure that, unless the entire hybrid financial asset is classified as

FVTPL, embedded derivatives that are not closely related to their host contract are separated.

9. In issuing the recent amendments to IAS 39, the Board clearly intended that embedded derivatives that are required to be separated (in the absence of a FVTPL classification for the entire instrument) are separated.

10. That being said, the staff recommend the Board propose amending IFRS literature to ensure that diversity in practice does not develop in this area.

Staff analysis

11. IAS 39 only deals with the separation of an embedded derivative from its host contract when an entity first becomes a party to that contract.

12. IFRIC 9 addresses the circumstances that an *initial* assessment should be reconsidered.

13. Before considering IFRIC 9, one question to consider is whether:

    (a) an assessment on reclassification constitutes the initial assessment; or

    (b) the initial assessment instead was made at inception of the hybrid financial instrument when classifying it as FVTPL.

14. Some think that by classifying a hybrid financial instrument as FVTPL on initial recognition there is no assessment of any embedded derivatives because that classification *categorically* prohibits their separation. That is, the reclassification of a financial asset is actually when the *initial* assessment (and possibly separation) of an embedded derivative occurs. Hence IFRIC 9 is not relevant.

15. Others think that the non-separation of an embedded derivative on initial recognition of a hybrid financial instrument classified as FVTPL is the consequence of applying paragraph 11(c) of IAS 39. Thus, according to this view the non-separation is the result of an initial embedded derivative assessment that concluded the requirements for separation were not met. Therefore, an assessment of an embedded derivative on reclassification of a

hybrid financial instrument constitutes a reassessment. Hence IFRIC 9 is relevant.

16. Given the difference in views, the staff believes that we need to consider the implications of the second view (and hence the possible effect of IFRIC 9).

17. In accordance with paragraph 7 of IFRIC 9, reassessment of the separation of an embedded derivative is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract. Consequently, the concern raised by the accounting firms is that some might read IFRIC 9 to *prohibit* the separation of an embedded derivative on the reclassification of a hybrid financial asset out of FVTPL unless there is a concurrent change in its contractual terms.

18. When IFRIC 9 was issued, reclassifications out of FVTPL were not permitted and hence the possibility of such reclassifications was not considered.

19. The staff notes that the rationale underlying IFRIC 9 for not reassessing embedded derivatives in the absence of a change in the terms of a contract is based on two key arguments:

    (a) changes in external circumstances are not ways to circumvent the recognition and measurement requirements for derivative financial instruments in IAS 39. Examples are the evolution of markets for certain items such as commodities or a change in use of a certain currency in an economic environment. Consequently, reassessment is not appropriate for such changes.

    (b) reassessing embedded derivatives in all hybrid instruments could be onerous because frequent monitoring would be required. This is because changes in market conditions and other factors affecting embedded derivatives can change the assessment of whether or not the economic characteristics and risks of the embedded derivative are closely related to those of the host contract. Thus, entities would have to continuously monitor these conditions and factors to ensure timely identification of a change in circumstances that requires a change in the accounting

treatment. For example, where the assessment of a foreign currency related embedded derivative depends on the functional currency of the counterparty, a change of the latter's functional currency would require a change in the treatment of the embedded derivative.

20. In developing the interpretation the IFRIC noted (in accordance with paragraph BC37 of IAS 39):

> 'that the rationale for the requirement in IAS 39 to separate embedded derivatives is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract'.

21. Based on this rationale, the staff thinks if assessment and separation of embedded derivatives does not occur when reclassifying hybrid financial assets out of FVTPL, the very structuring opportunities that the embedded derivative accounting requirements in IAS 39 were intended to prevent are created. This is because by initially classifying a hybrid instrument as FVTPL and later reclassifying it into another category, an entity can circumvent requirements for separation of an embedded derivative. For example, a debt instrument with a prepayment option that is not 'closely related' to the host instrument would be accounted for as an integral part of the debt instrument–and the entire instrument would be measured at amortized cost–after reclassification out of FVTPL. Thus, application of IFRIC 9 to hybrid financial assets that are reclassified out of FVTPL would circumvent one of the purposes of embedded derivative accounting.

22. As noted previously, it is clear that the Board did not intend the requirements to separate particular embedded derivatives from hybrid financial instruments to be circumvented as a result of the recent amendments to IAS 39 permitting some reclassifications of financial assets.

23. The staff further notes that neither of the two arguments that support IFRIC 9's approach of not reassessing embedded derivatives in the absence of a change in the terms of a contract apply to reclassifications:

(a) reclassifications of financial assets out of FVTPL in accordance with paragraph 50(c) of IAS 39 are optional. Therefore, reclassifications reflect internal circumstances within an entity's control instead of changes in external circumstances.

(b) reassessing embedded derivatives in hybrid instruments does not require frequent monitoring. Again, reclassifications of financial assets out of FVTPL in accordance with paragraph 50(c) of IAS 39 are optional. Consequently, instead of frequent monitoring being required an entity only needs to evaluate changes in market conditions and other factors affecting embedded derivatives if and when it elects to reclassify financial assets out of FVTPL. Therefore, a reassessment is not an onerous categorical requirement imposed on an entity independent of its decisions but a consequence that results from and accompanies the entity's election of an alternative (ie its own free choice).

24. The staff notes that paragraph BC8 of the Basis for Conclusions of IFRIC 9 refers to paragraph AG33(b) of IAS 39 because that guidance illustrates an assessment of an embedded derivative at inception. However, the staff emphasises that this Application Guidance is in the form of examples. Therefore, an example illustrating an assessment for particular contractual features at inception of the contract does not warrant a conclusion that such an assessment and separation should only be made at inception. Consequently, the staff does not think paragraph BC8 of the Basis for Conclusions of IFRIC 9 or paragraph AG33(b) of the Application Guidance of IAS 39 are inconsistent with separation of an embedded derivatives after the inception of a contract.

25. The staff also notes that reclassification from a fair value based measurement to a cost based measurement (including amortised cost) is conceptually tantamount to initial recognition for accounting purposes. This is because such a reclassification resets the (amortised) cost of the reclassified financial asset to its fair value on the date of reclassification, which is comparable to initial recognition when the instrument is measured at its fair value (transaction price).

Possible approaches to amending IFRS

26. In the staff's view there are at least two possible approaches to clarify that an entity is required to assess and possibly separate an embedded derivative when reclassifying hybrid financial assets out of FVTPL:

27. **Approach A** – propose amending the scope of IFRIC 9 (paragraphs 3–5) by including an additional scope exception for reclassifications, similar to the scope exception for hybrid financial instruments acquired in a business combination. Alternatively, paragraph 11 of IAS 39 could be amended so as to refer to separation either on initial recognition or reclassification, as applicable.

28. In addition, a new example in the application guidance in IAS 39 could be included to address the possible separation of an embedded derivative from a hybrid financial asset after inception of the contract.

29. **Approach B** – propose amending paragraph 7 of IFRIC 9 by including another exception to the Interpretation's principle (the first exception being a change in the terms of the contract). Paragraph 7 could be amended as follows (inserted text is underlined):

> 'An entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is either (i) a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract or (ii) a reclassification of a financial asset out of the fair value through profit or loss category, in which cases reassessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.'

Staff recommendation

30. The staff recommends that the Board proposes amending IFRS literature to ensure that no diversity in practice develops in this important area of accounting.

31. The staff recommends Approach B. This is because the change is focused on IFRIC 9, and that Interpretation would therefore continue to be the main guidance for the assessment of embedded derivatives after the inception of the contract. Approach B would also require fewer changes to IFRS literature than Approach A.

32. The staff recommends that the Board also propose retrospective application. The staff is not aware of diversity in practice at the moment. Furthermore, given how recently the amendments to IAS 39 were issued, the staff can see no reason to make any exception to the principle of retrospective application as set out in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*

33. The staff recommends that the exposure draft have a comment period of 30 days. That is the minimum permitted by paragraph 42 of the *IASB Due Process Handbook*. Given the urgent nature of the proposed amendments and the current environment that we are operating in, the staff does not believe that a longer period is appropriate.

34. **Question to the Board:**

(a) Do you agree with the staff recommendation to propose changes to IFRS literature? If not, why do you believe changes are unnecessary?

(b) Do you agree with Approach B? If not, what approach do you prefer, and why?

(c) Do you agree with proposing retrospective application for any proposed amendments? If not, what is your proposal and what is your basis for that proposal?

(d) Do you agree with the proposed comment period of 30 days? If not, what period do you prefer, and why?

Subsequent issues

35. Should the Board decide to amend IFRIC 9 and/or IAS 39, there are some additional issues that may need to be addressed through additional application guidance in IAS 39 and/or IFRIC 9.

36. The additional issues relate to questions that arise from reassessment and separation after the inception of the contract (in the absence of contractual changes). These are:

(a) **Issue 1:** Should a reassessment be based on the circumstances that exist on the date of reclassification or that existed at the date of inception of the contract?

(b) **Issue 2:** If the reassessment is based on the circumstances that exist on the date of reclassification, do some of the current criteria and examples in the Application Guidance of IAS 39 need amendment?

(c) **Issue 3:** What date should be used for determining the stated or implied substantive terms of an embedded non-option derivative?

(d) **Issue 4:** If the reclassification date is used for determining the stated or implied substantive terms of an embedded non-option derivative, how should 'day one differences' (in accordance with paragraph AG76A of IAS 39) be treated when separating components at dates subsequent to inception?

(e) **Issue 5:** Is a clarification required that, if the fair value of an embedded derivative that would have to be separated cannot be reliably determined, the entire hybrid financial instrument must remain in or be reclassified into the FVTPL category?

37. Those issues are addressed in agenda paper 6D2. In that agenda paper, the staff asks whether the Board wishes to include guidance on those issues in any proposed amendments.