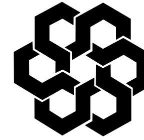

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International Accounting Standards Board

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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: related issues (Agenda Paper 6D2)**

Introduction

1. Agenda paper 6D1 considers an issue raised by some of the accounting firms at the public round table meetings on the global financial crisis. The issue relates to the interaction between IAS 39 (as recently amended) and IFRIC 9 *Reassessment of Embedded Derivatives*. Those firms requested the Board consider amendments to IFRS literature to prevent any practice developing whereby embedded derivatives that should be separately accounted for are not, following reclassification of a financial asset. Paper XXD1 recommends the Board propose some amendments to ensure that such practice does not develop.

2. This paper asks the Board whether, in proposing such amendments, some related issues also should be addressed. The issues 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 fair value through profit or loss category?

3. If the Board agrees with the staff recommendation on Issue 1, the Board does not need to address Issues 2 to 4. The staff recommendation on Issue 1 is that a reassessment on reclassification should be performed on the basis of the circumstances that existed at the inception of the contract.

4. This paper provides analyses of these issues and staff recommendations. Each issue is structured as follows:

(a) an explanation of the issue

(b) a staff analysis of the issue

(c) some possible approaches

(d) the staff recommendation.

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?

5. When reassessing an embedded derivative after the inception of the hybrid financial instrument, the question arises whether the relevant circumstances for that reassessment are those that exist or existed on the date of:

   (a) reclassification; or

   (b) inception of the contract (ie 'looking back').

Staff analysis

Does it matter?

6. The staff thinks it sometimes matters.

7. Whether an embedded derivative is required to be separated from the host contract depends upon whether the embedded derivative is 'closely related' to the host contract. IAS 39 illustrates the notion of 'closely related' by a list of examples in paragraphs AG30 and AG33.

8. In many of those examples, it makes no difference whether the assessment is performed on the basis of the circumstances that existed at inception of the contract or that exist on the date of reclassification. For example, equity- or commodity-indexed interest or principal payments embedded in a host debt contract are features that are unrelated to specific circumstances on a specific date.

9. However, for some of the examples it does make a difference.

   (a) **Paragraph AG30(g) of IAS 39** - call, put or prepayment options are not closely related to the host debt or insurance contract unless the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract. Because on reclassification of a financial asset the

fair value becomes the new amortised cost, this may result in a different separation answer.

(b) **Paragraph AG33(a) of IAS 39** - an embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest otherwise due on an interest-bearing host debt or insurance contract is closely related to the host contract under certain conditions. One of those conditions is that the embedded derivative must not permit a doubling or more of the holder's initial rate of return on the host contract and resulting in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract. Whether the 'holder's initial return' is assessed as of the date of inception or the date of reassessment may result in a different separation answer. Another condition is that the combined instrument must not allow a settlement that results in the holder not recovering substantially all of its recognised investment. Because on reclassification of a financial asset the fair value becomes the new amortised cost, this may result in a different separation answer.

(c) **Paragraph AG33(b) of IAS 39** - an embedded floor or cap on the interest rate on a debt or insurance contract is closely related to the host contract, provided it is neither leveraged nor in the money when the contract is issued. This applies accordingly for other cap and floor option features (eg commodity options embedded in commodity purchase contracts). An embedded option may get in the money after inception. That is, a different separation answer may arise.

(d) **Paragraph AG33(d) of IAS 39** - an embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument is closely related to the host contract under certain conditions. Some of those conditions relate to specific circumstances on a specific date such as (i) the functional currency of the counterparty, (ii) a currency routinely used around the world to denominate the related good or service, or (iii) a currency commonly used in an economic environment for transactions of non-financial items. (The recently proposed annual improvements may

amend these criteria). However, all three aspects can change over time, resulting in a different separation answer.

Other relevant literature

10. Other IFRS requirements entail applying the list of examples in paragraphs AG30 and AG33 of IAS 39 after the inception of the contract. The question is whether that has any consistency implications.

11. For a reassessment in accordance with IFRIC 9 related to *changes in the terms of a contract,* it is clear that the reassessment can only be meaningful if it is performed on the basis of the new terms that triggered the reassessment. Otherwise the entity would look to terms that no longer apply.

12. IFRS 3 *Business Combinations* (as revised in 2008) requires an assessment of whether an embedded derivative should be separated from the host contract in accordance with IAS 39 based on the conditions that exist at the acquisition date. This is because it is an (initial) assessment rather than a reassessment from the acquirer's perspective because the business combination has an effect equivalent to entering into that contract (albeit indirectly). That is, the business combination is the event that results in the acquirer recognising the contract in its statement of financial position for the first time (initial recognition). This is also consistent with the treatment of a purchase of a contract as initial recognition from the buyer's perspective (refer to paragraph BC10 of the Basis for Conclusions of IFRIC 9).

13. However, a reassessment of an existing contract on reclassification of the hybrid financial instrument (in the absence of a change of its contractual terms) out of the fair value through profit or loss (FVTPL) category is different because the entity has already recognised the hybrid contract.

Possible considerations

14. One of the reasons that embedded derivatives are separated is to prevent an entity from circumventing derivative accounting by embedding the derivatives in non-derivative contracts (refer to paragraph BC37 of the Basis for

Conclusions of IAS 39). Such structuring opportunities exist when a contract is designed (that is, prior to its inception). On reclassification of a hybrid financial asset out of FVTPL such structuring opportunities are not obvious.

15. Furthermore, an approach that 'looks back' to the inception of the contract when assessing possible separation of an embedded derivative ensures that:

    (a) the determination of whether an embedded derivate is separated remains unaffected by the initial classification of the hybrid financial instrument as FVTPL that is subsequently reversed, and

    (b) there is some comparability in the accounting for derivative features between those entities that reclassified financial assets with derivative features that were required to be separated, and those entities that entered into the same or similar contracts that either (i) remain in the FVTPL category or (ii) that separated the embedded derivative at initial recognition and accounted for the host contract some other way.

16. A practical disadvantage of looking back is that information about circumstances that existed at the inception of the contract may not be available. However, the staff questions whether, in many situations, this would be the case for example regarding historic data from observable markets. We acknowledge, however, that information regarding the conditions in relation to embedded foreign currency derivatives (refer to paragraph 9(d) of this paper) may be more difficult to obtain, or at least be susceptible to the influence of hindsight.

Possible approaches

17. The possible approaches are set out in paragraph 5. That is, the two dates that could be specified either in IFRIC 9 or in IAS 39 as the relevant point in time for determining the circumstances to be used for the purpose of reassessing an embedded derivative after inception of the hybrid financial instrument are:

    (a) reclassification; or

(b) inception of the hybrid contract (ie looking back).

Staff recommendation

18. The staff recommends that a reassessment on reclassification should be performed on the basis of the circumstances that existed at the inception of the contract.

19. This date is consistent with one of the stated purposes of embedded derivative accounting (ie anti-abuse) and provides some element of comparability. Furthermore, since the terms of the embedded features in the hybrid have not changed, the staff sees no reason to arrive at a different answer as to separation than would have been the case at initial recognition of the hybrid contract.

20. In paper 6D1 the staff recommends changing paragraph 7 of IFRIC 9 so as to require a reassessment of embedded derivatives on reclassification of a hybrid financial instrument out of FVTPL. Consistent with that the staff recommends inserting a new paragraph 7A into IFRIC 9 as follows:

> 'The reassessment of a financial asset on reclassification out of the fair value through profit or loss category in accordance with paragraph 7 shall be performed on the basis of the circumstances that existed when the entity first became a party to the contract.'

21. **Question to the Board:**

(a) Do you agree with the staff recommendation to use the circumstances that existed when the entity first became a party to the contract as the basis for the reassessment? If so, do you want to insert a paragraph 7A into IFRIC 9?

(b) If you do not agree with the staff recommendation to use the circumstances that existed when the entity first became a party to the contract as the basis for the reassessment, does the Board want to use the circumstances on the date of reclassification? If so, why and how do you wish to amend IAS 39 or IFRIC 9?

Issue 2 - If the reassessment is based on the circumstances on the date of reclassification, do some of the current criteria and examples in the Application Guidance of IAS 39 need amendment?

22. If the Board agrees with the staff recommendation above, there is no need to consider this issue.

23. However, if the reassessment is to be performed on the basis of the circumstances at the date of reclassification, some of the criteria and examples in the Application Guidance of IAS 39 may need to be amended (see paragraph 25).

Staff analysis

24. Some of the examples in the Application Guidance of IAS 39 analysed in paragraph 9 of this paper explicitly refer to or implicitly relate to the inception of the contract. All of the conditions used in these examples could be applied by reference to circumstances on the date of reclassification using then-current information (eg market data), or calculations of parameters (eg rates of return or amortised cost) based on the instrument's fair value on that date. The assessment would be the same as for an entity that acquired the same instrument on the same date, eg in a secondary market.

Possible approaches

25. Two of the examples could be amended in order to clarify their application by reference to the circumstances on the date of reclassification:

    (a) **paragraph AG33(a) of IAS 39** - replace the reference to 'initial rate of return' with 'rate of return, as of the date of assessment (or reassessment) for embedded derivatives,'

    (b) **paragraph AG33(b) of IAS 39** - replace the references to 'is issued' and 'at inception' with 'is assessed (or reassessed) for embedded derivatives'

and 'when the contract is assessed (or reassessed) for embedded derivatives', respectively.

Staff recommendation

26. If the reassessment is performed on the circumstances existing at the date of reclassification the staff recommend that the two examples highlighted in the previous paragraph should be amended.

27. **Question to the Board: Do you agree with the staff recommendation to amend the two examples in the Application Guidance of IAS 39 (refer to paragraph 25 of this paper)? If not, what do you prefer doing and why?**

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

28. If the Board agrees with the staff recommendation in paragraph 21, there is no need to consider this issue. That is because if the Board decides that the reassessment is to be performed on the basis of the circumstances existing at the date of inception, the staff believes that it is clear that the date of inception of the contract should also be used to determine the stated or implied substantive terms of an embedded non-option derivative.

29. However, if the reassessment is performed on the basis of the circumstances that exist at the date of reclassification, the Board will need to address the question of what date should be used to determine the stated or implied substantive terms of an embedded non-option derivative.

Staff analysis

30. Paragraph AG28 of IAS 39 states that 'an embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition'.

31. This is an important question, as the substantive terms will drive any subsequent fair value measurement of the separated derivative.

32. The terms of a non-option derivative could be determined by reference to the circumstances on two different dates:

    (a) reclassification; or

    (b) inception of the hybrid contract.

33. If the Board decides that a reassessment is to be based on the circumstances that exist on the date of reclassification of the contract (that is, the Board disagrees with the staff recommendation in paragraph 21), then it would be consistent to determine the terms of the non-option derivative as of the date of reclassification.

34. However, this approach has the following drawbacks:

    (a) It would create an inconsistency between the treatments of embedded option-based versus non-option derivatives. An embedded option-based derivative is separated on the basis of the <u>stated</u> terms of the option feature whereas an embedded non-option derivative is separated on the basis of its <u>stated or implied</u> substantive terms <u>so that its fair value is zero</u>. Therefore, the terms of an embedded option-based derivative would be the same irrespective of whether it is separated at inception or a later date whereas the implied terms of a non-option derivative differ depending on the date of its separation because its fair value is calibrated to zero on the respective date.

    (b) Calibrating the fair value of a non-option embedded derivative to zero on the date of reclassification results in the counterparties using different (implied) terms for the same embedded derivative even though they entered into it with each other at the same time. Because the embedded derivative is calibrated to a fair value of zero at different points in time the fair value of the one counterparty will not be the opposite value of the

other counterparty as it would be for a free-standing derivative. This does not seem to make any sense.

(c) This approach results in the same outcome as if the hybrid contract were acquired in a secondary market on the date of reclassification. This is despite that fact that the contract has previously been recognised. Thus, it would treat a mere accounting event (decision to reclassify) like a commercial transaction (entering into a contract).

(d) If there is an unamortised 'day one difference' for the hybrid financial instrument in accordance with paragraph AG76A of IAS 39 this raises an additional issue (refer to Issue 4 in this paper).

Possible approaches

35. Either IFRIC 9 or IAS 39 could be amended to specify the date that should be used for determining the stated or implied substantive terms of an embedded non-option derivative. That could be the date of

(a) reclassification; or

(b) inception of the hybrid contract.

Staff recommendation

36. The staff recommends that the date of contract inception should be used for determining the stated or implied substantive terms of an embedded non-option derivative. Using this date would avoid the drawbacks set out in the preceding analysis.

37. As previously noted (refer to paragraph 28 of this paper) the staff thinks that the issue is clear if the Board agrees with the staff recommendation in paragraph 20, ie to insert a new paragraph 7A into IFRIC 9 so as to require the reassessment of an embedded derivative to be performed on the basis of the circumstances that prevailed when the entity first became a party to the contract.

38. However, if the Board considered further clarification necessary or helpful a new paragraph 7B could be inserted into IFRIC 9 as follows:

> 'If the reassessment of a financial asset on reclassification out of the fair value through profit or loss category in accordance with paragraph 7 results in the separation of an embedded non-option derivative (such as an embedded forward or swap) it is separated from its host contract on the basis of its stated or implied substantive terms, so that it would have had a fair value of zero when the entity first became a party to the contract.'

39. **Questions to the Board:**

    (a) Do you agree with the staff recommendation to calibrate embedded non-option derivatives to a fair value of zero on the date the entity first became party to the contract? If so, do you want to insert a paragraph 7B into IFRIC 9 in order to clarify the requirement?

    (b) If you do not agree with the staff recommendation to calibrate embedded non-option derivatives to a fair value of zero on the date the entity first became party to the contract, does the Board want to use the date of reclassification? If so, why and how do you wish to amend IAS 39 or IFRIC 9?

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' be treated when separating components at dates subsequent to inception?

40. If the Board agrees with the staff recommendation in paragraph 21 and paragraph 39(a), there is no need to consider this issue.

41. However, if the reclassification date is used for determining the stated or implied substantive terms of an embedded non-option derivative then the Board needs to consider how any unamortised 'day one differences' (in accordance with paragraph AG76A of IAS 39) should be accounted for.

Staff analysis

42. On initial recognition of a hybrid financial instrument classified as at fair value through profit or loss there may be a difference between the transaction price and its value determined using a valuation technique whose variables do not solely include data from observable markets (a day one difference).

43. Reclassification is not a change in a factor that market participants would consider in setting a price. Thus, any unamortised original day one difference should not be recognised in profit or loss on reclassification. Instead, the amortisation of the original day one difference must continue.

44. Given that paragraph AG76A of IAS 39 requires the amortisation method to reflect 'a change in a factor (including time) that market participants would consider in setting a price' the reclassification and separation of a hybrid financial instrument into its components should not affect the amortisation pattern for the original day one difference. This is because the pattern is required to reflect (assumptions about) a commercial phenomenon, which is unaffected by a reclassification for accounting purposes.

45. The unamortised day one difference has to be allocated to the separated components of the hybrid financial instrument. This is because the unamortised day one difference is treated as a measurement (valuation) adjustment for presentation purposes rather than an asset or liability of its own.

46. The staff believes that an allocation of any unamortised day one difference to the host contract component would be consistent with the residual approach of paragraph AG28 of IAS 39. For an embedded <u>option-based</u> derivative this is already a consequence of its separation on the basis of the stated terms of the option feature because the terms of an embedded option-based derivative would be the same irrespective of whether it is separated at inception or a later date.

Possible approaches

47. The staff thinks that either IFRIC 9 or IAS 39 could be amended to clarify that

    (a) any unamortised original day one difference cannot be recognised in profit or loss on reclassification;

    (b) the amortisation pattern for the difference should be retained, ie the amortisation to profit or loss each period remains the same as if the hybrid financial instrument had not been reclassified and separated into its components; and

    (c) any unamortised day one differences are allocated to the host contract component for disclosure purposes, ie a measurement adjustment.

Staff recommendation

48. If the Board agrees with the staff recommendations in paragraph 21 and paragraph 39(a) this issue does not need to be addressed.

49. If the Board did not agree with those staff recommendations then the staff recommends clarifying the treatment of unamortised day one differences as contemplated in paragraph 47 of this paper. The following question is based on the premise in this paragraph.

50. **Question to the Board: Do you want to clarify the treatment of unamortised day one differences as recommended in paragraph 47. If not, why and what would you prefer to do instead?**

Issue 5 – To clarify 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 fair value through profit or loss category

51. Paragraphs 12–13 of IAS 39 require designation of a hybrid financial instrument as FVTPL if an entity is unable to separately measure the embedded derivative that would have to be separated:

(a) at acquisition; or

(b) at the end of a subsequent financial reporting period.

52. This raises the question as to what the appropriate accounting is if a hybrid financial instrument is reclassified out of FVTPL after its acquisition and on that date the entity is unable to separately measure the embedded derivative that would have to be separated. This scenario may arise on any date after acquisition that is not a reporting period end. Because this scenario is not directly addressed in paragraphs 12–13 of IAS 39 the staff thinks the requirement should be clarified.

Staff analysis

53. If an entity reclassified a hybrid financial instrument out of FVTPL during a financial reporting period and the entity could not separately measure the fair value of an embedded derivative that would have to be separated this would result in an inappropriate accounting outcome. The hybrid financial instrument in its entirety would have to be moved back into the FVTPL category at the end of the financial reporting period in accordance with paragraph 12 of IAS 39 (unless the embedded derivative had become separately measurable in between reclassification and the end of the financial reporting period).

54. The staff believes that a scenario whereby an entity could move a hybrid financial instrument out of and back into the FVTPL category within the same period should be prohibited if the entity cannot separately measure the embedded derivative from the outset, ie the date of reclassification.

55. In the staff's view that prohibition would be consistent with the rationale behind the requirement of paragraph 12 of IAS 39 to classify the entire hybrid financial instrument as FVTPL on acquisition if an entity is unable to separately measure an embedded derivative that would have to be separated. On the date of reclassification this is equivalent to a requirement that the entire

hybrid financial instrument must remain in the FVTPL category (as long as an entity is unable to measure the embedded derivative separately).

56. If at the date of reclassification the embedded derivative was separately measurable and moved out of FVTPL the entire hybrid financial instrument would still have to be reclassified into FVTPL if at a later end of a financial reporting period the entity would become unable to measure the embedded derivative separately. This is already a consequence of paragraph 12 of IAS 39 in its current version.

Possible approaches

57. The staff thinks that paragraph 12 of IAS 39 could be amended as follows (inserted text is underlined):

> '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 the end of a subsequent financial reporting period, it shall designate the entire hybrid (combined) contract as at fair value through profit or loss. Similarly, if an entity is unable to separately measure the embedded derivative that would have to be separated on reclassification of a hybrid (combined) contract out of the fair value through profit or loss category that reclassification is prohibited. Thus, in such circumstances the hybrid (combined) contract remains classified as fair value through profit or loss in its entirety.'

Staff recommendation

58. The staff recommends clarifying paragraph 12 of IAS 39 as suggested in paragraph 57 of this paper.

59. **Question to the Board: Do you agree with the staff recommendation to amend paragraph 12 of IAS 39? If not, does the Board want to provide any clarification on this issue at all? If not, why not?**