30 Cannon Street, London EC4M 6XH, United Kingdom

Phone: +44 (0)20 7246 6410   Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org   Website: http://www.iasb.org

International
Accounting Standards
Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
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: **February 2009, London**

Project: **Financial Instruments IFRIC 9 *Reassessment of Embedded Derivatives* and IAS 39 *Financial Instruments: Recognition and Measurement***

Subject: **Embedded Derivatives (Agenda paper 11)**

BACKGROUND TO ED PROPOSAL

1. In December 2008, the IASB published the exposure draft *Embedded Derivatives*, proposed amendments to IFRIC 9 and IAS 39 (ED).

2. The ED proposed amendments to IFRIC 9 and IAS 39 regarding the assessment of an embedded derivative when the entity reclassifies a hybrid (combined) financial asset out of the fair value through profit or loss (FVTPL) category. The proposals were to require:
   (a) an entity to assess whether an embedded derivative is required to be separated from a host contract when the entity reclassifies a hybrid (combined) financial asset out of the FVTPL category.
   (b) the assessment to be made on the basis of the circumstances that existed when the entity first became a party to the contract.

(c) that if the fair value of an embedded derivative that would have to be separated cannot be reliably measured, the entire hybrid financial instrument must remain in the FVTPL category.

3. Appendix A contains the relevant paragraphs from the ED.

4. The purpose of this paper is to:
   (a) set out the views of respondents to the ED; and
   (b) ask the Board to address issues raised by respondents and to decide how to proceed with the proposed amendments.

5. The overall recommendation of the staff is that the Board finalise the amendments, subject to some drafting changes. However, in finalising the amendments, the staff specifically asks the Board to re-evaluate the consequences of requiring the effective date that was proposed in the ED.

OVERVIEW OF COMMENTS RECEIVED ON THE ED

6. The IASB received 40 comment letters by the comment deadline of 21 January 2009. In total, 50 comment letters have been received as of the date of the posting of this paper. Appendix B contains an analysis of responses by type of respondent and geographical region.

7. Nearly all respondents agreed with the proposed amendments to IFRIC 9 and IAS 39. The proposed amendments were widely recognised as a clarification of what the Board's intention was when issuing *Reclassification of Financial Assets* (Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*) in October 2008 (Reclassification Amendments). Some respondents commented that the Board did not need to issue any clarifying amendment because the accounting treatment proposed in the ED was, in their view, already clear.

8. There were more divergent views regarding the proposed effective date and transition. Most respondents supported the proposed effective and transition. However, some disagreed with using an effective date before the issue date of any

final amendment, and others proposed a variety of different effective dates, including requiring an effective date of 1 July 2008 to be consistent with the Reclassification Amendments.

9. A few respondents raised an issue regarding the assessment of whether or not the economic characteristics and risks of embedded credit derivatives in relation to investments in synthetic collateralised debt obligations (CDOs) are closely related to the economic characteristics and risks of such investments. The issue was raised in the context of the Proposed Statement 133 Implementation Issue No. C22, *Exception Related to Embedded Credit Derivatives* (draft DIG C22), recently published by the US Financial Accounting Standards Board for comment. The objective of the draft DIG C22 is to clarify US GAAP. However, because investments in synthetic CDOs would be subject to the proposed amendments of the ED if they were reclassified out of the FVTPL category these respondents requested that the Board clarifies whether draft DIG C22 is consistent with IFRSs.

10. The staff notes that the ED clarifies the assessment of embedded derivatives on reclassification of hybrid (combined) financial instruments out of the FVTPL category in general. Thus, dealing with one specific type of embedded derivative is not in the scope of this ED.

11. The staff further notes that the Board already discussed the IFRS requirements regarding embedded credit derivatives in relation to investments in synthetic (CDOs) in its November and December 2008 meetings (refer to Agenda Papers 11B and 6E of these meetings, respectively). The Board noted that there is no diversity in IFRS practice, and decided to retain the existing IFRS requirements.

12. In addition, the feedback from all of the IASB/FASB public round tables (as well as the responses to the IASB ED *Investments in Debt Instruments*) clearly indicated that many constituents (including almost all users) believe that the IASB should not attempt to short-term patches that eliminate or reduce specific differences between US GAAP and IFRSs, but rather should focus on the broader project to replace IAS 39.

ANALYSIS OF RESPONSES TO THE QUESTIONS SET OUT IN THE ED

Question 1 of the ED The exposure draft clarifies that an entity must assess whether an embedded derivative is required to be separated from a host contract when the entity reclassifies a hybrid (combined) financial asset out of the fair value through profit or loss category. Do you agree with that clarification? If not, why? What would you propose instead, and why?

13. There was almost unanimous support for the proposed clarification that an assessment of embedded derivatives is required when an entity reclassifies a hybrid (combined) financial asset out of the FVTPL category. As stated previously, some respondents questioned the need for the proposed clarification.

Staff analysis

14. The staff notes that the feedback received provides strong evidence that the proposed amendments would clarify that an assessment of embedded derivatives is required when an entity reclassifies a hybrid (combined) financial asset out of the FVTPL category. Thus, it would prevent divergence in practice developing. The staff notes that some comments letters included drafting suggestions that will be taken into consideration in finalising the amendments.

Staff recommendation

15. The staff recommends that the Board proceed with the proposed amendments (subject to some drafting changes).

Question to the Board

16. Does the Board agree with the staff recommendation to proceed with the proposed clarification that an assessment of embedded derivatives is required when an entity reclassifies a hybrid (combined) financial asset out of the FVTPL category? If not, why? What does the Board propose instead, and why?

Question 2 of the ED The exposure draft requires the assessment to be made on the basis of the circumstances that existed when the entity first became a party to the contract. Do you agree with that proposal? If not, why? What would you propose instead, and why?

17. Most respondents agreed with the proposal in the ED that the assessment should be made on the basis of the circumstances that existed when the entity first became a party to the contract. That point in time was considered to be conceptually sound and consistent with existing IFRSs.

18. Some of those respondents requested the Board to clarify:
    (a) the relevant circumstances in a scenario where after the entity first became party to the contract but before reclassification out of the FVTPL category there is a change in the contractual terms of the hybrid (combined) financial instrument that significantly modifies the cash flows that would otherwise be required; in this scenario the relevant circumstances for the assessment should be those reflecting the change in contractual terms (consistent with paragraph 7 of IFRIC 9);
    (b) that the reference to the circumstances that existed when the entity first became a party to the contract does not include the criterion of paragraph 11(c) of IAS 39 (that the entire hybrid (combined) financial instrument is classified as at FVTPL). This is because the hybrid (combined) financial instruments reclassified out of the FVTPL category were classified as FVTPL on their initial recognition. Hence if paragraph 11(c) of IAS 39 is included in the assessment, an embedded derivative would never be separated on reclassification of the hybrid (combined) financial instrument.

19. A few respondents disagreed with the proposal in the ED and instead suggested to make the assessment on the basis of the circumstances that exist on the date of reclassification or the reporting date. They cited the following reasons:

(a) some reclassifications require the existence of 'rare circumstances', which means an event of economic substance has occurred since the entity first became party to the contract; thus, using the circumstances on the date of reclassification would better reflect the basis for the reclassification;

(b) some entities may encounter practical difficulties in obtaining information as of the date when the they first became party to the contract, in particular when the contract was entered into a long time ago;

(c) an assessment using a date prior to the reclassification date may involve hindsight; and

(d) using the date of reclassification would be more consistent with US GAAP, which requires an assessment of embedded derivatives on an ongoing basis.

Staff analysis

20. As noted above, most respondents agree that, in order to be consistent with existing IFRSs, the relevant circumstances for assessing the embedded derivative are those that existed on the date when the entity first became a party to the contract.

21. However, some of those respondents requested clarification (see paragraph 18 of this paper). The staff agrees that such a clarification is useful. (Therefore, all following references in this paper to the circumstances that existed when the entity first became a party to the contract shall be taken to be the later date of that date or the date of a change in contractual terms with a significant effect).

22. The reasons given by the few who disagreed with the assessment to be made on the basis of the circumstances that existed when the entity first became a party to the contract are analysed below.

'Rare circumstances', which means an event of economic substance has occurred since the entity first became party to the contract

23. The staff notes that not all reclassifications of hybrid (combined) financial instruments out of the FVTPL category require 'rare circumstances' as a precondition. Reclassifications in accordance with paragraph 50D of IAS 39 can occur in the absence of 'rare conditions' depending only on a change in intent and

ability of management to hold the instrument for the foreseeable future or until maturity.

24. The staff believes that an assessment of embedded derivatives should not be affected by an outside macro-economic event or a change in management intent. The staff notes that this approach is consistent with the principle in IFRIC 9 – that a reassessment should occur only if there is a change in contractual terms.

Practical difficulties

25. The staff considered the aspect of practical difficulties in obtaining information in its analysis preceding the ED (refer to paragraph 16 of the Agenda Paper 6D2 of the December 2008 Board meeting). In particular, the staff notes that embedded foreign currency derivatives in accordance with paragraph AG33(d) of IAS 39 (which would be the most likely type to cause practical difficulties to obtain information) do not apply to host contracts that are financial instruments (other than insurance contracts). Therefore, they would not affect the reclassification of <u>financial assets</u> that are hybrid (combined) financial instruments in accordance with paragraph 50(c) of IAS 39.

26. The staff believes that the comment letters did not offer any additional evidence that any practical difficulties are so severe that they should become an overriding consideration. However, the staff notes that if an entity is unable to obtain the information required for the assessment on the basis of the circumstances that existed when it first became party to the contract it cannot comply with the assessment as required by the proposed amendments. Consequently, the entity would be precluded from reclassifying the hybrid (combined) financial instrument out of FVTPL.

Use of hindsight

27. In its analysis preceding the ED the staff evaluated for which examples of 'closely related' assessments in the application guidance of IAS 39 using the circumstances of different dates would result in different outcomes (refer to paragraphs 6 to 9 of the Agenda Paper 6D2 of the December 2008 Board meeting). The staff believes that the example that would potentially be susceptible to significant hindsight is that in paragraph AG33(d) of IAS 39 regarding embedded foreign currency derivatives.

28. However, as explained in paragraph 25 of this paper, that example does not affect hybrid (combined) financial instruments that are financial assets. The respondents concerned about hindsight did not raise any specific examples or circumstances.

29. Thus, the staff believes that the comment letters did not provide any additional evidence that hindsight would significantly affect a sound bona fide assessment.

On-going reassessment of embedded derivatives.

30. The staff notes that a continuous assessment of embedded derivatives is inconsistent with IFRSs. IFRIC 9 addresses the issue and establishes a principle that does not involve a continuous assessment but rather on an exception basis (change in contractual terms). Therefore, the issue does not just relate to the relevant circumstances for an assessment on reclassifications but it is a difference in the principles of IFRSs and US GAAP. The scope of the proposed clarification does not involve a general review of existing differences between IFRSs and US GAAP.

31. Similarly to the issue discussed in the previous paragraph, this is a fundamental aspect of embedded derivative accounting that is not caused by or only related to the proposed clarification. Thus, addressing this issue is outside the scope of the ED.

32. The staff further notes that using a different point in time than when the entity first became a party to the contract would not only be inconsistent with existing IFRSs but also increase complexity of both the accounting rules and application of those rules; more changes to requirements and additional guidance would be required to address several issues (refer to paragraphs 23 to 50 of the Agenda Paper 6D2 of the December 2008 Board meeting).

Staff recommendation

33. The staff recommends retaining the proposed requirement that the assessment be made on the basis of the circumstances that existed when the entity first became a party to the contract the reasons set out in the staff analysis above. The staff proposes to change the drafting so as to reflect the clarifications that respondents requested as set out in paragraph 18 of this paper.

Question to the Board

34. Does the Board agree with the staff recommendation to retain the proposed requirement that the assessment be made on the basis of the circumstances that existed when the entity first became a party to the contract the reasons set out in the staff analysis above (subject to drafting changes reflecting the clarifications that respondents requested as set out in paragraph 18 of this paper)? If not, why? What does the Board propose instead, and why?

Question 3 of the ED

The exposure draft proposes that if the fair value of an embedded derivative that would have to be separated cannot be reliably measured, the entire hybrid financial instrument must remain in the fair value through profit or loss category.

Do you agree with that proposal? If not, why? What would you propose instead, and why?.

35. There was almost unanimous support for the proposed amendment to IAS 39 that stipulates that if the fair value of an embedded derivative that would have to be separated cannot be reliably measured, the entire hybrid financial instrument must remain in the fair value through profit or loss category.

Staff analysis

36. The staff notes that the feedback received indicates that amending paragraph 12 of IAS 39 in order to adapt it for situations when an entity reclassifies a hybrid (combined) financial asset out of the FVTPL category is appropriate. The staff notes that some comments letters included drafting suggestions that will be taken into consideration in finalising the amendments.

Staff recommendation

37. The staff recommends that the Board proceed with the proposed amendment of paragraph 12 of IAS 39 (subject to some drafting changes).

Question to the Board

38. Does the Board agree with the staff recommendation to proceed with the proposed amendment of paragraph 12 of IAS 39? If not, why? What does the Board propose instead, and why?

Question 4 of the ED

Do you agree with the proposed effective date? If not, why? What would you propose instead, and why?

39. Most respondents agreed with the proposed effective date of annual periods ending on or after 15 December 2008. While they generally considered an effective date before the date of issue of a new IFRS inappropriate they agreed with the proposals in the ED because of the specific circumstances. They acknowledged that the ED clarifies the Board's original intention when issuing the Reclassification Amendments in October 2008 and the limited time the Board had in making these amendments.

40. The respondents who disagreed with the effective date did so for different reasons, including:
    (a) 'backdating' is generally inappropriate for standard setting (eg because it creates difficulties for adoption as law in some jurisdictions);
    (b) the proposed timing would not allow preparers sufficient lead time to implement the necessary changes;
    (c) the effective date should be aligned with the Reclassification Amendments (ie use 1 July 2008);
    (d) the effective date should not result in restatements as an error;
    (e) restatement as an error should be required.

Staff analysis

41. The staff believes the Board has at least the following alternatives for setting the effective date:
    (a) proceed with annual periods ending on or after 15 December 2008 as the effective date;
    (b) align the effective date with that of the Reclassification Amendments (ie use 1 July 2008);
    (c) use an effective date of financial statements authorised for issue on or after the date of issue of the final amendments;
    (d) use a later date than under (c) above.

42. The alternative effective dates do not affect the recognition or measurement of financial instruments or the profit or loss because the ED does not includes specific transitional provisions. Thus, paragraph 19(b) of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* results in full retrospective application of the amendments (ie the financial statements are restated).

43. The different effective dates only affect entities that have already published financial statements that apply different accounting than that set out in the ED.

44. The effect of different effective dates on such entities is therefore solely whether the restatement of the comparative information is presented as the result of:
    (a) a change in accounting policy (with the related disclosures – refer to paragraphs 19(b) and 28 of IAS 8); or
    (b) an error (with the related disclosures – refer to paragraphs 42 and 49 of IAS 8).

45. The following paragraphs analyse the consequences of each alternative effective date contemplated in the paragraph 41 of this paper.

Annual periods ending on or after 15 December 2008

46. Using an effective date of annual periods ending on or after 15 December 2008 has the following consequences:
    (a) all financial statements with an annual reporting period ending before 15 December 2008 that did not comply with the proposed amendments would be restated as the result of a change in accounting policy; and
    (b) all financial statements with an annual reporting period ending on or after 15 December 2008 that did not comply with the proposed amendments would be restated as the result of an error.

Effective date of 1 July 2008

47. Using an effective date of 1 July 2008 means that all financial statements that did not comply with the proposed amendments – irrespective of their reporting period and their issue date – would be restated as the result of an error.

Effective date of financial statements authorised for issue on or after the date of issue of the final amendments

48. Using an effective date of financial statements authorised for issue on or after the date of issue of the final amendments has the following consequences:
    (a) all financial statements authorised for issue before that date that do not comply with the proposed amendments would be restated as the result of a change in accounting policy; and
    (b) all financial statements authorised for issue on or after that date that would not comply with the proposed amendments would be restated as the result of an error.

Effective date after the date of issue of the final amendments

49. Using an effective date after the date of issue of the final amendments (using either the date they are authorised for issue or their reporting period end as the reference basis) means giving preparers additional lead time and that:
    (a) all financial statements before that date that do not comply with the proposed amendments would be restated as the result of a change in accounting policy; and
    (b) only financial statements after that date that would not comply with the proposed amendments would be restated as the result of an error.

Summary of different effective dates

50. The following table summarises these different outcomes (note that only financial statements that used accounting policies different from the proposed amendments are affected).

	Possible effective date	Error	Change in accounting policy
(a)	**Annual periods ending on or after 15 December 2008**	F/S with financial year end on/after 15 December 2008	F/S with financial year end before 15 December 2008
(b)	**1 July 2008**	All F/S	N/A
(c)	**F/S authorised for issue on/after the date of issue of the final amendments**	F/S authorised for issue when/after the amendments are final	F/S authorised for issue before amendments are final
(d)	**Later date than under alternative (c)**	F/S on/after the cut-off date	F/S before the cut-off date

Interim financial reports

51. The staff notes that in interim financial reports changing the accounting treatment of embedded derivatives to conform with the proposed amendments results in restating the financial statements of prior interim periods of the current financial year and the comparable interim periods of any prior financial years that will be restated in the annual financial statements in accordance with IAS 8. The restatements would be presented as the result of a change in accounting policy or that of an error consistent with the annual financial statements.

Other considerations

52. The staff believes it is important to note that the ED proposes the same effective date for all the amendments (refer to the analyses of Questions 1 to 3 in this paper). Namely:
    (a) the requirement to assess embedded derivatives (amendment to paragraph 7 of IFRIC 9);
    (b) the circumstances to consider in making that assessment (addition of paragraph 7A of IFRIC 9); and
    (c) clarification of paragraph 12 of IAS 39.

53. It is, of course, possible to require different effective dates for the different amendments (eg regarding paragraphs 7 and 7A of IFRIC 9) – although that will increase the complexity of any final amendments.

54. An important factor to consider is whether setting an effective date before issuance of any final amendments sets an unwelcome precedent in other situations. That is, the proposed amendments are not yet a requirement. However, to avoid reporting an accounting error (assuming an effective date of 15 December 2008, or before), an entity would have had to comply with the proposed amendments. This could set a precedent that entities can choose to apply other proposed amendments (EDs) before any final amendment is issued.

55. Setting an effective date for all financial statements authorised for issue on or after the date of issue of any final amendments (that is, option 'c' in the summary table in paragraph 50 of this paper) would avoid this possible precedent. Under option 'c' preparers would have to comply with the amendments as soon as they are issued (with immediate effect), and the risk of any precedent alluded to in the previous paragraph could be avoided.

56. Alternatively, instead of moving the effective date as under option 'c', reporting an accounting error could also be avoided by a consequential amendment to IAS 8 that exempts restatements resulting from the final amendments from being presented as the restatement of an error. However, this would not avoid the issue of setting a precedent (see paragraph 54 of this paper) and also increase complexity because of adding a one-off exemption to IAS 8.

Staff recommendation

57. The staff recommends that the Board carefully evaluates the different alternatives and their respective consequences that are discussed in the staff analysis, and ensure that the chosen effective date is consistent with the objectives of the Board with regard to this particular amendment.

Question to the Board

58. What effective date does the Board prefer, and why?

Question 5 of the ED

Are the transition requirements appropriate? If not, why? What would you propose instead, and why?

59. The feedback received on the proposed transition requirement was largely consistent with that on the proposed effective date. This reflects that these two issues were overwhelmingly considered to be linked.

Staff analysis

60. The staff believes that the key decision is that on the effective date. Retrospective application should be required irrespective of the effective date chosen (including in case of a decision to use different effective dates for different proposed amendments) because the proposed amendments reflect the Board's original intention when it issued the Reclassification Amendments in October 2008. Prospective application would defeat the purpose of clarifying the Board's original intention.

Staff recommendation

61. The staff recommends to retain the proposed transition requirements for the reasons set out in the staff analysis.

Question to the Board

62. Does the Board agree with the staff recommendation to retain the proposed transition requirements? If not, why? What does the Board propose instead, and why?

Appendix A

Proposed amendments to IFRIC Interpretation 9 *Reassessment of Embedded Derivatives*

Paragraph 7 is amended (new text is underlined and deleted text is struck through). Paragraphs 7A and 9A are added.

Consensus

7 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 (a) a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract or (b) a reclassification of a financial asset out of the fair value through profit or loss category, in which cases an ~~re~~assessment 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.

7A The assessment whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on reclassification of a financial asset out of the fair value through profit or loss category in accordance with paragraph 7 shall be made on the basis of the circumstances that existed when the entity first became a party to the contract.

Effective date and transition

9A An entity shall apply amended paragraph 7 and paragraph 7A for annual periods ending on or after [15 December 2008].

Appendix A

Proposed amendments to International Accounting Standard 39 *Financial Instruments: Recognition and Measurement*

Paragraph 12 is amended (new text is underlined). Paragraph 103J is added.

Embedded derivatives

…

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 the end of a subsequent financial reporting period, it shall designate the entire hybrid (combined) contract as at fair value through profit or loss. <u>Similarly, if an entity is unable to measure separately 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. In such circumstances the hybrid (combined) contract remains classified as at fair value through profit or loss in its entirety.</u>**

…

Effective date and transition

103J An entity shall apply amended paragraph 12 for annual periods ending on or after [15 December 2008].

Appendix B

Respondents (by type)	Number
Academics	1
Accounting firms	7
Banks	4
Industry/sector organisations	6
Insurers	1
Preparers	5
Professional associations	9
Service providers	1
Standard setters	16
Total	50

Respondents (by geographical region)	Number
Africa	3
Asia Pacific (excluding Australia/New Zealand)	5
Australia/ New Zealand	5
Europe	22
International/Multi-regional[1]	9
Latin America	3
North America	3
Total	50

[1] Multi-regional comprises of respondents representing multiple regions, such as the joint international responses from each of the Big 4 Accounting Firms, and international professional organisations.