Project **Financial Instruments – Recognition and Measurement**

Topic **Classification – implications of embedded derivatives**

Introduction

Background

1. At the May 2009 IASB meeting the Board discussed possible approaches to the classification of financial instruments.[1] At a high-level the Board considered the following potential classification criteria:

   - characteristics of the financial instrument;
   - the business model; and
   - the liquidity of the market (if any) for the financial instrument.

2. At that meeting the Board requested that the staff develop a classification approach in more detail as follows:

   (a) using as the starting point the approach that the IASB decided to use for the forthcoming *IFRS for Private Entities* (IFRS for SMEs)[2]; and

   (b) amending that starting point to reflect that the classification approach would apply to entities other than small and medium-sized entities (SMEs) with the corresponding increase in complexity of instruments, transactions and other aspects that need to be considered.

[1] Agenda paper 5E of the May 2009 IASB meeting.
[2] See Appendix C of agenda paper 5E of the May 2009 IASB meeting (Approach 2)

Purpose of this paper

3. This paper explains the implications of accounting for embedded derivatives on classification. The accounting for embedded derivatives determines the unit of account that is used as the starting point for classification (ie the subject to which classification criteria are applied).

4. Thus, this paper sets the scene for the discussion of the classification approach. Other papers (agenda papers 2B, 2C and 2D) address classification, building on the discussion of the starting point (unit of account) in this paper. However, there is also some interaction between changing the classification approach and the approach chosen for accounting for embedded derivatives (see section 'Alternative 1: Implications of retaining the status quo' below).

5. This paper does not ask the Board for any decisions. The accounting for embedded derivatives is inextricably linked to the classification approach, as explained below. Thus, the staff recommendations and the questions to the Board regarding how to address the accounting for embedded derivatives are included in agenda paper 2E.

Implications of embedded derivatives for classification

Accounting for embedded derivatives under existing requirements (status quo)

6. Under existing requirements[3] a financial instrument is first assessed for embedded derivatives, which may result in bifurcation of hybrid (combined) financial instruments into a derivative financial instrument[4] and a non-derivative host contract. Each component resulting from the bifurcation (or the hybrid

[3] See IAS 39.10–11.
[4] In some circumstances several different embedded derivatives may have to be separated (see IAS 39.AG29).

contract in its entirety if bifurcation does not apply) is a separate unit of account for the purpose of classification.

7. The separation of an embedded derivative often (but not always) results in a host contract that has less *cash flow variability* (as compared to *fair value variability)* than the hybrid contract in its entirety. Thus, the approach used for embedded derivative accounting can change the cash flow characteristics for the unit of account that is used for classification purposes (eg a host contract compared to the hybrid contract without bifurcation). As a consequence, the accounting for embedded derivatives also affects the classification of financial instruments because the variability of cash flows is used as a classification criterion.

8. One of the criteria for separating an embedded derivative[5] is whether the economic characteristics and risks of the embedded derivative are 'closely related' to those of the host contract. This criterion is a practical expedient according to which an embedded derivative is not separated in circumstances that make it unlikely that the derivative was embedded with a view to a particular accounting outcome.[6] Therefore, the examples[7] of what types of embedded derivatives are closely related the host contract largely reflect contractual features that are common in commercial practice. This criterion does not differentiate on the basis of the cash flow variability of the hybrid contract.

9. The Board has not yet decided whether and, if so, when to revisit embedded derivative accounting. There are at least three possible ways of dealing with this issue:

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[5] The other two criteria are whether the embedded feature on a standalone basis meets the definition of a derivative and whether the hybrid contract is measured at fair value through profit or loss (see IAS 39.11(b) and (c)).
[6] See Basis for Conclusions on IAS 39, paragraph BC37.
[7] See IAS 39.AG30 and AG33.

(a) **Alternative 1**: maintain the existing requirements;

(b) **Alternative 2**: eliminate the concept of embedded derivative accounting (ie abandon bifurcation of hybrid contracts); or

(c) **Alternative 3**: change the bifurcation criteria (eg amend or change the notion of 'closely related').

Alternative 1: Implications of retaining the status quo

10. Retaining the status quo means that practice that has evolved over the years for assessing whether embedded derivatives are *closely related* would not be affected by the decision on classification.

11. However, the classification criteria chosen by the Board would still affect the *overall assessment* of embedded derivatives. That is because of the first step of determining the host contract. If the assessment of that host contract were to result in a classification as at fair value through profit or loss, then the entire hybrid contract would be classified as at fair value through profit or loss (rather than being bifurcated)[8].

12. The overall assessment of embedded derivatives could be affected depending on how the measurement categories for financial instruments will change as a result of this project. For example, the new classification criteria might result in financial instruments being classified as at fair value through profit or loss that might not meet the existing classification criteria for that category (ie be held for trading (as currently defined[9]) or be designated under the fair value option[10]). For example, some host contracts that are currently classified as available-for-sale but would not qualify for amortised cost in accordance with the new

[8] See IAS 39.11(c).
[9] See IAS 39.9.
[10] Mandatory classification of a financial instrument as at fair value through profit or loss also results when an embedded derivative that would have to be separated cannot be separately measured, which means the entire hybrid contract must be 'designated' as fair value through profit or loss (see IAS 39.12).

classification approach would by default be classified as at fair value through profit or loss.

13. Hence, even if Alternative 1 was chosen by the Board, this interaction between the new classification approach and the overall assessment of embedded derivatives needs to be considered.

14. Alternative 1 would allow using existing practice for a first screening of embedded derivative features. Thus, the decision about what qualifies for amortised cost could largely be made similar to existing requirements (depending on the classification approach chosen regarding the characteristics of the financial instrument–see agenda paper 2B).

Alternative 2: Eliminate the concept of embedded derivative accounting

Repercussions of non-financial host contracts

15. This alternative would change the unit of account by no longer using bifurcation to address embedded derivatives. Choosing this alternative raises the question whether this change in the unit of account should apply to:

    (a) only those derivatives that are embedded in *financial* host contracts; or

    (b) all embedded derivatives (ie also those embedded in *non-financial* host contracts).

16. For hybrid contracts with *non-financial* host contracts embedded derivative accounting is not solely a financial instrument accounting issue. Thus, abandoning bifurcation of all hybrid contracts would require a larger project scope than financial instruments. Derivatives embedded in non-financial host contracts (eg leases or executory contracts to buy or sell non-financial items) would have to be addressed, for example as follows:

(a) outside the new financial instruments standard (whether individually in other IFRS standards or in a separate standard that specifically deals with those embedded derivatives); or

(b) by including hybrid contracts with non-financial hosts in their entirety in the scope of the new financial instruments standard. This still requires some criteria that determine when this consequence is appropriate, which might be scattered across different IFRS standards. This would also fundamentally change the scope of the standard for financial instruments (the working premise is that the scope of this project will remain broadly similar to today's requirements). This approach is used in the forthcoming IFRS for SMEs.[11]

17. Alternatively, if bifurcation were abandoned only for hybrid contracts with financial host contracts then significant parts of the existing embedded derivative accounting requirements would have to be retained (while some of the guidance solely related to financial host contracts would be removed).

Repercussions of recognising any fair value changes in other comprehensive income

18. At its May meeting the Board adopted a working premise that for financial instruments measured at fair value would allow changes in fair value to be recognised in:

(a) profit or loss; or

(b) other comprehensive income (OCI) without transfers to profit or loss (ie neither impairment nor recycling of amounts on derecognition).

[11] However, such a decision would contradict the change the Board proposed for the application of the fair value option as part of its Annual Improvements (2008–2009 cycle). That proposal would result in precluding hybrid contracts with non-financial host contracts being accounted for as financial instruments in their entirety.

19. If the Board retains the alternative of recognising fair value changes in OCI this has a knock-on effect on the accounting for embedded derivatives. Under existing requirements embedded derivatives that are not closely related to the host contract must be separated unless the entire hybrid contract is classified as at fair value *through profit or loss*. For host contracts that are measured at fair value but classified as available-for-sale (ie with fair value changes recognised in OCI) separation of an embedded derivative that is not closely related is still required. This is because standalone derivatives must be classified as at fair value through profit or loss and embedded derivative accounting aims at achieving the same accounting for those embedded derivatives that must be separated.

20. Possible alternatives to address this issue are:

    (a) Retaining the notion of separating embedded derivatives (at least in cases where the host contract is classified as at fair value through OCI);

    (b) Allowing all fair value changes of hybrid financial instrument to be recognised in OCI (irrespective of whether the fair value changes include amounts attributable to embedded derivatives–this would be a significant change from existing requirements and will almost certainly be inconsistent with the outcome for standalone derivatives);

    (c) Restricting the availability of fair value through OCI to financial instruments that are not hybrid contracts (ie do not include an embedded derivative–this would still require guidance for testing whether or not a financial instrument includes an embedded derivative);

Possible approaches for Alternative 2

21. Alternative 2 could be achieved as follows:

(a) by retaining the existing 'closely related' criterion[12] for the assessment of embedded derivatives; in this case the consequence of an embedded derivative not being closely related to its financial host contract would no longer be bifurcation but instead the entire hybrid contract would be classified as fair value through profit or loss; or

(b) by subjecting every hybrid contract (with a financial host contract) in its entirety to the same classification criteria used for all other financial instruments; this is the approach the IASB decided to use for the forthcoming IFRS for SMEs.

22. Similarly to Alternative 1[13], the approach under item (a) above could build on practice regarding the 'closely related' assessment that has evolved over the years. The approach under item (b) above would require developing new classification criteria that also appropriately address the characteristics of financial instruments that are hybrid contracts. One way of doing this is using the same approach chosen for the forthcoming IFRS for SMEs as a starting point. Other approaches using different classification criteria could also be developed so as to appropriately address characteristics of hybrid contracts.

Alternative 3: Changing the assessment of embedded derivatives

23. Alternative 3 would retain the concept of bifurcating embedded derivatives but revisit the criteria for bifurcation. As previously explained in this paper (see paragraph 8 above), 'closely related' criterion is only a practical expedient providing relief from separation of an embedded derivative in circumstances that largely reflect common commercial practice. However, this approach is not primarily looking at the cash flow variability of the hybrid contract to differentiate financial instruments.

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[12] See IAS 39.11(a). NB: the criterion of whether the embedded feature would meet the definition of a derivative on a standalone basis is not necessary as it is already included in the definition of an embedded derivative (see IAS 39.10) so that it does not have to be replicated as a separate criterion.
[13] See section 'Alternative 1: Implications of retaining the status quo' above.

24. Thus, the Board might want to consider whether the existing 'closely related' notion provides an appropriate balance between

    (a) providing relief from some complex accounting requirements as a practical expedient; and

    (b) the objective of this project and making it operational (see paragraph 25 below).

25. The objective of classification was discussed in a previous paper on classification.[14] In summary, the objective of classification is to ensure that financial instruments are allocated to measurement categories in such a way that the resulting information is useful to users. That means information should assist in assessing the amounts, timing and uncertainty of future cash flows. Thus, a criterion like 'closely related' that has only a loose relation to cash flow variability might not be considered to adequately reflect the objective of classification.

26. One possible approach is as follows: In order to better reflect the objective of classification the criterion of 'closely related' could be eliminated. Instead, it could be replaced with a materiality overlay like the one that IAS 39 *Financial Instruments: Recognition and Measurement* uses for the fair value option.[15] That means any embedded derivative would be separated from (at least) a financial host contract that is accounted for other than as at fair value through profit or loss unless the embedded derivative would not significantly modify the host contract's cash flows.

[14] See paragraphs 9–11 of agenda paper 5E of the May 2009 IASB meeting.
[15] See IAS 39.11A(a).

Summary

27. In summary:

    (a) the accounting for embedded derivatives has implications for classification because it affects the unit of account that is used as the starting point for classification;

    (b) changing the classification approach might also have repercussions for the accounting for embedded derivatives (depending on the approach chosen);

    (c) the accounting for embedded derivatives and the classification approach are inextricably linked; hence, the staff recommendations and questions to the Board are included in agenda paper 2E.