Exposure Draft **ED 172**
December 2008

Embedded Derivatives (Proposed Amendments to AASB Interpretation 9 and AASB 139)

Comments to AASB by 16 January 2009

Prepared by the
Australian Accounting Standards Board

Australian Government

Australian Accounting Standards Board

Commenting on this Exposure Draft

Constituents are strongly encouraged to respond to both the AASB and the IASB. The AASB is seeking comment by 16 January 2009. Comments should be addressed to:

The Chairman
Australian Accounting Standards Board
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Collins Street West Victoria 8007
AUSTRALIA
E-mail: standard@aasb.gov.au

Respondents to the IASB are asked to send their comments electronically through the 'Open to Comment' page on the IASB website (www.iasb.org)

All non-confidential submissions to the AASB will be made available to the public on the AASB website: www.aasb.gov.au.

Obtaining a Copy of this Exposure Draft

This Exposure Draft is available on the AASB website: www.aasb.gov.au.
Alternatively, printed copies of this Exposure Draft are available by contacting:

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AASB REQUEST FOR COMMENTS

In light of the Australian Accounting Standards Board's (AASB's) policy of incorporating International Financial Reporting Standards (IFRSs) into Australian Accounting Standards, the AASB is inviting comments on:

(a) any of the proposals in the attached International Accounting Standards Board (IASB) Exposure Draft, including the specific questions on the proposals as listed in the Invitation to Comment section of the attached IASB Exposure Draft; and

(b) the 'AASB Specific Matters for Comment' listed below.

The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major issues. The AASB regards both critical and supportive comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

Due Date for Comments to the AASB

Comments should be submitted to the AASB by 16 January 2009. This will enable the AASB to consider those comments in the process of formulating its own comments to the IASB. Constituents are also strongly encouraged to send their response to the IASB.

AASB Specific Matters for Comment

1. The IASB is proposing that the amendments be applicable to annual reporting periods ending on or after 15 December 2008. AASB Standards are legislative instruments and under the *Legislative Instruments Act 2003* there is an impediment to making an instrument that applies to a date prior to the instrument being made. Accordingly, the AASB will be commenting to the IASB that the effective date should be a date after the amendments are made. Accordingly, the AASB would particularly value any additional comments on whether:

   (a) there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals to these entities, particularly any issues relating to:

      (i) not-for-profit private sector entities; and

      (ii) for-profit public sector entities;

   (b) overall, the proposals would result in financial statements that would be useful to users; and

   (c) the proposals are in the best interests of the Australian economy.

Exposure Draft

EMBEDDED DERIVATIVES

(PROPOSED AMENDMENTS TO IFRIC 9 AND IAS 39)

Comments to be received by 21 January 2009

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This exposure draft *Embedded Derivatives* (Proposed amendments to IFRIC 9 *Reassessment of Embedded Derivatives* and IAS 39 *Financial Instruments: Recognition and Measurement*) is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as amendments to IFRIC 9 and IAS 39. Comments on the exposure draft and the Basis for Conclusions should be submitted in writing so as to be received by **21 January 2009.** Respondents are asked to send their comments electronically to the IASB Website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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Introduction

1 IFRIC 9 *Reassessment of Embedded Derivatives* was developed by the International Financial Reporting Interpretations Committee and issued by the International Accounting Standards Board in 2006 with mandatory application for annual periods beginning on or after 1 June 2006. IAS 39 *Financial Instruments: Recognition and Measurement* was revised in 2003 with mandatory application for annual periods beginning on or after 1 January 2005. This exposure draft contains proposals by the Board to amend IFRIC 9 and IAS 39. The proposals would require 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 fair value through profit or loss category.

2 Following the issue of *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7 *Financial Instruments: Disclosures*) in October 2008 constituents alerted the Board to a possible unintended consequence of those amendments related to the interaction between the amendments and IFRIC 9. Some of those taking part in the public round-table meetings held by the Board and the US Financial Accounting Standards Board in November and December 2008 in response to the global financial crisis also raised that issue. They asked the Board to consider amending IFRSs to prevent any practice developing whereby, following reclassification of a financial asset, embedded derivatives that should be separately accounted for are not.

3 This exposure draft proposes amendments that would 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 fair value through profit or loss 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 fair value through profit or loss category.

Invitation to comment

The Board invites comments on the amendments to IFRIC 9 and IAS 39 proposed in this exposure draft, particularly on the questions set out below. Comments are helpful if they:

(a) comment on the questions as stated,

(b) indicate the specific paragraph or group of paragraphs to which they relate,

(c) contain a clear rationale, and

(d) include any alternative the IASB should consider, if applicable.

Respondents need not comment on all of the questions and are encouraged to comment on any additional issues that, in their view, warrant consideration.

The Board is not requesting comments on matters not addressed in this exposure draft.

Comments should be submitted in writing so as to be received no later than **21 January 2009**.

Question 1

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?

Question 2

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?

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Question 3

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?

Question 4

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

Question 5

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

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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].

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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].

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Approval by the Board of *Embedded Derivatives* (proposed amendments to IFRIC 9 and IAS 39) published in December 2008

Embedded Derivatives (proposed amendments to IFRIC 9 and IAS 39) was approved for publication by the thirteen members of the International Accounting Standards Board.

Sir David Tweedie	Chairman
Thomas E Jones	Vice-Chairman
Mary E Barth	
Stephen Cooper	
Philippe Danjou	
Jan Engström	
Robert P Garnett	
Gilbert Gélard	
James J Leisenring	
Warren J McGregor	
John T Smith	
Tatsumi Yamada	
Wei-Guo Zhang	

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Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the proposed amendments to IFRIC 9 and IAS 39.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in proposing amendments to IFRIC 9 *Reassessment of Embedded Derivatives* and IAS 39 *Financial Instruments: Recognition and Measurement*. Individual Board members gave greater weight to some factors than to others.

Reassessment of embedded derivatives

BC2 Following the issue of *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7 *Financial Instruments: Disclosures*) in October 2008 constituents told the Board that there was uncertainty about the interaction between those amendments and IFRIC 9 regarding the assessment of embedded derivatives. Some of those taking part in the public round-table meetings held by the Board and the US Financial Accounting Standards Board in November and December 2008 in response to the global financial crisis also raised that issue. They asked the Board consider further amendments to IFRSs to prevent any practice developing whereby, following reclassification of a financial asset, embedded derivatives that should be separately accounted for are not.

BC3 In accordance with paragraph 7 of IFRIC 9, assessment of the separation of an embedded derivative after an entity first became a party to the contract 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. Constituents told the Board that some might interpret IFRIC 9 as prohibiting the separation of an embedded derivative on the reclassification of a hybrid (combined) financial asset out of the fair value through profit or loss category unless there is a concurrent change in its contractual terms.

BC4 The Board noted that when IFRIC 9 was issued, reclassifications out of the fair value through profit or loss category were prohibited and hence IFRIC 9 did not consider the possibility of such reclassifications.

BC5 The Board was clear that it did not intend the requirements to separate particular embedded derivatives from hybrid (combined) financial instruments to be circumvented as a result of the amendments to IAS 39 regarding the reclassification of financial assets issued in October 2008. Therefore, the Board decided to clarify IFRIC 9 by amending paragraph 7. The Board also noted that the proposed amendments converge with US GAAP in relation to the assessment of embedded derivatives.

BC6 The Board believes that unless assessment and separation of embedded derivatives is done when reclassifying hybrid (combined) financial assets out of the fair value through profit or loss category, structuring opportunities are created that the embedded derivative accounting requirements in IAS 39 were intended to prevent. This is because, by initially classifying a hybrid (combined) financial instrument as at fair value through profit or loss and later reclassifying it into another category, an entity can circumvent requirements for separation of an embedded derivative. The Board also noted that the only appropriate accounting for derivative instruments is to be included in the fair value through profit or loss category.

BC7 The Board decided also to clarify that an assessment on reclassification should be made on the basis of the circumstances that existed when the entity first became a party to the contract. This date is consistent with one of the stated purposes of embedded derivative accounting (ie preventing circumvention of the recognition and measurement requirements for derivatives) and provides some degree of comparability. Furthermore, because the terms of the embedded features in the hybrid (combined) financial instrument have not changed, the Board did not see a reason for arriving at an answer on separation different from what would have been the case at initial recognition of the hybrid (combined) contract.

Inability to measure an embedded derivative separately

BC8 The Board also considered another issue related to a reclassification of a hybrid (combined) financial asset out of the fair value through profit or loss category. If the fair value of the embedded derivative that would have to be separated cannot be reliably measured, the Board decided to propose clarifying that the hybrid (combined) financial asset in its entirety should remain in the fair value through profit or loss category. The Board noted that the proposed clarification to paragraph 12 would prevent reclassification of a hybrid (combined) financial asset out of that category between financial reporting dates, and hence avoid a requirement to reclassify the hybrid (combined) financial asset back into the fair value through profit or loss category at the end of the financial reporting period.

Effective date and transition

BC9 The Board proposes an effective date of annual periods ending on or after 15 December 2008. The Board noted that although the effective date of new IFRSs and amendments to IFRSs is usually 6–18 months from the date of issue, the urgent need to clarify some aspects of how to apply *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) issued in October 2008 demands earlier application. The Board believes that an effective date for annual periods ending on or after 15 December 2008 will ensure appropriate separation of embedded derivatives on reclassification of hybrid (combined) financial assets out of the fair value through profit or loss category.

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