Compiled Interpretation **Interpretation 9**

Reassessment of Embedded Derivatives

This compiled UIG Interpretation applies to annual reporting periods beginning on or after 1 January 2014. Early application is not permitted. It incorporates relevant amendments made up to and including 20 December 2013.

Prepared on 10 July 2014 by the staff of the Australian Accounting Standards Board.

Australian Government

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UIG Interpretation 9 *Reassessment of Embedded Derivatives* (as amended) is set out in paragraphs 1 – 12. Interpretations are listed in Australian Accounting Standard AASB 1048 *Interpretation of Standards*. In the absence of explicit guidance, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies.

COMPILATION DETAILS

UIG Interpretation 9 *Reassessment of Embedded Derivatives* as amended

This compiled Interpretation applies to annual reporting periods beginning on or after 1 January 2014. It takes into account amendments up to and including 20 December 2013 and was prepared on 10 July 2014 by the staff of the Australian Accounting Standards Board (AASB).

This compilation is not a separate Interpretation issued by the AASB. Instead, it is a representation of Interpretation 9 (April 2006) as amended by other pronouncements, which are listed in the Table below.

Table of Pronouncements

Pronouncement	**Month issued**	**Application date** ***(annual reporting periods … on or after …)***	**Application, saving or transitional provisions**
Interpretation 9	Apr 2006	*(beginning)* 1 Jun 2006	see (a) below
AASB 2007-8	Sep 2007	*(beginning)* 1 Jan 2009	see (b) below
AASB 2008-3	Mar 2008	*(beginning)* 1 Jul 2009	see (c) below
AASB 2009-3	Apr 2009	*(ending)* 30 Jun 2009	see (d) below
AASB 2009-4	May 2009	*(beginning)* 1 Jul 2009	see (e) below
AASB 2011-7	Aug 2011	*(beginning)* 1 Jan 2013	see (f) below
AASB 2013-9	Dec 2013	Pt B *(beginning)* 1 Jan 2014	see (g) below

(a) Entities may elect to apply this Interpretation to annual reporting periods beginning on or after 1 January 2005 but before 1 June 2006.

(b) Entities may elect to apply this Standard to annual reporting periods beginning on or after 1 January 2005 but before 1 January 2009 provided that AASB 101 *Presentation of Financial Statements* (September 2007) is also applied to such periods.

(c) Entities may elect to apply this Standard to annual reporting periods beginning on or after 30 June 2007 but before 1 July 2009 provided that AASB 3 *Business Combinations* (March 2008) and AASB 127 *Consolidated and Separate Financial Statements* (March 2008) are also applied to such periods.

(d) Entities are not permitted to apply this Standard to earlier annual reporting periods.

(e) Entities may elect to apply this Standard, or its amendments to individual pronouncements, to annual reporting periods beginning on or after 1 January 2005 but before 1 July 2009.

(f) AASB 2011-7 has been amended by AASB 2012-6 (made 10 September 2012) and AASB 2012-10 (made 18 December 2012).

For-profit entities may elect to apply this Standard to annual reporting periods beginning on or after 1 January 2005 but before 1 January 2013. The Standard applies for not-for-profit entities to annual reporting periods beginning on or after 1 January 2014. Not-for-profit entities may elect to apply this Standard to annual reporting periods beginning on or after 1 January 2013 but before 1 January 2014. If an entity elects to apply this Standard to such annual reporting periods, it shall also apply AASB 10 *Consolidated Financial Statements* and associated Standards to such periods.

(g) Early application of Part B of this Standard is not permitted.

Table of Amendments

Paragraph affected	How affected	By … [paragraph]
5	footnote added amended amended	AASB 2008-3 [81] AASB 2009-4 [12] AASB 2011-7 [60]
7	amended	AASB 2009-3 [7]
7A	added	AASB 2009-3 [7]
Aus8.1	amended	AASB 2007-8 [7, 8]
Aus8.4	amended deleted	AASB 2007-8 [8] AASB 2013-9B [37]
9 (preceding heading)	amended	AASB 2009-3 [8]
10	added	AASB 2009-3 [8]
11	added	AASB 2009-4 [13]
12	added	AASB 2011-7 [61]

COMPARISON WITH IFRIC 9

Interpretation 9 and IFRIC 9

UIG Interpretation 9 *Reassessment of Embedded Derivatives* as amended incorporates International Financial Reporting Interpretations Committee Interpretation IFRIC 9 *Reassessment of Embedded Derivatives* as amended, issued by the International Accounting Standards Board. Paragraphs that have been added to this Interpretation (and do not appear in the text of IFRIC 9) are identified with the prefix "Aus", followed by the number of the preceding IFRIC paragraph and decimal numbering.

Compliance with IFRIC 9

Entities that comply with Interpretation 9 as amended will simultaneously be in compliance with IFRIC 9 as amended.

INTERPRETATION 9

UIG Interpretation 9 was issued in April 2006.

This compiled version of Interpretation 9 applies to annual reporting periods beginning on or after 1 January 2014. It incorporates relevant amendments contained in other AASB pronouncements up to and including 20 December 2013 (see Compilation Details).

URGENT ISSUES GROUP

INTERPRETATION 9

REASSESSMENT OF EMBEDDED DERIVATIVES

References

Accounting Standard AASB 1 *First-time Adoption of Australian Accounting Standards*

Accounting Standard AASB 3 *Business Combinations*

Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement*

Background

1 Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* paragraph 10 describes an embedded derivative as 'a component of a hybrid (combined) instrument that also includes a non-derivative host contract – with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.'

2 AASB 139 paragraph 11 requires an embedded derivative to be separated from the host contract and accounted for as a derivative if, and only if:

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

Scope

3 Subject to paragraphs 4 and 5 below, this Interpretation applies to all embedded derivatives within the scope of AASB 139.

4 This Interpretation does not address remeasurement issues arising from a reassessment of embedded derivatives.

5 This Interpretation does not apply to embedded derivatives in contracts acquired in:

(a) a business combination (as defined in AASB 3 *Business Combinations* (as revised in 2008));

(b) a combination of entities or businesses under common control as described in paragraphs B1-B4 of AASB 3 (revised 2008); or

(c) the formation of a joint venture as defined in AASB 11 *Joint Arrangements*

or their possible reassessment at the date of acquisition.[1]

Issue

6 AASB 139 requires an entity, when it first becomes a party to a contract, to assess whether any embedded derivatives contained in the contract are required to be separated from the host contract and

1 AASB 3 (as revised in March 2008) addresses the acquisition of contracts with embedded derivatives in a business combination.

accounted for as derivatives under the Standard. This Interpretation addresses the following issues:

(a) Does AASB 139 require such an assessment to be made only when the entity first becomes a party to the contract, or should the assessment be reconsidered throughout the life of the contract?

(b) Should a first-time adopter make its assessment on the basis of the conditions that existed when the entity first became a party to the contract, or those prevailing when the entity adopts Australian equivalents to IFRSs for the first time?

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 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 on the later date of:

(a) when the entity first became a party to the contract; and

(b) a change in the terms of the contract that significantly modified the cash flows that otherwise would have been required under the contract.

For the purpose of this assessment paragraph 11(c) of AASB 139 shall not be applied (i.e. the hybrid (combined) contract shall be treated as if it had not been measured at fair value with changes in fair value recognised in profit or loss). If an entity is unable to make this assessment the hybrid (combined) contract shall remain classified as at fair value through profit or loss in its entirety.

8 A first-time adopter shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required by paragraph 7.

Application

Aus8.1 This Interpretation applies to:

(a) each entity that is required to prepare financial reports in accordance with Part 2M.3 of the *Corporations Act 2001* and that is a reporting entity;

(b) general purpose financial statements of each other reporting entity; and

(c) financial statements that are, or are held out to be, general purpose financial statements.

Aus8.2 This Interpretation applies to annual reporting periods beginning on or after 1 June 2006.
[Note: For application dates of paragraphs changed or added by an amending pronouncement, see Compilation Details.]

Aus8.3 This Interpretation may be applied to annual reporting periods beginning on or after 1 January 2005 but before 1 June 2006, permitting early application in the context of adopting all Australian equivalents to International Financial Reporting Standards for such periods. Early application is encouraged. An entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act may apply this Interpretation to such annual reporting periods when an election has been made in accordance with subsection 334(5) of the Corporations Act in relation to AASB 1048 *Interpretation of Standards*. When an entity applies this Interpretation to such an annual reporting period, it shall disclose that fact.

Effective Date and Transition

9 [Deleted by the UIG]

10 AASB 2009-3 *Amendments to Australian Accounting Standards – Embedded Derivatives* issued in April 2009 amended paragraph 7 and added paragraph 7A. An entity shall apply those amendments for annual reporting periods ending on or after 30 June 2009.

11 Paragraph 5 was amended by AASB 2009-4 *Amendments to Australian Accounting Standards arising from the Annual Improvements Project*, issued in May 2009. An entity shall apply that amendment prospectively for annual reporting periods beginning on or after 1 July 2009. If an entity applies AASB 3 (as revised in 2008) for an earlier period, it shall apply the amendment for that earlier period and disclose that fact.

12 AASB 2011-7 *Amendments to Australian Accounting Standards arising from the Consolidation and Joint Arrangements Standards,* issued in August 2011, amended paragraph 5(c). An entity shall apply that amendment when it applies AASB 11.

BASIS FOR CONCLUSIONS ON IFRIC 9

This IFRIC Basis for Conclusions accompanies, but is not part of, UIG Interpretation 9. The UIG considers that this Basis for Conclusions is an essential feature of the Interpretation. An IFRIC Basis for Conclusions may be amended to reflect the requirements of the UIG Interpretation and AASB Accounting Standards where they differ from the corresponding International pronouncements.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

BC2 As explained below, the IFRIC was informed that uncertainty existed over certain aspects of the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* relating to the reassessment of embedded derivatives. The IFRIC published proposals on the subject in March 2005 as D15 *Reassessment of Embedded Derivatives* and developed IFRIC 9 after considering the thirty comment letters received.

BC3 IAS 39 requires an entity, when it first becomes a party to a contract, to assess whether any embedded derivative contained in the contract needs to be separated from the host contract and accounted for as a derivative under the Standard. However, the issue arises whether IAS 39 requires an entity to continue to carry out this assessment after it first becomes a party to a contract, and if so, with what frequency. The Standard is silent on this issue and the IFRIC was informed that as a result there was a risk of divergence in practice.

BC4 The question is relevant, for example, when the terms of the embedded derivative do not change but market conditions change and the market was the principal factor in determining whether the host contract and embedded derivative are closely related. Instances when this might arise are given in paragraph AG33(d) of IAS 39. Paragraph AG33(d) states that an embedded foreign currency derivative is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(a) the functional currency of any substantial party to that contract;

(b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

(c) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (e.g. a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

BC5 Any of the currencies specified in (a)–(c) above may change. Assume that when an entity first became a party to a contract, it assessed the contract as containing an embedded derivative that was closely related (because it was in one of the three categories in paragraph BC4) and hence not accounted for separately. Assume that subsequently market conditions change and that if the entity were to reassess the contract under the changed circumstances it would conclude that the embedded derivative is not closely related and therefore requires separate accounting. (The converse could also arise.) The issue is whether the entity should make such a reassessment.

BC5A In 2009 the International Accounting Standards Board observed that the changes to the definition of a business combination in the revisions to IFRS 3 *Business Combinations* (as revised in 2008) caused the accounting for the formation of a joint venture by the venturer[2] to be within the scope of IFRIC 9. Similarly, the Board noted that common control transactions might raise the same issue depending on which level of the group reporting entity is assessing the combination.

BC5B The Board observed that during the development of the revised IFRS 3, it did not discuss whether it intended IFRIC 9 to apply to those types of transactions. The Board did not intend to change existing practice by including such transactions within the scope of IFRIC 9. Accordingly, in *Improvements to IFRSs* issued in April 2009, the Board amended paragraph 5 of IFRIC 9 to clarify that IFRIC 9 does not apply to embedded derivatives in contracts acquired in a combination between entities or businesses under common control or the formation of a joint venture.

BC5C Some respondents to the exposure draft *Post-implementation Revisions to IFRIC Interpretations* issued in January 2009 expressed the view that investments in associates should also be excluded from the scope of IFRIC 9. Respondents noted that paragraphs 20–23 of IAS 28 *Investments in Associates* state that the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are

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2 IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31. IFRS 11 uses the term 'joint venturers' to designate parties that have joint control of a joint venture.

also adopted in accounting for the acquisition of an investment in an associate.

BC5D In its redeliberations, the Board confirmed its previous decision that no scope exemption in IFRIC 9 was needed for investments in associates. However, in response to the comments received, the Board noted that reassessment of embedded derivatives in contracts held by an associate is not required by IFRIC 9 in any event. The investment in the associate is the asset the investor controls and recognises, not the underlying assets and liabilities of the associate.

Reassessment of embedded derivatives

BC6 The IFRIC noted that the rationale for the requirement in IAS 39 to separate embedded derivatives is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract (for example, by embedding a commodity forward in a debt instrument). Changes in external circumstances (such as those set out in paragraph BC5) are not ways to circumvent the Standard. The IFRIC therefore concluded that reassessment was not appropriate for such changes.

BC7 The IFRIC noted that as a practical expedient IAS 39 does not require the separation of embedded derivatives that are closely related. Many financial instruments contain embedded derivatives. Separating all of these embedded derivatives would be burdensome for entities. The IFRIC noted that requiring entities to reassess embedded derivatives in all hybrid instruments could be onerous because frequent monitoring would be required. Market conditions and other factors affecting embedded derivatives would have to be monitored continuously to ensure timely identification of a change in circumstances and amendment of the accounting treatment accordingly. For example, if the functional currency of the counterparty changes during the reporting period so that the contract is no longer denominated in a currency of one of the parties to the contract, then a reassessment of the hybrid instrument would be required at the date of change to ensure the correct accounting treatment in future.

BC8 The IFRIC also recognised that although IAS 39 is silent on the issue of reassessment it gives relevant guidance when it states that for the types of contracts covered by paragraph AG33(b) the assessment of whether an embedded derivative is closely related is required only at inception. Paragraph AG33(b) states:

> An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract,

> provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest *when the contract is issued*, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (e.g. a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money *at inception* and are not leveraged. (Emphasis added)

BC9 The IFRIC also considered the implications of requiring subsequent reassessment. For example, assume that an entity, when it first becomes a party to a contract, separately recognises a host asset and an embedded derivative liability. If the entity were required to reassess whether the embedded derivative was to be accounted for separately and if the entity concluded some time after becoming a party to the contract that the derivative was no longer required to be separated, then questions of recognition and measurement would arise. In the above circumstances, the IFRIC identified the following possibilities:

(a) the entity could remove the derivative from its balance sheet and recognise in profit or loss a corresponding gain or loss. This would lead to recognition of a gain or loss even though there had been no transaction and no change in the value of the total contract or its components.

(b) the entity could leave the derivative as a separate item in the balance sheet. The issue would then arise as to when the item was to be removed from the balance sheet. Should it be amortised (and, if so, how would the amortisation affect the effective interest rate of the asset), or should it be derecognised only when the asset is derecognised?

(c) the entity could combine the derivative (which is recognised at fair value) with the asset (which is recognised at amortised cost). This would alter both the carrying amount of the asset and its effective interest rate even though there had been no change in the economics of the whole contract. In some cases, it could also result in a negative effective interest rate.

The IFRIC noted that, under its view that subsequent reassessment is appropriate only when there has been a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required by the contract, the above issues do not arise.

BC10 The IFRIC noted that IAS 39 requires an entity to assess whether an embedded derivative needs to be separated from the host contract and accounted for as a derivative when it first becomes a party to a contract. Consequently, if an entity purchases a contract that contains an embedded derivative it assesses whether the embedded derivative needs to be separated and accounted for as a derivative on the basis of conditions at that date.

BC11 The IFRIC considered an alternative approach of making reassessment optional. It decided against this approach because it would reduce comparability of financial information. Also, the IFRIC noted that this approach would be inconsistent with the embedded derivative requirements in IAS 39 that either require or prohibit separation but do not give an option. Accordingly, the IFRIC concluded that reassessment should not be optional.

BC11A Following the issue of *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) in October 2008 constituents told the International Accounting Standards 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 to 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.

BC11B 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.

BC11C 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.

BC11D 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 issued in October 2008. Therefore, the Board decided to clarify IFRIC 9 by amending paragraph 7.

BC11E 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.

BC11F 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, or, if later, the date of a change in the terms of the contract that significantly modified the cash flows that otherwise would be required under the contract. This date is consistent with one of the stated purposes of embedded derivative accounting (i.e. 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 (or a later date of a change in the terms of the contract). In addition, the Board clarified that paragraph 11(c) of IAS 39 should not be applied in assessing whether an embedded derivative requires separation. The Board noted that before reclassification the hybrid (combined) financial instrument is necessarily classified at fair value through profit or loss so that for the purpose of the assessment on reclassification this criterion is not relevant but would, if applied for assessments made in accordance with paragraph 7A of the Interpretation, always result in no embedded derivative being separated.

First-time adopters of IFRSs

BC12 In the Implementation Guidance with IFRS 1 *First-time Adoption of International Financial Reporting Standards*, paragraph IG55 states:

> When IAS 39 requires an entity to separate an embedded derivative from a host contract, the initial carrying amounts of the components at the date when the instrument first satisfies the recognition criteria in IAS 39 reflect circumstances at that date (IAS 39, paragraph 11). If the entity cannot determine the initial

carrying amounts of the embedded derivative and host contract reliably, it treats the entire combined contract as a financial instrument held for trading (IAS 39, paragraph 12). This results in fair value measurement (except when the entity cannot determine a reliable fair value, see IAS 39, paragraph 46(c)), with changes in fair value recognised in profit or loss.

BC13 This guidance reflects the principle in IFRS 1 that a first-time adopter should apply IFRSs as if they had been in place from initial recognition. This is consistent with the general principle used in IFRSs of full retrospective application of Standards. The IFRIC noted that the date of initial recognition referred to in paragraph IG55 is the date when the entity first became a party to the contract and not the date of first-time adoption of IFRSs. Accordingly, the IFRIC concluded that IFRS 1 requires an entity to assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of conditions at the date when the entity first became a party to the contract and not those at the date of first-time adoption.

DELETED IFRIC 9 TEXT

Deleted IFRIC Interpretation 9 text is not part of UIG Interpretation 9.

Paragraph 9

An entity shall apply this Interpretation for annual periods beginning on or after 1 June 2006. Earlier application is encouraged. If an entity applies the Interpretation for a period beginning before 1 June 2006, it shall disclose that fact. The Interpretation shall be applied retrospectively.