

FINANCIAL REPORTING
EXPOSURE DRAFT

PROPOSED AMENDMENTS TO
UITF ABSTRACT 42 (IFRIC 9)
'REASSESSMENT OF EMBEDDED DERIVATIVES'
AND
FRS 26 (IAS 39)
'FINANCIAL INSTRUMENTS:
RECOGNITION AND MEASUREMENT'

EMBEDDED
DERIVATIVES



ACCOUNTING
STANDARDS
BOARD

This draft is issued by the Accounting Standards Board for comment. It should be noted that the draft may be modified in the light of comments received before being issued in final form.

For ease of handling, we prefer comments to be sent by email (in Word format) to

asbcommentletters@frc-asb.org.uk

Comments may also be sent in hard copy form to:

Deepa Raval
ACCOUNTING STANDARDS BOARD
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

Comments should be despatched so as to be received no later than 31 July 2009. All replies will be regarded as on the public record, unless confidentiality is requested by the commentator.

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We aim to publish responses within 10 working days of receipt.

We will publish a summary of the consultation responses, either as part of, or alongside, our final decision.

**PROPOSED AMENDMENTS TO
UITF ABSTRACT 42 (IFRIC 9)
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DERIVATIVES’
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CONTENTS

	<i>Pages</i>
Preface	3-5
Proposed amendments to Urgent Issues Task Force (UITF) Abstract 42 (IFRIC 9) 'Reassessment of Embedded Derivatives' and Financial Reporting Standard (FRS) 26 (IAS 39) 'Financial Instruments: Recognition and Measurement'	6-16

ACCOUNTING STANDARDS BOARD JUNE 2009 ED AMENDMENTS TO
UITF ABSTRACT 42 AND FRS 26

PREFACE

Background

- 1 In December 2004, the Accounting Standards Board (ASB) issued Financial Reporting Standard (FRS) 26 (IAS 39) 'Financial Instruments: Measurement'. FRS 26 implemented the requirements of International Accounting Standard (IAS) 39 for those applying UK standards.
- 2 In March 2009, the International Accounting Standards Board (IASB) issued 'Embedded Derivatives – Amendments to IFRIC 9 and IAS 39'. The amendments 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. These amendments are the result of the IASB issuing amendments to IAS 39 and IFRS 7 'Reclassification of Financial Assets' in October 2008. The ASB is proposing to make equivalent amendments to UITF Abstract 42 and FRS 26 to ensure their continued convergence with IFRIC 9 and IAS 39.

The IASB's amendments

- 3 The amendments require:
 - (a) an entity to assess, under IFRIC 9, 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 on the later date of
 - (i) when the entity first became a party to the contract; and
 - (ii) a change in the terms of the

contract that significantly modified the cash flows that otherwise would have been required under the contract; and

- (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.
- 4 The amendments are in response to an issue raised by the IASB's constituents to prevent any practice developing whereby, following reclassification of a financial asset, embedded derivatives that should be separately accounted for are not.
- 5 The effective date for application of the amendments issued by the IASB is for annual periods ending on or after 30 June 2009.

The ASB's proposals

- 6 The amendments proposed in this Financial Reporting Exposure Draft (FRED) will ensure that UITF Abstract 42 (IFRIC 9) and FRS 26 (IAS 39) remain converged with IFRIC 9 and IAS 39. The ASB considers that these proposals will clarify the requirements in this area. As such, the ASB is proposing to retain the effective date of 30 June 2009.

Regulatory impact

- 7 In the ASB's view, the proposals set out in this FRED should not impose significant additional costs of preparation. The ASB believes that the amendments will result in information which is of benefit to users of the financial statements. The ASB would, however, welcome views on whether there are any significant costs resulting from these proposals and, if so, whether they can be quantified. The ASB would also welcome

views on whether the benefits arising from the proposals in this FRED would outweigh any costs involved.

Date from which effective

- 8 It is proposed that the [draft] FRS will be effective for accounting periods ending on or after 30 June 2009.

Invitation to comment

- 9 The ASB is requesting comments on the ASB's proposals for implementing the IASB's amendments in the UK, by 31 July 2009. The ASB would welcome comments on the following issues:

ASB Q1: Do you agree that the effective date should be 30 June 2009 so that the UK Standards remain converged with IFRS?

ASB Q2: Do you agree that the benefits of the proposals in the exposure draft would outweigh any additional costs involved? If not, please explain why.

**PROPOSED AMENDMENTS TO URGENT ISSUES TASK
FORCE ABSTRACT 42 (IFRIC 9) REASSESSMENT OF
EMBEDDED DERIVATIVES AND FINANCIAL
REPORTING STANDARD 26 (IAS 39) FINANCIAL
INSTRUMENTS: RECOGNITION AND
MEASUREMENT**

CONTENTS

**Proposed amendments to UITF Abstract 42 (IFRIC 9)
*'Reassessment of Embedded Derivatives'***

**Proposed amendments to FRS 26 (IAS 39)
*'Financial Instruments: Recognition and Measurement'***

Board approval of Amendments

**Amendments to the Basis for Conclusions on
UITF Abstract 42**

Amendments to the Basis for Conclusions on FRS 26

PROPOSED AMENDMENTS TO UITF ABSTRACT 42 (IFRIC 9) REASSESSMENT OF EMBEDDED DERIVATIVES

[ASB note: The text of UITF Abstract 42 (IFRIC 9) 'Reassessment of Embedded Derivatives' includes strike-through and underlining to show changes made by the ASB to the original text of the IFRIC. The amended text of UITF Abstract 42 set out below adopts the same convention; as a result, it is not possible to use strike-through and underlining to illustrate the changes to the existing standard. Instead, the changes are described in the text boxes appearing at the start of each set of proposed changes.]

Paragraph 7 is amended (~~new text is underlined and deleted text is struck through~~) to read as follows. Paragraphs 7A and 10 are added.

UITF 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 ~~IAS 39~~ FRS 26 shall not be applied (ie 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.

Effective date and transition

- 10 *Embedded Derivatives* (Amendments to ~~IFRIC 9~~ UITF Abstract 42 and ~~IAS 39~~ FRS 26 issued in ~~March~~ [Month] 2009 amended paragraph 7 and added paragraph 7A. An entity shall apply those amendments for annual periods ending on or after 30 June 2009.

PROPOSED AMENDMENTS TO FRS 26 (IAS 39) *FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT*

[ASB note: The text of FRS 26 (IAS 39) 'Financial Instruments: Recognition and Measurement' includes strike-through and underlining to show changes made by the ASB to the original text of the IAS. The amended text of FRS 26 set out below adopts the same convention; as a result, it is not possible to use strike-through and underlining to illustrate the changes to the existing standard. Instead, changes are described in the text boxes appearing at the start of each set of proposed changes.]

Paragraph 12 is amended (new text is underlined and deleted text is struck through) to read as follows. 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 date period, it shall designate the entire hybrid (combined) contract as at fair value through profit or loss. 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.**

Effective date and transition

- 103J An entity shall apply paragraph 12, as amended by *Embedded Derivatives* (Amendments to ~~IFRIC 9~~ UITF Abstract 42 and ~~IAS 39~~ FRS 26), issued in ~~March~~ [Month] 2009, for annual periods ending on or after 30 June 2009.

**Approval by the Board of *Embedded Derivatives*
(Amendments to IFRIC 9 and IAS 39) issued in
March 2009***

Embedded Derivatives (Amendments to IFRIC 9 and IAS 39)
was approved for issue by the fourteen 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	
Prabhakar Kalavacherla	
James J Leisenring	
Warren J McGregor	
John T Smith	
Tatsumi Yamada	
Wei-Guo Zhang	

* ASB footnote: the IASB's statement of approval of the amendments has been included unchanged; the reference to the 'Board' is to the IASB.

Amendments to the Basis for Conclusions on UITF Abstract 42

ASB Note: The amendments to the Basis for Conclusions that the IASB prepared to accompany its amendments is set out below in full. All references in this section to ‘the Board’ and ‘Board members’ are references to the IASB Board and IASB Board members.

After paragraph BC11 a heading and paragraphs BC11A–BC11F are added.

Reassessment of embedded derivatives

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 (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 (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.

Amendments to the Basis for Conclusions on FRS 26

ASB Note: The amendments to the Basis for Conclusions that the IASB prepared to accompany its amendments is set out below in full. All references in this section to 'the Board' and 'Board members' are references to the IASB Board and IASB Board members.

Paragraph BC11F and a sub-heading and paragraph BC40A are added.

Background

BC11F Following the issue of *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) 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. In response the Board issued *Embedded Derivatives* (Amendments to IFRIC 9 and IAS 39) in March 2009. The amendment to IAS 39 clarifies the consequences if the fair value of the embedded derivative that would have to be separated cannot be measured separately.

Embedded derivatives

Inability to measure an embedded derivative separately (paragraph 12)

BC40A As described in paragraph BC11F, 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 measured separately, the Board decided to clarify

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 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. The amendments were issued in March 2009.

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