

UITF abstract 42
(IFRIC Interpretation 9)
Reassessment of Embedded Derivatives

(Issued 7 April 2006)

Preface by the Urgent Issues Task Force

This Abstract has the effect of implementing the International Accounting Standards Board's (IASB's) International Financial Reporting Interpretations Committee (IFRIC) Interpretation 9 'Reassessment of Embedded Derivatives' in the UK and the Republic of Ireland for entities preparing their financial statements in accordance with UK accounting standards and, in doing so, are applying FRS 26 (IAS 39) 'Financial Instruments: Measurement'. a

FRS 26 implements IAS 39 'Financial Instruments: Recognition and Measurement' for listed entities* preparing their financial statements in accordance with UK accounting standards for accounting periods beginning on or after 1 January 2005, and for unlisted entities that adopt the fair value accounting rules in the Companies Act 1985, for accounting periods beginning on or after 1 January 2006. FRS 26 includes transition provisions for entities adopting the standard that are similar to those in IFRS 1 'First-time Adoption of International Financial Reporting Standards'. b

This Abstract incorporates the text of IFRIC 9.† The text of IFRIC 9 contains various references to International Financial Reporting Standards (IFRSs). In this Abstract those references have been amended to enable the Interpretation to be applied in a UK context. The UITF believes that those amendments do not change the requirements of IFRIC 9 in any way. c

* Except for certain listed entities in the Republic of Ireland, for which the commencement date is 1 January 2006.

† Deleted text has been struck through and inserted text is underlined.

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BASIS FOR CONCLUSIONS ON IFRIC 9

References

- ~~FRS 26 (IAS 39) *Financial Instruments: Recognition and Measurement*~~
- ~~IFRS 1 *First-time Adoption of International Financial Reporting Standards*~~
- ~~IFRS 3 *Business Combinations* FRS 6 *Acquisitions and Mergers*~~

Background

~~IAS 39~~ FRS 26 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.' 1

~~IAS 39~~ FRS 26 paragraph 11 requires an embedded derivative to be separated from the host contract and accounted for as a derivative if, and only if: 2

- (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 (ie a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

Scope

Subject to paragraphs 4 and 5 below, this ~~Interpretation~~ Abstract applies to all embedded derivatives within the scope of ~~IAS 39~~ FRS 26. 3

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

This ~~Interpretation~~ Abstract does not address the acquisition of contracts with embedded derivatives in a business combination nor their possible reassessment at the date of acquisition. 5

Issue

~~IAS 39~~ FRS 26 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 accounted for as derivatives under the Standard. This ~~Interpretation~~ Abstract addresses the following issues: 6

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- (a) Does ~~IAS 39~~ FRS 26 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 ~~IFRSs~~ FRS 26 for the first time?

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 a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment 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.
- 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.

Effective date and transition

- 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 accounting treatment required by this Abstract should be adopted in financial statements related to accounting periods beginning on or after 1 June 2006, but earlier adoption is encouraged. The Interpretation Abstract shall be applied retrospectively.~~

Basis for Conclusions on IFRIC Interpretation 9

This Basis for Conclusions accompanies, but is not part of, IFRIC 9.

ASB note: The IFRIC's Basis for Conclusions, which accompanies IFRIC 9, is set out below in full.

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 (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

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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.

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 (eg 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).

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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.

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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.