Accounting Standards Board september 2009

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

AMENDMENTS TO FRS

Amendments to UITF Abstract 42 (IFRIC 9) 'Reassessment of Embedded Derivatives' and FRS 26 (IAS 39) Financial Instruments: Recognition and Measurement is issued by the Accounting Standards Board in respect of its application in the United Kingdom and by the Institute of Chartered Accountants in Ireland in respect of its application in the Republic of Ireland.

AMENDMENTS TO

UITF ABSTRACT 42 (IFRIC 9)

'REASSESSMENT OF EMBEDDED DERIVATIVES'

AND

FRS 26 (IAS 39)

'FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT'

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PREFACE

Introduction

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 The Urgent Issues Task Force (UITF) issued UITF Abstract 42 (IFRIC 9) 'Reassessment of Embedded Derivatives' in April 2006. This Abstract had 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.

3 In June 2009, the ASB published a Financial Reporting Exposure Draft (FRED) of amendments to UITF Abstract 42 and FRS 26. The FRED set out in full the amendments made to IFRIC 9 and IAS 39 by the IASB in March 2009. The objective of issuing the FRED was to ensure that UITF Abstract 42 and FRS 26 remain converged with IFRIC 9 and IAS 39, respectively.

4 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.

5 Respondents to the ASB FRED were supportive of the proposed changes. Any issues were raised directly with the IASB following the issue of the IASB Exposure Draft in December 2008.

Date from which effective

6 The effective date for the amendments to UITF Abstract 42 and FRS 26 is for annual periods ending on or after 31 December 2009. Earlier application is permitted.

AMENDMENTS TO URGENT ISSUES TASK FORCE ABSTRACT 42 (IFRIC 9) 'REASSESSMENT OF EMBEDDED DERIVATIVES'

Amendment to the Preface by the Urgent Issues Task Force

[Strike-through and underlining are used to show changes made by the ASB in implementing IASB text, and not changes made to the existing standard resulting from this amendment.]

The following paragraph is added to follow paragraph c:

"d In September 2009 the Accounting Standards Board amended UITF Abstract 42 to incorporate changes made by the IASB to IFRIC 9 'Reassessment of Embedded Derivatives'. The amendments are applicable for annual periods ending on or after 31 December 2009".

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 text of the corresponding IFRIC. The amended text of UITF Abstract 42 set out below adopts the same convention; as a result, it is not practicable to use strike-through and underlining to illustrate changes to the existing UITF Abstract. Instead, the changes are described in the text boxes appearing at the start of each set of 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.

<u>UITF</u> 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 case~~s~~ 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~~ September 2009 amended paragraph 7 and added paragraph 7A. An entity shall apply those amendments for annual periods ending on or after ~~30 June 2009~~ 31 December 2009. Earlier application is permitted.

AMENDMENTS TO FINANCIAL REPORTING STANDARD 26 (IAS 39) 'FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT'

Amendment to the Preface by the Accounting Standards Board

[Strike-through and underlining are used to show changes made by the ASB in implementing IASB text, and not changes made to the existing standard resulting from this amendment.]

The following paragraph is added to follow paragraph z:

"a1 In September 2009 the Board amended FRS 26 to incorporate changes made by the IASB to IAS 39 'Financial Instruments: Recognition and Measurement' *'Embedded Derivatives'*. The amendments are applicable for accounting periods ending on or after 31 December 2009".

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 text of the corresponding IAS. The amended text of FRS 26 set out below adopts the same convention; as a result, it is not practicable to use strike-through and underlining to illustrate changes to the existing standard. Instead, the changes are described in the text boxes appearing at the start of each set of 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 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~~ September 2009, for annual periods ending on or after ~~30 June 2009~~ 31 December 2009. Earlier application is permitted.

ADOPTION OF AMENDMENTS

Approval by the ~~Board~~ IASB 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	

Approval by the Accounting Standards Board of *Embedded Derivatives* (Amendments to UITF Abstract 42 and FRS 26)

Amendments to UITF Abstract 42 *(IFRIC 9)* 'Reassessment of Embedded Derivatives' and *FRS 26 (IAS 39)* 'Financial Instruments: Recognition and Measurement' was approved for issue by the ten members of the Accounting Standards Board.

Ian Mackintosh	Chairman
David Loweth	Technical Director
Nick Anderson	
Michael Ashley	
Edward Beale	
Marisa Cassoni	
Peter Elwin	
Ken Lever	
Robert Overend	
Andy Simmonds	

APPENDIX: OTHER MATERIAL TO BE INSERTED IN UITF ABSTRACT 42 AND FRS 26

Amendment to FRS 26 Notes on the Standard's Application in the UK and the Republic of Ireland

Paragraph N67 is added as follows:

N67 An amendment to FRS 26 was issued by the Board in September 2009 following the IASB's amendments to IFRIC 9 'Reassessment of Embedded Derivatives' and IAS 39 Financial Instruments: Recognition and Measurement *'Embedded Derivatives'*. The amendments clarify the treatment of embedded derivatives when an entity reclassifies a financial asset out of the fair value through profit or loss category. The effective date for the amendment is for annual periods ending on or after 31 December 2009. Earlier application is permitted to enable entities to align the accounting under UK GAAP with the equivalent IFRS amendment which has an effective date for annual periods ending on or after 30 June 2009.

Amendments to the Basis for Conclusions on UITF Abstract 42 (IFRIC 9) 'Reassessment of Embedded Derivatives'

ASB Note: The amendments to the IASB's Basis for Conclusions, which accompanies IFRIC 9 (and has been reproduced in UITF Abstract 42) is set out below. 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 (IAS 39) 'Financial Instruments: Recognition and Measurement'

ASB Note: The amendments to the IASB's Basis for Conclusions, which accompanies IAS 39 (and has been reproduced in FRS 26) is set out below. 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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