

Basis for Conclusions on IFRIC Interpretation 9 *Reassessment of Embedded Derivatives*

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

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).
- 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

IFRIC 9 BC

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 venturer¹ 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* published 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 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

¹ 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.

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]

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

IFRIC 9 BC

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 (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.

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

IFRIC 9 BC

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.