

# Embedded Derivatives: Amendments to IFRIC 9 and IAS 39

## Background

The International Accounting Standards Board (the IASB or the Board) has published *Embedded Derivatives - Amendments to IFRIC 9 and IAS 39 (the Amendments)*. These Amendments were discussed at 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.

The IASB had previously issued a set of amendments in October 2008 entitled, *Reclassification of Financial Assets (Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 7 Financial Instruments: Disclosures)*, which permitted entities, in certain circumstances, to reclassify financial instruments previously held for trading into other categories which are not measured at fair value through profit or loss.

For such instruments there had previously been no need to consider the separation of any embedded derivatives, because the entire instrument was recorded at fair value through profit or loss. However, when an instrument is not recorded at fair value through profit or loss, it is necessary to assess whether to separate, and report at fair value through profit or loss, any embedded derivative if its economic characteristics and risks are not closely related to those of the host instrument. Normally, this assessment would be made at the inception of the transaction.

IFRIC 9 prohibited the subsequent reassessment of whether to separate embedded derivatives unless there was a change in the terms of the contract significantly modifying the cash flows. Arguably, in the circumstances of a reclassification, the question is not one of reassessment (as none was previously required) but of assessment for the first time. However, this was not entirely clear and the IFRIC did not contemplate reclassifications from the held-for-trading category when IFRIC 9 was written. The IASB therefore amended IFRIC 9 to clarify that assessment is required in such circumstances.

## Summary of the Amendments

The Amendments to IFRIC 9 require:

- ▶ An entity to assess whether an embedded derivative must be separated from a host contract when the entity reclassifies a hybrid financial asset out of the fair value through profit or loss category; and
- ▶ The assessment to be made on the basis of the circumstances that existed on the later of:
  - ▶ the date when the entity first became a party to the contract,
  - ▶ and the date of a change in the terms of the contract that significantly modifies the cash flows that otherwise would have been required under the contract (for this assessment IAS 39 provisions that do not require separation of an embedded derivative or hybrid (combined) contracts measured at fair value through profit or loss shall not apply).

IAS 39 is also amended to state that, if the fair value of an embedded derivative that would have to be separated on reclassification cannot be reliably measured, the entire hybrid financial instrument must remain classified as at fair value through profit or loss.

The Amendments are applicable for annual periods ending on or after 30 June 2009.

### Business impact

The Amendments impact any entity that either has already reclassified or will reclassify hybrid financial instruments in accordance with the October 2008 amendments to IAS 39. Once effective, entities would need to assess, if they have not already done so, whether there are any embedded derivatives in such instruments that need to be separated.

It is possible that an entity has reclassified hybrid instruments in its financial statements without assessing the requirement to separate embedded derivatives. In this case, the assessment would have to be made for the purpose of its first financial statements issued after 30 June 2009. Relevant comparative information may need to be restated.

In addition, if an entity has previously reclassified a hybrid instrument without reassessing the requirement to separate embedded derivatives but, on applying the Amendment to IFRIC 9, it turns out that there is an otherwise separable embedded derivative that cannot be reliably measured, the entire hybrid financial instrument would remain classified as at fair value through profit or loss and any reclassification would need to be reversed.

The requirement to base the assessment on the circumstances that existed when the entity first became a party to the contract could cause practical difficulties for some entities if the relevant information is no longer readily available. However, this requirement could reduce the likelihood of an embedded derivative needing to be separated in some circumstances. It is more likely, for example, that a prepayment option will be regarded as closely related to a host debt contract in accordance with paragraph AG 30 (g) of IAS 39, and therefore will not need to be separated. This is because the exercise price of the prepayment option is likely to be much closer to the amortised cost of the host contract on initial recognition than to the new amortised cost calculated on reclassification.

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