



European Financial Reporting Advisory Group ■

xx xxxx, 2005

D15 Comment Letters
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

PLEASE SEND YOUR COMMENTS AT svetlana.boysen@efrag.org BY 31 May 2005

Dear Sir/Madam,

Re: IFRIC Draft Interpretation D15 *Reassessment of Embedded Derivatives*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IFRIC Draft Interpretation D15 *Reassessment of Embedded Derivatives*. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive amendments on the issues.

We agree with the conclusion the IFRIC has reached in D15 that entities shall assess whether to separate embedded derivatives when the entity first becomes a party to the contract, and that subsequent reassessment should be prohibited. We share the arguments in the basis for conclusion that support this consensus. In particular, we share the IFRIC's view that requiring subsequent reassessment could be onerous and not justifiable in terms of benefits. Furthermore, we agree that changes due to subsequent reassessment might raise complicated measurement issues.

As a clarification, we suggest the basis for conclusions should explain that the reference in paragraph 4 to "a change in the terms of the contract" is intended to include changes to the substance of the contract as a result of certain changes in market conditions. For example, it is not uncommon for a long-dated gas contract for which no observable gas price in existence at inception to allow pricing either on the gas price or on a proxy price (for example the electricity price). Such contracts will initially be valued on the basis of the electricity price but, when observable gas prices become available, the contract is priced on the basis of those prices. An implication of this we understand is that, prior to observable gas prices becoming available, the contract will be deemed to contain an embedded derivative; on observable gas prices becoming available, there will no longer be an embedded derivative. We understand that the intention of D15 is that, for such contracts, a reassessment would be required when the observable gas prices become available. We support this intention, but do not think the intention is clear from the current wording of the draft interpretation.

We also agree with the conclusion in paragraph 5 that 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 when it first became a party to the contract. This conclusion is in line with the principle in IFRS 1 *First-time Adoption of International Financial Reporting Standards* that a first-time adopter should apply IFRSs as if they had been in place from initial recognition. Furthermore it is a natural consequence of the conclusion that subsequent reassessment of embedded derivatives is prohibited.

Question for respondents:

As explained above, D15 makes it clear that first-time adopters are required to make their assessments about the existence of embedded derivatives and the need to account for them separately on the basis of the conditions that existed when the first-time adopter first became a party to the contract. Some commentators have suggested that the IASB should allow entities a choice: the assessments can be made either on the basis of the conditions that existed when the first-time adopter first became a party to the contract or on the basis of the conditions that existed when the first-time adopter first adopted IAS 39. (If the IASB were to allow this choice, amendments would need to be made to existing standards.)

Those suggesting that such a choice should be permitted argue that it can be onerous carrying out the assessments retrospectively. They also argue that the main advantage of requiring the assessments to be carried out retrospectively is that it achieves convergence with US practice. However, US convergence is an issue for only some entities so, by giving a choice, entities would be able to weigh the cost and benefits of each approach.

On the other hand, those not in favour of permitting a choice of approach argue that it is no more onerous carrying out the assessment retrospectively than it is to carry it out on the basis of the conditions on the date of adoption—the information that needs to be gathered and the assessments that need to be made are the same. Some even argue that, because it is usually easier to separate an embedded derivative on initial recognition than subsequently (because difficult apportionment issues arise), it is less onerous to carry out the assessment retrospectively than on adoption.

EFRAG invites comment on this issue.

If you would like further clarification of the points raised in this letter, Paul Ebling or myself would be happy to discuss these further with you.

Yours sincerely,

Stig Enevoldsen
EFRAG, Chairman