xx January 2009

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 20 January 2009

Dear Sir / Madam

Re: Exposure Draft of Proposed Amendments to IFRIC 9 and IAS 39

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft of proposed amendments to IFRIC 9 *Reassessment of Embedded Derivatives* and IAS 39 Financial *Instruments: Recognition and Measurement* "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 interpretations/amendments on the issues.

We agree with the conclusions reached in the ED that:

- an entity shall 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;
- the assessment is made on the basis of the circumstances that existed when the entity first became a party to the contract; and
- if an entity is unable to separate a non-closely related embedded derivative from the host contract, the entire hybrid financial instrument must not be reclassified out of the fair value though profit and loss category.

However, in the Appendix to this letter we suggest some changes to the proposed amendments.

We hope that you find our comments helpful. If you wish to discuss them further, please do not hesitate to contact Svetlana Boysen or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix — Responses to the invitation to comment

Question 1 and Question 2

The exposure draft clarifies that an entity must 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. Do you agree with that clarification? If not, why? What would you propose instead, and why?

The exposure draft requires the assessment to be made on the basis of the circumstances that existed when the entity first became a party to the contract. Do you agree with that proposal? If not, why? What would you propose instead, and why?

<u>General comments on what the amendments are seeking to achieve</u>

1 We respond to question 1 and question 2 together because we consider the issues addressed to be linked.

2 We agree with the conclusion reached in the ED that an entity must 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. One of the requirements underlying IAS 39 is that all derivatives shall be measured at fair value through profit or loss, and that the requirements for embedded derivatives are designed to ensure this is the case regardless of whether the derivatives are standalone or embedded in a host contract. EFRAG would not have expected the IASB to amend this principle or make an exception to it without a full consideration of the issues and a comprehensive due process. The October 2008 amendment to IAS 39 involved neither.

3 We furthermore agree that the assessment of embedded derivatives on reclassification should be made on the basis of the circumstances that existed when the entity first became a party to the contract. As the ED explains (in paragraph BC6), this is being proposed to ensure that it makes no difference to the way in which an embedded derivative is accounted for whether the host contract is reclassified out of fair value through profit or loss and we agree that this is the right objective.

4 However, although we agree with the IASB's conclusions reached in the ED, we have some comments regarding the actual proposed amendments and they are set out in the paragraphs below.

<u>Detailed comments on the amendment proposed to paragraph 7 of IFRIC 9</u>

5 The proposal is that paragraph 7 of IFRIC 9 should be amended as follows: "Subsequent reassessment is prohibited unless there is <u>either (a)</u> a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract <u>or (b) a reclassification of a financial asset out of the fair value through profit or loss category</u>, in which cases an reassessment is required".

6 Existing paragraph 7 of IFRIC 9 requires an assessment of embedded derivatives on initial recognition to determine whether the embedded derivative must be separated. If that assessment concludes that the embedded derivative does not need to be separated and can be measured together with the host contract at cost, that assessment is not re-assessed unless the terms of the contract change. If that assessment concludes that the embedded derivative needs to be measured at fair value through profit or loss, that assessment is also not re-assessed unless the terms of the contract change.

7 We think the new guidance in paragraph 7A that assessment of embedded derivatives upon reclassification of hybrid instruments out of the fair value through profit or loss category shall be based on the circumstances that existed at the initial recognition of the instrument is consistent with the current requirements. For that reason:

(a) we are concerned that the proposed amendment to paragraph 7 of IFRIC 9 seems to imply that what has to be done when there has been a reclassification is an exception to existing IFRIC 9. We do not think that is correct.

(b) we are not convinced that an amendment to paragraph 7 of the kind proposed is needed. Paragraph 11 of IAS 39 already makes it clear that an assessment of embedded derivatives is required when the hybrid instrument is not classified as at fair value through profit or loss. There is no reference to this requirement applying only on initial recognition, so it is in effect an ongoing requirement.

8 On the other hand, we think it might be helpful if the scope of IFRIC 9 (and of paragraph 7 in particular) was clarified to make it clear that it deals only with assessments as to whether embedded derivatives are closely related to the host contract. Although IFRIC 9's Basis for Conclusions explains that the need to address such issues was the reason for developing IFRIC 9, the text of the Interpretation refers to assessments as to whether embedded derivatives need to be separated. In our view that is a broader scope than that implied by the Basis for Conclusions. We think that, had the scope of IFRIC 9 been more precisely (and therefore narrowly) expressed in the first place, the uncertainty that the ED is seeking to address would not have arisen because there would be no doubt that a reclassification makes it necessary to assess whether a reclassified hybrid contract contains an embedded derivative that require separation.

<u>Detailed comments on proposed new paragraph 7A of IFRIC 9</u>

9 The proposal is that a new paragraph (paragraph 7A) should be inserted in IFRIC 9.

10 Although we think the proposed new paragraph is helpful, we think its wording does not take into account the possibility that at some point in time after initial recognition and before reclassification out of fair value through profit or loss there was a change in the terms of the instrument that significantly affected its cash flows. Our understanding is that in such circumstances in accordance with paragraph 7 of IFRIC 9 on reclassification the embedded derivative would need to be assessed based on the conditions at the date of the change in terms. To reflect this, we suggest amending the proposed guidance in paragraph 7A as follows:

"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 <u>at the later of the date</u> when the entity first became a party to the contract <u>and the date a reassessment is required by paragraph 7</u>."

11 **Question to constituents:** We note that the assessment as it is described in proposed paragraph 7A could be influenced by hindsight. Usually the concern when an accounting decision can be influenced by hindsight is the risk of accounts manipulation. Although we are not in favour of standards that are driven by anti-abuse thinking, in this case our evaluation is that such a risk is not significant anyway. If you are aware of situations where the use of hindsight in applying the requirements of proposed paragraph 7A might be a concern please let us know.

Another potential application issue with IFRIC 9

12 We understand that the objective of this ED is to clarify how IFRIC 9 interacts with the requirements concerning the reclassification of financial instruments out of the fair value through profit or loss category. We would nevertheless like to draw the IASB's attention to another potential IFRIC 9 application issue, which is how to apply its requirements on assessment or reassessment of embedded derivatives if there is a change in IAS 39's requirements on what can be considered a closely related or a non-closely related embedded derivative. In particular, the question is whether entities will be required to reassess whether embedded derivatives in hybrid instruments outstanding at the time when the change becomes effective have to be accounted for separately or must no longer be separated and, if that is the case, how recognition and measurement should work.

13 We raise this point because we note that the FASB and the IASB are currently deliberating an issue relating to whether derivatives embedded in collateralised debt obligations can be considered closely related to the host contract in certain cases. We think that, should this result in changes that have an effect on IAS 39's closely-non closely related embedded derivatives requirements, such issues as mentioned in the above paragraph would need to be addressed.

Question 3

The exposure draft proposes that if the fair value of an embedded derivative that would have to be separated cannot be reliably measured, the entire hybrid (combined) financial instrument must remain in the fair value through profit or loss category. Do you agree with that proposal? If not, why? What would you propose instead, and why?

14 We agree with that, if an embedded derivative is not closely related to the host contract but it cannot be measured separately, the entire hybrid financial instrument must remain in the fair value though profit and loss category. This avoids the necessity of reclassifying the hybrid (combined) financial asset back into the fair value through profit or loss category at the end of the financial reporting period if the entity concludes that the embedded derivative is not closely related but is unable to measure it separately in accordance with paragraph 12.

15 We therefore agree with the clarification, which is achieved by adding a sentence to paragraph 12 of IAS 39. Indeed, we think that the proposed new sentence directly follows from the existing requirements in paragraph 12.

16 However, we think that the reference in paragraph BC 8's explanation of the rationale for the amendment to an inability to measure the fair value of the embedded derivative reliably could be confusing. We understand that under IAS 39 reliability of measurement is considered to be a potential issue only in the case of unquoted equity instruments or derivatives linked to such unquoted equity instruments. Paragraph 13 of IAS 39 addresses hybrid instruments that contain such embedded derivatives. Paragraph 12 of IAS 39 emphasises inability to measure embedded derivatives *separately* which could, for example, be the case for some complex financial instruments. Thus, paragraph 12 does not deal with reliability, and therefore it is not clear why paragraph BC 8 of the Basis for Conclusions is talking about reliability. We suggest changing the wording of paragraph BC8 to be in line with the requirements in paragraph 12 as amended as follows: "If ~~the fair value of~~ the embedded derivative that would have to be separated cannot be ~~reliably~~ measured separately, the Board decided to propose clarifying that the hybrid (combined) financial asset in its entirety should remain in the fair value through profit or loss category."

Question 4 and Question 5

Do you agree with the proposed effective date? If not, why? What would you propose instead, and why?

Are the transition requirements appropriate? If not, why? What would you propose instead, and why?

17 We respond to question 4 and question 5 together because we consider the issues addressed to be linked.

18 The IASB explains in the ED that, in setting the effective date of the proposed amendment, the IASB wanted to ensure appropriate separation of embedded derivatives on reclassification of hybrid (combined) financial assets out of the fair value through profit or loss category. The ED proposes that the proposed amendments should be applied to annual periods ending on or after 15 December 2008; 15 December being the date when the IASB made a decision during its public meeting to propose these amendments.

19 We agree with what the IASB wants to achieve: an uncertainty has arisen that could have an effect on reclassifications made under the October 2008 amendment to IAS 39. However, we are not sure that the proposed effective date and transition requirements do that because, under the October 2008 amendment, entities could reclassify financial instruments out of the fair value through profit or loss category as early as of 1 July 2008 and, if such an entity has an annual period ended any time after 1 July 2008 but before 15 December 2009, it seems that it would not need to apply the conclusions in the ED to such reclassifications.

20 We think that the effective date and transitional requirements should be drafted so as to have the effect that the clarifications in the ED will be applicable as of the earliest date on which such reclassifications become possible (ie 1 July 2008).

21 We recognise that this means backdating the effective date. Normally, EFRAG would oppose a proposal to backdate an effective date. Although EFRAG has a strong preference for new, clarified or amended requirements in IFRS to be applied retrospectively (to ensure comparability of reported information through time), it also recognises that to apply new, clarified or amended requirements retrospectively it is necessary for sufficient lead time to be given to entities to enable them to prepare for a change. Moreover, backdating an effective date is problematic for jurisdictions that require legal endorsement of any changes to IFRS before they can be applied.

22 However, exceptionally in this case we support backdating the effective date. This is because we believe (and we mentioned this above) that these amendments clarify something which the IASB clearly intended when it allowed reclassifications out of the fair value through profit or loss category in the October 2008 amendment to IAS 39 that allowed certain reclassifications out of the fair value through profit or loss category. In fact, this clarification should have been part of the October 2008 amendment. However, because of the urgency with which the IASB was requested to proceed with the October 2008 amendment without following a normal due process it is understandable that an omission of this kind can happen.

23 **Question to constituents:** Exceptionally in this case EFRAG supports backdating the amendments proposed in this ED for reasons explained in the preceding paragraphs. However, if you are aware of situations where these amendments may cause significant implementation problems due to the backdating of the effective date, please let us know.