EFRAG
European Financial Reporting Advisory Group

28 January 2009

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

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 shall be 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 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 does not believe the IASB intended to amend this principle or make an exception to it in its October 2008 amendment to IAS 39—that would have required a full consideration of the issues and a comprehensive due process and 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 BC7), this is being proposed to ensure consistency in accounting for embedded derivatives no matter how the host contracts are initially classified. 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 amendments proposed and they are set out in the paragraphs below.

<u>Scope of IFRIC 9</u>

5 We understand that many interpret IFRIC 9 as generally prohibiting any assessment of embedded derivatives subsequent to initial recognition of the hybrid contract.

6 However, in our view the focus of IFRIC 9 is on whether entities should reconsider whether an embedded derivative is closely related to the host contract. We think paragraph BC5 of IFRIC 9 confirms this in its explanation of the reason for developing IFRIC 9:

> "...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...and hence not accounted for separately. Assume that subsequently market conditions changed and that if the entity were to reassess the contract under the changes 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."

7 Based on this (and other relevant) explanations in the Basis for Conclusion in IFRIC 9, we believe that the purpose of IFRIC 9 is to prohibit *re*-assessment of embedded derivatives with regard to whether the embedded derivatives are *closely related to the host contract or not*, which is a narrower scope than prohibiting any assessment of embedded derivatives subsequent to initial recognition. We think it would be helpful if the scope of IFRIC 9 (and of par*agraph* 7 in particular) was clarified accordingly.

8 That would help to make it clear that IFRIC 9 does not prohibit an assessment of embedded derivatives upon reclassification of financial instruments out of the fair value through profit or loss category. Such a clarification would eliminate any possibility of IFRIC 9 being seen to contradict paragraph 11 of IAS 39, which 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.)

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

9 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 in IFRIC 9 that prohibit re-assessment of embedded derivatives subsequent to initial recognition. We therefore support proposed new paragraph 7A (subject to the point raised below).

10 However, 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 it <u>is</u> an exception, and therefore find the proposed amendment unhelpful. Indeed, we are not convinced that an amendment to paragraph 7 of the kind proposed is needed.

11 While we agree with the proposed guidance in paragraph 7A, 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 has been 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>."

12 We note that some commentators argue that, when entities reclassify hybrid financial instruments out of the fair value through profit or loss category, derivatives embedded in such instruments should be reassessed based on the market conditions <u>on the date of reclassification</u>. We understand that these commentators reason that it might not be feasible to identify market conditions at initial recognition for instruments that were acquired a long time before they were reclassified, even for hybrid instruments in the trading category. In addition, some are concerned that the approach proposed in the ED means there is a risk that the assessment will be influenced by hindsight.

13 As stated earlier, we believe that requiring that the assessment of embedded derivatives upon reclassification of hybrid instruments should be based on the conditions that existed at the initial recognition would ensure consistent treatment of embedded derivatives irrespective of the initial classification of the host contract. We recognise that it is possible that in some circumstances this might be difficult to do, but IAS 8 already allows for such circumstances. We therefore support the proposal.

14 However, if the IASB in the final amendment decides to amend its approach and require entities to reassess embedded derivatives upon reclassification out of the fair value through profit or loss category based on the conditions at the time of reclassification, we agree with IASB staff comment in the observer notes for the December 2008 IASB meeting that some of the current criteria and examples in IAS 39’s Application Guidance would need to be amended.

<u>Another potential application issue with IFRIC 9</u>

15 Although 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 that is arising. The issue is how to apply IFRIC 9’s 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 the change becomes effective have to be accounted for separately or must no longer be separated and how recognition and measurement should work.

16 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-related/nonclosely-related embedded derivatives requirements, such issues 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?

17 We agree 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.

18 We therefore agree with the ED’s proposal to add a sentence to paragraph 12 of IAS 39 to clarify it. Indeed, we think that the proposed new sentence directly follows from the existing requirements in paragraph 12.

19 However, we note that paragraph BC8, which explains the IASB’s rationale in proposing the amendment, refers to an inability to measure the fair value of the embedded derivative reliably. This is confusing because it seems to us that it is

paragraph 13 of IAS 39 that deals with the circumstances when the fair value of embedded derivatives cannot be measured reliably. The scope of paragraph 12 seems to be wider. For example, we understand that paragraph 12 would require the hybrid instrument to remain in the fair value through profit or loss category if the terms of the embedded derivative are so interlinked with the terms of the host instrument that it is impossible to separate the embedded derivatives in any meaningful way. We think it would be helpful if the rationale could be clarified on this issue.

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?

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

21 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.

22 We think that the effective date and transitional requirements should be such that the effect will be that the clarifications in the ED will be applicable as of the earliest date on which such reclassifications become possible (ie 1 July 2008). Taking into account that, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, the amendments need to be applied retrospectively, we believe that the effective date and transitional provisions of the amendments achieve this effect. We therefore support the effective date and transitional provisions.

23 We recognise that this means backdating the effective date. Normally, EFRAG would oppose a proposal to backdate an effective date, not least because backdating an effective date is problematic for jurisdictions that require legal endorsement of any changes to IFRS before they can be applied. 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.