EFRAG
European Financial Reporting Advisory Group

EFRAG'S EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENT TO IFRIC 9 AND IAS 39 "EMBEDDED DERIVATIVES"

INTRODUCTION

1 Following discussions in 2007 between the various parties involved in the EU endorsement process, it was decided that more extensive information than hitherto should to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of the Amendment to IFRIC 9 and IAS 39 "Embedded Derivatives" (the Amendment).

2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendment, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. (The results of the consultations EFRAG has carried out seem to confirm this). Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing the Amendment in the EU, to consult on the results of those initial assessments, and to finalise those assessments in the light of the comments and information received.

EFRAG's endorsement advice

3 EFRAG also carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

A SUMMARY OF THE AMENDMENT

4 A derivative is a financial instrument whose price is dependent upon or derived from one or more underlying assets such as stocks, bonds, commodities, currencies, interest rates and market indexes. Derivatives require little initial investment however they may result in significant fluctuation in ultimate cash flow to their holders. IFRS requires all derivative contracts to be measured at fair value on the grounds that fair value provides the most useful information about such instruments.

5 The IFRS requirements for derivatives are furthermore designed to ensure that derivative contracts are accounted for at fair value regardless of whether they are stand alone derivatives or embedded in other contracts. To ensure that, IAS 39 requires entities to assess whether a financial instrument contains an embedded derivative and, if it does, to account for the host instrument and the embedded derivative separately unless they are 'closely related'. The only circumstance in which it is not necessary to carry out such an assessment and to separate the host contract and the embedded derivative is where it would not make a difference to the accounting (because they are already being accounted for in the way that the embedded derivatives would need to be accounted for, at fair value with changes in fair value reported in profit or loss ('at fair value through profit or loss')). That would be the case for financial instruments acquired for trading purposes and for those financial instruments that the entity chooses to account for at fair value through profit or loss at initial recognition.

6 In October 2008 IAS 39 was amended to allow entities in some rare circumstances to cease accounting at fair value through profit or loss for—in other words, to reclassify out of the fair value through profit or loss category—non-derivative financial assets that were acquired for trading purposes.

7 IFRIC 9 provides guidance on the assessment of financial instruments with embedded derivatives. However, IFRIC 9 as originally issued did not address a situation where the entity initially carried the instrument at fair value through profit or loss (and therefore was not required to assess embedded derivatives in that instrument) but subsequently took advantage of the October amendment and switched to a different way of accounting for this instrument.

8 The Amendment 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. The Amendment further clarifies that the assessment should be made on the basis of the circumstances that existed when the entity first became a party to the contract. That is necessary to ensure consistency in the treatment of embedded derivatives irrespective of the way the entity accounted for hybrid contract containing the embedded derivatives initially. Finally, the Amendment clarifies that, if the entity concludes that the derivative requires to be accounted for at fair value but is unable to estimate the fair value of the embedded derivative separately, the entity has to continue to account for the entire instrument at fair value through profit or loss.

EFRAG'S INITIAL ANALYSIS OF COSTS AND BENEFITS OF THE AMENDMENT

9 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users from implementing the Amendment, both in year one and in subsequent years. The results of the initial assessment can be summarised as follows.

(a) EFRAG's initial assessment was that the Amendment is likely to involve:

  (i) some preparers in some additional year one costs, but no ongoing costs. However, EFRAG's initial assessment was that, when considered in aggregate, the additional year one costs would not be significant.

  (ii) users in no year one or ongoing incremental costs.

(b) EFRAG's initial assessment of the benefits that would arise from the Amendment was that the Amendment was likely to result in a reduction in divergence in practice, thereby enhancing consistency and comparability of the information provided. This should be a benefit to all stakeholders.

(c) EFRAG's initial assessment was that the benefits to be derived from implementing the Amendment in the EU were likely to exceed the costs involved in its implementation.

10 EFRAG published its initial assessment of the costs and benefits of implementing the Amendment in the EU and supporting analysis on 27 March 2009 and invited comment on the material by 8 May 2009. In response, EFRAG received eight comment letters. Three of those letters did not comment on EFRAG's initial assessment of costs. The remaining five comment letters agreed with EFRAG's initial assessment and had no additional comments.

EFRAG's FINAL ANALYSIS OF THE COSTS AND BENEFITS OF THE AMENDMENT

11 Based on its initial analysis and comment letters received in response to that analysis, EFRAG's final analysis of the costs and benefits of the Amendment is presented in the paragraphs below.

Costs for preparers

12 The Amendment eliminates the uncertainty in the application of IFRS that arose as a result of October 2008 amendment to IAS 39. In effect what the Amendment does is clarify that the accounting treatment of embedded derivatives has not changed as a result of the October amendment.

13 Since the uncertainty existed, some entities might have interpreted and applied the requirements in IAS 39 differently. As a result, there will be some implications for past reclassifications for some entities. In accordance with the transitional arrangements:

(a) entities would have to apply the Amendment for annual periods ending on or after 30 June 2009. That would mean that all relevant transactions that took place on or after 1 July 2008 in those annual periods would need to be reported in accordance with the Amendment; and

(b) entities would have to restate comparative information for annual periods that ended before 30 June 2009.

This will involve entities that interpreted the requirements in IAS 39 differently prior to this Amendment in additional one-off costs. However, the IASB's swift action in identifying and addressing the uncertainty involved will have decreased the likelihood of a large number of entities interpreting the requirements differently and of the amount of those costs being significant.

14 Going forward, there will be costs involved in assessing embedded derivatives in financial assets that entities choose to reclassify out of fair value through profit or loss. However, such the option to reclassify in this way can be exercised only in rare cases. In addition, if an entity believes that the costs of exercising that option exceed the benefits it will not reclassify. In any case, such costs are due to the existing IFRS requirements and therefore are not incremental. The Amendment

itself may even reduce costs for preparers going forward a little because it has removed an uncertainty in IFRS requirements.

15 To summarise, EFRAG's assessment is that, although there will be some year one costs for some entities from implementing the Amendment, such costs are unlikely to be significant. Furthermore, there are unlikely to be any ongoing incremental costs from implementing this Amendment.

Costs for users

16 EFRAG's assessment is that the Amendment will not increase the costs to users of using the financial statements in any way.

Benefits for preparers and users

17 EFRAG has concluded that the Amendment will result in reducing the divergence in practice, thereby enhancing consistency and comparability of the information provided. This should be a benefit to all stakeholders.

Overall assessment

18 EFRAG's assessment is that the benefits that will arise from implementation of the Amendment in the EU are likely to exceed the insignificant costs involved.

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