EFRAG

European Financial Reporting Advisory Group

Jörgen Holmquist
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

27 May 2009

Dear Mr Holmquist

Adoption of the Amendment to IFRIC 9 and IAS 39 "Embedded Derivatives"

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of the Amendment to IFRIC 9 and IAS 39 *Financial Instruments: Recognition and Measurement* "Embedded Derivatives" (the Amendment), which was issued by the IASB in March 2009. It was issued as an Exposure Draft in December 2008 and EFRAG commented on that draft.

The Amendment concerns the treatment of derivative financial instruments embedded in other contracts. 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 that assessment should be made on the basis of the circumstances that existed when the entity first became a party to the contract. Finally, the Amendment clarifies that, if the entity concludes that the derivative requires fair value accounting but is unable to measure 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.

The Amendment becomes effective for annual periods ending on or after 30 June 2009 and shall be applied retrospectively.

EFRAG has carried out an evaluation of the Amendment. As part of that process, EFRAG issued an initial evaluation for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports the Amendment and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that:

- it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

- it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt the Amendment and, accordingly, EFRAG recommends its adoption. EFRAG's reasoning is explained in the attached 'Appendix - Basis for Conclusions'.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

APPENDIX
BASIS FOR CONCLUSIONS

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as adviser to the European Commission on endorsement of the final IFRS or Interpretation on the issue.

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In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

INTRODUCTION

1 The Amendment clarifies that an entity must assess whether embedded derivatives are required to be measured separately at fair value when the entity no longer measures the hybrid financial instrument containing the embedded derivatives asset at fair value through profit or loss. The amendment further clarifies that in order to ensure consistency in treatment of embedded derivatives, 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. If the entity concludes that embedded derivatives require fair value accounting but is unable to measure the fair value of the embedded derivatives separately, the Amendment clarifies that the entity has to continue to account for the entire hybrid instrument at fair value through profit or loss.

2 EFRAG assessed whether the information resulting from the application of the Amendment would meet the criteria for EU endorsement; in other words, that:

(a) it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

(b) it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG also considered whether it would be in the European interest to adopt the amendment.

3 Having formed tentative views on these issues and prepared a draft assessment, EFRAG issued that draft assessment on 27 March 2009 and asked for comments on it by 8 May 2009. EFRAG has considered all the comments received in

response, and the main comments received are dealt with in the discussion in this appendix.

EVALUATION

Relevance

4 According to the IASB's Framework, information has the quality of relevance when it influences the economic decisions of users by helping them to evaluate past, present or future events or confirming, or correcting, their past evaluations. EFRAG considered whether the Amendment would result in the provision of relevant information—information that has predictive value, confirmatory value or both—and whether it might result in the omission of any information that is relevant.

5 IFRS considers that accounting for derivatives, regardless of whether they are stand alone derivatives or embedded in other contracts, at fair value through profit or loss provides relevant information for users of financial statements. As a result, that has been the required accounting treatment for all derivatives (other than those embedded derivatives that are closely related to the host instrument) for some time now.

6 However, in October 2008 the IASB amended IAS 39 to allow entities to reclassify non-derivative financial assets out of the fair value through profit or loss accounting category in some rare cases. As a result of that amendment, an uncertainty has arisen as to how the requirements for assessment of embedded derivatives should be applied in such situations. In particular, the October amendment has created uncertainty as to whether derivatives embedded in reclassified instruments are still required to be measured at fair value through profit or loss and, if they are, how that should be achieved.

7 Guidance on assessment of embedded derivatives is in IFRIC 9. However, when IFRIC 9 was developed the situation described in the preceding paragraph was not possible, so IFRIC 9 did not address it in its guidance.

8 The Amendment clarifies that, regardless of whether a derivative is embedded in an instrument that has been reclassified or in some other instrument, as long as it is not closely related to that other instrument it shall be accounted for in exactly the same way. In other words, the Amendment ensures that the accounting treatment that the IASB believes is most relevant for derivatives is applied to all derivatives in all circumstances.

9 EFRAG's view is that the accounting treatment of derivatives, including embedded derivatives, prior to the October amendment resulted in information that meets the relevance criteria. It believes it follows that the information provided by applying this latest Amendment will also meet the relevance criterion.

Reliability

10 The Framework explains that information has the quality of reliability when it is free from material error and bias, can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost. EFRAG has considered whether information resulting from the application of the Amendment exhibits those qualities.

11 Since the Amendment only clarifies the application of existing requirements, it does not give rise to concerns about bias, faithful representation, or completeness. In theory it is possible that it gives rise to concerns about material errors because of difficulties in estimating the numbers involved. However, EFRAG notes that the existing IFRIC 9 already requires exactly the same type of estimates to be made in certain circumstances and EFRAG considers that the information provided by applying existing IFRIC 9 meets the reliability criteria.

12 As such, EFRAG does not believe that the application of the Amendment will result in the provision of information that lacks the characteristic of reliability.

Comparability

13 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

14 EFRAG notes that the Amendment will eliminate causes of diversity in current practice and will ensure that existing requirements are applied consistently.

15 Furthermore, the Amendment clarifies that, if the entity assesses the need to separate embedded derivatives at the time when the entity reclassifies such instruments out of fair value through profit or loss, the assessment should be made on the basis of the circumstances that existed when the entity first became a party to the contract. In this way, the Amendment ensures that accounting for embedded derivatives will be the same irrespective of how the instrument was initially classified. That will further enhance the comparability of the information provided.

16 For all these reasons EFRAG believes that the Amendment meets the comparability criterion.

Understandability

17 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.

18 Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most aspects are covered by the discussion above about relevance, reliability and comparability (because, for example, information that represents something as similar when it is in fact dissimilar is not comparable, and that lack of comparability will mean it is also not understandable). As a result, EFRAG believes that the main additional issue it needs to consider in assessing whether the information resulting from the application of the Amendment is understandable is whether that information will be very complex. EFRAG's assessment is that the Amendment will not add to the complexity of the information provided.

19 EFRAG has therefore concluded that the information that results from the application of the Amendment meets the understandability criterion.

Transitional arrangements

20 The amendment is to be applied retrospectively for annual periods ending on 30 June 2009. EFRAG believes that retrospective application will ensure that issues of relevance and reliability do not arise (and the comparability and understandability of the information is maintained, because users are able to identify the effect that the change in accounting has had on previously-reported numbers and to take that into account in their long-term trend analysis).

True and Fair

21 Having concluded that the information that results from the application of the Amendment will meet the criteria of relevance, reliability, comparability and understandability and being unaware of any other reason to be concerned about the accounting effect of the Amendment, EFRAG sees no reason to believe that the amendment is inconsistent with the true and fair view requirement.

European Interest

22 EFRAG has considered whether the benefits of implementing the Amendment in the EU exceed the costs of doing so. Its assessment is that, although implementation of the Amendment would involve some costs, they are likely to be outweighed by the benefits.

CONCLUSION

23 EFRAG's overall conclusion is that the Amendment satisfies the criteria for EU endorsement and EFRAG should therefore recommend its endorsement.