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Deloitte global IFRS leadership team IFRS global office

Global IFRS leader

Ken Wild

kwild@deloitte.co.uk

IFRS centres of excellence

Americas

D. J. Gannon

iasplusamericas@deloitte.com

Asia-Pacific

Hong Kong

Stephen Taylor

iasplus@deloitte.com.hk

Melbourne

Bruce Porter

iasplus@deloitte.com.au

Europe-Africa

Johannesburg

Graeme Berry

iasplus@deloitte.co.za

Copenhagen

Jan Peter Larsen

dk_iasplus@deloitte.dk

London

Veronica Poole

iasplus@deloitte.co.uk

Paris

Laurence Rivat

iasplus@deloitte.fr

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IFRIC 9 – Reassessment of Embedded Derivatives

On 1 March 2006, the International Financial Reporting Interpretations Committee (IFRIC) issued IFRIC 9 **Reassessment of Embedded Derivatives**. The Interpretation clarifies whether an entity should reassess whether an embedded derivative needs to be separated from the host contract after the initial hybrid contract is recognised. IFRIC 9 concludes that reassessment is prohibited, unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required.

The issue

IAS 39 **Financial Instruments: Recognition and Measurement** requires an entity, when it first becomes a party to a contract, to assess whether any embedded derivatives contained in the contract are required to be separated from the host contract and accounted for as derivatives. Separation is required where the economic characteristics and risks of the embedded derivative are not closely related to the host contract.

IFRIC 9 addresses two questions:

- 1) Does an entity have to reconsider its assessment of whether an embedded derivative needs to be separated after the initial recognition of the hybrid contract?
- 2) Should a first-time adopter of International Financial Reporting Standards (IFRSs) make its assessment of whether an embedded derivative needs to be separated when the entity first became a party to the hybrid contract, or when the entity adopts IFRSs for the first time?

The consensus

The IFRIC concluded that an entity generally should not reassess its conclusion as to whether an embedded derivative needs to be separated from the hybrid contract after it is initially recognised. Similarly, a first-time adopter of IFRSs should make its assessment on the basis of conditions existing when the entity became party to the hybrid contract, not when it adopts IFRSs. An entity should only revisit its assessment if the terms of the contract change, and the expected future cash flows of the embedded derivative, the host contract, or both, have changed significantly relative to the previously expected cash flows on the contract.

The application

The application of IFRIC 9 is best illustrated by example:

- A European company with the euro as its functional currency enters into purchase contracts denominated in yen with a Japanese company that has yen as its functional currency. Since the contracts are denominated in yen, the contracts are considered to be closely related because they are in the functional currency of one of the parties to the transactions. Subsequently, the functional currency of the Japanese supplier changes to US dollars because the economic environment in which the company operates has changed. Any **new** yen-denominated purchase contracts would fail to be considered closely related according to IAS 39:AG33d(i) as they would not be in the functional currency of either party to the contract. However, those contracts entered into prior to the change in the supplier's functional currency where the embedded derivatives were considered closely related are not reassessed and continue to be accounted for as was done in the past.
- Prior to the deregulation of an energy market, the prices of gas and of electricity were linked and, therefore, correlation between the two prices was high. If an electricity contract was considered to be a normal sale, purchase or usage contract, in accordance with IAS 39.5, but the pricing of the contract was linked to the gas price, the price adjustment feature was concluded to be closely related at inception of the contract. Following deregulation of the market, the price of gas and the price of electricity are no longer correlated and, therefore, an assessment that the price adjustment feature was not closely related would be applied to **new** contracts with the same terms. However, those electricity contracts entered into prior to deregulation of the market, and previously considered to have closely related embedded derivatives, are not reassessed and continue to be accounted for as was done in the past.

In both examples above, the contract terms remain unchanged. Therefore, the embedded derivative assessment is not reperformed, irrespective of whether the factors that led to the conclusion have changed. Assessment of whether an embedded derivative is closely related is performed when the contract is initially recognised and is not revisited unless the contract terms change. This principle applies equally to a continuing IFRS reporter as well as to a first-time adopter of IFRSs.

The Interpretation does not address the remeasurement issues arising from a reassessment of embedded derivatives where reassessment is required (i.e. where there is a change that significantly modifies the cash flows otherwise required under the contract). Neither does the Interpretation address the acquisition of contracts with embedded derivatives in a business combination nor their possible reassessment at the date of acquisition.

Effective date and transition

Entities are required to apply IFRIC 9 retrospectively for annual periods beginning on or after 1 June 2006. Earlier application is encouraged. If an entity applies the Interpretation for a period beginning before 1 June 2006, that fact should be disclosed.

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