

21 January 2009

Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Re: Exposure Draft, Embedded Derivatives - proposed amendments to IFRIC 9 and IAS 39

Dear Sir David,

Deloitte Touche Tohmatsu is pleased to respond to the exposure draft, *Embedded Derivatives*, proposed amendment to IFRIC 9 and IAS 39 (the “Exposure Draft”).

We are supportive with the Board’s decision to address this issue in response to requests for clarification that have arisen since the amendment to IAS 39, *Reclassification of Financial Assets*, was issued in October 2008. We agree with the conclusions of the Exposure Draft. We believe however, that the interaction between the amended IAS 39.12 and the retained IAS 39.13 should be clarified. Specifically, it should be clearer whether an entity may reclassify a financial asset even though it cannot reliably measure the embedded derivative but can reliably measure the entire financial instrument and the financial host contract.

Our detailed responses to the invitation to comment questions are included in Appendix A.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907 or Andrew Spooner in London at +44 (0) 207 007 0204.

Sincerely,



Ken Wild
Global IFRS Leader

Appendix A: Invitation to Comment

Question 1

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?

We agree.

Question 2

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?

We believe that an entity should make the assessment based on circumstances that existed at the later of the date the entity first became party to the contract and the date when there has been a change to the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract. If there has been a change to the terms of the contract between inception and the date of reclassification, paragraph 7A as currently drafted would not permit an entity to reassess based on condition that existed at the date that the terms were changed. We do not believe there should be a difference in the assessment of an embedded derivative between an entity that initially designated the instrument as at 'fair value through profit or loss' and an entity that did not.

Accordingly, we believe the proposed paragraph 7A could be amended as below:

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 at the later of the date when the entity first became a party to the contract and the date of the change in terms of the contract that significantly modified the cash flows that otherwise would have been required under the contract.

Instead of paragraph 7A an alternative approach may be to include the guidance on assessing embedded derivatives at the date of reclassification described in paragraph 7A into paragraph 7.

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?

IAS 39.13 currently requires that if an embedded derivative requires separation and the entity "is unable to determine reliably the fair value of an embedded derivative" then its fair value

should be determined by deducting the fair value of the financial host contract from the fair value of the entire financial instrument. Only if this cannot be done should the entire instrument be measured at fair value through profit or loss under IAS 39.12. In other words, we believe IAS 39.13 must be applied before considering IAS 39.12.

We note that IAS 39.13 is unaffected by the amendment. We therefore assume, and support, that on the date of reclassification, should the entity not be able to fair value the embedded derivative reliably, it could still determine the fair value of the embedded derivative by deducting the fair value of the host contract from the fair value of the entire contract. However, we are not sure whether this was the intent of the Board as expressed in the exposure draft for the following reasons:

- (i) IAS 39.12 states if an entity is “*unable to measure* the embedded derivative”
- (ii) IAS 39.13 states if an entity is “*unable to determine reliably* the fair value of an embedded derivative.
- (iii) IAS 39.BC8 (proposed) states “if the fair value of the embedded derivative that would have to be separated cannot be *reliably measured*”

The language used in the proposed BC8 is more aligned with the language in IAS 39.13, not IAS 39.12. Therefore, should an entity not be able to reliably measure the embedded derivative at the date of reclassification it is not clear whether the entity is prohibited from reclassifying, or instead can reclassify and separate out the embedded derivative by applying IAS 39.13. We support the latter view and urge the Board to consider and clarify this point.

We believe the amended IAS 39.12 may not entirely reflect the intent of the Board as described in paragraph BC8 (reproduced below):

The Board also considered another issue related to a reclassification of a hybrid (combined) financial asset out of the fair value through profit or loss category. If the fair value of the embedded derivative that would have to be separated cannot be reliably measured, 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. The Board noted that the proposed clarification to paragraph 12 would prevent reclassification of a hybrid (combined) financial asset out of that category between financial reporting dates, and hence avoid a requirement to reclassify the hybrid (combined) financial asset back into the fair value through profit or loss category at the end of the financial reporting period.

It appears from BC8 that the Board was addressing a situation where the entity could fair value the embedded derivative at the date of reclassification, but could not fair value the embedded derivative at the end of the first financial reporting date immediately after reclassification. The Board’s intent appears to prohibit reclassification at the reclassification date because at the end of financial reporting period the financial asset would have to be designated as at fair value through profit or loss even if this is the classification category it has been reclassified from. If this was the intention of the Board we believe IAS 39.12 could be clearer as this paragraph as currently drafted could be read as only applying to situations where the embedded derivative cannot be fair valued at the date of reclassification. Our proposal to make IAS 39.12 and BC8 consistent is below:

If an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid (combined) contract as at fair value through profit or loss. Similarly, if an entity is unable to measure separately the embedded derivative that would have to be separated on reclassification of a hybrid (combined) contract out of the fair value through profit or loss category, that reclassification is prohibited. This is the

case if the entity is unable to measure separately the embedded derivative at the date of reclassification or the end of the first financial reporting period immediately after that date. In such circumstances the hybrid (combined) contract remains classified as at fair value through profit or loss in its entirety.

We also note IAS 39.50A should be amended. This paragraph currently states that a financial instrument cannot be reclassified into the fair value through profit or loss category. However, IAS 39.12 clearly states that if an entity is unable to measure an embedded derivative separately after acquisition the entity must “designate the entire hybrid (combined) contract as at fair value through profit or loss”. Therefore, in limited circumstances the standard requires financial instruments to be reclassified to fair value through profit or loss after initial recognition. To remove the inconsistency between IAS 39.12 and 50A we propose the following amendment to IAS 39.50A (new text underlined):

... An entity shall not reclassify any financial instrument into the fair value through profit or loss category after initial recognition except where required by paragraph 12 of this standard.

Question 4

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

We agree.

Question 5

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

We agree.