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Accounting alert

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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. It is expected that the Australian Accounting Standards Board (AASB) will adopt this interpretation and release UIG 9, an Australian equivalent of IFRIC 9, at the next meeting of the AASB.

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

AASB 139 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 Australian Equivalents to International Financial Reporting Standards (A-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 A-IFRSs for the first time?

The consensus

IFRIC 9 concludes that the 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.

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 A-IFRS should make its assessment on the basis of conditions existing when the entity became party to the hybrid contract, not when it adopts A-IFRS. 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 an example:

> an Australian company with the Australian Dollar 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 AASB 139: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.

Where the contract terms remain unchanged an embedded derivative assessment is not reperformed, irrespective of whether the factors that led to the initial conclusion have changed.

In the example 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.

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. Early application is encouraged.

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.

It is anticipated that UIG 9 will have the same effective date and transitional provisions as those contained in IFRIC 9.

Feedback and assistance

We welcome your feedback on the matters covered in this Accounting Alert – please email your comments to accounting_alerts@deloitte.com.au.

For assistance in applying the requirements outlined in your organisation, please contact your local Deloitte office or contact our Lead National Technical Partner Bruce Porter on +61 (0) 3 9208 7490, or by e-mail to bruporter@deloitte.com.au.