

IAS Plus Update.

Clarification regarding assessment of embedded derivatives

On 12 March 2009, the International Accounting Standards Board (IASB) issued *Embedded Derivatives (Amendments to IFRIC 9 and IAS 39)*. The amendments clarify the accounting for embedded derivatives when a financial asset is reclassified out of the 'fair value through profit or loss' (FVTPL) category as permitted by the October 2008 amendments to IAS 39 *Financial Instruments: Recognition and Measurement*.

The amendments are effective for annual periods ending on or after 30 June 2009, and must be applied retrospectively.

Background

Following the amendments to IAS 39 in October 2008, which permitted reclassifications out of the FVTPL category for certain held-for-trading financial assets in limited circumstances, the IASB became aware of uncertainty regarding the interaction between the amendments and IFRIC 9 *Reassessment of Embedded Derivatives* regarding the assessment of embedded derivatives.

Prior to the amendments, IFRIC 9 prohibited the reassessment of the separation of an embedded derivative after an entity first became a party to the contract 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. IFRIC 9 did not consider whether reassessment is appropriate when a financial asset is reclassified out of FVTPL because such reclassifications were prohibited at the time IFRIC 9 was issued.

The Board decided that IFRIC 9 and IAS 39 should be amended to make clear that an entity is required to assess whether an embedded derivative is closely related to the host contract at the date of reclassification.

Overview of amendments

Following amendment, IFRIC 9.7 makes clear that reassessment is prohibited, except in the following two circumstances, when it is required:

- (a) when there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract; and
- (b) when there is a reclassification of a financial asset out of the FVTPL category.

Prior to the amendments, reassessments were permitted only in the circumstances described in (a).

The revised requirements will ensure that all financial instruments reclassified out of FVTPL are assessed for embedded derivatives at the date of reclassification.

A new paragraph 7A has been added to IFRIC 9 to clarify that, in assessing embedded derivatives at the time of a reclassification, the assessment should be based on circumstances that existed on the **later** date of:

- (a) when the entity first became party to the contract; and
- (b) when there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract.

This 'look back' requirement may prove challenging where an entity has held the reclassified instrument for an extended period.

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IAS 39 has been amended to prohibit reclassification out of FVTPL if an entity is unable to separately measure the embedded derivative on reclassification. In such circumstances, the entire hybrid (combined) contract remains classified as at FVTPL.

Effective date and transition

The amendments are effective for annual periods ending on or after 30 June 2009. As the amendments do not contain any transitional provisions, they should be applied retrospectively in accordance with *IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors*.

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