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IAS Plus Update.

Proposed amendments regarding the assessment of embedded derivatives on reclassification

On 23 December 2008, the International Accounting Standards Board (IASB) published an Exposure Draft (ED) proposing to amend IFRIC 9 **Reassessment of Embedded Derivatives** and IAS 39 **Financial Instruments: Recognition and Measurement**. The proposals would clarify the accounting for embedded derivatives in the case of a reclassification of a financial asset **out** of the 'fair value through profit or loss' (FVTPL) category as permitted by the October 2008 amendments to IAS 39.

The comment period for the ED is very short, with comments requested by 21 January 2009. The proposed effective date is annual periods ending on or after 15 December 2008 (see below).

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 regarding the assessment of embedded derivatives.

As currently drafted, IFRIC 9 prohibits the reassessment of the separation of an embedded derivative after an entity first becomes 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 (re)assessment is appropriate when a financial asset is reclassified out of FVTPL because such reclassifications were prohibited when IFRIC 9 was issued.

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

Overview of proposals

Under the proposals, IFRIC 9.7 would be amended to make clear that (re)assessment 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 **[existing requirement of IFRIC 9 – would not be changed by the proposed amendments]**; and

b) when there is a reclassification of a financial asset out of the FVTPL category.

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

A new paragraph IFRIC 9.7A would be added, requiring an entity to make the assessment as to whether to account for embedded derivatives separately on the basis of circumstances that existed when the entity became first party to the contract, i.e. when the financial asset was initially recognised. This 'look back' requirement may prove challenging for instruments that an entity has held for an extended period of time.

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As a consequential amendment, the proposals would modify IAS 39.12 to state that if an entity is unable to measure the fair value of the embedded derivative(s) in a hybrid contract it would be precluded from reclassification. In that case, the entire financial asset would remain classified as at FVTPL.

Effective date and transition

The ED proposes that the amendments should be effective for annual periods ending on or after 15 December 2008. In the case of a calendar-year-end entity, this would mean that for the purposes of its December 2008 financial statements (assuming that the amendments are finalised before the date of issue of those financial statements), entities that have reclassified financial assets under the reclassification amendment to IAS 39 in October 2008 would be required to assess whether any embedded derivatives require separation at the date of reclassification if the entity had not performed such an assessment at that date.

As the proposals do not contain any transitional provisions, the amendments would have to be applied retrospectively in accordance with IAS 8 **Accounting Policies, Changes in Accounting Estimates and Errors**.

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