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Endorsement of Amendment to IFRIC 9 *Reassessment of Embedded Derivatives* and IAS 39 *Financial Instruments: Recognition and Measurement*

Introduction, background and conclusions

Attachment 1: Effect study prepared by the European Financial Reporting Advisory Group (EFRAG)

Attachment 2: Endorsement advice prepared by EFRAG

1. EFFECT STUDY

The European Commission has agreed with the European Parliament that Effect Studies should be prepared for new accounting standards and interpretations up for endorsement in the European Union (EU). The Commission Services together with the European Financial Reporting Advisory Group (EFRAG) prepare these studies containing description of the accounting issues involved, results from stakeholder consultations as well as analysis of effects of using the new accounting rules in the EU.

EFRAG has prepared an Effect Study for the Amendment to IFRIC 9 *Reassessment of Embedded Derivatives* and IAS *39 Financial Instruments: Recognition and Measurement* (attached). As the EFRAG Effect Study refers to the Endorsement Advice, we also included it in attachments.

This cover note contains background information, comments and a conclusion by the Commission Services.

2. BACKGROUND ON IFRIC 9 AND IAS 39 *Embedded Derivatives*

Explanation of the issue

IFRIC 9 provides guidance on the assessment of financial instruments with embedded derivatives. However, IFRIC 9 as originally issued did not address a situation where the entity initially carried the instrument at fair value through profit or loss (and therefore was not required to assess embedded derivatives in that instrument) but subsequently decided to reclassify it out of that portfolio according to the "Reclassification of Financial Assets amendment" issued in October 2008.

Following the issue of reclassification (Amendments to IAS 39 and IFRS 7) in October 2008 the International Accounting Standards Board was told that there was uncertainty about the interaction between those amendments and IFRIC 9 regarding the assessment of embedded derivatives.

The IASB was asked to act in order to prevent any diversity in practice developing as a result of the abovementioned amendments made to IAS 39 in October 2008.

Why the issue need clarification?

As said, as a result of the reclassification amendment, uncertainty has arisen as to how the requirements for assessment of embedded derivatives should be applied in such situations. In particular, the October amendment has created uncertainty as to whether derivatives embedded in reclassified instruments are still required to be measured at fair value through profit or loss and, if they are, how that should be achieved.

According to the current IFRIC 9 requirements, assessment of the separation of an embedded derivative after an entity first became a party to the contract 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. Constituents told the Board that some might interpret IFRIC 9 as prohibiting the separation of an embedded derivative on the reclassification of a hybrid (combined) financial asset out of the fair value through profit or loss category unless there is a concurrent change in its contractual terms.

The Amendment clarifies that, regardless of whether a derivative is embedded in an instrument that has been reclassified or in some other instrument, as long as it is not closely related to that other instrument it shall be accounted for in exactly the same way. In other words, the Amendment ensures that the accounting treatment that the IASB believes is most relevant for derivatives is applied to all derivatives in all circumstances.

How do the amendments to IFRIC 9 and IAS 39 "Embedded derivatives" suggest dealing with the issue?

The Amendment 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.

It also clarifies that in order to ensure consistency in treatment of embedded derivatives, assessment of embedded derivatives on reclassification should be made on the basis of the and circumstances that existed when the entity first became a party to the contract.

If the entity concludes that embedded derivatives require fair value accounting but is unable to measure the fair value of the embedded derivatives separately, the "Embedded derivatives amendment" clarifies that the entity has to continue to account for the entire hybrid instrument at fair value through profit or loss.

In order to include this last requirement, that assure consistent accounting treatment of all embedded derivatives, the IASB has introduced a small amendment into IAS 39.

IASB and EFRAG consultations

The IASB carried out a consultation according to its due process. IASB published an exposure draft *Embedded Derivatives (Proposed amendments to IFRIC 9 and IAS 39)* on 22 December 2008 and received 55 comment letters. The final amendments were issued on 12 March 2009

EFRAG consulted publicly on its endorsement advise. Commentators to the EFRAG consultation were supportive to the proposal to recommend endorsement of amendment of IFRIC 9 and IAS 39 "*Embedded derivatives*". EFRAG has also carried out an assessment of the likely costs and benefits of implementing the amendments.

3. EFFECT ANALYSIS

Main points identified in the EFRAG Effect Analysis

<u>Improvement in consistency and in comparability</u>

EFRAG's analysis concluded that the "Embedded derivatives amendments" will eliminate causes of diversity in current practice and will ensure that existing requirements are applied consistently.

Overall EFRAG concluded that the benefits arising from applying the amendments were likely to exceed the costs involved in its implementations.

The Commission Services agree with the EFRAG analysis and conclude that the amendment of IFRIC 9 and IAS 39 "*Embedded derivatives*" will improve the overall quality and comparability of the financial information and therefore benefit users.

Costs for preparers and users

EFRAG's analysis gives an overview of the expected incremental costs for preparers and users. With regard to prepares, EFRAG concludes that amendments to IFRIC 9 and IAS 39 could result in some incremental year-one cost, however such costs are unlikely to be significant. No additional costs are expected for users.

EFRAG notes that the amendment to IFRIC 9 and IAS 39 "*Embedded derivatives*" could result in some incremental year-one cost only for prepares but it may even reduce costs for preparers going forward a little because it has removed an uncertainty in IFRS requirements. The amendments will not involve any incremental year-one or ongoing cost for users.

4. OVERALL COST-BENEFIT CONSIDERATIONS AND COMMISSION SERVICES CONCLUSIONS

On the basis of EFRAG's Effect Study, the Commission Services have considered the main costs and benefits of endorsing the amendment to IFRIC 9 and IAS 39 "*Embedded derivatives*". The Services conclude that the benefits of the amendments outweigh the costs introduced by the Interpretation.

The Commission services believe that the amendments to IFRIC 9 and IAS 39 will have positive cost-benefits effects and that they should therefore be endorsed in the EU without delay.

Attachment 1

EFRAG
European Financial Reporting Advisory Group

EFRAG'S EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENT TO IFRIC 9 AND IAS 39 "EMBEDDED DERIVATIVES"

INTRODUCTION

1 Following discussions in 2007 between the various parties involved in the EU endorsement process, it was decided that more extensive information than hitherto should to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of the Amendment to IFRIC 9 and IAS 39 "Embedded Derivatives" (the Amendment).

2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendment, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. (The results of the consultations EFRAG has carried out seem to confirm this). Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing the Amendment in the EU, to consult on the results of those initial assessments, and to finalise those assessments in the light of the comments and information received.

EFRAG's endorsement advice

3 EFRAG also carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

A SUMMARY OF THE AMENDMENT

4 A derivative is a financial instrument whose price is dependent upon or derived from one or more underlying assets such as stocks, bonds, commodities, currencies, interest rates and market indexes. Derivatives require little initial investment however they may result in significant fluctuation in ultimate cash flow to their holders. IFRS requires all derivative contracts to be measured at fair value on the grounds that fair value provides the most useful information about such instruments.

5 The IFRS requirements for derivatives are furthermore designed to ensure that derivative contracts are accounted for at fair value regardless of whether they are stand alone derivatives or embedded in other contracts. To ensure that, IAS 39 requires entities to assess whether a financial instrument contains an embedded derivative and, if it does, to account for the host instrument and the embedded derivative separately unless they are 'closely related'. The only circumstance in which it is not necessary to carry out such an assessment and to separate the host contract and the embedded derivative is where it would not make a difference to the accounting (because they are already being accounted for in the way that the embedded derivatives would need to be accounted for, at fair value with changes in fair value reported in profit or loss ('at fair value through profit or loss')). That would be the case for financial instruments acquired for trading purposes and for those financial instruments that the entity chooses to account for at fair value through profit or loss at initial recognition.

6 In October 2008 IAS 39 was amended to allow entities in some rare circumstances to cease accounting at fair value through profit or loss for—in other words, to reclassify out of the fair value through profit or loss category—non-derivative financial assets that were acquired for trading purposes.

7 IFRIC 9 provides guidance on the assessment of financial instruments with embedded derivatives. However, IFRIC 9 as originally issued did not address a situation where the entity initially carried the instrument at fair value through profit or loss (and therefore was not required to assess embedded derivatives in that instrument) but subsequently took advantage of the October amendment and switched to a different way of accounting for this instrument.

8 The Amendment 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. The Amendment further clarifies that the assessment should be made on the basis of the circumstances that existed when the entity first became a party to the contract. That is necessary to ensure consistency in the treatment of embedded derivatives irrespective of the way the entity accounted for hybrid contract containing the embedded derivatives initially. Finally, the Amendment clarifies that, if the entity concludes that the derivative requires to be accounted for at fair value but is unable to estimate the fair value of the embedded derivative separately, the entity has to continue to account for the entire instrument at fair value through profit or loss.

EFRAG'S INITIAL ANALYSIS OF COSTS AND BENEFITS OF THE AMENDMENT

9 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users from implementing the Amendment, both in year one and in subsequent years. The results of the initial assessment can be summarised as follows.

(a) EFRAG's initial assessment was that the Amendment is likely to involve:

(i) some preparers in some additional year one costs, but no ongoing costs. However, EFRAG's initial assessment was that, when considered in aggregate, the additional year one costs would not be significant.

(ii) users in no year one or ongoing incremental costs.

(b) EFRAG's initial assessment of the benefits that would arise from the Amendment was that the Amendment was likely to result in a reduction in divergence in practice, thereby enhancing consistency and comparability of the information provided. This should be a benefit to all stakeholders.

(c) EFRAG's initial assessment was that the benefits to be derived from implementing the Amendment in the EU were likely to exceed the costs involved in its implementation.

10 EFRAG published its initial assessment of the costs and benefits of implementing the Amendment in the EU and supporting analysis on 27 March 2009 and invited comment on the material by 8 May 2009. In response, EFRAG received eight comment letters. Three of those letters did not comment on EFRAG's initial assessment of costs. The remaining five comment letters agreed with EFRAG's initial assessment and had no additional comments.

EFRAG'S FINAL ANALYSIS OF THE COSTS AND BENEFITS OF THE AMENDMENT

11 Based on its initial analysis and comment letters received in response to that analysis, EFRAG's final analysis of the costs and benefits of the Amendment is presented in the paragraphs below.

Costs for preparers

12 The Amendment eliminates the uncertainty in the application of IFRS that arose as a result of October 2008 amendment to IAS 39. In effect what the Amendment does is clarify that the accounting treatment of embedded derivatives has not changed as a result of the October amendment.

13 Since the uncertainty existed, some entities might have interpreted and applied the requirements in IAS 39 differently. As a result, there will be some implications for past reclassifications for some entities. In accordance with the transitional arrangements:

(a) entities would have to apply the Amendment for annual periods ending on or after 30 June 2009. That would mean that all relevant transactions that took place on or after 1 July 2008 in those annual periods would need to be reported in accordance with the Amendment; and

(b) entities would have to restate comparative information for annual periods that ended before 30 June 2009.

This will involve entities that interpreted the requirements in IAS 39 differently prior to this Amendment in additional one-off costs. However, the IASB's swift action in identifying and addressing the uncertainty involved will have decreased the likelihood of a large number of entities interpreting the requirements differently and of the amount of those costs being significant.

14 Going forward, there will be costs involved in assessing embedded derivatives in financial assets that entities choose to reclassify out of fair value through profit or loss. However, such the option to reclassify in this way can be exercised only in rare cases. In addition, if an entity believes that the costs of exercising that option exceed the benefits it will not reclassify. In any case, such costs are due to the existing IFRS requirements and therefore are not incremental. The Amendment itself may even

reduce costs for preparers going forward a little because it has removed an uncertainty in IFRS requirements.

15 To summarise, EFRAG's assessment is that, although there will be some year one costs for some entities from implementing the Amendment, such costs are unlikely to be significant. Furthermore, there are unlikely to be any ongoing incremental costs from implementing this Amendment.

Costs for users

16 EFRAG's assessment is that the Amendment will not increase the costs to users of using the financial statements in any way.

Benefits for preparers and users

17 EFRAG has concluded that the Amendment will result in reducing the divergence in practice, thereby enhancing consistency and comparability of the information provided. This should be a benefit to all stakeholders.

Overall assessment

18 EFRAG's assessment is that the benefits that will arise from implementation of the Amendment in the EU are likely to exceed the insignificant costs involved.

Stig Enevoldsen
EFRAG, Chairman
27 May 2009

Attachment 2

EFRAG

European Financial Reporting Advisory Group

Jörgen Holmquist
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels
27 May 2009

Dear Mr Holmquist

Adoption of the Amendment to IFRIC 9 and IAS 39 "Embedded Derivatives"

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of the Amendment to IFRIC 9 and IAS 39 *Financial Instruments: Recognition and Measurement* "Embedded Derivatives" (the Amendment), which was issued by the IASB in March 2009. It was issued as an Exposure Draft in December 2008 and EFRAG commented on that draft.
The Amendment concerns the treatment of derivative financial instruments embedded in other contracts. The Amendment 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. The Amendment further clarifies that that assessment should be made on the basis of the circumstances that existed when the entity first became a party to the contract. Finally, the Amendment clarifies that, if the entity concludes that the derivative requires fair value accounting but is unable to measure the fair value of the embedded derivative separately, the entity has to continue to account for the entire instrument at fair value through profit or loss.

The Amendment becomes effective for annual periods ending on or after 30 June 2009 and shall be applied retrospectively.

EFRAG has carried out an evaluation of the Amendment. As part of that process, EFRAG issued an initial evaluation for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.
EFRAG supports the Amendment and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that:

- it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

- it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt the Amendment and, accordingly, EFRAG recommends its adoption. EFRAG's reasoning is explained in the attached 'Appendix - Basis for Conclusions'.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

APPENDIX
BASIS FOR CONCLUSIONS

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as adviser to the European Commission on endorsement of the final IFRS or Interpretation on the issue.
In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as adviser to the European Commission on endorsement of the final IFRS or Interpretation on the issue.
In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

INTRODUCTION

1 The Amendment clarifies that an entity must assess whether embedded derivatives are required to be measured separately at fair value when the entity no longer measures the hybrid financial instrument containing the embedded derivatives asset at fair value through profit or loss. The amendment further clarifies that in order to ensure consistency in treatment of embedded derivatives, assessment of embedded derivatives on reclassification should be made on the basis of the circumstances that existed when the entity first became a party to the contract. If the entity concludes that embedded derivatives require fair value accounting but is unable to measure the fair value of the embedded derivatives separately, the Amendment clarifies that the entity has to continue to account for the entire hybrid instrument at fair value through profit or loss.

2 EFRAG assessed whether the information resulting from the application of the Amendment would meet the criteria for EU endorsement; in other words, that:

(c) it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

(d) it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG also considered whether it would be in the European interest to adopt the amendment.

3 Having formed tentative views on these issues and prepared a draft assessment, EFRAG issued that draft assessment on 27 March 2009 and asked for comments on it by 8 May 2009. EFRAG has considered all the comments received in response, and the main comments received are dealt with in the discussion in this appendix.

EVALUATION

Relevance

4 According to the IASB's Framework, information has the quality of relevance when it influences the economic decisions of users by helping them to evaluate past, present or future events or confirming, or correcting, their past evaluations. EFRAG considered whether the Amendment would result in the provision of relevant information—information that has predictive value, confirmatory value or both—and whether it might result in the omission of any information that is relevant.

5 IFRS considers that accounting for derivatives, regardless of whether they are stand alone derivatives or embedded in other contracts, at fair value through profit or loss provides relevant information for users of financial statements. As a result, that has been the required accounting treatment for all derivatives (other than those embedded derivatives that are closely related to the host instrument) for some time now.

6 However, in October 2008 the IASB amended IAS 39 to allow entities to reclassify non-derivative financial assets out of the fair value through profit or loss accounting category in some rare cases. As a result of that amendment, an uncertainty has arisen as to how the requirements for assessment of embedded derivatives should be applied in such situations. In particular, the October amendment has created uncertainty as to whether derivatives embedded in reclassified instruments are still required to be measured at fair value through profit or loss and, if they are, how that should be achieved.

7 Guidance on assessment of embedded derivatives is in IFRIC 9. However, when IFRIC 9 was developed the situation described in the preceding paragraph was not possible, so IFRIC 9 did not address it in its guidance.

8 The Amendment clarifies that, regardless of whether a derivative is embedded in an instrument that has been reclassified or in some other instrument, as long as it is not closely related to that other instrument it shall be accounted for in exactly the same way. In other words, the Amendment ensures that the accounting treatment that the IASB believes is most relevant for derivatives is applied to all derivatives in all circumstances.

9 EFRAG's view is that the accounting treatment of derivatives, including embedded derivatives, prior to the October amendment resulted in information that meets the relevance criteria. It believes it follows that the information provided by applying this latest Amendment will also meet the relevance criterion.

Reliability

10 The Framework explains that information has the quality of reliability when it is free from material error and bias, can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost. EFRAG has considered whether information resulting from the application of the Amendment exhibits those qualities.

11 Since the Amendment only clarifies the application of existing requirements, it does not give rise to concerns about bias, faithful representation, or completeness. In theory it is

possible that it gives rise to concerns about material errors because of difficulties in estimating the numbers involved. However, EFRAG notes that the existing IFRIC 9 already requires exactly the same type of estimates to be made in certain circumstances and EFRAG considers that the information provided by applying existing IFRIC 9 meets the reliability criteria.

12 As such, EFRAG does not believe that the application of the Amendment will result in the provision of information that lacks the characteristic of reliability.

Comparability

13 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

14 EFRAG notes that the Amendment will eliminate causes of diversity in current practice and will ensure that existing requirements are applied consistently.

15 Furthermore, the Amendment clarifies that, if the entity assesses the need to separate embedded derivatives at the time when the entity reclassifies such instruments out of fair value through profit or loss, the assessment should be made on the basis of the circumstances that existed when the entity first became a party to the contract. In this way, the Amendment ensures that accounting for embedded derivatives will be the same irrespective of how the instrument was initially classified. That will further enhance the comparability of the information provided.

16 For all these reasons EFRAG believes that the Amendment meets the comparability criterion.

Understandability

17 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.

18 Although there are a number of aspects to the notion of ‘understandability’, EFRAG believes that most aspects are covered by the discussion above about relevance, reliability and comparability (because, for example, information that represents something as similar when it is in fact dissimilar is not comparable, and that lack of comparability will mean it is also not understandable). As a result, EFRAG believes that the main additional issue it needs to consider in assessing whether the information resulting from the application of the Amendment is understandable is whether that information will be very complex. EFRAG’s assessment is that the Amendment will not add to the complexity of the information provided.

19 EFRAG has therefore concluded that the information that results from the application of the Amendment meets the understandability criterion.

Transitional arrangements

20 The amendment is to be applied retrospectively for annual periods ending on 30 June 2009. EFRAG believes that retrospective application will ensure that issues of relevance and reliability do not arise (and the comparability and understandability of the information is maintained, because users are able to identify the effect that the change in accounting has had on previously-reported numbers and to take that into account in their long-term trend analysis).

True and Fair

21 Having concluded that the information that results from the application of the Amendment will meet the criteria of relevance, reliability, comparability and understandability and being unaware of any other reason to be concerned about the accounting effect of the Amendment, EFRAG sees no reason to believe that the amendment is inconsistent with the true and fair view requirement.

European Interest

22 EFRAG has considered whether the benefits of implementing the Amendment in the EU exceed the costs of doing so. Its assessment is that, although implementation of the Amendment would involve some costs, they are likely to be outweighed by the benefits.

CONCLUSION

23 EFRAG's overall conclusion is that the Amendment satisfies the criteria for EU endorsement and EFRAG should therefore recommend its endorsement.