INTERPRETATION OF STATUTORY BOARD FINANCIAL REPORTING STANDARD

INT SB-FRS 109 and SB-FRS 39 Amendments

Embedded Derivatives
Amendments to INT SB-FRS 109 and SB-FRS 39

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Amendments to Interpretation of Statutory Board Financial Reporting Standard INT SB-FRS 109 *Reassessment of Embedded Derivatives*

Paragraph 7 is amended (new text is underlined and deleted text is struck through). Paragraphs 7A and 10 are added.

Consensus

7 An entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is either (a) a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract or (b) a reclassification of a financial asset out of the fair value through profit or loss category, in which cases an reassessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

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 on the later date of:

(a) when the entity first became a party to the contract; and

(b) a change in the terms of the contract that significantly modified the cash flows that otherwise would have been required under the contract.

For the purpose of this assessment paragraph 11(c) of SB-FRS 39 shall not be applied (ie the hybrid (combined) contract shall be treated as if it had not been measured at fair value with changes in fair value recognised in profit or loss). If an entity is unable to make this assessment the hybrid (combined) contract shall remain classified as at fair value through profit or loss in its entirety.

Effective date and transition

10 *Embedded Derivatives* (Amendments to INT SB-FRS 109 and SB-FRS 39) issued in May 2009 amended paragraph 7 and added paragraph 7A. An entity shall apply those amendments for annual periods ending on or after 30 June 2009.

Amendments to Statutory Board Financial Reporting Standard SB-FRS 39 *Financial Instruments: Recognition and Measurement*

Paragraph 12 is amended (new text is underlined). Paragraph 103J is added.

Embedded derivatives

12 **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. <u>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. In such circumstances the hybrid (combined) contract remains classified as at fair value through profit or loss in its entirety.</u>**

Effective date and transition

103J An entity shall apply paragraph 12, as amended by *Embedded Derivatives* (Amendments to INT SB-FRS 109 and SB-FRS 39), issued in May 2009, for annual periods ending on or after 30 June 2009.

Amendments to the Basis for Conclusions on Interpretation of Statutory Board Financial Reporting Standard INT SB-FRS 109 *Reassessment of Embedded Derivatives*

After paragraph BC11 a heading and paragraphs BC11A-BC11F are added.

Reassessment of embedded derivatives

BC11A Following the issue of *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) (adopted as Amendments to SB-FRS 39 and SB-FRS 107) in October 2008 constituents told the International Accounting Standards Board that there was uncertainty about the interaction between those amendments and IFRIC 9 (adopted as INT SB-FRS 109) regarding the assessment of embedded derivatives. Some of those taking part in the public round-table meetings held by the International Accounting Standards Board and the US Financial Accounting Standards Board in November and December 2008 in response to the global financial crisis also raised that issue. They asked the Board to consider further amendments to IFRSs to prevent any practice developing whereby, following reclassification of a financial asset, embedded derivatives that should be separately accounted for are not.

BC11B In accordance with paragraph 7 of INT SB-FRS 109, 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 it 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.

BC11C It was noted that when INT SB-FRS 109 was issued, reclassifications out of the fair value through profit or loss category were prohibited and hence INT SB-FRS 109 did not consider the possibility of such reclassifications.

BC11D It was clear that it did not intend the requirements to separate particular embedded derivatives from hybrid (combined) financial instruments to be circumvented as a result of the amendments to SB-FRS 39 issued in October 2008. Therefore, it was decided to clarify INT SB-FRS 109 by amending paragraph 7.

BC11E It was believed that unless assessment and separation of embedded derivatives is done when reclassifying hybrid (combined) financial assets out of the fair value through profit or loss category, structuring opportunities are created that the embedded derivative accounting requirements in SB-FRS 39 were intended to prevent. This is because, by initially classifying a hybrid (combined) financial instrument as at fair value through profit or loss and later reclassifying it into another category, an entity can circumvent requirements for separation of an embedded derivative. It was also noted that the only appropriate accounting for derivative instruments is to be included in the fair value through profit or loss category.

BC11F It was decided also to clarify that an assessment on reclassification should be made on the basis of the circumstances that existed when the entity first became a party to the contract, or, if later, the date of a change in the terms of the contract that significantly modified the cash flows that otherwise would be required under the contract. This date is consistent with one of the stated purposes of embedded derivative accounting (ie preventing circumvention of the recognition and measurement requirements for derivatives) and provides some degree of comparability. Furthermore, because the terms of the embedded features in the hybrid (combined) financial instrument have not changed, it did not see a reason for arriving at an answer on separation different from what would have been the case at initial recognition of the hybrid (combined) contract (or a later date of a change in the terms of the contract). In addition, it was clarified that paragraph 11(c) of SB-FRS 39 should not be applied in assessing whether an embedded derivative requires separation. It was noted that before reclassification the hybrid (combined) financial instrument is necessarily classified at fair value through profit or loss so that for the purpose of the assessment on reclassification this criterion is not relevant but would, if applied for assessments made in accordance with paragraph 7A of the Interpretation, always result in no embedded derivative being separated.