

[DRAFT] INTERPRETATION OF FRS

Reassessment of Embedded Derivatives

Comments to be received by 30 April 2005

INVITATION TO COMMENT

The Council on Corporate Disclosure and Governance (CCDG) invites comments on any aspect of this draft Interpretation *Reassessment of Embedded Derivatives*. It would particularly welcome answers to the questions below. Comments are most helpful if they indicate the specific paragraph to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing so as to be received no later than **30 April 2005**, preferably by email to: accounting_stds@acra.gov.sg or addressed to:

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[DRAFT] INTERPRETATION OF FRS X

Reassessment of Embedded Derivatives

[Draft] Interpretation of FRS X *Reassessment of Embedded Derivatives* ([draft] INT FRS X) is set out in paragraphs 1-6. [Draft] INT FRS X is accompanied by a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to the Interpretations of Financial Reporting Standards*.

References

- FRS 39 *Financial Instruments: Recognition and Measurement* (as amended in 2005)
- FRS 101 *First-time Adoption of Financial Reporting Standards*

Background

1. FRS 39 paragraph 10 describes an embedded derivative as ‘a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.’
2. FRS 39 paragraph 11 requires an embedded derivative to be separated from the host contract and accounted for as a derivative if, and only if:
 - (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
 - (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
 - (c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

Issue

3. FRS 39 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 under the Standard. This [draft] Interpretation addresses the following issues:
 - (a) Does FRS 39 require such an assessment to be made only when the entity first becomes a party to the contract, or should the assessment be reconsidered throughout the life of the contract?
 - (b) Should a first-time adopter make its assessment on the basis of the conditions that existed when the entity first became a party to the contract, or those prevailing when the entity adopts FRSs for the first time?

Consensus

4. 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 a change in the terms of the contract, in which case it is required.

5. First-time adopters shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed when it first became a party to the contract.

Effective date and transition

6. An entity shall apply this [draft] Interpretation for annual periods beginning on or after [date to be set at three months after the Interpretation is finalised]. Earlier application is encouraged. If an entity applies the [draft] Interpretation for a period beginning before [date to be set at three months after the Interpretation is finalised], it shall disclose that fact. The [draft] Interpretation shall be applied retrospectively.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the draft Interpretation.

Introduction

BC1 This Basis for Conclusions summarises the considerations in reaching the consensus.

Background

BC2 FRS 39 requires an entity, when it first becomes a party to a contract, to assess whether any embedded derivative contained in the contract needs to be separated from the host contract and accounted for as a derivative under the Standard. However, the issue arises whether FRS 39 requires an entity to continue to carry out this assessment after it first becomes a party to a contract, and if so, with what frequency. The Standard is silent on this issue and as a result there was a risk of divergent practices developing.

BC3 The question is relevant when the terms of the embedded derivative do not change, but market conditions change, and the market was the principal factor in determining whether the host contract and embedded derivative are closely related. Instances when this might arise are given in paragraph AG33(d) of FRS 39. Paragraph AG33(d) states that an embedded foreign currency derivative is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

- (a) the functional currency of any substantial party to that contract;
- (b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or
- (c) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (e.g. a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

BC4 Any of the currencies specified in (a)-(c) above may change. Assume that when an entity first became a party to a contract, it assessed the contract as containing an embedded derivative that was closely related (because it was in one of the three categories in paragraph BC 3) and hence not accounted for separately. Assume that subsequently market conditions change and that if the entity were to reassess the contract under the changed circumstances it would conclude that the embedded derivative is not closely related and therefore requires separate accounting. (The converse could also arise.) The issue is whether the entity should make such a reassessment.

Basis for consensus

Reassessment of embedded derivatives

BC5 It was noted that the rationale for the embedded derivatives requirements in FRS 39 is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract (for example, by embedding a commodity forward in a debt instrument). Changes in external circumstances (such as those set out in paragraph BC4) are not ways to circumvent the Standard. Since the question of reassessment arises primarily because of changes in external circumstances, it was concluded that reassessment should not be required.

BC6 It was noted that FRS 39 as a practical expedient does not require the separation of embedded derivatives that are closely related. Many financial instruments contain embedded

derivatives. Separating all of these embedded derivatives would be burdensome for entities. It was noted that requiring entities to reassess embedded derivatives subsequently in all hybrid instruments could also be onerous because frequent monitoring would be required in order to achieve the correct accounting result. Market conditions and other factors affecting embedded derivatives would have to be monitored continuously to ensure timely identification of a change in circumstances and amendment of the accounting treatment accordingly. For example, if the functional currency of the counterparty changes during the reporting period so that the contract is no longer denominated in a currency of one of the parties to the contract, a reassessment of the hybrid instrument would be required at the date of change to ensure the correct accounting treatment in future.

- BC7 It was also recognised that although FRS 39 is generally silent on the issue of reassessment it gives guidance in one particular instance. For the types of contracts covered by paragraph AG33(b) it states that the assessment of whether an embedded derivative is closely related is required only at inception. Paragraph AG33(b) states:

An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest *when the contract is issued*, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (e.g. a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money *at inception* and are not leveraged. (Emphasis added)

- BC8 The implications of requiring subsequent reassessment were also considered. For example, assume that an entity, when it first becomes a party to a contract, separately recognises a host asset and an embedded derivative liability. If the entity were to be required to reassess whether the embedded derivative is to be accounted for separately and if the entity were to conclude some time after becoming a party to the contract that the derivative is no longer required to be separated, then questions of recognition and measurement would arise. In the above circumstances, the following possibilities were identified:

- (a) the entity could remove the derivative from its balance sheet and recognise a corresponding gain or loss in profit or loss. This will lead to recognition of a gain or loss even though there has been no transaction and no change in the value of the total contract or its components.
- (b) the entity could leave the derivative as a separate item in the balance sheet. The issue then arises as to when the item is removed from the balance sheet. Should it be amortised (and, if so, how does the amortisation affect the effective interest rate of the asset), or should it be derecognised only when the asset is derecognised?
- (c) the entity could combine the derivative (at fair value) with the asset (at amortised cost). This will alter both the carrying amount of the asset and its effective interest rate even though there has been no change in the economics of the whole contract. This will result in measuring the asset at a combination of amortised cost (the host contract) and fair value (the embedded derivative). In some cases, it could also result in a negative effective interest rate.

It was noted that under the view that subsequent reassessment is prohibited the above issues do not arise.

- BC9 It was also concluded that an entity is required under FRS 39 to assess whether an embedded derivative needs to be separated from the host contract and accounted for as a derivative when it first becomes a party to a contract. Consequently, if an entity purchases a contract that contains an embedded derivative it assesses whether the embedded derivative needs to be separated and accounted for as a derivative on the basis of conditions at the date of purchase.

- BC10 An alternative approach of making reassessment optional was considered. However, this approach was not favoured, because it would reduce comparability of financial information.

Also, it was noted that this approach would be inconsistent with the embedded derivative requirements in FRS 39 that either require or prohibit separation but do not give an option. Accordingly, it was concluded that reassessment should not be optional.

- BC11 The draft Interpretation contains the conclusion that reassessing whether an embedded derivative needs to be separated from the host contract and accounted for as a derivative is prohibited under FRS 39. The concern that this conclusion could potentially be extended to the reassessment of contracts that fall within paragraphs 5-7 of FRS 39 was considered. Those paragraphs deal with whether contracts to buy or sell a non-financial item come within the scope of FRS 39 and hence are accounted for as derivatives. In particular, they specify that a contract that is not settled net or is in accordance with an entity's expected purchase, sale and usage requirements is not within the scope of FRS 39 and hence is not accounted for as a derivative. It was noted that different considerations arise for such contracts. Consequently, it was concluded that the draft Interpretation should address only the reassessment of embedded derivatives that are within the scope of FRS 39.

First-time adopters of FRSs

- BC12 Paragraph IG55 of FRS 101 *First-time Adoption of Financial Reporting Standards* states:

When FRS 39 requires an entity to separate an embedded derivative from a host contract, the initial carrying amounts of the components at the date when the instrument first satisfies the recognition criteria in FRS 39 reflect circumstances at that date (FRS 39, paragraph 11). If the entity cannot determine the initial carrying amounts of the embedded derivative and host contract reliably, it treats the entire combined contract as a financial instrument held for trading (FRS 39, paragraph 12). This results in fair value measurement (except when the entity cannot determine a reliable fair value, see FRS 39, paragraph 46(c)), with changes in fair value recognised in profit or loss.

- BC13 This guidance reflects the principle in FRS 101 that a first-time adopter should apply FRSs as if they had been in place from initial recognition. This is consistent with the general principle used in FRSs of full retrospective application of Standards. It was noted that the date of initial recognition referred to in paragraph IG55 is the date when the entity first became a party to the contract and not the date of first-time adoption of FRSs. Accordingly, it was concluded that FRS 101 requires an entity to assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of conditions at the date when the entity first became a party to the contract and not those at the date of first-time adoption.