Hong Kong Institute of Certified Public Accountants 香港會計師公會

MEMBERS' HANDBOOK

Update No. 63

(Issued March 2009)

This Update relates to the issuance of:

- Amendments to HK(IFRIC)-Int 9 *Reassessment of Embedded Derivatives* and HKAS 39 *Financial Instruments: Recognition and Measurement* – Embedded Derivatives

Document Reference and Title	***Instructions***	***Explanations***
VOLUME II		
Contents of Volume II	Discard existing pages ii and iii and replace with revised page ii and iii.	Revised contents pages
HONG KONG ACCOUNTING STANDARDS (HKAS)		
HKAS 39 *Financial Instruments: Recognition and Measurement* (Standard)	Replace cover page and pages 4 and 6A with revised cover page and pages 4 and 6A. Insert page 87K after pages 87J.	Amendments to HK(IFRIC)-Int 9 and HKAS 39 – Note
HKAS 39 *Financial Instruments: Recognition and Measurement* (Basis for Conclusions)	Insert page 147J after page 147I.	Amendments to HK(IFRIC)-Int 9 and HKAS 39 – Note
HONG KONG (IFRIC) INTERPRETATIONS (HK(IFRIC)-Int)		
HK(IFRIC) Interpretation 9 *Reassessment of Embedded Derivatives*	Replace cover page and pages 2 and 4A with revised cover page and revised pages 2 and 4A. Insert page 4B after 4A and pages 8 and 9 after page 7.	Amendments to HK(IFRIC)-Int 9 and HKAS 39 – Note

Note:

Amendments to HK(IFRIC)-Int 9 *Reassessment of Embedded Derivatives* and HKAS 39 *Financial Instruments: Recognition and Measurement* – Embedded Derivatives clarify the accounting treatment of embedded derivatives for entities that make use of the reclassification amendment issued in October 2008.

The reclassification amendment allows entities to reclassify particular financial instruments out of the 'at fair value through profit or loss' category in specific circumstances. The amendments to HK(IFRIC)-Int 9 and HKAS 39 clarify that on reclassification of a financial asset out of the 'at fair value through profit or loss' category all embedded derivatives have to be assessed and, if necessary, separately accounted for in financial statements.

The amendments form part of the response to views received in the round-table discussions organised by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board in November and December 2008. Participants asked the IASB to clarify the accounting treatment of embedded derivatives in the reclassification amendments in order to avoid divergence in practice.

The amendments set out in *Embedded Derivatives* apply retrospectively and are required to be applied for annual periods ending on or after 30 June 2009.

Note: * *With effect from 24 May 2005, all Interpretations that are developed locally by the Institute are named Hong Kong Interpretations.*

Hong Kong Accounting Standard 39

Financial Instruments: Recognition and Measurement

(a) The related amendments to HKAS 39 and HKFRS 7 on *Reclassification of Financial Assets* are set out in Appendix D of this HKAS 39 issued in October 2008. Appendix D also includes a further amendment, *Reclassification of Financial Assets—Effective Date and Transition* issued in December 2008, clarifying the effective date and transition requirements of those earlier amendments. An entity shall apply those amendments on or after 1 July 2008.

(b) An entity shall apply amendments resulting from *Improvements to HKFRSs* issued in October 2008 for annual periods beginning on or after 1 January 2009.

(c) The related amendment to HKAS 39 on *Eligible Hedged Items* is set out in Appendix E of this HKAS 39 issued in November 2008. An entity shall apply this amendment retrospectively for annual periods beginning on or after 1 July 2009.

(d) An entity shall apply amendments resulting from HKFRS 1 (Revised) *First-time Adoption of Hong Kong Financial Reporting Standards* issued in December 2008 for annual periods beginning on or after 1 July 2009.

(e) An entity shall apply amendments to HK(IFRIC)-Int 9 and HKAS 39 on *Embedded Derivatives* issued in March 2009 for annual periods ending on or after 30 June 2009.

Implementation Guidance

Illustrative Example

Hong Kong Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (HKAS 39) is set out in paragraphs 1-109 and Appendices A-~~D~~F. All the paragraphs have equal authority. HKAS 39 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Appendix F

Amendments to HK(IFRIC)-Int 9 and HKAS 39 *Embedded Derivatives* - effective for annual periods ending on or after 30 June 2009

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. 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.

Effective date and transition

103J An entity shall apply paragraph 12, as amended by *Embedded Derivatives* (Amendments to HK(IFRIC)-Int 9 and HKAS 39), issued in March 2009, for annual periods ending on or after 30 June 2009.

Appendix E

Amendments to Basis for Conclusions on HK(IFRIC)-Int 9 and HKAS 39 *Embedded Derivatives* – effective for annual periods ending on or after 30 June 2009

Paragraph BC11F and a sub-heading and paragraph BC40A are added.

Background

BC11F Following the issue of *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) in October 2008 constituents told the Board that there was uncertainty about the interaction between those amendments and IFRIC 9 regarding the assessment of embedded derivatives. In response the Board issued *Embedded Derivatives* (Amendments to IFRIC 9 and IAS 39) in March 2009. The amendment to IAS 39 clarifies the consequences if the fair value of the embedded derivative that would have to be separated cannot be measured separately.

Embedded derivatives

Inability to measure an embedded derivative separately (paragraph 12)

BC40A As described in paragraph BC11F, the Board also considered another issue related to a reclassification of a hybrid (combined) financial asset out of the fair value through profit or loss category. If the fair value of the embedded derivative that would have to be separated cannot be measured separately, the Board decided to clarify that the hybrid (combined) financial asset in its entirety should remain in the fair value through profit or loss category. The Board noted that the clarification to paragraph 12 would prevent reclassification of a hybrid (combined) financial asset out of that category between financial reporting dates, and hence avoid a requirement to reclassify the hybrid (combined) financial asset back into the fair value through profit or loss category at the end of the financial reporting period. The amendments were issued in March 2009.

HK(IFRIC)-Int 9
~~Issued May 2006~~Revised March 2009

Effective for annual periods
beginning on or after 1 June 2006

HK(IFRIC) Interpretation 9

Reassessment of Embedded Derivatives

An entity shall apply amendments to HK(IFRIC)-Int 9 and HKAS 39 on *Embedded Derivatives* issued in March 2009 for annual periods ending on or after 30 June 2009.

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Contents

Hong Kong (IFRIC) Interpretation 9 *Reassessment of Embedded Derivatives* (HK(IFRIC)-Int 9) is set out in paragraphs 1-9 and ~~the~~ Appendi~~x~~ces A-B. HK(IFRIC)-Int 9 is accompanied by a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Appendix A
Amendments resulting from other HKFRSs

The following sets out amendments required for this Interpretation resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Interpretation and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

HKFRS 3 *Business Combinations* (issued in March 2008) - effective for annual periods beginning on or after 1 July 2009

Paragraph 5 is footnoted as follows:

5 This Interpretation does not address the acquisition of contracts with embedded derivatives in a business combination nor their possible reassessment at the date of acquisition.*

* HKFRS 3 (as revised in 2008) addresses the acquisition of contracts with embedded derivatives in a business combination.

Appendix B

Amendments to HK(IFRIC)-Int 9 and HKAS 39 *Embedded Derivatives* - effective for annual periods ending on or after 30 June 2009)

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

Conclusions

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 ~~re~~assessment 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 HKAS 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 HK(IFRIC)-Int 9 and HKAS 39) issued in March 2009 amended paragraph 7 and added paragraph 7A. An entity shall apply those amendments for annual periods ending on or after 30 June 2009.

Appendix A

Amendments to Basis for Conclusions on HK(IFRIC)-Int 9 and HKAS 39 *Embedded Derivatives* - effective for annual periods ending on or after 30 June 2009

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) in October 2008 constituents told the International Accounting Standards Board that there was uncertainty about the interaction between those amendments and IFRIC 9 regarding the assessment of embedded derivatives. Some of those taking part in the public round-table meetings held by the 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 IFRIC 9, 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.

BC11C The Board noted that when IFRIC 9 was issued, reclassifications out of the fair value through profit or loss category were prohibited and hence IFRIC 9 did not consider the possibility of such reclassifications.

BC11D The Board 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 IAS 39 issued in October 2008. Therefore, the Board decided to clarify IFRIC 9 by amending paragraph 7.

BC11E The Board believes 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 IAS 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. The Board also noted that the only appropriate accounting for derivative instruments is to be included in the fair value through profit or loss category.

BC11F The Board 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, the Board 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, the Board clarified that paragraph 11(c) of IAS 39 should not be applied in assessing whether an embedded derivative requires separation. The Board 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.