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Accounting Standards Committee of Germany
Der Standardisierungsrat®

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EFRAG
Stig Enevoldsen
13-14 Avenue des Arts
B-1210 Brussels
Belgique

Berlin, 8 Mai 2009

Dear Stig,

EFRAG's Assessment of the amendment to IFRIC 9 and IAS 39 'Embedded Derivatives'

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on EFRAG's Assessment of the amendment to IFRIC 9 and IAS 39 'Embedded Derivatives'. We appreciate the opportunity to comment on EFRAG's assessment.

We agree with the views set out in the assessment. As a national standard-setter we are not in a position to answer the questions regarding the costs that will arise for preparers and for users to implement the amendment.

Please find attached our comments on the above mentioned EFRAG's assessments and the comments of Allianz SE.

If you have any further questions, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr

President

European Financial Reporting Advisory Group

INVITATION TO COMMENT ON EFRAG'S ASSESSMENTS OF THE AMENDMENT TO IFRIC 9 AND IAS 39 'EMBEDDED DERIVATIVES'

Comments should be sent to commentletter@efrag.org or uploaded via our website by 8 May 2009

EFRAG has been asked by the European Commission to provide it with advice and supporting material on the amendment to IFRIC 9 *Reassessment of Embedded Derivatives* and IAS 39 *Financial Instruments: Recognition and Measurement* "Embedded Derivatives". In order to do that, EFRAG has been carrying out a technical assessment of the amendment against the criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing the costs and benefits that would arise from its implementation in the EU.

A summary of the amendment is set out in Appendix 1.

Before finalising its two assessments, EFRAG would welcome your views on the issues set out below. Please note that all responses received will be placed on the public record unless the respondent requests confidentiality. In the interest of transparency EFRAG will wish to discuss the responses it receives in a public meeting, so we would prefer to be able to publish all the responses received.

1 Please provide the following details about yourself:

(a) Your name or, if you are responding on behalf of an organisation or company, its name:

German Accounting Standards Board (GASB)

(b) Are you/Is your organisation or company a:

☐ Preparer ☐ User ☒ Other (please specify)

National Standard-setter

(c) Please provide a short description of your activity/ the general activity of your organisation or company:

(d) Country where you/your organisation or company is located:

Germany

(e) Contact details including e-mail address:

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2 EFRAG's initial assessment of the amendment is that it meets the technical criteria for endorsement. In other words, it is not contrary to the true and fair principle and it meets the criteria of understandability, relevance, reliability and comparability. EFRAG's reasoning is set out in Appendix 2.

(a) Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

(b) Are there any issues that are not mentioned in Appendix 2 that you believe EFRAG should take into account in its technical evaluation of the amendment? If there are, what are those issues and why do you believe they are relevant to the evaluation?

There are no other issues.

3 EFRAG is also assessing the costs that will arise for preparers and for users on implementation of the amendment in the EU, both in year one and in subsequent years. Some initial work has been carried out, and the responses to this Invitation to Comment will be used to complete the assessment.

The results of the initial assessment are set out in paragraph 8 of Appendix 3. To summarise, EFRAG's initial assessment is that the amendment is:

(a) likely to involve some preparers in some additional year one, but no ongoing, incremental costs. However, EFRAG's initial assessment is that the additional year one costs will not be significant.

(b) likely to involve users in no year one or ongoing incremental costs.

Do you agree with this assessment?

☐ Yes ☐ No

If you do not, please explain why you do not and (if possible) explain broadly what you believe the costs involved will be?

As a national standard-setter, we are not in a position to answer this question.

4 EFRAG's initial assessment is that the amendment will improve consistency and comparability of the information provided (see Appendix 3, paragraph 7) and that the benefits to be derived from that are likely to exceed the costs involved (see Appendix 3, paragraph 9).

Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not and what you think the implications should be for EFRAG's endorsement advice?

5 EFRAG is not aware of any other factors that should be taken into account in reaching a decision as to what endorsement advice it should give the European Commission on the amendment.

Do you agree that there are no other factors?

☒ Yes ☐ No

If you do not, please explain why you do not and what you think the implications should be for EFRAG's endorsement advice?

APPENDIX 1
A SUMMARY OF THE AMENDMENT

1 This Amendment concerns the treatment of derivative financial instruments embedded in other contracts.

2 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.

3 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 or for those financial instruments which the entity chose to account for at fair value through profit or loss at initial recognition.

4 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.

5 IFRIC 9 provides guidance on 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.

6 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. That is necessary to ensure that the way the entity accounted for hybrid contract containing embedded derivatives initially does not affect accounting for embedded derivatives. 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.

APPENDIX 2
EFRAG'S TECHNICAL ASSESSMENT OF THE AMENDMENT AGAINST THE ENDORSEMENT CRITERIA

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 however, 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:

(a) 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

(b) 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.

EVALUATION

Relevance

3 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.

4 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.

5 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.

6 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.

7 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 will 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.

8 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

9 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.

10 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.

11 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

12 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.

13 EFRAG notes that the Amendment eliminates causes of diversity in current practice and ensures that existing requirements are applied consistently.

14 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.

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

Understandability

16 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.

17 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.

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

Transitional arrangements

19 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

20 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

21 EFRAG has considered whether the benefits of implementing the Amendment in the EU exceed the costs of doing so. Its initial assessment (as explained more fully in Appendix 3) is that, although implementation of the Amendment would involve some costs, they are likely to be outweighed by the benefits.

CONCLUSION

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

APPENDIX 3
EFRAG'S EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENT

1 EFRAG has also considered whether, and if so to what extent, implementing the Amendment in the EU might involve preparers or users incurring incremental costs, and whether those costs are likely to be exceeded by the benefits to be derived from its adoption.

Costs for preparers

2 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 that it clarifies that the accounting treatment of embedded derivatives has not changed as a result of the October amendment.

3 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 who 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 that a large number of entities would be involved and the amount of those costs being significant.

4 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 a choice can be exercised only in rare cases. In addition, if an entity believes that the costs exceed the benefits it will not make this choice. 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.

5 To summarise, EFRAG's initial 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

6 EFRAG's initial 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

7 EFRAG has concluded, for the reasons explained in Appendix 2, 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.

Conclusion

8 Summarising the comments above, EFRAG's initial assessment is as follows.

(a) The Amendment is likely to involve some preparers in some additional year one costs. However, EFRAG's initial assessment is that those costs will not be significant for those entities that will be required to change their accounting. The Amendment is not likely to result in additional incremental ongoing costs for preparers.

(b) The Amendment is likely to involve users in no year one or ongoing incremental costs.

(c) The Amendment is likely to result in some benefits for all stakeholders.

9 EFRAG's initial assessment is that the benefits of implementing the Amendment in the EU are likely to outweigh the costs involved.