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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: 13 December 2007, London

Project: IAS 39 Financial Instruments: Recognition and Measurement

Subject: Application of paragraph AG33(d)(iii) – Bifurcation of embedded foreign currency derivative (Agenda Paper 3C)

Background

1. Paragraph AG33(d) of IAS 39 specifies whether foreign currency derivatives embedded in some contracts (for example, contracts to buy or sell non-financial items) are closely related to the host contracts. If the embedded derivatives are not closely related, IAS 39 requires them to be separated and accounted for as a derivative.

2. Paragraph AG33(d)(iii) of IAS 39 does not allow bifurcation of a non-option foreign currency derivative embedded in a non-financial or insurance host, if it is not leveraged and requires payments denominated in 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.

3. The IFRIC was asked about the application of paragraph AG33(d)(iii) of IAS 39 – in particular, what the "economic environment" is in determining whether

a currency is commonly used in contracts to buy or sell non-financial items. This issue relates to what items are in the scope of IAS 39.

4. In May 2007, the IFRIC issued a tentative agenda decision, noting that applying AG33(d)(iii) of IAS 39 requires an entity to:
   - identify where the transaction takes place; and
   - identify currencies that are commonly used in the economic environment in which the transaction takes place.

5. However, the IFRIC decided at its September2007 meeting to refer the issue to the Board because any guidance developed would be more in the nature of application guidance rather than an interpretation. Furthermore, there is diversity in practice. The IFRIC also asked the staff to undertake additional analysis so that IFRIC could suggest to the Board suitable revisions to the standard.

6. At the November IFRIC meeting, the staff set out a number of alternative approaches that the IFRIC could recommend to the Board (please see appendix 3 for a copy of the paper)[1]. The IFRIC concluded that the Board intended paragraph AG33(d) to apply to embedded foreign currency derivatives that are integral to an arrangement and thus considered to be closely related to the terms of the host contract. The IFRIC therefore asked the Staff to draft suggested wording consistent with its conclusion about the Board's intentions.

THIS PAPER

7. This paper analyses the issue and the differences and inconsistencies in practice with respect to the application of paragraph AG33(d)(iii) and suggests amended wording for the Board's consideration.

THE ISSUE

8. AG33(d) of IAS 39 states that: 'An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is

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[1] This issue relates to what is in the scope of IAS 39. Paper 3B discusses paragraph 11A of IAS 39, which also relates to what is in the scope of IAS 39. The staff paper for the IFRIC considered both issues together and it is attached as appendix 3.

denominated in foreign currency) is closely related to the host contract provided that it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(i) the functional currency of any substantial party to that contract;

(ii) 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

(iii) 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).'

[emphasis added]

9. To apply AG33(d)(iii) of IAS 39, the following two questions have to be considered:

- ***Question 1***: What is the "economic environment" in which a transaction takes place?
- ***Question 2***: What are the currencies that are "commonly" used in contracts to buy or sell non-financial items in the economic environment in which the transaction takes place?

10. The standard does not explain the meaning of an economic environment. This is unclear particularly for cross-border transactions.

11. The staff understands entities are interpreting "economic environment" in differing ways, including the following:

    - The country of the reporting entity (for example entities in South Africa commonly use the US dollar in all trades). This could be supported by reference to IAS 39 IG C.7;
    - The internal or external trade environment (for example entities in South Africa commonly use the US dollar in all external trade, but not

in internal trade). This could be supported by the reference to "internal or external" in IAS 39 paragraph AG33(d)(iii);

- The internal and external trade environment in a specific industry (for example entities in the motor industry in South Africa commonly use the US dollar for external trade but not for internal trade);
- The internal or external trade environment of a specific company (for example a particular entity may commonly use the US dollar for external trade with particular countries).

12. A related matter is whether "common" is considered in the context of a particular entity, or in the context of an industry, or of a country.

13. Constituents note that AG33(d)(iii) uses the term "commonly" but there is no guidance as to the quantum of transactions or value that would need to be denominated in a foreign currency to conclude that the currency was commonly used.

14. Other related interpretive questions raised by constituents include:
    - what evidence does an entity require to support the notion that the use of a currency is common?
    - does the reporting entity need to investigate published statistics?
    - if the reporting entity has to look for statistics, what percentage of business needs to be conducted in that currency to assert that use of the currency is common?
    - whether the consideration that a currency is "commonly used" in AG33(d)(iii) excludes from the population set those transactions falling under the other AG33(d) exemptions.

15. There are a variety of views on the appropriate interpretation of AG33(d)(iii) and, consequently, there is significant diversity in practice.

STAFF ANALYSIS

Why was AG33(d) of IAS 39 introduced?

16. As noted in BC37 of IAS 39, the underlying principle is to separate and account for all embedded derivatives. IAS 39 requires entities to identify

derivatives embedded in all contracts, whether those contracts are financial or non-financial.

17. However, because of the practical burden in identifying and measuring embedded derivatives, IAS 39 gives an exception to the general principle; embedded derivatives that are closely related to the host contracts should not be separately accounted for.

18. Since it is common for entities to enter into non-financial contracts that are denominated in a foreign currency, IAS 39 specifies situations in which foreign currency embedded derivatives are closely related and should not be separately accounted for. These situations are set out in paragraph AG33(d) of IAS 39.

19. Paragraphs BC39 and BC40 of IAS 39 explain why AG33(d) of IAS 39 was introduced. Paragraph BC39 of IAS 39 states: ‘The requirement to separate embedded foreign currency derivatives may be burdensome for entities that operate in economies in which business contracts denominated in a foreign currency are common. For example, entities domiciled in small countries may find it convenient to denominate business contracts with entities from other small countries in an internationally liquid currency (such as the US dollar, euro or Yen) rather than the local currency of any of the parties to the transaction. In addition, an entity operating in a hyperinflationary economy may use a price list in a hard currency to protect against inflation, for example, an entity that has a foreign operation in a hyperinflationary economy that denominates local contracts in the functional currency of the parent.’ [emphasis added]

20. Paragraph BC 40 of IAS 39 states: ‘In revising IAS 39, the Board … decided that a foreign currency derivative in a contract should not be required to be separated if it is denominated in a currency that is commonly used in business transactions (that are not financial instruments) in the environment in which the transaction takes place. A foreign currency derivative would be viewed as closely related to the host contract if the currency is commonly used in local business transactions, for example, when monetary amounts are viewed by the general population not in terms of the local currency but in terms of a

relatively stable foreign currency, and prices may be quoted in that foreign currency (see IAS 29 *Financial Reporting in Hyperinflationary Economies*)" [emphasis added] (see also BC40 of IAS 39).

21. The superseded Implementation Guidance Question 25-6 of IAS 39, Foreign currency derivative: currency of primary economic environment, stated: "For the purpose of applying IAS 39.25(d), the currency of the primary economic environment in which any substantial party to the contract operates refers to the currencies used in measuring items in the financial statements of any substantial party to the contract (measurement currency), or the currencies of the countries in which any substantial party to the contract is domiciled. If a contract's payments are denominated in any of those currencies, **then that currency is integral to the arrangements and thus considered to be closely related to the terms of the contract.** The determination that a contract does not have an embedded derivative does not affect the determination of an enterprise's measurement currency (see SIC-19, Reporting Currency – Measurement and Presentation of Financial Statements under IAS 21 and IAS 29)". [emphasis added]

22. The intent of paragraph AG 33(d) (as stated above and in BC40) is to exempt preparers from separating embedded foreign currency derivatives if the embedded derivatives are integral to the arrangement and hence bear a close economic relationship to the terms of the contract; that is, embedded foreign currency derivatives that have been entered into for reasons that are clearly not based on achieving a desired accounting result or for speculative purposes.

23. The staff believes that a contract denominated in the following foreign currencies is consistent with such an approach:
    - the functional currency of any substantial party to that contract
    - 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)
    - a local currency of any substantial party to that contract

- a liquid international currency used by parties domiciled in small countries, as a convenient means of exchange
- a hard currency used by an entity operating in a hyperinflationary economy to protect against inflation
- a foreign currency commonly used in local business transactions - for example, when monetary amounts are viewed by the general population not in terms of the local currency but in terms of another related currency.

24. A common thread running through all these situations is that these currencies have many of the characteristics of a functional currency (i.e the currency of the primary economic environment in which an entity operates).

25. Paragraphs 9 and 10 of IAS 21 *The Effects of Changes in Foreign Exchange Rates* provide guidance on identifying an entity's functional currency.

26. Paragraph 9 of IAS 21 states that: "The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. An entity considers the following factors in determining its functional currency:

    (a) the currency:

    (i) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and

    (ii) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

    (b) the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

27. Paragraph 10 of IAS 21 also states that: "The following factors may also provide evidence of an entity's functional currency:

    (a) the currency in which funds from financing activities (ie issuing debt and equity instruments) are generated.

    (b) the currency in which receipts from operating activities are usually retained."

28. The staff therefore recommends that paragraph AG33(d)(iii) of IAS 39 be amended to refer to the characteristics of a functional currency as detailed in paragraph 9 of IAS 21 (see appendix 1).

QUESTIONS FOR THE BOARD

29. Does the Board agree with the staff recommendation? If not, what alternative does the Board wish to pursue and why?

30. In the staff's opinion, the issue meets the criteria for inclusion in the annual improvements process (i.e. a minor and non-urgent issue). Does the Board agree that this issue should be included as part of the Annual Improvements process? If not, how would the Board like to proceed?

31. Does the Board agree with the draft amendments and Basis for Conclusion on the proposed amendment (see appendix 2)?

Appendix 1

DRAFT AMENDMENTS

AG33 The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

…

(d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument ~~(such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency)~~ is integral to the arrangement and hence ~~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:

(i) the functional currency of any substantial party to that contract;

(ii) 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

(iii) a currency that has one or more of the characteristics of a functional currency, as set out in paragraph 9 of IAS 21, of a substantial party to the contract ~~is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place~~ (eg a local currency or hard currency used by an entity operating in a hyperinflationary economy to protect against inflation) ~~a relatively stable and liquid currency that is commonly used in local business transactions or external trade)~~

…

Appendix 2

Draft Basis for Conclusions on
Proposed Amendments to IAS 39: Financial Instruments: Recognition and Measurement

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

1. The Board was advised that there was diversity in practice regarding the application of the paragraph AG33(d)(iii); in particular, what the "economic environment" is in determining whether a currency is commonly used in contracts to buy or sell non-financial items.

2. Paragraph AG 33(d) is intended to prohibit the separation of embedded foreign currency derivatives if the embedded derivatives are integral to the contractual arrangement. That is, embedded foreign currency derivatives that have been entered into for reasons that are clearly not based on achieving a desired accounting result or for speculative purposes.

3. The Board believes that contracts denominated in the following foreign currencies are likely to be integral to the contractual arrangement :
   - the functional currency of any substantial party to that contract
   - 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)
   - a local currency of any substantial party to that contract
   - a liquid international currency used by parties domiciled in small countries, as a convenient means of exchange
   - a hard currency used by an entity operating in a hyperinflationary economy to protect against inflation
   - a foreign currency commonly used in local business transactions - for example, when monetary amounts are viewed by the general

population not in terms of the local currency but in terms of another related currency..

4. The Board noted that these currencies have one or more of the characteristics of a functional currency as set out in paragraph 9 of IAS 21.

5. Accordingly, the Board proposes to amend AG33(d) to refer to the characteristics of a functional currency.

Appendix 3

IAS 39 *Financial Instruments: Recognition and Measurement*

Application of Paragraph 11A and AG33 (d)(iii)

[Appendix omitted from observer note]