30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **May 2007, London**

Project: **IAS 39: *Financial Instruments: Recognition and Measurement***
AG 33(d)(iii) of IAS 39 (Agenda Paper 11(v))

BACKGROUND

1. The IFRIC has been asked to provide guidance on how to apply *AG 33(d)(iii)* of IAS 39 *Financial Instruments: Recognition and Measurement*.

2. AG 33(d) of IAS 39 states: '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 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 (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).'

3. The submission asks a number of questions in relation to *AG33(d)(iii)*, including:

- in determining whether a currency is 'commonly used', should transactions denominated in currencies set out in AG33(d)(i) and AG33(d)(ii) be excluded?
- what percentage should be assigned to the term 'common'?
- what is meant by 'economic environment'?

4. The original submission is set out in the Appendix to this paper (for background information only). [The original submission omitted from observer note].

STAFF ANALYSIS

What are the requirements in AG33(d)(iii) of IAS 39?

5. AG33(d) of IAS 39 specifies whether foreign currency derivatives embedded in certain contracts (for example, contracts to buy or sell non-financial items) are closely related to the host contracts[1].

6. AG33(d)(iii) first requires an entity to identify the economic environment in which the transaction takes place. It then requires the entity to identify currencies that are commonly used in contracts to buy or sell non-financial items in that economic environment.

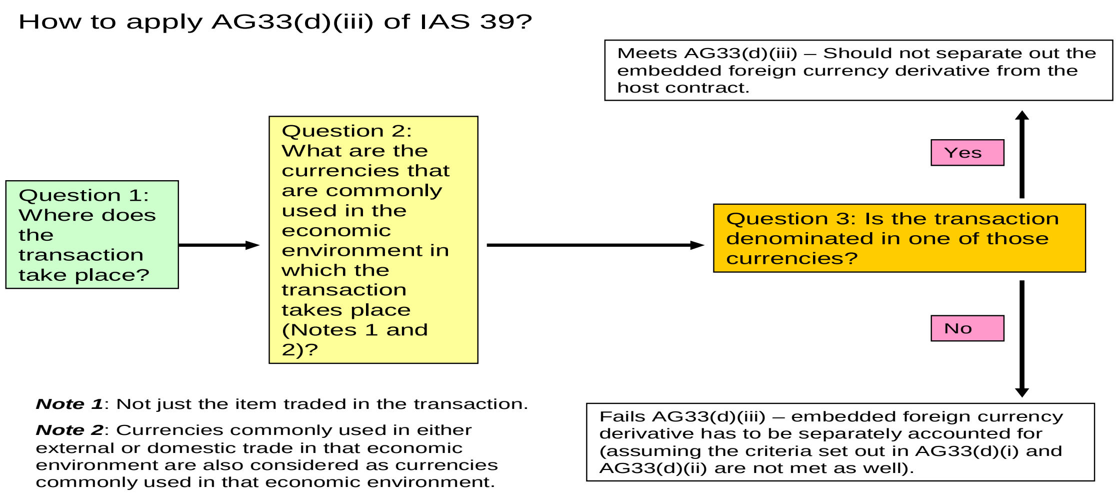
[1] IAS 21 paragraph 4 states: 'foreign currency derivatives that are not within the scope of IAS 39 (eg some foreign currency derivatives that are embedded in other contracts) are within the scope of the Standard.'

7. AG33(d)(iii) requires transactions to buy or sell non-financial items in that economic environment should be considered – i.e. *all* non-financial item transactions in that economic environment have to be considered.

8. AG33(d)(iii) gives an example – that is, a relatively stable and liquid currency that is commonly used in local business transactions *or* external trade. Therefore, a currency that is commonly used in *either* external *or* internal trade in that economic environment is also considered as a currency that is commonly used in that economic environment.

9. C.7 of the Guidance on Implementing IAS 39 gives an example – that is a Norwegian entity sells oil to a French entity. In applying AG33(d)(iii), IG C.7 takes into account *all* non-financial item transactions that take place in Norway.

10. The flow chart below summaries the requirements of AG33(d)(iii) of IAS 39.



Two Issues arising from the application of AG33(d)(iii) of IAS 39

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

- ***Question 1***: Where does the transaction take 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?

Question 1: Where does the transaction take place?

12. It is obvious for an entity to determine the place of a transaction that is between two entities operating in the same country. This paper does *not* discuss it further.

13. It is also obvious for an entity to determine the place of a transaction in which the goods sold are physically located in a particular country. For example, a sale of a property located in Country A obviously takes places in Country A. Again, this paper does *not* discuss it further.

14. However, it is *less obvious* for an entity to determine the location in which a cross-border transaction takes place. For example, Country B entity sells goods to Country C entity. A question arises as to whether the transaction takes place in Country B or Country C.

15. [Paragraph omitted from observer note].

16. [Paragraph omitted from observer note].

17. [Paragraph omitted from observer note].

Question 2: What are the currencies that are commonly used in the economic environment in which the transaction takes place?

18. To identify commonly used currencies, it is crucial to consider what *the 'population' of the economic environment is*.

19. IAS 39 does *not* provide much guidance on how to determine the ‘population’ of an economic environment. AG33(d)(iii) of IAS 39 merely requires that *all* non-financial item transactions in that economic environment have to be considered.

20. IG C.7 of IAS 39 gives an example to illustrate how to apply AG33(d) of IAS 39. That example takes into account *all* non-financial item transactions in the *country* in which the transaction takes place in determining whether an entity meets AG33(d)(iii). Therefore, one of the examples of an economic environment is the country in which the transaction takes place.

21. In addition, as mentioned above, currencies that are commonly used in either external or internal trade in an economic environment are also considered as currencies that are commonly used in that economic environment. Therefore, other examples of an economic environment are the external trade or internal trade environment of the country in which the transaction takes place.

22. Apart from the above-mentioned examples of an economic environment, a question arises as to *whether an economic environment could be something else*.

23. Consider the following two examples:

Example 1 – An export sale

- Entity A sells plant and machinery to Entity B.
- Entity A and Entity B are operating in Country A and Country B respectively.
- The functional currency of Entity A is Currency A.
- The currency in which the transaction is denominated is Currency C.
- From Entity A's perspective, the sale transaction takes place in Country A.
- Details of all export transactions (non-financial items) in Country A are as follows:

Country	Percentage (as compared with all export sales in Country A)	Currency in which the transactions are commonly denominated
Country B	10%	Currency C[2]
Country D	90%	Currency D

Example 2 – A local sale

- Entity I sells cars in Country I.
- Obviously, the transaction takes place in Country I.
- Most local transactions (particularly, necessities) in Country I are denominated in Currency I.
- Sales of luxury goods (e.g. luxury cars imported from elsewhere) in Country I are denominated in Currency J[3].

24. In Example 1, some believe that the 'population' of the economic environment only includes all export sales to Country B. In that case, Entity A does *not* separately account for the embedded foreign currency derivative.

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[2] Some ask whether Currency C is the functional currency of Entity B (i.e. whether Entity A meets the requirements in AG33(d)(i)). However, in practice, it is difficult for Entity A to know and verify the functional currency of Entity B.

In addition, some ask whether Currency C meets AG33(d)(ii) – that is the currency in which the price of the related goods or service that is acquired or delivered is routinely denominated in commercial transactions around the world. However, each criterion set out in AG33(d) should be considered *separately*.

[3] Some ask whether Currency J meets AG33(d)(ii) – that is the currency in which the price of the related goods or service that is acquired or delivered is routinely denominated in commercial transactions around the world. However, each criterion set out in AG33(d) should be considered *separately*.

25. However, *if* the ‘population’ of the economic environment includes all export sales in Country A, Entity A may fail the requirement in AG33(d)(iii) and may have to separate the foreign currency embedded derivative from the host sale contract and account for the embedded derivative as a derivative (i.e. fair value through profit or loss).

26. In Example 2, some believe that the economic environment could be the luxury goods market in Country I. In that case, Entity I does *not* separately account for the embedded foreign currency derivative.

27. The ‘population’ of the economic environment for Example 1 could also be the external trade of Country I (see the discussion in paragraph 21). If Currency J is a currency that is commonly used in all export sales in Country I, Entity I does *not* separately account for the embedded foreign currency derivative.

28. However, *if* the ‘population’ of the economic environment includes all local transactions in Country I, Entity I may fail the requirement in AG33(d)(iii) and may have to separate the embedded foreign currency from the host sale contract and account for the embedded derivative as a derivative (i.e. fair value through profit or loss).

Why was AG33(d) of IAS 39 introduced? Any hints in determining what the population of an economic environment is?

29. As noted in BC37 of IAS 39, there is an underlying principle to account for embedded derivatives – that is, all embedded derivatives should be separated from the host contracts and accounted for as derivatives (i.e. fair value through profit or loss).

30. In addition, IAS 39 requires entities to identify derivatives embedded in contracts and to apply the relevant embedded derivative provision, regardless of whether or not the host contracts are within the scope of IAS 39 (see IAS 39 paragraph 2, AG33(d)(iii) of IAS 39 and C.8 of the Guidance on Implementing IAS 39).

31. However, in view of the difficulties in identifying and measuring embedded derivatives separately, IAS 39 gives an exception to the general principle – that is,

embedded derivatives that are closely related to the host contracts should *not* be separately accounted for.

32. In addition, since it is common for entities to enter into contracts that are denominated in a foreign currency, IAS 39 specify circumstances in which foreign currency embedded derivatives should *not* be separately accounted for, which are set out in AG33(d) of IAS 39.

33. IAS 39 does *not* give exception to all contracts that are denominated in a foreign currency *in order to avoid any abuse of the exception to the principle requirement*.

34. BC39 and 40 of IAS 39 further explains why AG33(d)(iii) of IAS 39 was introduced.

- BC39 of IAS 39 states: 'The requirement to separate embedded foreign currency derivatives may be burdensome for entities that operate in economies in which <u>business contracts denominated in a foreign currency are common</u>. For example, entities domiciled in small countries may find it convenient to denominate business contracts with entities from other small countries <u>in an internationally liquid currency (such as the US dollar, euro or Yen)</u> 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 <u>denominates local contracts in the functional currency of the parent.</u>'

- 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) <u>in the environment in which the transaction takes place</u>. A foreign currency derivative would be viewed as <u>closely related</u> to the host contract if the currency is commonly used in local business transactions, for example, when monetary amounts are viewed <u>by the general population not in terms of the local currency but in terms of a relatively stable foreign currency</u>, and prices may be quoted in that foreign currency (see IAS 29 *Financial Reporting in Hyperinflationary Economies*) (see BC40 of IAS 39).'

35. The above Basis for Conclusions does *not* state that an economic environment must be a country. 'Commonly used' currencies might include any internationally liquid currencies or other foreign currencies (e.g. the functional currency of the parent entity in case that the entity operates in a hyperinflationary economy).

Possible ways to proceed with the issues

36. The staff believes that there are at least three possible ways to address the issues:

- ***Alternative 1*** **–** *not* to take the issues onto the IFRIC's agenda. Some believe that the issues indeed relate to how to apply IAS 39. In their views, circumstances vary case-by-case. Judgment has to be exercised in determining whether the requirements in AG33(d)(iii) are satisfied based on the facts of each case.
- ***Alternative 2*** **–** to develop an Interpretation to specify what an economic environment is (though some argue that any guidance developed would be Application Guidance); *or*
- ***Alternative 3*** **–** to refer the issues to Board to ask the Board to clarify what an economic environment is (particularly whether the economic environment is *only* restricted to be a country). The Board could then clarify through its Annual Improvement Process.

37. In the staff's view, to apply AG33(d)(iii) appropriately, it is crucial to know what the population of an economic environment is.

38. In addition, as compared with Alternative 2, the staff believes that it is more effective and efficient to take Alternative 3. According to the IASB work plan, the first exposure draft for the Board's Annual Improvements Process is expected to be published in October 2007.

STAFF RECOMMENDATION

39. IAS 39 is *not* clear in respect of the determination of the location in which a cross-border transaction takes place (see Question 1 above). Nor is IAS 39 clear in respect of what the ‘population’ of an economic environment is.

40. The submission states the issue has significant widespread relevance. The submission also notes that there is diversity in practice in respect of the determination of an economic environment.

41. As mentioned above, the staff believes that it is more effective and efficient to refer the issues to the Board. Therefore, the staff recommends that the IFRIC should *not* take the issue onto its agenda.

42. Instead, the staff recommends that the IFRIC should take Alternative 3 (i.e. to refer the issues to the Board and to ask the Board to clarify the issues through its Annual Improvements Process).

43. Wording for the proposed tentative agenda decision is set out in paragraph 47 of this paper.

44. The staff does *not* recommend the IFRIC to interpret the term ‘common’ (although the submission does ask the IFRIC to address it as well).

45. In the staff’s view, it is not appropriate, for principle-based IFRSs, to interpret ‘common’. Nor is it appropriate to assign a specific percentage to define ‘common’.

46. Moreover, once the Board clarifies what an economic environment is, the staff does not expect significant demand for interpreting the term ‘common’.

47. Wording for the proposed tentative agenda decision is set out below: [Paragraph omitted from observer note].

QUESTIONS TO THE IFRIC

48. Does the IFRIC agree that the issues should be referred to the Board for clarification? If not, what alternative does the IFRIC wish to take?