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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: **November 2007, London**

Project: **Financial Instruments**

Subject: **Application of Paragraph 11A and AG33 (d)(iii) (Agenda Paper 3)**

BACKGROUND

1. In the May 2007 IFRIC *Update* the IFRIC published tentative agenda decisions regarding the application of two paragraphs of IAS 39.

    a. AG33(d)(iii) – The issue relates to assessing the economic environment in which the transaction takes place in the context of determining whether a currency is commonly used in contracts to buy or sell non-financial items and thus is not an embedded foreign currency derivative requiring separation.

    b. Paragraph 11A – The issue relates to whether the fair value option in this paragraph can be applied to all contractual arrangements with one or more embedded derivatives, including contractual arrangements with hosts outside the scope of IAS 39.

2. The IFRIC considered the responses to both tentative agenda decisions at its meeting in July and agreed that the Staff should analyse those issues further and make a recommendation to the IFRIC on the action it should take.

3. Based on that analysis, the IFRIC concluded at its September meeting that paragraph 11A of IAS 39 and paragraph AG33(d) of the accompanying application guidance required clarification. Hence, it decided that the issues should be referred to the Board. The Staff was also asked to undertake additional analysis so that the IFRIC could suggest suitable revisions to the standard to the Board.

PURPOSE OF THIS PAPER

4. Both of the issues set out in paragraph 1 relate to the scope of IAS 39. Paragraph AG33 (d)(iii) of IAS 39 specifies whether a component (embedded derivative) of a hybrid non-financial contract is in the scope of IAS 39. The issue relating to paragraph 11A (the FVO) concerns whether a component (host contract) of a hybrid non-financial contract is in the scope of IAS 39.

5. This paper discusses four alternative approaches to how IAS 39 might be revised. Such revisions would clarify the scope of IAS 39 and eliminate diversity in practice. This paper asks which Alternative or Alternatives the IFRIC wishes to recommend to the Board for consideration.

6. Each Alternative is described in fairly general terms. This paper does not attempt to comprehensively address all the issues that would need to be considered to implement each Alternative.

ALTERNATIVES DISCUSSED

7. The four Alternatives discussed in this paper are:
    a. **Alternative A –** Extend the scope of IAS 39 to include all contracts that have the characteristics of a derivative (as set out in paragraph 9 of IAS 39).

    b. A**lternative B –** Extend the scope of IAS 39 to include, in their entirety, all contracts to buy or sell a non-financial item that could either be settled net, or that are not in accordance with the entity's expected purchase, sale or usage requirements

c. **Alternative C –** Extend the scope of the Fair Value Option (FVO) in IAS 39.

d. **Alternative D –** Clarify paragraph 11A and paragraph AG33(d).

8. This paper considers the issues together as they both relate to the scope of IAS 39. However, Alternative C addresses only the FVO issue. Therefore the IFRIC might want to consider combining Alternative C with another Alternative (for example, Alternative B).

ALTERNATIVE A – Extend the scope of IAS 39 to include all contracts that have the features of a derivative (as set out in paragraph 9 of IAS 39)

9. Most non-financial contracts have the characteristics of a derivative, as set out in paragraph 9 of IAS 39.

10. Despite this, many such contracts are not in the scope of IAS 39 today (although they may be eligible to be designated as hedged items as discussed in the following paragraph). A principle that all contracts with similar characteristics should be recognised and measured similarly suggests that all contracts with the characteristics of a derivative should be recognised and measured at fair value.

11. IAS 39 permits many non-financial contracts to be designated as hedged items in fair value hedge accounting relationships, including those contracts that would otherwise not be recognised. Application of hedge accounting results in recognizing the previously unrecognised hedged item (the non-financial contract) for changes in value of the hedged risk. The fair value adjustments to the hedged item arising from application of fair value hedge accounting ultimately affects the cost of the non-financial item that is the subject of the contract; if the non-financial contract is hedged in its entirety for all risks then the non-financial asset or liability delivered or exchanged under the contract is recognised at an amount equal to its fair value on initial recognition rather than at the transaction price.

12. Furthermore, no standard comprehensively specifies how non-financial contracts (firm commitments) should be accounted for. Such contracts are usually not recognised under IFRS until at least one of the parties has performed under the agreement such that it either is entitled to receive an asset or is obligated to disburse an asset. For example, an entity that has entered into a service or a

purchase and sales contract will delay recognition until the ordered goods or services have been shipped, delivered, or rendered.

13. Although non-financial contracts are often not recognised under IFRS, they nonetheless meet the definition of an asset and liability. Arguably, most such contracts also meet *The Framework* requirement that, to be recognised, an item must have a cost or value that can be measured with reliability.

14. Recognition of all such contracts would improve the representational faithfulness of the financial statements. This is because the entity would recognise all of its contractual assets and liabilities. Measuring such contracts at fair value would also provide more timely and relevant information for users to assess future cash flow prospects. Furthermore, comparability between the financial results of an entity in different reporting periods, as well as between different entities, would be improved.

15. Recognition of all such contracts would also reduce complexity, for some preparers, associated with obtaining and applying hedge accounting, and the requirement to identify and separate embedded derivatives in non-financial contracts. On the other hand, it might increase complexity for some preparers because an entity would be required to measure all such non-financial contracts.

16. Although Alternative A is the correct conceptual approach in the Staff's view, it would represent a significant change to the way that such contracts are currently accounted for. Hence it is unlikely to be considered a change that is appropriate to make as part of amending the accounting for financial instruments. Furthermore, the Staff recognises that the Board has other projects (notably revenue recognition) that are addressing similar issues.

ALTERNATIVE B – Extend the scope of IAS 39 to include, in their entirety, all contracts to buy or sell a non-financial item that could either be settled net, or that are not in accordance with the entity's expected purchase, sale or usage requirements

17. Whether a non-financial contract *in its entirety* is in the scope of IAS 39 depends upon whether it can be net settled and, if so, whether the item that is the subject of the contract is part of the entity's expected purchase, sale or usage requirements.

18. Whether part of a non-financial contract, that in its entirety is not in the scope of IAS 39, is separated out and accounted for as a derivative depends upon whether that part of the contract (the embedded derivative) is closely related to the rest of the contract. This means that part of a non-financial contract might be accounted for as a derivative despite the fact that the non-financial contract in its entirety is considered to be part of the entity's normal purchase, sale or usage requirements.

19. Alternative B could take several different forms. These include:

    a. Any non-financial contract that can be net settled would be in the scope of IAS 39 in its entirety. Whether the contract is in accordance with the entity's normal purchase, sale or usage requirements would be irrelevant.

    b. Any non-financial contract that is not part of the entity's normal purchase, sale or usage requirements would be in the scope of IAS 39 in its entirety. Whether the contract can be net settled would be irrelevant.

20. Alternative B is similar in approach to Alternative A, but with a narrower scope. Therefore many of the comments regarding Alternative A apply also to Alternative B.

21. Either of the approaches under this Alternative would result in some non-financial contracts in their entirety being in the scope of IAS 39 that, today, would not be (and vice-versa).

22. A criterion based on net settlement would result in non-financial contracts that are similar to financial instruments (because of their proximity to cash or other financial instrument) being accounted for similarly.

23. A criterion based on normal usage would not be based on any similarity between financial and non-financial contracts. However, it could be argued that if such contracts are not being entered into for normal usage purposes then the entity should recognise and measure the non-financial contracts (in effect, the contracts are being 'traded'). This approach is similar to the approach for non-financial contracts in the Exposure Draft of a Proposed IFRS for Small and Medium-sized Entities.

24. The effects and implications of Alternative B include that there would be:

    a. No requirement to identify and separate embedded derivatives in non-financial contracts (embedded derivatives in financial instruments would still need to be identified and separated if the relevant criteria are met). Such a contract would either be in or out of the scope of IAS 39 in its entirety. This is an area of significant complexity for preparers, as demonstrated by the application of paragraph AG33(d)(iii) of IAS 39.

b. No need to apply hedge accounting to non-financial contracts that are in the scope of IAS 39 (although there may be greater volatility in profit or loss if the hedging instrument is only being used to hedge FX risk)

c. Greater comparability between entities, and between different reporting periods for the same entity.

The effects of Alternative B are similar to those set out for Alternative A.

Alternative C – Extend the scope of the Fair Value Option (FVO)

25. Alternative C would clarify and extend the scope of the FVO in IAS 39.

26. The key questions under this Alternative are:

a. Should the scope be extended only to non-financial *contracts* and, if so, which ones?

b. Should a scope extension also cover some *non-contractual* assets and liabilities?

The answers to the above questions will depend on:

i. Interaction with other projects of the Board

ii. Interaction with other IFRSs

iii. Effect on current accounting practice(s)

27. The Staff notes that some non-financial items (contractual and non-contractual) that are not within the scope of IAS 39 are allowed or required to be measured at fair value under IFRS (for instance items within the scope of IAS 40 *Investment Property* – including some operating leases, and IAS 41 *Agriculture*). The following discussion assumes that any extension of the FVO in IAS 39 would not apply to such items.

28. The Staff also notes that phase 2 of the FASB fair value option project is considering whether some non-financial assets and liabilities (including physical and non-physical commodity inventories and Emission Rights) that are not currently eligible for FVO designation should be. Any recommendation from the IFRIC to expand the scope of the IAS 39 FVO should be considered in the context of convergence between US GAAP and IFRS.

29. The following paragraphs discuss the various items that might be considered in any extension of the FVO in IAS 39.

a) Permit application of FVO to some or all non-financial contracts

30. This alternative would allow the FVO to be applied to some or all non-financial contracts. Paragraph 11A of IAS 39 allows some contracts with embedded derivatives that meet the requirements of IAS 39 paragraph 11A(a) and (b) to be fair valued. (Paragraph 11A (a) and (b) ensure that contracts with 'non-substantive' embedded derivatives are not eligible for designation as a fair value hedge – see comments in footnote[1].)

31. This Alternative would result in an entity not being required to separately measure such embedded derivatives, as well as avoiding the need to obtain and apply fair value hedge accounting to such non-financial contracts.

32. One approach to Alternative C is to permit an entity to apply the FVO to any non-financial contract that has the features of a derivative (as set out in paragraph 9 of IAS 39).

33. As discussed under Alternative A, IAS 39 permits many of these non-financial contracts to be designated as hedged items in fair value hedge accounting relationships, including those contracts that would otherwise not be recognised. Application of hedge accounting results in recognising the previously unrecognised hedged item (at fair value) for changes in value of the hedged risk.

34. Rather than requiring all such contracts to be accounted for at fair value (as suggested under Alternative A), preparers could be allowed to elect to fair value

[1] As noted, paragraph 11A of IAS 39 deals with fair valuing an entire (financial) contract that contains a 'substantive' embedded derivative. However, it does not cover a situation in which the entire contract is a derivative.

such contracts. However, this approach will not address the application issues associated with paragraph AG33(d)(iii).

35. Another approach to Alternative C might be to extend the FVO to all contracts that meet the expected purchase, sale or usage requirements criterion.

36. IAS 39 paragraph 5 explicitly states that IAS 39 should be applied to a contract to buy or sell a non-financial item (that can be settled net in cash or another financial instrument, or by exchanging financial instruments), subject to one exception - if the contract is entered into and continues to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

37. However IAS 39 requires an embedded derivative to be separated out from the host contract and accounted for as a derivative unless certain conditions are met, whether or not the contract as a whole can be net settled.

38. Hence, it might be logical to provide preparers the option to either make use of this exception *for the entire contract* (see comments below) or account *for the entire contract* at fair value (as a derivative).

39. The Staff's research seems to indicate that controversy over the application of the FVO to non-financial contracts is limited almost entirely to 'normal' purchase and sale contracts that are not otherwise within the scope of IAS 39 (for example, because they cannot be net settled). Some respondents to the previous IFRIC tentative decisions indicate that they are not aware of paragraph 11 A being applied to any other types of contracts.

40. This approach would allow preparers to use consistent accounting for all purchase and sale contracts without having to distinguish between those within and those outside the scope of IAS 39.

41. However, this approach does not address the application issues associated with paragraph AG33(d)(iii) of IAS 39. To address the issues relating to the application of paragraph AG33(d), this approach could be combined with approach (b) under Alternative B whereby any non-financial contract that is part of the entity's

normal purchase, sale or usage requirements is outside the scope of IAS 39 *in its entirety*, regardless of the nature of settlement (see paragraph 19).

42. Preparers will thereby have the option to elect to fair value the whole contract under IAS 39 or the contract in its entirety will be outside the scope of IAS 39.

b) Permit application of FVO to non-financial- non-contractual assets and liabilities

43. **Commodities and similar assets**: IAS 2 *Inventories* permits broker-traders to measure inventory at fair value less costs to sell. IAS 2 also allows producers of agricultural products and produce and minerals and mineral products to measure such items at net realisable value. All other entities are required under existing standards to recognise inventory at lower of cost or net realisable value.

44. The Board has been asked on a number of occasions by some entities to allow specific commodities that are traded in active markets to be fair valued to reflect the way that such items are evaluated and managed by the entity. For example, some central banks have requested that they be permitted to fair value their holdings of gold (monetary gold). Monetary gold does not meet the definition of inventory nor financial asset and hence is not within the scope of IAS 2 and IAS 39.

45. Allowing such items to be designated under the FVO would be consistent with the FVO eligibility criteria in paragraphs 9(b)(i) and (ii) of IAS 39. (Also see earlier comments regarding phase 2 of the FASB FVO project. In addition the FASB has a potential FSP that would amend ARB 43 *Restatement and Revision of Accounting Research Bulletins* and that could require some commodity inventories to be accounted for at fair value.)

46. **Emission rights:** There is no guidance on accounting for Emission Rights under IFRS. There is an active market for these items. Once again, it would be possible to permit such items to be designated under the FVO when such designation would be consistent with the FVO eligibility criteria in paragraphs 9(b)(i) and (ii) of IAS 39. The IASB has emission rights on its agenda (although that project is currently inactive). The FASB is also addressing the accounting for emission rights in the context of phase 2 of its FVO project, and as part of a separate but related project on Emission Allowances.

ALTERNATIVE D – Clarify paragraph 11A and paragraph AG33(d)

47. Alternative D proposes that the Board simply clarify the meaning of paragraph 11A and paragraph AG33(d)(iii) of IAS 39.

48. Alternative D is the least ambitious Alternative discussed in this paper. Unlike all of the other Alternatives, it might also qualify to be part of the Annual Improvements process.

Paragraph 11A

49. The Board could confirm that paragraph 11A applies only to contracts with embedded derivatives that have financial hosts, or clarify that the FVO option could be applied to all contracts with embedded derivatives.

50. Having researched the development of the FVO in IFRS, the Staff believes that the Board intended the FVO to be applied only to financial instruments. However, the Board did not discuss whether financial reporting might be improved if the FVO might be applied to non-financial items.

Paragraph AG33(d)(iii)

51. Paragraph AG 33, provides in part, that:

> *"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 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 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)."

52. The issue relates to assessing the economic environment in which the transaction takes place in the context of determining whether a currency is commonly used in contracts to buy or sell non-financial items and thus is not an embedded foreign currency derivative requiring separation.

53. The superseded Implementation Guidance Question 25-6 of IAS 39, Foreign currency derivative: currency of primary economic environment, answered the question - "What is the currency of the primary economic environment in which any substantial party to the contract operates for the purpose of applying IAS 39.25(d)?"

54. The implementation guidance on the above was as follows:

"*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)"*.

55. As underlined, above, the intent of paragraph AG 33(d) is to allow for non bifurcation of hybrid contracts if the embedded derivatives are **integral** to the arrangement and hence bear a close economic relationship to the host contract.

These are contracts that have been entered into for reasons that are clearly not based on achieving a desired accounting result or for speculative purposes.

56. The FASB has similar provisions in Statement No. 133 Accounting for Derivative Instruments and Hedging Activities. SFAS 133 provides that an embedded foreign currency derivative instrument should not be separated from the host contract and considered a derivative instrument if the host contract is not a financial instrument and it requires payment(s) 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 international commerce (for example, the U.S. dollar for crude oil transactions)

    c. The local currency of any substantial party to the contract

    d. The currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary.

57. DIG B21 (FAS 133) concluded that if a contract's payments are denominated in one of the above currencies, that foreign currency is **integral** to the arrangement and thus considered to be clearly and closely related to the terms of the contract.

58. There are different possible approaches to clarifying what embedded foreign exchange derivative features that are integral to the arrangements in IFRS.

59. One approach is to simply list the examples in SFAS 133. Another approach might be to state that any foreign exchange embedded derivative in a normal usage contract is considered to be integral to the arrangements. There may also be other possible approaches.

60. There is diversity in application of paragraph AG33(d)(iii) and clarification by the Board of its original intention for AG33(d) to apply to only features that are integral to the whole arrangement (and hence closely related to the host contract)

will promote consistency in application of the standard and comparability between financial statements.

STAFF RECOMMENDATION

61. The Staff recommends that the IFRIC propose that the Board adopt Alternative D, for the following reasons:

    a. Amending paragraph 11A and AG33(d), as proposed under Alternative D, will clarify the meaning of those provisions of the standard. Such clarification will ensure consistent application of IAS 39 in these areas and therefore enhance comparability.

    b. This approach is a focused revision to IAS 39. The other Alternatives represent a more fundamental reconsideration with significant interaction with other ongoing projects.

    c. The proposal in Alternative D will have no effect on other IFRSs and as such will not significantly change financial reporting generally under IFRS

QUESTIONS TO THE IFRIC

62. Which Alternative or Alternatives discussed in this paper does the IFRIC recommend that the Board pursue? If the IFRIC has an Alternative that is not discussed in this paper, what is that Alternative and why should the Board pursue it?