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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:** September 2007, London

**Project:** IAS 39 Tentative Agenda Decisions -- Research Report  
(Agenda Paper 7E, Appendix 1)

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## ***EMERGING ISSUES COMMITTEE DRAFT ABSTRACT OF ISSUE DISCUSSED***

This Draft Abstract is issued by the Emerging Issues Committee for comment. The consensus views in the draft may be modified in light of the comments received. **Comments should be submitted in writing by August 20, 2007.** All replies will be put on public record unless confidentiality is requested. Comments should be addressed to:

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# **DETERMINING WHETHER A CONTRACT FOR THE PURCHASE OR SALE OF A NON-FINANCIAL ASSET SUCH AS A COMMODITY IS ROUTINELY DENOMINATED IN A SINGLE CURRENCY IN COMMERCIAL TRANSACTIONS AROUND THE WORLD**

**Date issued:** July 23, 2007

## **References**

CICA. *CICA Handbook – Accounting*, “Financial Instruments — Recognition and Measurement,” Section 3855.

IASB. *Financial Instruments: Recognition and Measurement*, IAS 39 (IG C.9).

FASB. Embedded Derivatives: When Embedded Foreign Currency Derivatives Warrant Separate Accounting, Statement 133 Implementation issue No. B21.

## **Introduction**

FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, paragraph 3855.37, requires an embedded derivative to be separated from the host contract and accounted for as a derivative if the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract. An exception is made in paragraph 3855.A34(d) for an embedded foreign currency derivative in a host contract that is 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) where the embedded derivative is not leveraged, does not contain an option feature, and requires payments denominated in “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).”

Section 3855 does not provide any guidance on how to define or apply the term “routinely denominated in commercial transactions around the world”.

## **Issue**

The issues are:

1. How should the term “routinely denominated” in paragraph 3855.A34(d) be interpreted?
2. What factors can be used to determine whether a contract for the purchase or sale of a non-financial item such as a commodity is routinely denominated in a particular currency in commercial transactions around the world?

## **EIC Discussion**

On the **first issue**, the Committee reached a consensus that “routinely denominated in commercial transactions around the world” should be interpreted to mean that a large

majority of similar transactions all around the world, not just in one local area, are based on a particular currency. The Committee observed that similar transactions cannot be routinely denominated in more than one currency around the world (see the discussion in the second issue below in respect of transactions that are denominated in a currency that is a “convenience translation” of the dominant currency). The Committee also noted that the existence of a relatively small proportion of transactions in one or two markets, or particular jurisdictions, that are denominated in a local currency that is not a convenience translation of the dominant currency does not preclude a non-financial item from being considered to be routinely denominated in a particular currency in commercial transactions around the world.

The Committee noted that the number of non-financial items that would qualify under paragraph 3855.A34 (d) will likely be limited. In practice, such items will primarily be commodities that are traded in US dollars in commercial transactions throughout the world.

On the **second issue**, the Committee reached a consensus that the following factors should be considered in determining whether there is a currency in which a good or service is routinely denominated in commercial transactions around the world. The Committee noted that the following discussion uses commodities as an example, given that, as noted in the first issue, the question of whether a good or service is routinely denominated in a particular currency in commercial transactions around the world frequently arises in connection with commodity transactions. However, the Committee observed that these factors also would apply in the case of non-financial assets other than commodities.

- (a) For certain types of commodity transactions, contracts may be based on a dominant currency (such as the US dollar) but may be denominated in local currencies in certain markets for regulatory or other reasons where such local currency transactions are based on the dominant currency price of that commodity translated at the spot rate into local currencies (a “convenience translation” mechanism). For example, although the dominant currency for crude oil transactions as noted in paragraph 3855.A34 (d) is the US dollar, some contracts for crude oil may be denominated in Canadian dollars in Canada, where the Canadian dollar price is a convenience translation of the US dollar crude oil price. The Committee noted that a simple convenience translation into local currencies of a commodity that is routinely denominated in a dominant currency would not negate the view that the commodity is routinely denominated in a single currency in commercial transactions around the world. On the other hand, if a commodity transaction is regularly denominated in various currencies in commercial transactions around the world where such foreign currency prices are not convenience translations of a dominant currency price, that commodity would not be considered to be routinely denominated in a particular currency. For example, natural gas transactions are regularly denominated in various currencies (such as US dollars, Canadian dollars and Euros) where the various foreign currency prices are not convenience translations into a dominant currency such as US dollars. For example, if cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in Euros in Europe, neither the US dollar nor the Euro is a currency in which the goods or services are routinely denominated in commercial transactions around the world.

- (b) The existence of an organized commodity exchange where a commodity is traded in a single currency provides a useful starting point in determining the dominant currency in which transactions in that commodity are denominated and, accordingly, whether such a commodity can be considered to be “routinely denominated” in that particular currency. The organized commodity exchanges may establish liquid markets for commodities quoted in a particular currency, and transactions between counterparties that are not conducted through the exchange are also denominated in that particular currency because to do otherwise would present arbitrage opportunities. For example, copper and gold are traded in US dollars on organized commodity exchanges and transactions between various counterparts that are not conducted through the exchange are also denominated in US dollars given the liquid markets established by the exchanges.
- (c) Certain commodities are not traded on organized exchanges, but global pricing forums exist that publish “spot prices” denominated in a dominant currency for that particular commodity. Transactions between market participants are based on those published spot prices. For example, uranium is presently not traded on a commodity exchange. However, certain organizations independently monitor uranium market activities and publish US dollar prices that have become generally accepted as spot prices for uranium. Contracts between market participants are denominated in US dollars based on these published spot prices. In Japan and Europe, transactions may be conducted in Japanese Yen or Euros, respectively, but such Yen and Euro price equivalents are convenience translations of the US dollar spot price. Accordingly, uranium contracts are considered to be routinely denominated in US dollars in commercial transactions around the world for purposes of paragraph 3855.A34 (d).

The Appendix to this Abstract provides examples of commodities and certain other items that are considered to be routinely denominated in US dollars for purposes of paragraph 3855.A34(d), based on consideration of the above-noted factors as of the date of this Abstract.

### **Basis of Application**

The Committee reached a consensus that the accounting treatment in this Abstract should be applied retrospectively to embedded foreign currency derivatives in host contracts that are not financial instruments accounted for in accordance with Section 3855 in financial statements issued for interim and annual periods ending on or after December 15, 2007. Earlier adoption is encouraged.

## **APPENDIX**

This Appendix is an integral part of this Abstract.

This Appendix provides examples of commodities and certain other items that are considered to be routinely denominated in US dollars for purposes of paragraph 3855.A34(d), based on consideration of the factors discussed in this Abstract.

- Aluminium
- Coal (coking and thermal)
- Copper
- Crude oil
- Diamonds [rough/raw and polish (wholesale market)]
- Gold
- Iron ore
- Jet fuel
- Lead
- Nickel
- NBSK pulp
- Palladium
- Platinum
- Silver
- Tin
- Titanium
- Uranium
- Wide-bodied aircraft
- Zinc

The above list is not intended to be exhaustive. Rather, it is a listing of commodities and certain other items that are routinely denominated in US dollars that have been identified at the date of this Abstract which may be used to support an assertion under paragraph 3855.A34(d) that these goods are routinely denominated in US dollars in commercial transactions around the world. Preparers should consider any circumstances arising subsequent to the date of this Abstract that might impact whether an item should remain on this list.