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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting:	**September 2007, London**
Project:	**IAS 39 Tentative Agenda Decisions -- Research Report** **Details of comments received from constituents** **(Agenda Paper 7E, Appendix 2)**

Paragraph 11A

Question to Respondents

Thank you for your comments on the IFRIC's tentative agenda decision on the application of the IAS 39, paragraph 11A fair value option to contracts with non-financial instrument hosts.

The IFRIC received several comments on this decision and asked the staff to do more research into the reasons for commentators' concerns. As a result, we'd like your help to better understand the types of contracts with non-financial hosts for which the paragraph 11A fair value option might be used.

Respondent 1 – National standard setter

1. We discussed the application of paragraph 11A with representatives of major audit firms to assess whether there is diversity in practice in [jurisdiction].

2. Responses as to the application of paragraph 11A were mixed. Half of the representatives confirmed that they did not allow constituents to fair value a hybrid instrument when the host contract is not a financial instrument, however, the other representatives stated that they do not prohibit their clients from using the fair value option in paragraph 11A to fair value a hybrid with a non-financial host (assuming it met the requirements of paragraph 11).

3. As such, we expect there to be diversity in practice in [jurisdiction]. Whilst we agree that it was not the intention of paragraph 11A to override the measurement requirements of every other Standard to allow the measurement of a non-financial asset or liability which is part of a hybrid instrument at fair value, we are sympathetic to the fact that it is being interpreted in this manner due to the wording of paragraph 11A. Paragraph 11 is clear in requiring a non-financial host to be accounted for in accordance with the relevant Standard, however, paragraph 11A starts with "Notwithstanding paragraph 11..." which implies that a hybrid with a non-financial host can be measured at fair value.

4. It is not necessarily clear from this paragraph that this treatment would not be acceptable for hybrids with non-financial hosts, given that paragraphs 11 and 12 (immediately before and after paragraph 11A) relate to such instruments.

5. The representatives who consider it appropriate to use the FVO to measure hybrids with non-financial host contracts provided the following examples for which they have allowed clients to measure the hybrid contract at fair value.

> *An example of a non-financial host with an embedded derivative that we have seen is a contract where the host contract is a commodity supply contract and there is an embedded derivative indexed to the quoted price of another commodity. Specifically, we saw a gas supply contract indexed to another gas price where the other gas price was considered not closely related. Theoretically, though it could probably also apply to a purchase/supply contract with an embedded foreign currency derivative.*
>
> *We would say that a derivative with both a financial & non-financial underlying is a financial instruments. An example is a contract whereby the issuer will pay the holder an amount indexed to a share index if an IPO does not occur. The IPO would be considered a non-financial variable, while the share price is a financial variable. We would treat the instrument as a derivative. However, there is some debate as to whether these are really two underlyings or whether the underlying is the share index and the IPO is a contingency. Another theoretical example would be a contract where the payout is indexed to a share price and EBITDA. We still consider EBITDA a non-financial variable specific to a party (pending IFRIC consideration of this issue) and the share price is a financial variable.*

Respondent 2 – National Standard Setter FI staff

6. My basic reaction to your query about paragraph 11A is:
   - Our standard does not have a comparable provision.
   - We do have a requirement to document expected use for normal purchase and sale contracts, which isn't in IAS 39. This requirement can be used as its own fair value option. That is, to treat a purchase or sale commitment as a derivative, it is simply not documented as meeting expected use. I understand that it is possible some are doing the same thing under US GAAP.
   - It would be a bit of a shame to force 11A to be restricted to financial contracts since that would force entities to use hedge accounting in circumstances where it might not be necessary right now.

Respondent 3 – Major firm engagement partner

7. My knowledge on the application of 11A is mostly based on what is going on in [jurisdiction]. Where we see use of 11A, and where we see it as being helpful to the entities, is in commodity contracts (metals, timber, pulp, oil, gas, other petroleum products, electricity, etc) either in contracts without net settlement or with contracts that otherwise fall within "own use".

8. We have not seen application of 11A in situations where the host contract is not a commodity purchase or sales contract or a contract on a commodity-like item. We see 11A as being helpful in a number of instances for such commodity or commodity-like contracts. In a number of combined instruments the value of the embedded derivative are correlated to the value of the host contract without being regarded as "closely related". Separating the embedded derivative might in such circumstances either only tell a part of the story or create an "artificial P&L volatility" as the fair value movement of the embedded derivative is actually (partly) offset by a non-recorded fair value change in the host contract. We also see companies that calculate and manage commodity market price risk exposures including "own use" contracts being motivated to look for embedded derivatives to apply the fair value option.

9. The IFRIC rejection in March 2007 on "Written options in retail energy contracts" was seen by a number of companies and at least one regulator as concluding that no retail energy contracts have net settlement and thus should be outside scope of IAS 39. Consequently, some utilities / electricity end user sales companies have contemplated using 11A to get physical end-user sales contracts within scope of IAS 39. These are mostly companies that purchase all the physical electricity for their sales from a pool on which forward contracts are only traded as financial contracts and are thus within the scope of IAS 39. However, we have not yet seen such actual application of 11A.

Respondent 4 – Preparer

10. All types of commodity purchase and sales contracts that are non-financial and include embedded derivatives that are not closely related to the host contract will be evaluated due to IAS 39 with the main focus on §5-§7, §10-§13 and AG 33(b). This evaluation is to decide whether we shall use or not use the fair value option in IAS 39 §11A. Examples of contracts we evaluate are energy purchase contracts, recovered paper purchase contracts and paper sales contracts.

11. Follow up question from staff – I assume that the contracts you refer to are normal purchase and sale contracts that are NOT within the scope of IAS 39 because they do not have net cash settlement provisions. Is that correct?

12. Response – That is correct and in line with IAS 39 §6(b) and §6(c) (we also take into consideration IAS 39 §6(a), §6 (d) and §7).

Paragraph AG33(d)(iii)

Question to Respondents

What interpretations have you heard about in practice? One of the comment letters set out five the commentator was aware of. Do you have any views on what would be a sensible interpretation of this requirement?

Respondent 1

13. In relation to the application of paragraph AG33(d)(iii) within the [jurisdiction] environment, representatives of major audit firms were approached to ascertain whether their firms had any internal guidance on the application of the requirements of the paragraph. Only one firm had any guidance formalised and listed numerous countries in which they consider that USD is considered a commonly used currency.

14. With a few of these countries, the Euro was also considered to be a commonly used currency. This firm also had a list of countries for which they considered that no currency other than the local currency could be considered to be 'commonly used'. These countries included Hong Kong, Singapore, Thailand and Philippines. Therefore, it can be seen that there is some divergence in practice. Whereas one firm would accept a contract written in USD being deemed to be closely related and therefore not require separate accounting for embedded derivatives, another firm indicated that contracts in Hong Kong would have to be written in HKD for the exemption to apply. This anomaly may be a result of the HKD and the USD being formally linked. Two of the firms indicated that they would make a decision on a case-by-case basis. One of these firms noted they would take into consideration, not only the country in which the trade is being conducted but which industry it relates to, e.g., luxury cars are commonly sold

into Russia in USD and therefore an embedded derivative does not need to be separately accounted for.

Respondent 2

15. I have heard that there are two issues with AG 33d - both sub paragraphs ii and iii have created similar challenges.

16. With diii, the issues seem be along the lines of 'how pervasive does use of a particular currency have to be in order to consider it *commonly used* in the economic environment...' and what evidence is needed to support such a contention. For example, we generally understand that trade with entities in many South American countries is conducted in USD and it is beginning to appear that the same holds true in China.

17. The interpretive questions become things like – how far does an entity have to go to support the notion that the use of USD is common?
    - is it the reporting entity's experience?
    - is it the reporting entity's understanding within their industry?
    - 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 USD to assert that use of the currency is common?
    - does the currency have to be used in local transactions or can it just be cross border payments? etc.

18. The issues with dii are similar but have a broader geographic scale and a narrower product focus. With dii, the challenge is to prove that transactions that are not in the currency in which the item is *routinely denominated* around the world are in fact linked to the USD price (because in almost all cases we are talking about USD). For example, we know that transactions within the EU will often be priced in euros but we believe that the price is the euro equivalent of the USD price. Thus the questions are along the lines of – how far does the reporting entity need to go to prove that only one currency is used for pricing transactions around the world.

19. [Paragraph omitted from observer note]

20. Therefore, both dii and diii are causing issues – how much is routine, how much is common, how much work does an entity have to do to prove the threshold has been met, and 'diversity in practice' is being addressed by local consortiums who tend to prepare lists that risk preclusion of the application of judgement to any non-list items.