



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**

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

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)**

BACKGROUND

1. In the May 2007 IFRIC *Update* the IFRIC published its tentative agenda decision regarding the application of two paragraphs of IAS 39:
 - AG 33(d)(iii) – The issue particularly 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.
 - 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. In the light of the issues raised by respondents, the IFRIC agreed that the staff needed additional time to analyse those issues further to be in a position to recommend any action to the IFRIC. Therefore the IFRIC deferred to a future meeting its decision on whether to confirm the tentative agenda decision.

3. The purpose of this paper is to report to the IFRIC the progress staff has made to date in researching the issues raised by respondents.

REQUESTS FOR FURTHER INFORMATION

4. With respect to IAS 39 AG33(d)(iii), the staff contacted one national standard setter who disagreed with the tentative agenda decision indicating significant practice problems existed in its jurisdiction, but did not provide details of the specific problems encountered. The staff also contacted two other national standard setters who had not commented on the tentative agenda decision but had previously raised questions with the staff on this issue.
5. The same national standard setters were requested to provide additional information on issues arising with respect to the application of IAS 39 paragraph 11A. In addition, other respondent who disagreed with the tentative agenda decision on this issue were contacted. They were asked to provide specifics about situations in which paragraph 11A was being applied in practice to contracts with non-financial hosts.
6. We received responses from all three national standard setters and two of the respondents on paragraph 11A. Two national standard setters consulted with their constituents to obtain information about practice issues and interpretations that are being used. With respect to AG33(d)(iii), we were advised that the Canadian Emerging Issues Committee had just released for comment a Draft Abstract [Interpretation] regarding the application of the Canadian equivalent of AG33(d)(ii). The Canadian Draft Abstract is included as Appendix 1 to this paper.
7. The two respondents on paragraph 11A provided input similar to that we received from the national standard setters.
8. The staff would like to acknowledge the help of these constituents. It was not an ideal time to request additional information, being vacation period in the Northern hemisphere and year end busy season in the Southern hemisphere. If the IFRIC believes that the staff needs to gather more information before we can proceed with further analysis, we will make further enquiries of constituents.

SUMMARY OF INFORMATION RECEIVED

9. Details of the responses received are included in Appendix 2 to this Agenda Paper. Following is a high level summary of the main issues raised.

AG33(d)(iii)

10. Both the original commentators on the tentative agenda decision and the national standard setters contacted subsequently confirmed that considerable confusion

regarding the application of AG33(d) exists in their jurisdictions. Consequently, they expect diversity in practice.

11. It would seem to be a matter of concern to the IFRIC or the Board that different organisations in the various jurisdictions appear to be taking different approaches to resolving this diversity. Based on comments from Respondent 1, some of the major audit firms in that jurisdiction are exercising judgement on a case-by-case basis, while others are developing detailed lists of acceptable currencies.
12. The Canadian interpretive body has adopted the second approach. The existence of this national interpretation supports the view of one of the original commentators on the tentative agenda decision that both sub-paragraphs (ii) and (iii) raise significant interpretation problems in practice resulting in diverse application of the standard.

Paragraph 11A

13. Respondents confirmed the information provided by the original commentators on the tentative agenda decision. That is, the fair value option in paragraph 11A is being applied to contracts with embedded derivatives and non-financial hosts provided they meet the conditions in that paragraph.
14. However, our research seems to indicate that this application is limited almost entirely to 'normal' purchase and sale contracts that are not otherwise within the scope of IAS 39. Some respondents indicate that they are not aware of paragraph 11 A being applied to any other types of contracts.

NEXT STEPS

15. The staff believes we have received enough information to ensure that we understand the practice issues. We also believe that although the issues arise on the application of IAS 39, they relate to questions on some of the basic requirements of the standard. Therefore responding to requests for clarification in this case does not constitute providing application guidance but rather would clarify the requirements of the standard itself.
16. The staff agrees with commentators who argue that it is impossible to read paragraph 11A out of the context of paragraphs 11 and 12 and the related application guidance. The staff notes that the concern that the option in 11A could be widely used to override the measurement requirements in other standards does not seem to be supported by practice.
17. In addition, the staff notes that paragraph 11A applies only to contracts, not to all other types of assets and liabilities. Other than in IAS 37 on onerous contracts, there is not much guidance in IFRSs on accounting for contracts in general. The accounting for some specific types of contracts is prescribed in standards such as

IAS 17 Leases, IAS 19 Employee Benefits, IAS 39 and IFRS 4 Insurance Contracts.

18. Finally, the staff notes that these issues are interrelated. A normal purchase and sale contract that is not within the scope of IAS 39 may be denominated in a foreign currency. An entity would be required to separate the foreign currency derivative unless it is considered closely related in accordance with paragraph AG33. Rather than trying to apply AG33, the entity may prefer to apply paragraph 11A and fair value the entire contract. This would also allow it 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.
19. The staff has concluded that resolution of these issues will likely require amendments to IAS 39. Therefore, the IFRIC could decide at this point not to add the issues to its agenda and to simply draw them to the attention of the Board. However, in the staff's view it would be more productive if the IFRIC could suggest to the Board the revisions to IAS 39 that it considers desirable, based on its research.
20. Consequently, the staff proposes next to analyse the interaction of various types of contracts with the embedded derivatives requirements in IAS 39 to determine whether and how the relevant paragraphs might be clarified.
21. With respect to AG33(d)(ii) and (iii), the staff proposes to analyse the background to the changes the Board made to the requirements of IAS 39 as part of the 2003 improvements project. The purpose will be to determine whether some of the Board's assumptions in making those changes have in fact been borne out in practice.
22. In carrying out these analyses, the staff expects to work closely with the Board's financial instruments team.

QUESTIONS FOR THE IFRIC

23. Does the IFRIC agree that sufficient research has been carried out to ensure we understand the practice issue? If not, what additional research does the IFRIC suggest we undertake?
24. Does the IFRIC agree with the staff conclusion that clarifying the requirements related to these issues does not constitute application guidance? If not, does the IFRIC wish to proceed to confirm the original tentative agenda decisions? (The tentative agenda decisions published in the May IFRIC Update are included in paragraphs 26 through 32 below.)
25. Does the IFRIC agree with the staff conclusion that resolution of these issues will require amendment of IAS 39, and should be referred to the Board? If so, does the IFRIC agree with the staff's proposal to conduct additional analysis so that the

IFRIC can suggest suitable revisions to the standard when the issues are referred to the Board?

TENTATIVE AGENDA DECISIONS PUBLISHED IN MAY

IAS 39 *Financial Instruments: Recognition and Measurement*—Scope of paragraph 11A

26. The IFRIC was asked whether the fair value option available in paragraph 11A of IAS 39 can be applied to all contractual arrangements with one or more embedded derivatives, including contractual arrangements that contain hosts outside the scope of IAS 39.
27. The scope of IAS 39 is set out in paragraphs 2-7 of the Standard. When a financial instrument contains one or more embedded derivatives, the conditions set out in IAS 39 paragraph 11A must be met in order to designate the financial instrument as at fair value through profit or loss in accordance with IAS 39 paragraph 9.
28. The IFRIC noted that the scope of paragraph 11A of IAS 39 should be consistent with the overall scope of IAS 39 set out in paragraphs 2-7. Consequently, the fair value option available in paragraph 11A of IAS 39 is not applicable to contracts that are outside the scope of IAS 39.
29. In the light of the above requirements, the IFRIC [did not expect] significant diversity in practice. The IFRIC therefore [decided] not to take the issue on to its agenda.

IAS 39 *Financial Instruments: Recognition and Measurement*—paragraph AG33(d)(iii)

30. The IFRIC was asked about the application of paragraph AG33(d)(iii) of IAS 39, particularly, what the economic environment is in determining whether a currency is commonly used in contracts to buy or sell non-financial items.
31. The IFRIC noted that paragraph AG33(d)(iii) requires an entity:
 - to identify where the transaction takes place; and
 - to identify currencies that are commonly used in the economic environment in which the transaction takes place.
32. The IFRIC [decided] not to take the issue on to its agenda because any guidance developed would be more in the nature of application guidance than an interpretation.