

STAFF PAPER

16–17 September 2014

IFRS Interpretations Committee Meeting

Project	New items for initial consideration
Paper topic	IAS 39 <i>Financial instruments: recognition and measurement</i> —Foreign currency embedded derivatives
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Introduction

1. In May 2014, the IFRS Interpretations Committee (the ‘Interpretations Committee’) received a request for guidance relating to the interpretation of the criterion ‘closely related’ in paragraph 11 of IAS 39 *Financial Instruments: Recognition and Measurement* to determine whether an embedded derivative should be separated from a host contract and accounted for as a derivative in accordance with IAS 39.
2. More specifically, the Interpretations Committee has been asked to consider whether a licence agreement (ie the host contract) contains an embedded foreign currency derivative that is closely related to the economic characteristics and risks (ie the closely related criterion) of the host contract, on the basis that the payments required under the licence agreement are denominated in a currency that is the currency in which such commercial transactions are routinely denominated around the world.
3. We performed outreach on this topic with the International Forum of Accounting Standard Setters (IFASS), securities regulators and the global IFRS technical

teams of the large accounting firms, in order to find out how widespread the issue raised by the submitter is and to what extent significant diversity in practice exists. The results of this outreach are included in this paper.

4. The submission received is reproduced in full in **Appendix B** of this paper.

Purpose of the paper

5. The purpose of this paper is to:
- (a) provide a description of the issue raised in the submission;
 - (b) provide a summary of the outreach results on the issue raised;
 - (c) present a staff analysis to the Interpretations Committee on how the transaction should be accounted for;
 - (d) present an assessment of the issue against the Interpretations Committee’s agenda criteria; and
 - (e) present a staff recommendation.

Submission description

6. The submission deals with a host contract that is denominated in a currency other than the functional currency of the submitter (or the functional currency of the counterparty) and contains an embedded foreign currency derivative that may or may not require separation under IAS 39.
7. Paragraph AG33 of IAS 39 provides examples in which an entity does not account for the embedded derivative separately from the host contract. In particular, paragraph AG33(d)(ii) states:

AG33 ...

(a) ...

(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) ...
- (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) ...

8. Paragraph AG33(d)(ii) of IAS 39 provides guidance on the ‘routinely- denominated’ criterion. This is further addressed in Section C.9 in the Guidance on implementing IAS 39.
9. The submitter has identified the following two views for the purposes of applying the above requirement in IAS 39 relating to embedded foreign currency derivatives:
 - (a) View A: the embedded foreign currency derivative is considered to be closely related to the licence agreement, on the basis that the routinely-denominated criterion has been met. This is because it is argued that the determination of routinely denominated can be based on market practice and the currency determining the risks and rewards inherent in the contract.
 - (b) View B: the routinely-denominated criterion has not been met. According to this view, the determination of routinely denominated has to be based on data, for example, exchange-traded products such as crude oil. Consequently, the embedded foreign currency derivative is not considered to be closely related to the licence agreement.

Summary of outreach activities

10. We asked national standard-setters, the large accounting firms and regulators the following questions:
- (a) **Question 1:** How is the routinely-denominated criterion interpreted in practice and what evidence has typically been provided to support that criterion?
 - (b) **Question 2:** To what extent is there diversity in practice and what types of goods or services have been commonly considered as fulfilling the routinely-denominated criterion?

Responses from national standard-setters, large accounting firms and regulators

11. We received responses from:
- (a) 12 national standard-setters;
 - (b) 6 large accounting firms; and
 - (c) 1 securities regulator.
12. We summarise the results of the outreach in the following paragraphs. The views expressed are informal opinions from national standard-setters, large accounting firms and securities regulators. They do not reflect the formal views of those organisations.

Responses received from national standard-setters

13. The geographical breakdown for the responses received from national standard-setters is as follows:

Geographical region	Number of respondents
Asia	3
Europe	3
Americas	3
Oceania	2

Africa	1
Total respondents	12

14. With respect to **Q1**, the majority of the national standard-setters stated that they have observed that the routinely-denominated criterion is generally evidenced with reference to items that are traded (usually on an organised exchange) in a single currency throughout the world. However, this would not preclude other items that are not exchange-traded, with one respondent providing the example of the global trade in rough diamonds.
15. With respect to **Q1**, one respondent stated that the separation of the foreign currency embedded derivative would increase volatility and was therefore of the view that foreign currency embedded derivatives should be regarded as closely related.
16. With respect to **Q2**, the majority of the national standard-setters stated that no significant divergence in practice was observed.

Responses received from large accounting firms

17. With respect to **Q1**, the majority of the large accounting firms stated that they have observed that the routinely-denominated criterion is interpreted narrowly in practice and is evidenced with reference to items that are traded in a single currency throughout the world. As a result, only a few items, such as crude oil and certain metals, would meet the routinely-denominated criterion. In general, the issue has been observed to be very specific and not common in practice.
18. With respect to **Q2**, the majority of the large accounting firms stated that they have not observed significant divergence in practice. Furthermore, the types of goods or services that are commonly considered as fulfilling the routinely-denominated criterion are limited to a few items such as crude oil and certain metals.

Response received from a securities regulator

19. With respect to **Q1**, the securities regulator stated that they have observed that the routinely-denominated criterion is interpreted narrowly in practice. As a result, only a few items, such as crude oil and certain metals, would meet the routinely-denominated criterion.
20. With respect to **Q2**, the respondent indicated that no significant diversity in practice has been observed.

Staff analysis

Routinely-denominated criterion

21. Section C.9 of the implementation guidance of IAS 39 states that “The currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world is only a currency that is used for similar transactions all around the world, not just in one local area....”¹ Consequently, an assessment of the routinely-denominated criterion for the purposes of paragraph AG33(d)(ii) is based on evidence of whether or not such commercial transactions are denominated in that currency around the world and not just in a local area or on market practice.
22. In addition, the assessment is a matter of fact and is therefore based on an assessment of available evidence. When undertaking this assessment, the type of goods or services is not a relevant consideration that would influence its outcome. Instead, it is the existence of such evidence that is integral to demonstrating whether or not the routinely-denominated criterion has been met.
23. It is worth noting, however, that these types of goods or services can have an impact on how difficult or straight-forward it may be to find available evidence. For example, evidence may be readily available for crude oil transactions around

¹ This guidance has been reproduced in Appendix C of this paper.

the world in the form of quoted prices denominated in US dollar in public markets.

Assessment against agenda criteria

24. The staff's assessment of the agenda criteria is as follows:²

Agenda criteria	
We should address issues (see paragraph 5.16 of the <i>IFRS Foundation Due Process Handbook</i>):	
that have widespread effect and have, or are expected to have, a material effect on those affected.	No. On the basis of our analysis of the outreach results received from standard-setters, large accounting firms and regulators (see paragraphs 11–20), we can indicate that this issue is not considered to be widespread and no diversity in practice exists. Because the issue analysed is not widespread and diversity in practice does not currently exist, we do not think that the Interpretations Committee should add this issue to its agenda.
in which financial reporting would be improved through the elimination, or reduction, of diverse reporting methods.	N/A
that can be resolved efficiently within the confines of existing IFRS and the <i>Conceptual Framework for Financial Reporting</i> .	N/A
In addition:	
Is the issue sufficiently narrow in scope that the Interpretations Committee can address it in an efficient manner, but not so narrow that it is not cost-effective for it to undertake the due process that would be required when making changes to IFRS (see paragraph 5.17 of the <i>IFRS Foundation Due Process Handbook</i>)?	N/A
Will the solution developed by the Interpretations Committee be effective for a reasonable time period (see paragraph 5.21 of the <i>IFRS Foundation Due Process Handbook</i>)? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified).	N/A

² These criteria can be found in the [IFRS Foundation Due Process Handbook](#) as indicated in the paragraphs above.

Staff recommendation

25. On the basis of our assessment of the Interpretations Committee's agenda criteria, the feedback received from the outreach activities and also on our analysis in this paper, we believe that the Interpretations Committee should not take the issue analysed in this paper onto its agenda. We have included proposed wording for a tentative agenda decision in Appendix A of this paper.

Questions for the Interpretations Committee

Questions for the Interpretations Committee

1. Does the Interpretations Committee agree with the analysis and conclusions reached?
2. Does the Interpretations Committee agree that we should not take this issue onto the agenda because it is not widespread?
3. If the Interpretations Committee agrees with the staff recommendation, does it agree with the proposed wording of the tentative agenda decision as set out in Appendix A?

Appendix A—Proposed wording for final agenda decision

- A1 The proposed wording for the final agenda decision is presented below (new text is underlined and deleted text is struck through).

IAS 39 *Financial Instruments: Recognition and measurement*—embedded foreign currency derivatives

The IFRS Interpretations Committee (the ‘Interpretations Committee’) received a request related to the interpretation of the criterion of ‘closely related’ in paragraph 11 of IAS 39 to determine whether an embedded derivative should be separated from a host contract and accounted for as a derivative in accordance with IAS 39.

More specifically, the Interpretations Committee was asked to consider whether a licence agreement (ie the host contract) contains an embedded foreign currency derivative that is closely related to the economic characteristics and risks (ie the closely related criterion) of the host contract, on the basis that the payments required under the licence agreement are denominated in a currency that is the currency in which such commercial transactions are routinely denominated around the world.

Based on the responses to the outreach request, the Interpretations Committee observed that the issue is not widespread. The Interpretations Committee therefore concluded that in the light of the existing guidance in IAS 39, neither an Interpretation nor an amendment to a Standard was necessary and consequently [decided] not to add this issue to its agenda.

Appendix B—Submission

B1 We received the following request. We have deleted details that would identify the submitter of this request.

Issues paper on foreign currency embedded derivatives

The entity conducts its license agreements (host contract) for international film productions routinely in US-Dollars, and therefore not in its own functional currency (EUR). To ensure an accurate accounting, it is necessary to determine whether these contracts contain an embedded foreign currency derivative in accordance with IAS 39.10, which must be accounted for separately from the license agreement. The obligation to separate the embedded derivative from the license agreement pursuant to IAS 39.11 depends on the criterion 'closely related', which is defined in IAS 39.AG33d. Since criteria IAS 39.AG33d i) and iii) conform only to license agreements with some contractual partners of the entity, criterion IAS 39.AG33d ii) is relevant to determine whether an embedded foreign currency derivative is closely related to the license agreement (host contract). Criterion ii) applies, if - for international film license agreements - the US-Dollars is "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."

International film productions are projects targeted for worldwide exploitation as opposed to local productions aimed at a single country. Due to their high production cost these international projects need to be refinanced by a worldwide release. Traditionally mainly the U.S. major studios {Walt Disney, Paramount, Sony, Twentieth Century Fox, Universal and Warner Bros., hereinafter referred to as majors) produce international films, but some independent producers such as Lionsgate / Summit or The entity are also part of this business. Refinancing of the production budget is either done by a worldwide sale of distribution and exploitation rights to local film distributors of a respective territory, or through the exploitation of the picture by foreign subsidiaries of the majors. Since the headquarters of the market-dominating majors are in the US, budgeting, exploitation and reporting (Box Office) of international film productions are routinely carried out in US- Dollars.

As part of the wholesale market, the entity pre-sells the worldwide distribution and exploitation rights of its international film productions to foreign film distributors in the respective territories

ahead of the start of actual production. These license agreements are regularly denominated in US-Dollars.

The incurred production costs must be pre-financed by the entity during the production phase (1 - 1.5 years), because the entity will only receive payment upon delivery of the completed film. Therefore the entity has concluded US-Dollar credit lines which are repaid at the time of the theatrical releases, when the US-Dollar income of the international license agreements is generated.

2. Current Practice

Relevant literature refers unanimously to criterion IAS 39.AG33d ii) 'closely related' as "*... the currency [that] would have to be used in similar transactions around the world, not Justin one local area*"(KPMG Insights into IFRS, 7.2.140.50).

For the interpretation of this issue, we have identified two views in relevant literature:

View A:

PWC Manual of Accounting holds the opinion that "*apart from crude oil and some metals which are routinely denominated in US dollar in international commerce, very few items, if any, are likely to meet this requirement*" (PWC manual of accounting - financial instruments, 5.87).

The E1C Draft Abstract of issues discussed at the IFRIC Meeting September 2007 assesses "*the number of non-financial items that would qualify under paragraph 3855.A34 (d) of IAS 39 (IG C.9) will likely be limited. In practice, such items will primarily be commodities that are traded in US dollars in commercial transactions throughout the world*". However, the Appendix mentions wide-body aircrafts and also diamonds (wholesale market) as examples that are considered to be 'routinely denominated in US dollars' even though they are not commodities. (EIC Draft Abstract, IAS 39 Tentative Agenda Decision - Research Report, July 2007)

View B:

KPMG Manual of Accounting states that "*... 'routinely denominated in commercial transactions around the world' means that a large majority of transactions should be traded in international commerce around the world in that currency*" (KPMG Insights into IFRS, Tz. 7.2.140.60) and "*...the existence of a relatively small proportion of*

transactions denominated in a local currency in one or two markets. or particular jurisdictions. does not preclude a commodity from meeting the definition of 'routinely denominated in commercial transactions around the world.'" (KPMG Insights into IFRS, 7.2.140.80; Deloitte iGAAP 2013, 10.5)

- In terms of international film productions, it is common market practice that license agreements of international films are carried out in US-Dollars. The US-Dollars share in the international film market amounts to more than 90 percent.
- Jet fuel, for instance, is locally often sold in local currency.

According to Deloitte iGAAP *"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. [...] Certain commodities are not traded on organised exchanges, but global pricing forums exist that publish 'spot' prices denominated in a dominant currency for that particular commodity."* (Deloitte iGAAP 2013, Tz. 10.5)

- The trading on a stock exchange is regarded as evidence of a currency routinely used in commercial transactions around the world; however, it is not a necessary condition. E.g. ..services" that are also mentioned in IAS 39.AG33d i) are not traded on a stock exchange.
- Films are traded in large part at film markets, which can be regarded as a type of trading platform. The prices for the individual product "film license" per territory are defined bilaterally between the parties.

IAS 39.AG33d ii) speaks of 'goods or services'. A more detailed definition is not expressed by the standards neither in the AGs, IGs nor in the BC of IAS 39.

- The relevant literature refers to 'goods or services' as defined in IAS 39.AG33 (d) (ii) primarily as commodities. However, the application of the standards cannot be limited thereto. This possible limitation is refuted, among other things, by the fact that wide-bodied aircrafts are unanimously considered by the literature as a subject for which the criterion 'closely related' applies, although this is not a commodity (see Ernst & Young International GAAP 2013, paragraph 5.2 .1. B).
- The Appendix to EIC Draft Abstract, IAS 39 Tentative Agenda Decision - Research Report, July 2007 not only lists wide-bodied aircrafts, but states explicitly that the examples mentioned are *"not intended to be exhaustive"*.
- Furthermore, it cannot be the intention of the standard only to apply for identical products worldwide, as a 'service' is in every instance execution-dependent. Consequently, it must be allowed by the standard formulation to refer to an international film production as a unique product in 'good or service'.

Given the fact that the risks and rewards of international film productions are both in US-Dollars, and that neither the standard nor the relevant literature require a limited interpretation of "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", we follow view B and argue that the criterion 'closely related' is applicable for the sale and acquisition of international productions in US-Dollars in accordance with IAS 39.AG33(d)(ii).

3. Reasons for the IFRS IC to address the issue

Criteria	Assessment
Is the issue widespread and has, or is expected to have, a material effect on those affected?	The issue is widespread and affects all international film production companies that do not have US Dollars as functional currency.
Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?	The application of the criterion 'closely related' to international film productions would improve financial accounting. The separation of the embedded foreign currency derivative from the host contract adds volatility to the company's balance sheet during production and exploration of the film. At closing date, analysts of the financial statement perceive a distorted picture due to fluctuations (positive and/or negative) of the financial results even though there is no actual exchange rate exposure.
Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?	Neither IAS 39 nor the framework provides any guidance on how to define or apply the term "routinely denominated in commercial transactions around the world". Relevant literature gives only some factors which are relevant in determining whether there is a currency in which a good or service is routinely denominated in. Listed examples are not exhaustive.
Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process?	The example is limited to international film productions and therefore sufficiently narrow in scope for the Interpretations Committee to address it.
Will the solution developed by the Interpretations Committee be effective for a reasonable time period? The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard	Although IFRS 9 is currently undergoing the endorsement process and will replace IAS 39, to our knowledge the criterion 'closely related' will be carried forward unchanged from IAS 39.

and/or if a short-term improvement is not justified.	
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Appendix C—Section C.9 of the implementation guidance of IAS 39

C.9 Embedded foreign currency derivatives: currency of international commerce

IAS 39.AG33(d) refers to the currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world. Could it be a currency that is used for a certain product or service in commercial transactions within the local area of one of the substantial parties to the contract?

No. The currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world is only a currency that is used for similar transactions all around the world, not just in one local area. 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 euro 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.