Grant Thornton

Technical Accounting Alert

Contracts for purchase or sale of non-financial items in a foreign currency

Introduction

The purpose of this alert is to ascertain:

a) When an **embedded foreign currency derivative** in a **host contract** for the sale or purchase of a non-financial item needs to be separated, and;
b) If separation is required, how is this done?

Note: in this TA alert, it is assumed throughout that the host sale or purchase contract is outside the scope of IAS 39. Contracts that can be settled net (rather than by physical delivery and gross settlement) are within the scope of IAS 39 unless they are for the entity's expected sale, purchase or usage requirements (IAS 39.5).

Note

On November 12 2009, the IASB published IFRS 9 Financial Instruments (IFRS 9). IFRS 9 addresses the classification and measurement of financial assets. The publication of IFRS 9 represents the completion of Phase 1 of IASB's project to replace IAS 30. However, at this stage IFRS 9 only addresses the classification and measurement of financial assets. Financial liabilities therefore continue to be accounted for in accordance with IAS 30. Work has begun on phases 2 and 3 of the project which addresses impairment and hedge accounting, respectively. Also, a separate project is underway to replace IAS 39's requirements on derecognition.

IFRS 9 WAS ISSUED IN AUSTRALIA AS AASB 9 FINANCIAL INSTRUMENTS WITH AN EFFECTIVE DATE OF 1 JANUARY 2013 AND THEREFORE AASB 9 REQUIREMENTS HAVE NOT BEEN CONSIDERED FOR THE PURPOSE OF THIS ALERT.

Relevant Australian Standards

References in this TA alert are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 21 The Effects of Changes in Foreign Exchange Rates	AASB 121 The Effects of Changes in Foreign Exchange Rates
IAS 39 Financial Instruments: Recognition and Measurement	AASB 139 Financial Instruments: Recognition and Measurement

Overview

An embedded derivative is a component of a combined (or hybrid) contract that also includes a non-derivative host contract. The embedded derivative requirements of IAS 39 apply both to financial and non-financial host contracts. The embedded derivative causes some or all or of the cash flows of the combined contract to vary in a way similar to a standalone derivative (IAS 39.10), according to an "underlying" variable (eg interest rate, commodity price or foreign exchange, or other variable). This variation would not occur in the same contract without the embedded derivative.

Applying the concept of embedded derivatives in practice can be challenging. It is necessary to:

- determine whether or not the contract includes an embedded derivative;
- determine whether or not the economic characteristics of the embedded derivative are **closely related** to those of the host contract; and
- if they are not closely related, separate the contract. This involves identifying the terms and conditions of the host component and the embedded. This in turn can require judgement, since the terms of the two components are not normally stated expressly.

IAS 30.AG 27 - 33 sets out numerous examples of host contracts and embedded derivatives, and provides guidance on whether or not they are closely related. IAS 39.IG. C1 to C11 address various specific implementation issues.

This TA alert provides guidance on foreign currency sale and purchase contracts, which are a common type of hybrid contract. Such contracts give rise to a currency exposure. IAS 39 aims to ensure that this exposure is recognised unless it is closely related to the economic characteristics of the host contract.

It is clear from the Basis for Conclusions to IAS 39 that the IASB believes that, in principle, all embedded currency derivatives should be separated (IAS 39.BC37). The scenarios in IAS 39.AG33(d) in which the embedded derivative is closely-related are therefore exceptions to the general requirement for separation. Accordingly, these exceptions should be used only when there is convincing evidence that they apply.

Guidance

(a) When does an embedded foreign currency derivative in a host contract for the sale or purchase of a non-financial item need to be separated?

Any contract for the sale or purchase of a non-financial item that is denominated in a foreign currency (i.e. a currency other than the functional currency of the reporting entity) is likely to contain an **embedded derivative**. The embedded derivative must be separated when its economic characteristics and risks are not **closely related** to those of the host contract (IAS 39.11). The embedded derivative is closely related if, and only if, the contract is denominated in:

- the functional currency of any substantial party to that contract (IAS 39.AG33(d)(i)) - normally the buyer or seller; or
- the currency in which the related non-financial item is routinely denominated around the world (IAS 39.AG33(d)(ii)); or
- 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 (IAS 39.AG33(d)(iii)).

In the first case, it is important to note that the functional currency of any substantial party to the contract may not be the currency of that party's country of domicile. The functional currencies of the parties should be determined in accordance with the definition and guidance in IAS 21.9 to 13. This may require judgement, and will require a specific determination when one or more of the parties does not apply IFRS.

Currency of denomination of the non-financial item (IAS 39.AG33(d)(ii))

The IAS 39.AG33(d)(ii) exception applies only to products and services in which a **large majority** of trading throughout the world is in the same currency. This is consistent with the guidance in IAS 39.IG.C9. It does not apply to products and services that are:

- commonly bought and sold in multiple currencies throughout the world (eg items traded throughout the world either in US dollars or in euros); or
- predominantly traded in a specific currency in some regions or countries but other currencies are used elsewhere in the world (items traded in US dollars in the Americas and euros in Europe).

In January 2008, the Canadian Emerging Issues Committee (EIC) published guidance on the application of these requirements: EIC 169 *Determining Whether a Contract is Routinely Denominated in a Single Currency* (EIC 169). The applicable requirements of Canadian GAAP are consistent with IAS 39 in this area. Accordingly, we consider that EIC 169 is also useful guidance in the context of IFRS. EIC 169 explains, inter alia, that:

> "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 … 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, 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. "

The key point in this extract is that a so-called convenience translation into other currencies does not of itself mean that the commodity is not routinely denominated in a single currency. We concur with this view.

The Canadian guidance referred to above includes a listing (not intended to be exhaustive) of commodities that are considered to be routinely denominated in US dollars. This is re-produced in the Appendix to this TA alert for convenience.

In practice, we expect that the IAS 39.AG 33(d)(ii) principle will be applied mainly to US dollar denominated sales and purchases of:

- crude oil; and
- certain commodities, subject to demonstrating that the commodity is mainly traded in US dollars throughout the world.

Currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment (IAS 39.AG33(d)(iii))

The IAS 39.AG33(d)(iii) exception applies to a currency that is commonly used in the economic environment in general. This does not mean that the majority of business transactions must be denominated in that currency. However, a specific currency should not normally be considered commonly used if its usage is limited to a single or small number of industries.

In Grant Thornton's view, the "economic environment" can be that of the reporting entity **or** the counter-party. In other words, if an entity based in Country X transacts in US dollars with an entity based in Country Y, and US dollars are commonly used in Country X but not Country Y, the exception applies (to both entities).

In some jurisdictions, the local currency is commonly used in domestic transactions, and another currency is commonly used in international trade (cross-border transactions). The currency commonly used in international trade may be driven primarily by the location of the main trading partners (ie countries to or from which companies in the relevant jurisdiction exports or import goods and services). In assessing whether a specific currency is commonly used, both local and cross-border transactions should be considered. For example, if the US dollar is commonly used in cross-border transactions in a country, it may be considered a commonly used currency for all transactions in that country, including local transactions.

Businesses operating in hyperinflationary environments may decide to price transactions in a "hard" currency to protect against inflation. Entities operating in small countries with relatively illiquid local currencies also sometimes denominate transactions with entities from other small countries in a more liquid currency. These factors are indicators that a non-local currency might be commonly used.

Application of these indicators might result in more than one non-local currency being considered commonly used in some economic environments. Making this assessment requires obtaining up-to-date information and evidence on business practices in the economic environment(s) in question.

In the absence of suitable evidence that a non-local currency is commonly used, the embedded derivative should not be considered closely related. It must therefore be separated from the host contract.

(b) If separation is required, how is this done?

Separation of embedded derivatives can be complex. The following guidance applies to a straightforward contract with the following characteristics:

- the sale or purchase of a fixed quantity of a non-financial item;
- delivery at a set future date;
- price fixed in a foreign currency ("the contract currency").

The main steps in separating this combined contract are as follows:

- the host contract is a sale or purchase contract denominated in the **functional currency of the reporting entity**;
- the amount of functional currency is determined using the relevant **forward exchange rate** (to the date of delivery) at the date the contract is entered into;
- the embedded derivative is a forward currency contract to buy or sell the applicable amount of the contract currency for the functional currency, at the same forward exchange rate. The effect is that the fair value of the embedded derivative is initially zero (as required by IAS 39.AG28 for "non-option derivatives").
- subsequent changes in the fair value of the embedded derivative are recorded in profit or loss;
- on delivery of the non-financial item, the host contract is fulfilled and the embedded derivative is effectively settled. A foreign currency debtor or creditor is recognised for the contract amount, translated at the spot rate in accordance with IAS 21.23(a). The closing carrying amount of the embedded derivative is added to the functional currency amount of the host contract to give the initial carrying amount of the debtor or creditor.

These steps are illustrated in the example below.

Separating the embedded derivative requires a detailed understanding of the contractual terms. Terms such as cancellation provisions, options to defer delivery and an ability to alter the volume of goods and services can all affect the determination.

Delivery of products or services is often delayed or accelerated compared to the original contract date. This should be dealt with by measuring the fair value of the derivative to the estimated delivery date (until delivery takes place).

Example

Entity A (a UK sterling functional currency entity) enters into a US$1,000,000 purchase contract on 1 January 20X1 with Entity B (a euro functional currency entity), to take delivery of inventory on 30.06.X1.Assume the embedded derivative does not meet the criteria in IAS 39.AG33(d) to be considered closely related.

Assume the following exchange rates:

Spot rate on 1.1.X1: US$/UK£	=	1.70
Six month forward rate on 1.1.X1: US$/UK£	=	1.68
Spot rate on 30.06.X1: US$/UK£	=	1.60

Analysis

The contract should be separated into a UK sterling denominated purchase order with an embedded currency forward to pay dollars and receive sterling. This is on the basis that the embedded creates a dollar exposure for an entity with sterling functional currency. A case can be made for analysing the contract into a euro purchase order with an embedded dollar/euro forward. However, this approach creates a euro exposure for a sterling functional currency entity, which is not implied in the contract. This would also make the accounting more complex.

The contract should be separated using the 6 month dollar/sterling forward exchange rate, as at the date of the contract (US$/UK£= 1.68). The two components of the contract are therefore:

- a purchase contract for £595,239 (US$1m/1.68)
- a six month currency forward to sell US$1m at 1.68.

Subsequently, the host contract is not accounted for until delivery (unless it becomes an onerous contract). The embedded derivative is recorded at fair value through profit or loss (unless designated as a cash flow hedging instrument, if appropriate). This gives rise to a gain or loss on the derivative, and a corresponding derivative asset or liability.

On delivery Entity A records the inventory at the amount of the host contract (£595,239). The embedded derivative is considered to expire. The derivative asset or liability (ie the cumulative gain or loss) is settled by becoming part of the financial liability that arises on delivery. In this case the carrying value of the currency forward at 30.06.X1 on maturity is £(1,000,000/1.6 - 595,239) = £29,761 (liability/loss).

The accounting entries are as follows (all in £s):

	Debit	Credit
Loss on currency forward (P&L)	£29,761	
Currency forward liability (B/S)		£29,761

To record loss on currency forward to 30.06.X1

	Debit	Credit
Inventory	£595,239	
Financial liability		£595,239

To record receipt of inventory based on implied terms of host contract

	Debit	Credit
Currency forward liability (B/S)	£ 29,761	
Financial liability		£29,761

To reclassify currency forward liability as a component of the financial liability

The effect is that the financial liability at the date of delivery is £625,000 (= 595,231 +29,761), equivalent to US$1,000,000 at the spot rate on 30.06.X1.Going forward, the financial liability is a US$ denominated financial instrument. It is retranslated at the dollar spot rate in the normal way, until it is settled.

This example illustrates the accounting when the embedded derivative is required to be separated. If the embedded is **not** separated (ie it is considered to be closely related) the inventory would be recorded at £625,000, the US$ dollar amount translated at the spot rate at the date of delivery. No derivative loss would be recorded in the statement of comprehensive income.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au

Appendix

Extract from Canadian Emerging Issues Committee Abstract EIC 169 *Determining Whether a Contract is Routinely Denominated in a Single Currency* (January 2008)

This Appendix provides repeats from EIC 169 examples of commodities and certain other items that are considered to be routinely denominated in US dollars. It is included here as a convenience and as a starting point for conducting the necessary analysis. Grant Thornton has not verified the list, which is based on consideration of the factors discussed in EIC 169. The 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 publication (January 2008). Preparers and auditors should consider any circumstances arising subsequent to that date that might impact whether an item should remain on this list.

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