Rechnungslegungs Interpretations
Accounting Interpretations Committee

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International Financial Reporting
Interpretations Committee (IFRIC)
Mr Robert Garnett
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Berlin, 21. Juni 2007

Dear Bob,

Comment Letter on the IFRIC's Tentative Agenda Decisions "IAS 39 – Scope of paragraph 11A" and "IAS 39 – Paragraph AG33(d)(iii) published in May 2007

IAS 39 – Scope of paragraph 11A

During its meeting in May 2007 the IFRIC discussed the issue whether the fair value option available in IAS 39.11A 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 set out in paragraphs 2-7.

In its tentative decision, the IFRIC notes that the scope of par. 11A "should be consistent with the overall scope of IAS 39" and concludes that the fair value option available in IAS 39.11A is therefore not applicable to contracts that are outside the scope of IAS 39.

We principally agree with the IFRIC that the fair value option should not be applied to contracts outside the scope of IAS 39. We have, however, considerable doubts that this conclusion adequately reflects IAS 39 as it is currently phrased and structured. In our view, the structure of IAS 39 and the wording in IAS 39.11A imply that the fair value option available in IAS 39.11A is also applicable to contracts outside the scope of IAS 39. This outcome could only be unambiguously avoided if the IFRIC would develop an Interpretation on this issue or refer the issue to the IASB suggesting an amendment of IAS 39.11A. Our reasoning for this is as follows:

IAS 39.11A allows applying the fair value option on contracts with one or more embedded derivatives, provided certain conditions are met. The scope of IAS 39 is defined in paras. 2-7 of IAS 39 in three steps:

(1) Basically, all *financial instruments* are within the scope of IAS 39, except for those financial instruments that fall into the scope of another standard (such as IAS 27, 28, 31 etc.) and the other standard takes precedence.
(2) In a second step, the scope of IAS 39 is widened to all *contracts* (that do not have to meet the definition of financial instruments) that are handled "as if they were" financial instruments (for example, by net cash settlement).
(3) In a third step, IAS 39.11 requires embedded *derivatives* to be separated from the host contract and to be accounted for under IAS 39, provided the conditions in IAS 39.11 are met. Derivatives may or may not meet the definition of a financial instrument, according to the definition of a derivative contained in IAS 39.9.

According to our understanding, the requirement in IAS 39.11 seeks to assure that all derivatives are accounted for under IAS 39 (i.e. with changes in fair value reported through profit or loss). Embedding a derivative in a contract that is not a financial instrument should not allow circumventing the requirement to account for all derivatives under IAS 39.

Consequently, the scope of IAS 39.11, according to our understanding, is broad: *Any contract* may contain embedded derivatives that may need to be separated. The host contract does neither need to meet the definition of a financial instrument, nor does it need to be within the scope of IAS 39 (as set out in paras. 2-7). The nature of the (host) contract is irrelevant.

This understanding is consistent both with

(1) the *definition* of a "contract": The term "contract" is currently not defined in IAS 39, but IAS 32 defines a contract as "an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law." Thus, the definition is very broad.

and

(2) the *purpose* of IAS 39.11 which is to bring any derivatives into the scope of IAS 39, regardless of whether the host contract is a financial instrument or whether it is, when considered alone (i.e. without the embedded derivative) within the scope of IAS 39. If interpreted otherwise, embedding a derivative in a host contract which is outside the scope of IAS 39 would effectively lead to circumventing the requirement to account for the derivative under IAS 39.

In par. 11A of IAS 39 the same term ("contract") as in IAS 39.11 is used. Consequently, we think that the scope of par. 11A is the same as for par. 11.

Thus, the fair value option may be applied to *any contract*, assuming the conditions in par. 11A are met. The contract may not need to be a financial instrument, nor does the host contract itself need to be within the scope of IAS 39. Consistent with our conclusion, one could obtain a fair value option for any contract by embedding a derivative into it.

We wish to stress again that we do not prefer this conclusion. We would not like to see the fair value option being applied to various contracts outside the scope of IAS 39. However, although we do not prefer this conclusion, we think it follows from the structure of IAS 39 and the wording of IAS 39.11A. Therefore, we would urge the IFRIC to take this issue onto its agenda. If the IFRIC may come to the conclusion that the wording of IAS 39.11A leaves little room for an Interpretation, the IFRIC may nevertheless decide to refer the issue to the IASB and suggest amending IAS 39. 11A.

IAS 39 – Paragraph AG33(d)(iii)

IAS 39.AG33 describes several situations in which the economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract so that an entity does not account for the embedded derivative separately from the host contract. According to IAS 39.AG33(d)(iii) an embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in 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.

The IFRIC was asked in a submission to interpret the terms “commonly used” and “economic environment”. In its Tentative Agenda Decision the IFRIC expressed the view that these issues could only be resolved by the development of application guidance that is not within the scope of the IFRIC’s work programme.

As we have learned from some of our constituents the preparers’ understanding of “commonly used” and “economic environment” is far from being similar so that diversity in practice can be assumed, i.e. one entity does account for an embedded foreign currency derivative separately while another entity does not. This can substantially affect financial statements. In our view, the quality and comparability of financial statements would be considerably improved if the understanding of the terms in question would be clarified. The AIC believes that this could be done by developing an Interpretation since all criteria set out in the IFRIC Handbook are met. Therefore, we would suggest to the IFRIC taking the issue onto its agenda.

Furthermore, the IFRIC could consider to enlarge the scope of this Interpretation by scanning IAS 39.AG33 for other terms and phrases that are also understood differently in practice. An example for this is IAS 39.AG33(d)(ii). It seems that even entities belonging to the same industry have no common understanding of the currency in which the price of the related good or service that is required or delivered is routinely denominated in commercial transactions around the world. Again, this implies diversity in practice with substantial effects on financial statements.

If, however, the IFRIC confirms its view that resolving the issue addressed in the submission would require the development of application guidance rather than an Interpretation, the IFRIC should not confine itself to simply reject the submission but should explicitly refer the issue to the IASB and suggest a clarification of IAS 39.AG33(d)(iii) and preferably also of other guidance included in IAS 39.AG33.

If you would like further clarification of the issues set out in this letter please do not hesitate to contact me.

With best regards

Stefan Schreiber
AIC, Chairman