Opinion

EAC/1625/16

Querist: CA. Sipan Garg, NTPC Limited, New Delhi

Subject: Accounting for Embedded Derivatives in Non-Financial Host Contracts as per Ind AS 109.

A. Facts of the Case

1. A Government of India (GoI) company is engaged in the construction and operation of thermal power plants in the country. The company has also diversified into hydro power generation, coal mining and oil & gas exploration etc. The company is registered under the Companies Act, 1956/Companies Act, 2013 and being an electricity generating company, is governed by the provisions of the Electricity Act, 2003. The company prepares its annual financial statements as per the provisions of the Companies Act, 2013. The company is also listed with the Bombay Stock Exchange and the National Stock Exchange. As the company is a listed entity with a net worth of more than Rs. 500 crore, the Indian Accounting Standards (Ind ASs) notified by the Ministry of Corporate Affairs (MCA) are applicable to the company w.e.f. financial year 2016-17.

Background

2. Provisions of Indian Accounting Standard (Ind AS) 109, 'Financial Instruments':

(i) Derivatives and Embedded Derivatives:

Ind AS 109, 'Financial Instruments' provides accounting guidelines in respect of derivatives and embedded derivatives.

The Standard defines a derivative as a financial instrument or other contract whose value changes in response to an 'underlying' like a commodity price or exchange rate. A derivative requires little or no initial investment and is settled at a future date. Examples of derivatives - commodity futures or forex forward contracts.

Derivatives which are not financial guarantee contracts or not part of an effective hedging arrangement are required to be accounted for at fair value through profit and loss account. This condition requires that changes in the fair value of derivatives are booked to the statement of profit and loss.

Paragraph 4.3.1 of Ind AS 109 defines an embedded derivative as follows:

"An embedded derivative is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to

be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. A derivative that is attached to a *financial instrument* but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument."

According to the querist, an embedded derivative is defined as a combined instrument which includes a non-derivative host contract and a derivative portion whose cash flows have the characteristics of a derivative. The following are few examples of embedded derivatives:

- A convertible bond – The host contract here is a debt instrument and the embedded derivative is the call option on equity securities.
- A loan paying interest based on an equity index – The host contract is a debt instrument with the interest portion being the embedded derivative which is based on an equity index.
- A loan with an interest rate formula which is leveraged: for example if the interest rate formula is 14.5 – 2.5 X LIBOR (3 months) – In this case there is a formula determining the interest rate which is the embedded derivative in a debt host contract.

Embedded derivatives can also be found in non-financial host contracts such as contracts for purchase of goods and services.

(ii) Accounting for embedded derivatives under Ind AS 109:

Provisions related to accounting for embedded derivatives under Ind AS are as follows:

"**4.3.3 If a hybrid contract contains a host that is not an asset within the scope of this Standard, an embedded derivative shall be separated from the host and accounted for as a derivative under this Standard if, and only if:**

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host (see paragraphs B4.3.5 and B4.3.8);

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

4.3.4 If an embedded derivative is separated, the host contract shall be accounted for in accordance with the appropriate Standards. This Standard does not address whether an embedded derivative shall be presented separately in the balance sheet.

4.3.5 Despite paragraphs 4.3.3 and 4.3.4, if a contract contains one or more embedded derivatives and the host is not an asset within the scope of this Standard, an entity may designate the entire hybrid contract as at fair value through profit or loss unless:

(a) the embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract; or

(b) it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

4.3.6 If an entity is required by this Standard to separate an embedded derivative from its host, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at fair value through profit or loss.

4.3.7 If an entity is unable to measure reliably the fair value of an embedded derivative on the basis of its terms and conditions, the fair value of the embedded derivative is the difference between the fair value of the hybrid contract and the fair value of the host. If the entity is unable to measure the fair value of the embedded derivative using this method, paragraph 4.3.6 applies and the hybrid contract is designated as at fair value through profit or loss."

Embedded foreign currency derivative in a host contract that is not a financial instrument

"B4.3.8

…

(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) the functional currency of any substantial party to that contract;

(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) 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 (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

As per the querist, it is clear from the above, that the Standard requires an embedded derivative to be separated from the host contract and accounted for as a derivative when all the following three conditions are met:

a) The economic characteristics and risks of the embedded derivative are not closely related to those of the host contract. For example, a variable interest rate loan wherein the interest rate is indexed to the value of an equity instrument is not closely related to the host loan contract since the characteristics and risks involved are different.
b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.
c) The entire contract is not measured at fair value through profit and loss account – For example, non-financial contracts like contracts for supply of equipment.

Exemption from accounting for embedded derivatives under Ind AS 109

In case of non-financial host contracts, under the following conditions an entity is exempted from separation of embedded derivatives:

a) If the contract is denominated in the functional currency of either of the parties to the contract – say a contract between an Indian purchaser (whose functional currency is INR) and a seller based in the USA (whose functional currency is USD) denominated in USD.
b) If the contract is denominated in a currency which is used around the world for international trade.
c) If the contract is denominated in a currency which is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place.

3. The company is the largest power producer in the country with an installed capacity of over 45,000 MW. In attainment of its vision to be the world's largest and best power producer, the company is constructing about 24,000 MW capacity. The company enters into various types of contracts for purchase and installation of power plant equipment, purchases for operation and maintenance and purchases of fuel including through imports. Procurement of power plant equipment is usually done through international competitive bidding (ICB) in

order to obtain equipment with the latest technology at competitive prices following transparent procurement procedures. Purchases to meet the operation and maintenance requirements of power stations are made from domestic and foreign vendors. This results in the following types of contracts:

a) Contracts with Indian vendors denominated in INR.
b) Contracts with Indian vendors in foreign currencies and/or INR in case of ICB (usually in multiple currencies).
c) Contracts with foreign vendors in the currency of the vendor.
d) Contracts with foreign vendors in a third currency.
e) Procurement of imported coal in USD or USD equivalent INR.

The procurements of power plant equipments are generally done through ICB. In such cases, neither the vendor nor the currency in which bids are likely to be received are known when bids are invited. There can therefore be no intention to enter into contracts with specific vendors in specific currencies with a view to achieve desired accounting results or for speculation. Further, the following characteristics of such contracts clearly indicate that there is no intention to enter into any derivative transaction:

- The contracts do not contain a leveraging provision.
- They are for purchase of items for 'own use'.
- The contracts provide for 'delivery' of ordered items and there is no option to 'net settle' at any point of time during the tenure of the contract.
- It would make no difference to the company who the vendor is or what currency is being quoted. What is important in an ICB framework is the competitiveness of the bid.

4. Two contracts which the company has entered into for equipment supplies for its project construction are discussed below:

a) Contract with domestic vendor awarded through ICB, parts of which are denominated in foreign currencies - Agency: M/s ABC, an Indian PSU.

Sl. No.	**Subject**	**Particulars**	**Remarks**
1.	Nature of the contracts	**First Contract:** The contract is for design, engineering, manufacturing, shop fabrication, assembly, inspection and testing at suppliers' work, type testing, packing, forwarding equipment/material /special tools & tackles and mandatory spares supply on CIF (Indian port of entry) basis.	First contract involves supply of imported equipment.
		Second Contract: The contract is for design, engineering, manufacturing, shop fabrication, assembly, inspection and testing at suppliers work, type testing, packing,	Second Contract involves supply of equipment manufactured / assembled in India.

		forwarding equipment/material /special tools & tackles and mandatory spares to site of all ex-manufacturing works/place of despatch (both in India). **Third Contract:** The contract is for port handling, transportation, transit insurance, installation, supervision, commissioning of all the equipment covered under first & second contract.	Third contract involves erection, commissioning, freight, insurance etc. of the equipment covered under first and second contract.
2.	Amount of contract	**First Contract.** USD 25,000,000 + EURO 47,356,082. **Second Contract.** USD 90,933,349 + EURO 94,266,958 + INR 37,287,567,022 **Third Contract.** INR 22,031,905,043	Payments shall be made to M/s ABC in the respective currencies.
3.	Terms of contract	The contracts have detailed time schedules having reference to the date of notification of award (NOA). The contract has multiple milestones over the period of 5 years from the date of award.	
4.	Payment terms	The payment terms are in percentage related to the stage of completion of the work.	

Relevant pages of contract agreements have been supplied separately by the querist for the perusal of the Committee.

b) Contract with an international vendor denominated in a currency (USD) which is neither the functional currency of the vendor nor INR which is the functional currency of the company - Agency: M/s XYZ, a corporation incorporated under the laws of Russia.

Sl. No	**Subject**	**Particulars**	**Remarks**
1.	Nature of the contracts	**First Contract:** The contract is for design, engineering, manufacturing, inspection and testing at suppliers work, packing, forwarding and despatch of plant & equipment along with all accessories, auxiliaries and	The second and third contracts have been awarded to their Indian subsidiaries/JVCs – M/s XYZ Energy (India) Limited, New Delhi).

		mandatory spares on CIF (Indian port of entry) basis.	The award value of second contract [ex-works (India) supply] is INR 215,13,98,061 and of the third contract (installation services) is USD 9,530,000 and INR 66,12,47,882.
2.	Amount of contract	USD 177,746,227.	
3.	Term of contract	The contract has detailed time schedules having reference to the date of notification of award (NOA). The contract has multiple milestones over the period of 5 years from the date of award.	
4.	Payment terms	The payment terms are in percentage related to the stage of completion of the work.	

Relevant pages of contract agreements have been supplied separately by the querist for the perusal of the Committee.

The above contracts have been entered into based on the ICB. As can be seen from the details of the above contracts, the intention of the parties is not to enter into any derivative contract and the purpose is to get the equipment supplies for construction of the power plants.

5. The company is of the view that these are not embedded derivative contracts considering the following facts:

(a) Procurement is made through ICB wherein global tenders are invited in which domestic bidders can bid in foreign currency to avail various incentives of the Government of India (GoI) and the Reserve Bank of India (RBI) permits payments in foreign currency by Indian entities to domestic vendors who have been awarded contracts through ICB.

(b) Ind AS 109 is based on the IFRS 9 which was framed from a western perspective where contracts are normally entered into in the functional currency of at least one of the parties to the contract if not both as is the case for European Union countries where Euro is the common currency. Contracts in a currency which is not the functional currency of either contracting party when entered into, are for the purpose of hedging or speculation.

The Indian economic scenario is much different from that of these countries such as of Europe following IFRS. In this regard, a critical factor to be considered is that INR is not fully convertible and therefore is not as liquid a currency as say USD, Euro or JPY. Therefore, an international vendor would always like to quote in a more liquid currency even if such a currency is not the functional currency of that vendor. Indian vendors who may be required to

procure components from abroad would also like to quote in such liquid currencies.

Therefore in the Indian context, contracts for import of power equipment are entered into in liquid currencies like, USD, Euro or JPY.

(c) Keeping in view the large capacity addition requirement in the power sector, the GoI has encouraged manufacturers to set up base for power generator equipments in the country. Accordingly, several international reputed power equipment manufacturers have set up or have initiated action to set up manufacturing facilities in India through their joint ventures (JVs)/subsidiary companies established in India. It is expected that in future, orders for equipment will be placed by Indian power generators on these JVs/subsidiary companies. Any import of equipment from the joint venture partner/foreign parent will be routed through these JVs/subsidiary companies. The Indian JVs/subsidiary companies would prefer to quote in foreign currency for the imported equipment and components supplied by them. Though such components are imported, by virtue of the fact that the contract for supply of equipment is between two Indian parties (viz. the Indian generating company and the Indian JV/subsidiary company of the foreign manufacturer), the requirement for accounting of embedded derivatives should not arise.

(d) In cases where the projects are funded by multilateral/bilateral financial institutions such as the World Bank, ADB/JICA etc., Indian importers have to follow the procurement guidelines of the respective organisations and do not have much flexibility regarding the tender conditions including the 'currencies of bid'. The currencies of bid are left to the choice of the bidder as per the standard bidding documents of these organisations. Derivative accounting for equipment procurement under such funding is not in keeping with the spirit behind the requirements of Ind AS 109 which is to prevent circumvention of derivative accounting through embedded derivatives. If embedded derivative principles are made applicable to such contracts then Indian power sector entities may avoid seeking funds from these multilateral/bilateral institutions. As there is a huge fund requirement for the growth of Indian power sector, it is not preferable that access to an important avenue of international funding is hampered by onerous accounting requirements.

(e) The tenure of contracts for supply of power plant equipment could be three to five years. An issue which will surely arise is the availability of such long period forward rates for foreign currencies on the date of contract. In India, market for forward contracts in USD is liquid for period upto 1 year and competitive quotes are not easily available for forward cover beyond 1 year. In the absence of market based forward rates, models will need to be developed involving various assumptions and approximations for estimating forward rates. Such rates would then be used for capitalisation of property, plant and equipment which is required to be recognised and measured at cost. In addition, power projects involve large number of equipments which are supplied in a

phased manner over the project schedule. The exact delivery schedules of the individual items are not known at the time of entering into the contract. The contract provides broad milestones for key activities and the schedules for supply of different equipment are worked out as the contract progresses and also undergo change from time to time. The estimation of forward rates applicable for the date of supply in such situation is extremely difficult and requires a substantial level of estimation. Additionally, such contracts are large and complicated and the time and cost involved in initial and subsequent estimates of delivery schedules for determination and revision of forward rates may not be commensurate with the results obtained.

(f) The accounting for property, plant and equipment based on forward rates is also not aligned to the requirements of regulators such as Central Electricity Regulatory Commission (CERC) for the power sector. For example, the company is a rate regulated entity whose rates are determined by CERC using a cost plus methodology. The regulator considers the actual costs incurred on account of property, plant and equipment for determining the capital base for fixation of tariff. If the company is required to account for embedded derivatives in case of contracts as discussed above, capitalisation of property, plant and equipment shall be at the forward rates determined at the time of entering into the contract. When actual payments are made to the vendors, the exchange rates will almost certainly be different from these forward rates. In such a situation, the capital cost considered for tariff determination will be different from the capital base in the books of account. There is no provision for separate recovery/payment of derivative losses/gains arising from embedded derivatives in the tariff regulations. Thus the financial statements of a rate regulated entity will neither present a true and fair view nor reflect the economic reality of the entity.

6. As discussed above, accounting for embedded derivatives in case of non-financial host contracts under Ind AS 109 is fraught with serious consequences for the Indian corporates, particularly for the rate regulated entities such as those in the power sector. Further, application of the embedded derivative accounting for non-financial contracts on delivery basis is difficult to appreciate and does not provide any particular advantage, particularly keeping in view the Indian context where much of the import and export trade is in USD/EURO. Further, as can be seen from the details of the above contracts, the intention of the parties is not to enter into any derivative contract and the purpose is to get the equipment supplies for construction of the power plant.

7. It can be appreciated that accounting requirements of Ind AS 109 for embedded derivatives in non-financial contracts do not intend to cover the Indian context or the Indian economic scenario where most of the foreign trade is denominated in USD/Euro. It appears to the querist that the requirements of the standard are not applicable to the cases of equipment supply contracts denominated in foreign currencies as per the spirit in which these provisions were envisaged. Further, for rate regulated entities, such accounting does not have much relevance as the fixed assets for tariff purposes are valued at costs incurred as per the CERC Tariff Regulations.

8. With regard to the issue as to why USD, Euro and JPY have been considered as liquid currencies by the company, the querist has separately informed that the USD, Euro and JPY currencies have been considered as liquid currencies based on the contracts entered into by the company. It has been seen that majority of the bidders are quoting in these currencies. Further, guidance has also been taken from paragraph BCZ4.94 of the Basis for Conclusions on International Financial Reporting Standard (IFRS) 9 'Financial Instruments', issued by the International Accounting Standards Board (IASB), which is reproduced below:

> "The requirement to separate embedded foreign currency derivatives may be burdensome for entities that operate in economies in which business contracts denominated in a foreign currency are common. For example, entities domiciled in small countries may find it convenient to denominate business contracts with entities from other small countries in an **internationally liquid currency (such as the US dollar, euro or yen)** instead of the local currency of any of the parties to the transaction. In addition, an entity operating in a hyperinflationary economy may use a price list in a hard currency to protect against inflation, for example, an entity that has a foreign operation in a hyperinflationary economy that denominates local contracts in the functional currency of the parent." (Emphasis supplied by the querist.)

9. The querist has also informed that International competitive bidding (ICB) is the most appropriate method of procurement in public procurement. This provides the company with a wide choice in selecting the best bid from competing suppliers and contractors. It gives prospective bidders equal opportunity to bid on goods and works that are being procured. The company generally employs ICB procedures for procurement in case of initial setting up of power plants or in case of renovation and modernisation (R&M) of power plants, which have large estimated values and domestic suppliers are limited. Further, in cases of procurement where certain incentives are made available by the Government of India for inviting bids under ICB such as procurement of goods for mega power projects, the company follows ICB procedures.

10. The step by step process relating to the International Competitive Bidding has been explained by the querist as follows:

1) A feasibility report for a project or a scheme of R&M is prepared.

2) Based on the project requirement, a package list is prepared, which indicates the details of goods and services to be procured for the project. The list is prepared by a committee comprising of members from various functions/departments and approved by the Chairmen and the Managing Director. During finalisation of the list, it is decided whether ICB or Domestic Competitive Bidding (DCB) is to be followed for a particular package. Where domestic suppliers are limited and/or goods are being procured where certain incentives are made available under ICB, ICB bidding procedure is resorted to.

3) After the package list is approved, cost estimate and qualification requirements for bidders are prepared based on the scope of package.

4) Invitation for bids (IFB) are advertised. In order to have wide publicity, copies of the IFB are issued to the prospective bidders (both foreign and domestic) and those bidders who have participated in similar tenders of the company in the past. Moreover, copies of IFB are sent to embassy of various countries.

5) Bidding documents are issued to those interested parties (both domestic and foreign), who pay the requisite tender fee.

6) The following is stipulated in the bidding documents regarding currencies to be quoted:

   Prices quoted by the bidders (both foreign and domestic) shall be in the following currencies:

   a) Plant and equipment to be quoted in any currency. Domestic bidders while quoting in foreign currency must comply with the requirement as laid down by the Government of India from time to time.

   b) Local transportation, inland transit insurance and other local costs incidental to delivery of the plant and equipment and installation services shall be quoted in local currency. However, foreign component, if any, of installation services (excluding civil, structural & allied works) may be quoted in foreign currency.

   c) If the bidder wishes to be paid in a combination of amounts in different currencies, it may quote its price accordingly, but use no more than three foreign currencies.

   d) The foreign currencies in which the bid prices are quoted shall be freely convertible.

7) Based on the bidding documents and scope of work stipulated in Technical Specifications, the bids are submitted by the bidders in two part (i.e. Part 1: Techno-Commercial Bid and Part 2: Price Bid.)

8) Initially, techno-commercial bids are opened at the date and time stipulated in front of the bidder's representatives who choose to attend the bid opening. Minutes of bid opening are prepared and signed.

9) The techno-commercial bids are evaluated and the price bids of those bidders are opened whose techno-commercial bids are found to be technically and commercially qualified and meeting the technical requirements.

10) The price bids are evaluated in line with the evaluation criteria specified in the bidding documents and the lowest evaluated bid (L1) is awarded the contract, if the award price is not substantially higher than the estimated cost of work. In exceptional cases, where the price of lowest bidder is substantially higher than the estimated cost of work and

the work is urgent, negotiations are resorted to bring down the price. Negotiations are only done with L1 bidder.

11) The contract is awarded in the bid currency quoted by the bidder and comprises of the following break-up:

a) **First Contract**: For CIF (Indian port of entry) supply of plant and equipment including type test charges and mandatory spares to be supplied from abroad. (in foreign currency)

b) **Second Contract**: For Ex-works (India) supply of plant and equipment including type test charges and mandatory spares to be supplied from within India. (Generally awarded partly in INR and partly in foreign currency)

c) **Third Contract**: For providing all services i.e. port handling, port clearance and port charges for the imported goods, further loading, inland transportation for delivery at site, inland transit insurance, unloading, storage, handling at site, installation services including erection, civil, structural & allied works, insurance covers other than inland transit insurance, testing, commissioning and conducting guarantee tests in respect of all the equipments supplied under the 'First Contract' & the `Second Contract' and all other services as specified in the contract documents. (Awarded in INR)

11. With regard to the basis for pricing a single contract in multiple currencies especially in contracts with local vendors/bidder, and whether the vendor/bidder can bid in foreign currency even for that component of the contract which does not involve any payment by the vendor in foreign currency, for example, supply of equipment manufactured in India, the querist has stated that, ICB procedure is followed in cases where domestic suppliers are limited and technology of the goods are mostly available with the foreign suppliers. In certain cases, domestic suppliers have to source components or raw materials from abroad in order to manufacture the domestic manufactured goods**.** Therefore, in order to have level playing field between the domestic bidder and foreign bidder and as the bids are being invited on competitive basis, domestic bidders are allowed to quote in foreign currency, subject to compliance with the requirement as laid down by the Government of India from time to time.

12. The querist has also clarified separately that this is the general practice in the industry in which the entity operates to procure equipment through ICB**.** However, in cases where ample competition is available in domestic market and no benefit is available from the GOI to resort to ICB, domestic competitive bidding is followed where bidders are allowed to quote in Indian Rupees Only. Other entities also follow this practice to procure equipment.

B. Query

13. Considering the above, the Expert Advisory Committee is requested to give its opinion on the following issues:

(a) Whether the accounting for foreign currency embedded derivatives is required for above noted contracts awarded through ICB, as mentioned in paragraphs 4 (a) and 4 (b).

(b) Whether accounting for embedded derivatives shall be applicable for other foreign currency contracts with foreign vendors, as mentioned in paragraph 4 (b) in any of the major liquid currencies used in international trade considering the Indian scenario.

C. Points considered by the Committee

14. The Committee notes from the Facts of the Case that the basic issue raised in the query relates to whether the foreign currency embedded derivatives in the contract entered into by the company with Indian vendor in USD and Euro and the contract with foreign vendor in a third currency (i.e. neither the functional currency of the company nor of the foreign vendor), can be considered as closely related to the host contract as per the guidance in paragraph B4.3.8 (d) of Ind AS 109. The Committee further notes that the querist has specifically referred to the guidance in paragraph B4.3.8 (d) (iii) of Ind AS 109 and has raised issue as to whether USD or Euro which have been used in the contracts mentioned above can be considered as a currency that is commonly used in contracts to purchase non-financial items in the economic environment in which the transactions or contracts referred to in the extant case takes place. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as assessment of substantial party to the contracts, accounting for the embedded derivative, accounting for the non-financial items purchased, etc. Further, the Committee has not evaluated the conditions referred in para B4.3.8 (d) (i) and (ii), since the same have not been specifically raised by the querist.

15. The Committee notes that the functional currency of the company is INR. The Committee also presumes that,

(i) the functional currency of the Indian vendor referred above is also INR and;
(ii) the functional currency of the foreign vendor is not USD .

16. The Committee further notes the following paragraph of Ind AS 109:

"B4.3.8

…

(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) the functional currency of any substantial party to that contract;

(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) 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 (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade)."

The Committee believes that the rationale for the above exemption is that when the embedded derivative bears a close economic relationship to the host contract, it is less likely that the derivative was embedded to achieve a desired accounting result.

17. The Committee further notes that as per the requirements of paragraph B4.3.8 (d) (iii) of Ind AS 109, an embedded foreign currency derivative in a host contract is considered as closely related to the host contract if it is denominated in a currency that is *commonly used* in contracts in the *economic environment* in which the transaction takes place. In this context, the Committee also notes the following paragraphs from the 'Basis for Conclusions' on International Financial Reporting Standard (IFRS) 9, 'Financial Instruments' (which is the corresponding International Standard of Ind AS 109), issued by the International Accounting Standards Board (IASB), as follows:

"BCZ4.94 The requirement to separate embedded foreign currency derivatives may be burdensome for entities that operate in economies in which business contracts denominated in a foreign currency are common. For example, entities domiciled in small countries may find it convenient to denominate business contracts with entities from other small countries in an internationally liquid currency (such as the US dollar, euro or yen) instead of the local currency of any of the parties to the transaction. In addition, an entity operating in a hyperinflationary economy may use a price list in a hard currency to protect against inflation, for example, an entity that has a foreign operation in a hyperinflationary economy that denominates local contracts in the functional currency of the parent.

BCZ4.95 In revising IAS 39, the IASB concluded that an embedded foreign currency derivative may be integral to the contractual arrangements in the cases mentioned in the previous paragraph. It decided that a foreign currency derivative in a contract should not be required to be separated if it is denominated in a currency that is commonly used in business transactions (that are not financial instruments) in the environment in which the transaction takes place (that guidance is now in IFRS 9). A foreign currency derivative would be viewed as closely related to the host contract if the currency is commonly used in local business transactions, for example, when monetary amounts are viewed by the general population not in terms of the local currency but in terms of

a relatively stable foreign currency, and prices may be quoted in that foreign currency (see IAS 29 *Financial Reporting in Hyperflationary Economies*)."

The Committee notes from the above that the objective behind this exception is to eliminate burden of separating embedded foreign currency derivatives for transactions between entities in smaller countries in international stable/liquid currencies instead of local currency of these entities or pricing in foreign currency by entities operating in hyperinflationary economy. Further, foreign currency derivatives are considered as closely related to host contract if monetary amounts are viewed in terms of foreign currency and not in local currency. From this, the Committee is of the view that 'commonly used' in the extant case should be assessed in the context of the country and not just commonly used by the company or for ICB purposes. The Committee also notes that the example in paragraph B4.3.8 (d) (iii) of Ind AS 109 refers to the currency commonly used in local business transactions or external trade. The Committee is further of the view that to apply this requirement, the company should first determine the economic environment in which the transaction takes place, viz., whether the transaction is a local business transaction or is an external trade and then the currencies that are commonly used in contracts to purchase or sell non-financial items in such economic environment. Accordingly, the Committee analyses the currency commonly used in in local business transactions (internal trade) or external trade as below:

Internal trade

From an Indian economic environment perspective, the Committee is of the view that Indian National Rupee (INR) is the currency which is commonly used for local transactions within India. This fact though, should not preclude the identification of a currency commonly used in external trade.

External trade

For any currency other than INR to be considered as 'commonly used' for external trade, the Committee believes that such assessment should be made on the basis of economic data which would support such assessment. For example, if economic data supports the contention that the US dollar is used in a wide variety of import or export contracts (external trade) by Indian entities, it can be argued that the US dollar is 'commonly used' in India for such trade. Similar assessment is required for other currencies as well. Accordingly, the Committee is of the view that the assessment regarding whether USD or Euro is a commonly used currency for external trade in the Indian economic environment should be supported by appropriate economic data (e.g. external trade statistics of India, etc.) for these currencies. It should not be concluded without such supporting evidence that these currencies are 'commonly used' in the Indian economic environment. However, in light of the Indian economic environment, the Committee notes that USD and Euro are generally considered to be the commonly used currency in foreign trade of India though this has to be substantiated by appropriate supporting evidence as discussed above.

18. Based on the above, the Committee is of the view that for local transactions (i.e. within India) with Indian vendors, INR should be considered as the 'commonly used'

currency and therefore, for contracts entered into by the company with Indian vendors in USD or Euro, the foreign currency embedded derivative is not closely related to the host contract. Accordingly, foreign currency embedded derivatives in such contracts are required to be accounted for in terms of paragraph 4.3.3 of Ind AS 109. For any currency to be considered as 'commonly used' for external trade, the company should support this assessment by appropriate external trade data and accordingly, for contracts with foreign vendors in a third currency, the foreign currency embedded derivative would be closely related to the host contract provided the company can appropriately conclude based on external trade data that USD or Euro are the 'commonly used' currency in India for external trade, as discussed in paragraph 17 above and in that case, foreign currency embedded derivatives are not required to be separated and accounted for in terms of paragraph 4.3.3 of Ind AS 109.

D. Opinion

19. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 13 above:

(a) For contracts entered into by the company with Indian vendors in USD or Euro, the foreign currency embedded derivative is not closely related to the host contract. Accordingly, foreign currency embedded derivatives in such contracts are required to be accounted for in terms of paragraph 4.3.3 of Ind AS 109, as discussed in paragraphs 16 to 18 above.

(b) For contracts with foreign vendors in a third currency, the foreign currency embedded derivative would be closely related to the host contract provided the company can appropriately conclude based on external trade data that USD or Euro are the 'commonly used' currency in India for external trade, as discussed in paragraph 17 above and in that case, foreign currency embedded derivatives are not required to be separated and accounted for in terms of paragraph 4.3.3 of Ind AS 109.