

## **Query No. 10**

**Subject:** *Accounting for Embedded Derivatives in Non-Financial Host Contracts as per Ind AS 109.*<sup>1</sup>

### **A. Facts of the Case**

1. A company (hereinafter referred to as ‘the company’) was incorporated on 16<sup>th</sup> August 1984 for procuring, transmission, processing and marketing of natural gas. The company has an authorized share capital of Rs 5,000 crore out of which Rs 2,254.98 crore is paid-up share capital as on 31<sup>st</sup> March 2018. The Government of India holds 53.59% equity of the company. The securities of the company are listed with National Stock Exchange (NSE), Bombay Stock Exchange (BSE) and London Stock Exchange.

2. One of the main activities of the company is to lay gas pipelines for transportation of natural gas. At present, the company owns over 11000 kms of pipeline and is currently having transmission capacity of about 206 MMSCM per day of natural gas. The company operates six LPG manufacturing plants in different parts of the country. The company is having an installed capacity of 1.52 Million MT of liquid hydrocarbons per annum. It is also having an integrated petrochemical plant of the capacity of 0.81 million tonnes per annum. The company has world’s longest pipeline for transmission of LPG. The company has integrated its business activities and operates into city gas distribution, wind power & solar power plant and telecom business. In addition to above, the company is currently participating in 10 Exploration & Production (E&P) blocks.

3. The querist has stated that the company has prepared its accounts as per Indian Accounting Standards (Ind ASs) w.e.f. 1st April 2016. In compliance to Companies (Indian Accounting Standards) Rules, 2015, the company prepared its financial statements for the financial year (F.Y.) 2016-17 with comparative figures for F.Y. 2015-16.

4. *Analysis of the Provisions of Ind AS 109, ‘Financial Instruments’ by the querist:*

(i) Derivatives and Embedded Derivatives

The querist has stated that Ind AS 109, ‘Financial Instruments’ provides accounting principles 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 are commodity futures, foreign exchange forward contracts, etc. 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.

Further, 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,

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<sup>1</sup> Opinion finalised by the Committee on 7.8.2019.

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  $14.5 - 2.5 \times \text{LIBOR (3 month)}$  – 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

(A) Provisions related to accounting for embedded derivatives under Ind AS 109 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.”

*(B) 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).”

Thus, 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.

(C) Exemption from accounting for embedded derivatives under Ind AS 109:

As per paragraph B4.3.8(d), 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.* (Emphasis supplied by the querist.)
- (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.

5. The company is currently executing a major Gas Pipeline Project, which is scheduled to be completed by December 2020. The company is also implementing other pipeline projects. The company procures coated / bare carbon steel line pipes to lay pipelines for any natural gas pipeline projects. Major part of project cost of any pipeline project of the company is consisting of coated / bare carbon steel line pipes of various sizes and grades. Carbon steel plates are the main raw materials for these pipes. *The domestic suppliers of these carbon steel pipes are majorly importing carbon steel plates for manufacture of coated / bare carbon steel line pipes for which they usually pay out in foreign currency. Carbon Steel plates and line pipes are mainly traded in USD in international market.* (Emphasis supplied by the querist.)

6. Existing Pipe Procurement Methodology:

6.1 As per Office Memorandum no. O-19023/1/91/ONG/D (V) dated 02.02.1993 (a copy of which has been supplied by the querist for the perusal of the Committee) of Ministry of Petroleum & Natural Gas (MoPNG) regarding “Procurement procedure and price preference scheme to be followed under Liberalized Exchange Rate Management System”, oil and gas companies including the company would procure their requirement of goods and services under International Competitive Bidding (ICB) basis where besides the Indian companies, the foreign companies / entities are permitted to bid for supply of good and services.

Further, as per the above said guidelines dated 02.02.1993, the following provisions are being made in case of procurement of goods and services under Liberalized Exchange Rate Management System:

- (i) *In pursuance of the decision of the Empowered Committee on indigenization of Oil field equipment and services, oil and gas companies would continue to procure their requirement of goods and services under international competitive bidding, (ICB) where foreign companies / entities are permitted to bid for supply of goods and services.*
- (ii) *In the global tenders to be floated by oil and gas companies for procurement of goods and services, Indian bidders will henceforth be permitted to bid in any currency (including Indian Rupees) and receive amounts in such currencies on par with foreign bidders. However, currency once quoted will not be allowed to be changed.*
- (iii) Since Indian bidders are now permitted to quote in any currency and also receive payment in the same currency, oil and gas companies will henceforth not be

compensating for any exchange rate fluctuation in respect of equipment, services and turnkey contracts to be finalized under these instructions.

- 6.2 MoP&NG, vide letter no. L-11011/4/05-GP dated 15.06.2005 (a copy of which has been supplied by the querist for the perusal of the Committee), forwarded the minutes of meeting of group (consisting of representative from MoP&NG, Oil PSUs and consultants) on tendering process for procurement of pipe held on 27th May 2005. As per the minutes, the group inter alia arrived at the consensus that the tenders for procurement of pipes *should be floated on ICB basis* with a view to fostering greater competition and bringing transparency in the procurement process.
- 6.3 Accordingly, the tender for line pipe is being invited through Open International Competitive Bidding basis through e-tendering by the company.
- 6.4 As per the trends of the past bids, it is noted that certain Indian/domestic bidders have submitted bids against the tenders floated by the company on ICB basis and received orders in USD in line with tender provision regarding bid currency. Further, the foreign bidders are submitting their bids generally in USD.
- 6.5 The company has placed orders on Indian suppliers amounting to USD 62 million during F.Y. 2016-17. During F.Y. 2017-18, the company awarded 11 major contracts for procurement of coated / bare line pipes to Indian vendors in USD. The approximate amount of total commitment of these 11 contracts is USD 395 million where the goods are to be supplied in a phased manner over a period of 6 to 12 months. The supplies may overlap more than one financial year. Besides there are some O&M contracts for purchase of chemicals, store and spares for own consumption amounting to USD 16 million.

(Emphasis supplied by the querist.)

7. Present accounting practice followed by the company for all these procurements of pipes from Indian vendors where payment is made in USD:
  - i) The liability is accounted for and the payment is made to the vendor as per the terms and conditions of the purchase order (PO).
  - ii) The company is making accounting entries only on despatch of pipes or when pipes are physically received as per the payment and other terms of the Purchase Order.
  - iii) Whenever delivery of pipe is made or received from Indian vendor, the liability is booked in INR after converting in US Dollars *at prevailing exchange rate* and is capitalized or shown under 'Capital Work in Progress'.
  - iv) On any reporting date of financial statement if the liability remains unpaid, it is reinstated with closing exchange rate by giving impact in profit and loss account.
  - v) The amount lying in 'Capital Work in Progress' is capitalised upon commissioning of Pipelines.
  - vi) During annual closing of accounts, the amount of unexecuted purchase orders is disclosed as 'Capital Commitment' in the 'Notes to Accounts' of financial statements.

The company feels that the above stated accounting methodology followed is correct; represents true and fair view of books of account and complies with the Accounting Standards.

8. The company is of the view that these POs / contracts are not embedded derivative contracts in view of the following facts:

- (a) The company is a Government company and has to abide by the Government circulars. If there were no such directives, the company might not have sought bids in foreign currency from domestic suppliers.
- (b) As per the MOPNG directives (as explained under paragraphs 6.1 and 6.2 above) procurements of coated / bare line pipes are made through ICB wherein global tenders are invited in compliance to Government circulars. Domestic bidders are allowed to bid in foreign currency and are permitted to receive payments in foreign currency.

This is a special dispensation given by MOPNG to the domestic bidders for supply of goods and services under ICB basis to oil and gas companies.

- (c) As the domestic bidders are allowed to quote in foreign currency, they are placed on par with the foreign bidders for offering best rates. The domestic suppliers mainly import steel plates which is the major raw material of coated / bare carbon steel line pipes and make payment in USD to their suppliers.
- (d) The steel plates and pipes are traded mainly in US Dollars in international market. Accordingly, the contracts are covered under exemption from accounting for embedded derivatives as per paragraph B 4.3.8(d) under Ind AS 109.
- (e) *In view of the fact stated above, it can be said that all these procurement contracts placed by the company to domestic bidders under ICB basis where the purchase order currency is a foreign currency do not qualify for embedded derivative accounting under Ind AS 109. The company has therefore not recognised these purchase orders as having any embedded derivative.*
- (f) *Since the company purchases pipes on International Competitive Bids (ICB) basis, as per Government Directives allowing domestic bidders to quote in foreign currency, all such domestic bidders are to be considered on the same footings as International bidders and the foreign currency (USD) quoted by domestic bidders is to be considered as functional currency of bidder for these contracts and hence it comes in exempted category.*
- (g) *It is also pertinent to mention that as per the company's information, other oil and gas companies and also other peer Government Companies do not account for embedded derivatives for the procurements made under ICB tender process where orders were placed on domestic vendors in foreign currency and accordingly payment made to vendors in foreign currency.*
- (h) The delivery schedule of coated / bare line pipes under these contracts spreads over 6 to 12 months from the date of placement of orders. Further, often the actual date of delivery is different from the contractual date. Therefore, the forward exchange rates considered earlier for a particular date will not be relevant and thereby will result in numerous complications in embedded derivative accounting.

Example of Purchase Order of coated carbon steel line pipe is given below.

Purchase Order Number: 1

- (i) Date of placing of PO: 28.12.2017
- (ii) PO Value: USD 19 million Delivery / Completion Schedule: August' 2018  
(with staggered delivery schedule)
- (iii) Spot Rate: Rs. 64.08/USD

- (iv) Forward rate on PO date for future last delivery date (August 2018): Rs. 65.95 / USD
- (v) Forward rate on reporting date (31<sup>st</sup> March'2018) for future last delivery date (August 2018): Rs. 66.29 / USD
- (vi) Value of embedded derivative as on 31<sup>st</sup> March'2018 would be Rs 0.65 Cr. {1,90,00,000 USD X (66.29-65.95)}
- (vii) Accounting entry on reporting date i.e. 31.03.2018 is as below:

Profit & Loss Account	Debit	Rs. 0.65 cr	
Embedded Derivative Liability	Credit	Rs. 0.65 cr	

- (viii) Under such circumstances, if the company has to give effect in the books of account (i.e. in profit and loss account) on the reporting date i.e. 31<sup>st</sup> March 2018 under Ind AS 109, of embedded derivatives, on the basis of forward rates, a huge notional amount will be recognised in the profit and loss account. *This notional amount will be charged to profit and loss account although there is no corresponding accounting / liability towards the supply as on 31.03.2018, as the physical delivery of carbon steel line pipes as per the contractual delivery dates are in future years.*

*Such accounting treatment will be incongruous and distorting the financial position as on 31.03.2018, since although there is no payment or liability recognised in the books of account as on 31.03.2018, the company will make notional entries in the profit and loss account.*

- (i) Further the said accounting treatment will have to be followed for every reporting period on quarterly basis without any actual delivery of material.
  - (j) This notional entry will have positive / negative fluctuations in the profit and loss figure for each reporting period and will not give true picture of the company's financial position to different stakeholders.
- Moreover, all these coated / bare line pipes are meant for natural gas pipeline project which will be ultimately capitalised in the books of account of the company on receipt of material.
- (k) It is also submitted that these purchases of coated / bare line pipes are for own use of the company for execution of cross country natural gas pipeline project and there is no speculation involved in the transactions.
  - (l) Notional entries of embedded derivatives on each reporting date will unnecessarily attract tax implications for the company.
  - (m) As discussed above, accounting for embedded derivatives in case of non-financial host contracts under Ind AS 109 will have a serious consequence for the Indian corporates with huge notional entries affecting their profit and loss account at each reporting date. These notional entries may have impact on tax liability as well.
  - (n) The company will be disclosing the above fact and details of ICB transactions by giving a suitable note in its annual accounts.

(Emphasis supplied by the querist.)

9. *Relevance of Ind AS 109 for Indian Companies:*

(i) The querist has stated that it should be appreciated that accounting requirements of Ind AS 109 for embedded derivatives in non-financial contracts do not appear to take into consideration the Indian context or the Indian economic scenario where most of the foreign trade is denominated in USD. This is a western concept relevant in developed countries and prevailing in the US and Europe where the transaction is in their domestic currency (e.g. USD, Euro, Pound Sterling etc.) which are also internationally traded currency. However, in the context of a developing country like India, this type of accounting treatment will lead to avoidable accounting complications, increase avoidable volatility in operating reports and is a huge burden for companies and is undesirable.

(ii) The need for the said Standard is required to be reviewed and interpreted in relation to Indian context and especially for the Public Sector Undertakings (PSU), who are strictly governed by rules and regulations of the Government of India.

10. Considering above facts, it is concluded by the company that its transactions are covered under exempted categories and it is not required to account for embedded derivatives. Further, in view of the facts and explanations given in paragraphs 8 and 9, the company is recognising the contracts with Indian bidders who have quoted in foreign currency against the ICBs floated by the company in pursuance of Government Policy, as being exempted under paragraph B 4.3.8(d) of Ind AS 109, from being classified as embedded derivative.

11. The querist has also supplied the following information in the context of the issue raised:

(i) Step by step process relating to the International Competitive Bidding (ICB):

*How the bidding is initiated:*

Open International Competitive bidding process is used for request for quotation (e-bids) from prospective bidders. Bids are to be submitted in the company's E-Tender website. Bidders shall submit their bids in two parts, i.e., part-I, Un-price bid containing all technical details along with applicable forms and format, and part-II, Price bid.

After receiving the Earnest Money Deposits (EMD) from the bidders, techno-commercial evaluation of the bids is made as per the documents submitted in Part-I Un-price bid and further documents as per TQ/CQ (technical query/commercial query) are evaluated. After acceptance of the same, Part-II price-bids are opened for the qualified and accepted bidders.

After that, comparative analysis is done for price bids prices/reverse auction (as the case may be) of the respective bidders and L1 bidder(s) are finalized. After finalization of the same, placement of order is made through issuance of Fax of Acceptance (FOA) to the bidder.

*Who are the bidders:*

Invitation for Bid (IFB) notices are made on the company's E-tender portal and also in Govt. Central Public Procurement Portal (CPP portal). Any steel pipe manufacturers who meet the technical and financial bid evaluation criteria can quote for the same.

*How the vendor is selected:*

Vendors/ bidders are selected who meet the technical and financial bid evaluation criteria.

*Any negotiations with prospective suppliers:*

Usually after price bid opening and reverse auction, no price negotiation is made with the prospective bidder(s), but in exceptional cases where L1 prices are more than the specified limit as compared with estimated prices and procurement case is urgent in nature, procurement policy permits for price negotiation with L1 bidder(s).

*How the price/currency is finalised:*

The pricing of a single contract is determined on the basis of prices quoted by the bidders and becomes L1 Price. Further, as per Instructions to Bidders (ITB), paragraph 12 "Indian bidders may submit bid in Indian Rupees or in US \$ / euro and receive payment in such currency".

*Is the contract necessarily awarded to the lowest bidder:*

As per ITB, paragraph 37 "The employer will award the contract to the successful bidder(s) whose bid has been determined to be substantially responsive, meets the technical & financial criteria and /or have been determined as a lowest bid on least cost basis to Employer".

(ii) With regard to the basis for pricing a contract especially in contracts with local vendors, the querist has mentioned that the pricing of a contract is determined on the basis of prices quoted by the bidders and becomes L1 Price as per ITB paragraph 33, 'Evaluation and comparison of bid'. "Further to facilitate evaluation and comparison, the employer will convert all the bid prices expressed in the amount in various currencies in which the bid price is payable to single currency and that will be Indian Rupees only" as per ITB para 32 Conversion to single currency. In case of ICB tender only, bids in foreign currency is allowed to quote. The vendor can bid in foreign currency even for that component of the contract which does not involve any payment by the vendor in foreign currency, as one to one matching not required for foreign currency amount vis-a vis payment by the vendor in foreign currency/ or items manufactured in India.

(iii) The querist has confirmed that the query has been raised in the context of procurement of coated/bare line pipes only, but this situation may also arise for other O&M contracts for purchase of chemicals, store and spares, etc. for which bids may be called on ICB tender.

(iv) With regard to the bids received for tenders floated as per ICB in past, for procurement of coated/bare line pipes, the querist has clarified that in past, the company has received bids in currencies other than USD also. As per ITB paragraph 12 "Indian bidders may submit bid in Indian Rupees or in US \$ / euro and receive payment in such currency. Foreign bidders may submit bid in the home currency of bidder's country or US \$ / Euro / INR." Accordingly, in previous ICB tenders also, bids are received in currencies other than USD also.

(v) With regard to any discretion of the company to fix the price in terms of currency other than the bid currency after the bidding process is over and at the time of entering into agreement/contract with the selected bidder, the querist has clarified that once the bidding process is over and at the time of entering into agreement with the selected bidder, the company cannot have discretion to fix the price in terms of currency other than the bid currency. As per Special conditions of Contract (SCC), Section III C paragraph 3, "the payment to Indian bidders shall be done as per following:

The unit ex-work/ex storage yard price quoted by the bidder in INR or US Dollar /Euro shall be paid in currency quoted.”

## **B. Query**

12. Considering the above facts and explanations, the Expert Advisory Committee is requested to give its opinion on the following:

- (a) Whether the opinion of the company as concluded above in paragraph 10 is correct.
- (b) The company is of the view that notwithstanding the logical explanation given in paragraphs 8 and 9 above, even if at all, an extreme view is taken, then the notional entry of MTM gain or loss required to be accounted for in the books of account of the company under embedded derivative, should be shown in Other Comprehensive Income (OCI) and not in the profit and loss account.

## **C. Points considered by the Committee**

13. 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 contracts for purchase of coated / bare carbon steel line pipes, entered into by the company with Indian vendors in USD, can be considered as closely related to the host contract as per paragraph B4.3.8(d) of Ind AS 109. 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 non-financial items purchased, etc.

14. The Committee 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).”

From the above, with regard to the first condition as to the functional currency, the Committee presumes from the Facts of the Case that USD is not the functional currency of the company. Further, the Committee notes from the Facts of the Case that the querist has contended that domestic (Indian) bidders should be considered on the same footing as International bidders and the foreign currency, viz., USD should be considered as ‘functional currency’ of the bidders *for these contracts*. In this regard, the Committee wishes to state that functional

currency is to be determined in the context of primary economic environment in which the company as a whole operates and not in the context of particular type of contracts entered into by the company. Since apparently, USD is not the functional currency of the Indian/ domestic bidders/suppliers in the extant case, this condition is not met.

15. The Committee further notes that as per the requirements of paragraph B4.3.8(d)(ii) 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 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). In this regard from the example quoted in the standard in terms of crude oil transactions for this condition, the Committee believes that such currency should be used for similar transactions all over the world and not merely in one region/area. In this regard, the Committee notes from the Facts of the Case that in the past for procurement of coated/bare line pipes, the company has received bids in currencies other than USD also. From this, it is clear that the price of coated /bare line pipes is not routinely denominated in USD in commercial transactions around the world. Further, terms of ICB provide option to bidders to select currency of bids. Therefore, the Committee is of the view that this condition is also not met.

16. The Committee also 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, 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 Hyperinflationary 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, etc. 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. In this regard, the Committee is of the view that as the transaction to buy coated/bare line pipes takes place with local/Indian suppliers in India in the extant case, although the bid is selected and the contract is awarded through ICB, economic environment should be construed in the context of economic environment in India in which local business transactions take place. The Committee is further of the view that Indian National Rupee (INR) is the currency which is commonly used for local transactions within India. Therefore, the transactions entered into by the company in USD with local/Indian suppliers for purchase of coated /bare line pipes do not fulfil the requirements of paragraph B4.3.8 (d) (iii) of Ind AS 109.

Accordingly, the Committee is of the view that in the extant case, the embedded foreign currency derivative in the host contract should not be considered as closely related to the host contract and the same should be separately accounted for by the company. In this regard, the Committee notes the following requirements of Ind AS 109:

**“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.”**

“B4.3.9 As noted in paragraph B4.3.1, when an entity becomes a party to a hybrid contract with a host that is not an asset within the scope of this Standard and with one or more embedded derivatives, paragraph 4.3.3 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through profit or loss. For that reason this Standard permits the entire hybrid contract to be designated as at fair value through profit or loss.

B4.3.10 Such designation may be used whether paragraph 4.3.3 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 4.3.5 would not justify designating the hybrid contract as at fair value through profit or loss in the cases set out in paragraph 4.3.5(a) and (b) because doing so would not reduce complexity or increase reliability.”

In accordance with the above requirements, the Committee is of the view that the embedded foreign currency derivative should be measured at fair value at initial recognition and subsequently with changes in fair value recognised in the statement of profit and loss and not in the statement of other comprehensive income, as being contended by the querist.

#### **D. Opinion**

17. On the basis of the above, the Committee is of the opinion that for contracts entered into by the company with domestic/Indian suppliers/vendors in USD, the foreign currency embedded derivative is not closely related to the host contract and should be accounted for separately, as discussed in paragraphs 14, 15 and 16 above. Further, the embedded foreign currency derivative should be measured at fair value at initial recognition and subsequently with changes in fair value recognised in the statement of profit and loss and not in the statement of other comprehensive income, as being contended by the querist, as discussed in paragraph 16 above.