

**GENERAL INSTRUCTION MANUAL**ISSUING  
ORG.

ACCOUNTING POLICIES &amp; SYSTEMS DEPARTMENT

SUBJECT

**IDENTIFICATION OF EMBEDDED DERIVATIVES**G. I. No. **230.010** ApprovedISSUE DATE  
09-15-09REPLACES  
7-06-2002APPROVAL  
RAKPAGE NO.  
Page 1 of 7

**CONTENT:** The purpose of this General Instruction (GI) is to establish a framework for ensuring that derivative instruments embedded in the contracts and agreements to which Saudi Aramco is a party are properly identified for appropriate accounting treatment. The text of this instruction includes:

1. Glossary
2. Background
3. Definitions
4. Review of Contracts and Agreements
5. Applicable Organizations
6. Annual Reporting of Contracts

Attachment I – Methodology for Review

Attachment II – Documentation for Review

**1. GLOSSARY****1.1. ABBREVIATIONS & ACCRONYMS**

AGOC	-	Aramco Gulf Operations Company, Ltd
AOC	-	Aramco Overseas Company B.V.
AP&PD	-	Accounting Policies & Procedures Division/AP&SD
AP&SD	-	Accounting Policies & Systems Department
ASC	-	Aramco Services Company
CRCCD	-	Contract Review & Cost Compliance Department
DJVD	-	Domestic Joint Venture Department
FAD	-	Financial Accounting Department
GI	-	General Instruction
IA	-	Internal Auditing
IAS	-	International Accounting Standard
IASB	-	International Accounting Standards Board
Luberef	-	Saudi Aramco Lubricating Oil Refinery Company
MS&JVC	-	Marketing, Supply & Joint Venture Coordination
OP&ICD	-	Operations Purchasing & Inventory Control Department
P&SPD	-	Projects & Strategic Purchasing Department
PS&CD	-	Planning, Support & Consulting Division/IA
SPOL	-	Saudi Petroleum Overseas Ltd.
TAD	-	Treasury Advisory Department
TSD	-	Treasury Services Department
Vela	-	Vela International Marine Limited

**1.2. RELATED MANUALS**

Saudi Aramco Contracting Manual

**2. BACKGROUND**

International Accounting Standard (IAS) 39, Financial Instruments: Recognition and Measurement issued by the International Accounting Standards Board (IASB) became effective for Saudi Aramco beginning with calendar year 2005. This Standard establishes, among other things, accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts. It requires that an entity recognize all derivatives as either assets or liabilities in their financial statements and measure those instruments at fair value through profit and loss.

A comprehensive review of all contracts and agreements must be performed to identify all embedded derivatives. This review is to be performed when Saudi Aramco or its subsidiaries (see section 4.1) first become party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract.

**3. DEFINITIONS****3.1. DERIVATIVE INSTRUMENTS**

A derivative instrument is a financial instrument with all these characteristics:

- 3.1.1. Its value changes in response to changes in a variable (called the underlying) such as a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating, or a similar variable.
- 3.1.2. It required little or no initial investment.
- 3.1.3. It is settled at a future date.

A derivative financial instrument must be measured at fair value on the balance sheet and the changes in fair value are accounted for through profit and loss.

**3.2. EMBEDDED DERIVATIVES**

Host contracts such as bonds, insurance policies, leases and purchase and sales contracts, may contain embedded derivative instruments. The embedded derivative may cause some or all of the cash flows of the host contract to change, according to a specified underlying (see 3.1.1). In order to prevent derivatives from being hidden (embedded) in host contracts that are not accounted for 'at fair value through profit and loss', the embedded derivative should be split from the host contract and accounted for separately if:

- 3.2.1. Its economic characteristics and risks are not closely related to those of the host contract.
- 3.2.2. A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative (on a stand-alone basis the embedded feature would meet the definition of a derivative).
- 3.2.3. The entire contract is not carried 'at fair value thorough profit and loss'.

**3.3. CLOSELY RELATED**

An embedded derivative and a host contract are closely related if the underlying economic characteristics and risks of the embedded derivative (the factors that cause the derivative to fluctuate in value) behave in the same manner to the host contract's economic characteristics and risks. For example, a normal purchase or sale contract may contain a price clause that modifies the contract's cash flows – an embedded derivative. In assessing whether or not the embedded derivative is closely related to the host contract, it would be necessary to determine whether the underlying in the price adjustment feature incorporated in the contract is related or unrelated to the cost or fair value of the goods or services sold or purchased.

**3.4. NON-FINANCIAL ASSET**

A non-financial asset is any asset other than:

1. Cash
2. a contractual right to receive cash or another financial asset from another entity
3. a contractual right to exchange financial instruments on potentially favorable terms with another entity
4. an equity instrument (evidence of ownership interest in an entity) of another entity

**4. REVIEW OF CONTRACTS AND AGREEMENTS****4.1. SCOPE OF REVIEW**

This GI applies to all contracts and agreements whether related to revenue/sales, expenses, capital projects or other areas that can be reasonably expected to provide for the receipt or payment of more than U.S. \$5 million, or equivalent, over the life of the contract or agreement. Only those contracts that were newly-executed, or draft contracts routed for Functional Review in accordance with Procedure 6 of the Saudi Aramco Contracting Manual, and existing contracts with changes in their terms that significantly modify the cash flows that otherwise would be required under the contract during the period of review need be examined in accordance with this G.I.

The scope of this GI applies to Saudi Aramco's consolidated subsidiaries whose accounting functions are performed in the Arabian Gulf region (refer to section 5). The following subsidiaries are excluded from the scope of this GI since their accounting functions are independently performed outside the region and are subject to independent audit:

- Aramco Services Company (ASC)
- Aramco Overseas Company B.V. (AOC)
- Saudi Petroleum Overseas Ltd. ( SPOL)

These subsidiaries are required to review their contracts and agreements on a quarterly basis and report on any embedded derivatives to FAD for IFRS compliance.

**4.2. TIMING OF REVIEW**

The review called for in this GI should be performed at the initial execution of the contract or agreement, draft contract routed for Functional Review, and for an existing contracts whose terms have been changed to significantly modify the cash flows that otherwise would be required by the contract. Documentation of the review (see section 4.4) should be provided by the 15<sup>th</sup> day of the month following the end of each calendar quarter.

**4.3. METHODOLOGY FOR REVIEW**

Utilizing the attached checklist (see Attachment I) or other format which has been approved by AP&SD, applicable organizations (see section 5) should review all newly-executed contracts and agreements, or draft contracts routed for Functional Review, and existing contracts whose terms have been significantly modify their cash flows to determine whether or not they contain embedded derivative instruments. The contracts should be analyzed by asking the following five questions:

- 4.3.1. Are any payments required by the contract adjusted for changes in inflation or other economic factors?
- 4.3.2. Are any payments required by the contract denominated in or linked to a currency that is different from the primary currency of either party to the agreement?
- 4.3.3. Are any payments required by the contract determined by reference to a change in a foreign exchange rate, commodity price or index, insurance loss index, interest rate index, or other external index, price, factor, etc?
- 4.3.4. Do any of the contracts require receipt or payment of any non-cash consideration?
- 4.3.5. Do any of the contracts provide an option to purchase or sell a non-financial asset?

Attachment I should contain a detailed explanation for any contract with an affirmative answer to any of the above questions.

**4.4. DOCUMENTATION OF REVIEW**

Upon completion of the review, a quarterly letter (see attachment II for format) should be forwarded to AP&SD, along with Attachment I checklist if completed, to:

Coordinator  
Accounting Policies & Procedures Division  
Accounting Policies & Systems Department  
T-574, Dhahran

Applicable organizations who do not provide the required documentation by the 20<sup>th</sup> of the month following the end of a quarter will receive a follow-up reminder letter from AP&PD. AP&PD will advise the Manager of the Planning, Support & Services Division (PS&CD) in Internal Auditing of applicable organizations who do not provide the required documentation by the end of the month following the end of a quarter.

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RAKPAGE NO.  
Page 5 of 7**5. APPLICABLE ORGANIZATIONS**

The requirements of this GI shall be performed by the following organizations:

1. Treasury Services Department (TSD)
2. Treasury Advisory Department (TAD)
3. Marketing, Supply and Joint Venture Coordination (MS&JVC), to include Bolanter Corporation N.V. and Saudi Petroleum, Ltd.
4. Vela International Marine Limited
5. Aramco Gulf Operations Company, Ltd.
6. Contract Review & Cost Compliance Department
7. Projects & Strategic Purchasing Department (P&SPD) and Operations Purchasing & Inventory Control Department (OP&ICD)
8. Financial Accounting Department (FAD), on behalf of Pandlewood Corporation
9. Domestic Joint Venture Department (DJVD), on behalf of Saudi Aramco Lubricating Oil Refinery Company (Luberef)

Approved: \_\_\_\_\_

**R.A. Krygsman, Manager**

Accounting Policies & Systems Department

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**ATTACHMENT I**  
METHODOLOGY FOR REVIEW

Organization:

Contract/Agreement No:

Contractor:

Total Estimated Contract Value:

Reviewed by:

Date Reviewed:

**Question Checklist**  
(Circle the correct response)

- (1) Are any payments required by the contract adjusted for changes in inflation? YES/NO
- (2) Are any payments required by the contract adjusted for changes in economic factors other than inflation? YES/NO
- (3) Are any payments required by the contract denominated in or linked to a currency that is different from the primary currency of either party to the agreement? YES/NO
- (4) Are any payments required by the contract determined by reference to a change in a foreign exchange rate? YES/NO
- (5) Are any payments required by the contract determined by reference to a change in a commodity price or index? YES/NO
- (6) Are any payments required by the contract determined by reference to a change in an insurance loss index? YES/NO
- (7) Are any payments required by the contract determined by reference to a change in an interest rate index? YES/NO
- (8) Are any payments required by the contract determined by reference to a change in any other external index, price, factor, etc.? YES/NO
- (9) Do any of the contracts require receipt or payment of any non-cash consideration? YES/NO
- (10) Do any of the contracts provide an option to purchase or sell a non-financial asset? YES/NO

**NOTE:** Provide explanation for any items answered as "YES" above.

**ATTACHMENT II**  
DOCUMENTATION FOR REVIEW

Coordinator  
Accounting Policies & Procedures Division  
T-574, Dhahran

RE: Review of Contracts/Agreements for Potential Embedded Derivatives – Quarter Ended  
(*Month, Day, Year*)

In accordance with the requirements of General Instruction (G.I.) 230.010, *Identification of Embedded Derivatives*, we have reviewed all contracts/agreements with an estimated value in excess of \$5 million which were newly-executed, draft contracts routed for Functional Review in accordance with Procedure 6 of the Saudi Aramco Contracting Manual, and all old contracts whose terms were changed to significantly modify the cash flows that otherwise would be required under the contract during the (*number*) quarter of (*year*). The following contracts contain provisions that meet one or more of the attributes outlined in the GI-Attachment I, which is also enclosed for your reference.

*(If none of the contracts reviewed during the quarter contain attributes identified in Attachment I, please reflect "NONE" in the columns below)*

Contract Number	Proponent	Contractor	Estimated Value

Please contact (*Name*) by e-mail or telephone (*number*) if you have any questions regarding the above or attached.

*(Signature by Department Head or higher level of authority or his designee)*