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International Accounting Standards Board

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **January 2007, London**

Project: **IAS 39 *Financial Instruments: Recognition and Measurement* - Written options in retail energy contracts (Agenda Paper 14(iv))**

SUMMARY OF THE ISSUE

1. The IFRIC has been asked to provide guidance on what constitutes a written option under paragraph 7 of IAS39 in the context of energy supply contracts to retail customers.

2. The submission asks whether such contracts are in the scope of IAS 39.

3. IAS39 primarily sets out accounting requirements for financial instruments.

4. However, paragraph 5 of IAS39 also requires IAS39 to be applied to contracts involving non-financial items that can be settled net (as defined in paragraph 6 of IAS39). An exemption from these requirements is given for contracts that were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale and usage requirements (the "normal use" criteria).

5. Paragraph 7 of IAS39 states that "a written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments," cannot meet the normal use criteria.

6. Industry practice currently is that energy supply contracts to retail customers are generally not accounted for under IAS 39, and it should be noted that there is no significant divergence in practice.

STAFF ANALYSIS AND RECOMMENDATION

7. BC24 states that a written option that can be settled net in cash or another financial instrument, or by exchanging financial instruments, is within the scope of the standard and cannot qualify as a "normal" purchase or sale.

8. This shows the two step approach to considering whether contracts involving non-financial items are within the scope of IAS 39, firstly whether or not they meet the net settlement criteria, and then whether or not they meet the normal usage exemption. If such contracts are written options they cannot meet the normal usage exemption.

What is a written option in the context of paragraph 7 of IAS 39?

9. Implementation guidance A2 of IAS39 states (in the context of an investor having a written option) *"The investor, however, cannot conclude that the option was entered into to meet the investor's expected purchase, sale or usage requirements <u>because the investor does not have the ability to require delivery</u> (IAS39.7). In addition, the option may be settled net in cash, therefore, the investor has to account for the contract as a derivative. Regardless of past practices, the investor's intention does not affect whether settlement is by delivery or in cash. The investor has written an option, and a written option in which the holder has a choice of physical settlement or net cash settlement can never satisfy the normal delivery requirements for the exemption from IAS 39 <u>because the option writer does not have the ability to require delivery</u>.* [Emphasis added].

10. The important feature of a contract that is relevant within a paragraph 7 context is the control over the physical delivery of the non-financial item. The writer of the

option has no control over whether the option will be exercised and hence whether the non-financial item will be exchanged.

11. As mentioned, the submission was primarily raised to address energy supply contracts to supply electricity or gas on demand at a fixed price to retail customers. The supplier has to stand ready to provide the customer with as much or as little of the non-financial item as the customer wants; therefore, the contract (for the supplier) meets the definition of a written option for the purposes of paragraph 7 of IAS 39; the supplier has no control over the amount of the non-financial item that will be delivered under the contract.

Are such contracts within the scope of IAS39 in the first place?

12. In order for contracts involving non-financial items to be included within the scope of IAS39 the contract must meet the net settlement criteria of paragraph 6 of IAS39.

13. Paragraph 6 of IAS39 lists four ways by which the net settlement criteria of paragraph 5 may be met:

    a. When the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;

    b. When the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse).

    c. When, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

    d. When the non-financial item that is the subject of the contract is readily convertible to cash.

14. The standard goes on to state, if criterion (b) or (c) applies, the normal usage exemption of paragraph 5 will not be available.

15. The staff do not believe that any of the above criteria are met by the types of contracts referenced in the submission. Therefore, although such contracts do represent written options, they are not within the scope of IAS 39.

Staff Recommendation

16. With regard to the original IFRIC submission, the staff believe that IAS 39 contains unambiguous guidance on what constitutes a written option for the purposes of paragraph 7.

17. The lack of control over the delivery or receipt of the non-financial item of any contract involving the sale or purchase of a non-financial item (which can be settled net in cash or another financial instrument, or by exchanging financial instruments – as set out in paragraph 6 of IAS39) is the determining factor for the purposes of paragraph 7 of IAS 39.

18. The staff recommendation is, therefore, not to take the IFRIC submission onto the agenda.

19. Proposed 'rejection' wording is set out below for the IFRIC's consideration.

[Paragraph omitted from observer note].

20. Questions to the IFRIC:

- Do you agree that the issue should not be taken onto the agenda?
- Do you have any comments on the 'rejection' wording?