IFRIC Meeting

Staff Paper

Agenda reference **5**

Date **November 2009**

Project	**Tentative agenda decisions**
Topic	**IAS 39 *Financial Instruments: Recognition and Measurement* — Unit of account for forward contracts with volumetric optionality**

Introduction

1. In July 2009 the IFRIC received a request to add an item to its agenda on providing guidance on whether a contract that has both option and non-option elements can be assessed as two separate contracts for the purpose of applying paragraphs 5-7 of IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). (The IFRIC agenda submission is attached as Appendix B.)

2. This paper:

   (a) provides an overview and analysis of the issue;

   (b) provides the staff's view on the issue;

   (c) assesses the issue against the criteria in the IFRIC's *Due Process Handbook*;

   (d) makes a recommendation to the IFRIC; and

   (e) asks the IFRIC whether they agree with the staff's recommendation.

Overview and analysis of the issue

Overview of the issue

3. It is common for entities in some industries (eg the energy industry) to enter into forward contracts to buy and sell a fixed quantity of a specified commodity at a fixed price over the term of the contracts.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IFRIC.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRIC or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

Decisions made by the IFRIC are reported in *IFRIC Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in *IASB Update*.

4. Entities enter into these contracts for many business reasons. For example, they might want to hedge against expected increases or decreases in the market price of a commodity and/or lock in a reliable source of supply or distribution channel.

5. Often these contracts provide the buyer with the flexibility to purchase additional quantities of the same commodity also at a fixed price (which typically is the same price as that for the quantities under the forward contract).

6. This flexibility allows the buyer to have the commodity (reliably) available when it needs to increase its production to meet higher than expected demand. Alternatively, the buyer may want to buy the additional quantities and sell them in the marketplace to make a profit.

7. The IFRIC agenda submission provides the following two examples to illustrate these types of contracts:

   (a) **Example 1:** Entity A enters into a contract with Entity B that allows Entity B to buy up to 100 units of natural gas per day for a specific period at a fixed price, subject to a minimum amount of 70 units per day. Entity B therefore has volumetric flexibility over 30 units at a fixed price in addition to the minimum 70 units it must buy. The entire arrangement (both in respect of the minimum quantity and of the volumetric optionality) is executed as one contract.

   (b) **Example 2**: Entity C enters into a contract under which it will deliver a set quantity of natural gas to Entity D for a fixed price over a specified period. The contract also contains a provision giving Entity D the right, but not the obligation, to extend the term of the contract by requiring the delivery of additional specified quantities of natural gas over an additional period at the same pre-set price. The entire arrangement is contained within one contract.

8. From the perspective of the selling entity, the types of contract that are illustrated in the two examples in the previous paragraph can economically be viewed as:

(a) a forward to sell a fixed number of units of a specified commodity at a fixed price over a specified period, and

(b) a written option to sell a fixed number of additional units of the same commodity at (typically) the same fixed price, either in the same period or over an additional pre-specified period.

9. **The issue is whether the forward and the written option should or must be analysed as two separate contracts for accounting purposes (in particular for the purpose of applying IAS 39.5-7), even though legally they are in a single contract.[1]**

10. What are the accounting outcomes for the entity that is committed under the contract to deliver (sell) the commodity if the contract that houses the forward and written option is assessed as a single unit of account rather than as two separate units of account?

11. **One contract (ie single unit of account).** If the contract were to be assessed as a single unit of account, the selling entity would have to account for the contract *in its entirety* as a derivative at fair value through profit or loss.

12. Because of the written option component, the selling entity does not control how much of the commodity it will deliver under the contract. In Example 1, Entity A might deliver all 100 units of natural gas per day, but it also might not. Similarly, in Example 2, Entity C might deliver the additional quantities if Entity D extended the contract, but it also might not.

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[1]The staff notes the following:

(a) The issue applies only to the entity that is required to deliver (sell) under the contract. The buyer could avail itself of the scope exception in IAS 39.5 provided it met the 'own use' requirements. See also IAS 39 IG A.2.

(b) The staff assumes that the commodity to be delivered under the contract is 'readily convertible to cash' and the contract is thus net-cash settleable in accordance with IAS 39.6(d). As a result, the staff assumes that the buyer under the contract is not a retail customer and that the issue of this submission therefore has a different scope than that of the submission that the IFRIC declined to add to its agenda in 2007 (see IFRIC Update—March 2007: *Written options in retail energy contracts*).

13. Whether the selling entity in these two examples delivers all possible quantities under the contract will depend on the actions of the buyer. The entity cannot *require* the buyer to take delivery of the contracted quantities of the commodity.

14. In these instances, IAS 39.7 (as can also be seen in IAS 39 IG A.2) is clear that an entity cannot assert that it 'entered into [the contract] for the purpose of the […] delivery of the non-financial item in accordance with [its] expected […] sale […] requirements'.

15. Once it is determined that the (entire) contract is within the scope of IAS 39, it is also clear that the contract meets the definition of a derivative in IAS 39.9, because:

    (a) its value changes in response to the changes in the market price of the commodity to be delivered under the contract.

    (b) it requires no initial net investment, or only an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. The staff understands that the entities that execute these types of contracts typically include the premium for the written option component into the fixed price of the forward component, and so the buyer does not pay the premium up front. However, even if the buyer were to pay the option premium up front, it would pay less than the amount it would otherwise have to pay to acquire the specified quantities of the commodity. Thus, the contract would be judged to have only a small initial net investment.

    (c) it is settled at a future date. The contract can be viewed as a series of forwards and written options that are settled over the term of the contract. For example, in Example 1, Entity A delivers up to 100 units of natural gas on a daily basis. Consequently, each day when it delivers the 100 units of natural gas to the buyer (in exchange for a right to a fixed amount of cash), one forward and one written option out of the series of daily forwards and written options is settled.

16. Because the contract, when assessed in its entirety, has all the characteristics of a derivative, the written option component (if thought of as a derivative embedded in a forward host contract) would not qualify to be separated under IAS 39.11(c). This paragraph states:

    > An embedded derivative shall be separated from the host contract and accounted for as a derivative under this Standard if, and only if:
    >
    > […]
    >
    > (c) the hybrid (combined) instrument 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 asset or financial liability at fair value through profit or loss is not separated).

17. In summary, if the unit of account for the purpose of assessment under IAS 39.5-7 is the entire contract, the entity that is committed under the contract to deliver (sell) would have to recognise the entire contract as a derivative at fair value through profit or loss.

18. **Two contracts (ie two units of account).** If the contract were assessed as two units of account (a separate forward and a separate written option), the selling entity might be able to avail itself of the 'own use' exception in IAS 39.5 to the forward component and, as a result, might have to account for only the written option component contract as a derivative at fair value through profit or loss.

19. Because the forward *requires* the buyer to take the quantities of the commodity that the selling entity delivers (ie there is no conditionality as to the delivery of the commodity), it would not be within the scope of IAS 39, provided the selling entity demonstrates that it entered into, and continues to hold, the forward to deliver the commodity in accordance with its expected sales requirements. (The staff notes that this outcome would apply regardless of the fact that the forward has all the characteristics of a derivative.)

20. Because the nature of a forward is that of an executory contract, the selling entity would account for it using accrual basis of accounting (ie when the entity delivers the commodity to the buyer, it would set up a receivable for the cash to be received from the buyer).

21. While the forward would be outside the scope of IAS 39, the written option would be in the scope of that Standard. In light of IAS 39.7, the selling entity could not make use of the 'own use' exception in IAS 39.5. A similar derivative analysis as that for the contract as a whole (see paragraph 15 of this paper) would indicate that the written option has all the elements of a derivative. As a result, the selling entity would have to account for the option as a derivative at fair value through profit or loss.[2]

22. One would expect the changes in fair value of the forward to be much more volatile than those for the written option. One would thus expect an entity that would have to account for the contract in its entirety as a derivative at fair value through profit or loss to report significantly more volatility in its profit or loss statement than an entity that accounted for only the written option component as a derivative.

23. So in summary, depending on whether these types of contracts are evaluated as one unit or two units of accounts, the difference in accounting outcomes and the resulting impact on the financial statements could be quite dramatic.

Analysis of the issue

24. The IFRIC agenda submission sets out three alternative views on this issue that have emerged in practice. They are the following:

    (a) **View 1:** Split the contract into a forward component and a written option component and apply IAS 39.5-7 to these components separately.

    (b) **View 2:** Apply IAS 39.5-7 to the contract in its entirety.

[2]The staff notes that if the entity did not receive the option premium on day 1 (because the premium was included in the price of the forward component), it would recognise a receivable for the premium equal in amount to the fair value of the written option (as to the credit, the entity would recognise a derivative liability for the option). The entity would derecognise the premium receivable over the term of the contract (ie a part of the payment that the entity receives upon each delivery of the commodity is for the option premium).

(c) **View 3:** Make an accounting policy choice and apply either View 1 or View 2 consistently to all similar contracts.

25. This submission provides the following supporting arguments for each of the three views.

26. **View 1**. Supporters of this view believe that how contractual rights and obligations are structured in form should not affect the accounting for those rights and obligations. They argue that the parties could easily enter into the forward and written option components as two separate contracts. If they were to do so, the parties would have the same contractual rights and obligations and thus would be in the same economic position as those parties that combine the forward and written option into a single contract. Nonetheless, the reporting of the contractual rights and obligations by the entity that under the contract is required to deliver would be remarkably different.

27. Consequently, those who support View 1 believe that the seller's and buyer's contractual rights and obligations should be accounted for consistently regardless of whether those rights and obligations are in a single contract or in two or more separate contracts.

28. Those in favour of View 1 also argue that regardless of whether IAS 39.5-7 are applied to the contract as a whole or to the forward and written option components separately, the accounting outcome would be the same. That is, the written option component would be accounted for under IAS 39 as a derivative at fair value through profit or loss, while the forward component would be accounted for under the accrual basis of accounting (provided it met the 'own use' exception in paragraph 5 of IAS 39).

29. Proponents of View 1 put forth this argument because they view the single contract as an executory (forward) host contract in which a written option derivative is embedded. The executory host contract would be outside the scope of IAS 39 (assuming it qualified for the 'own use' exception in IAS 39.5). Because the written option has one-sided risk, its economic characteristics and risks are not closely related to those of the host contract. Accordingly,

IAS 39.11 would require the embedded option to be separated from the host contract.

30. Therefore, those who prefer View 1 contend that even if the contract as a whole were in the scope of IAS 39, it would qualify to be accounted for as two separate contracts.

31. **View 2**. Supporters of this view argue that the unit of account in IAS 39 is the contract as a whole and only in limited circumstances does IAS 39 allow for a contract to be split into components that are accounted for separately. For example, a hybrid instrument that is within the scope of IAS 39 might contain embedded derivatives that require separation.

32. Proponents of View 2 note that the exceptions in IAS 39 to accounting for contracts in their entirety may apply only after it is determined that the contract as a whole is within the scope of IAS 39. In other words, the unit of account being the entire contract is the same in the scope section of IAS 39 as it is in the other (non-scope) sections of that Standard (unless specific exceptions in these other sections apply that allow or require a contract to be bifurcated into its components).

33. For example, the scope of IAS 39 as stated in paragraph 2 of that Standard is 'all types of financial instruments' and IAS 32 *Financial Instruments: Presentation* defines 'financial instruments' as

> [a]ny **contract** that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. [Emphasis added]

34. In addition, the 'own use' scope exception in paragraphs 5-7 refers to '**contract(s)** to buy or sell a non-financial item'. [Emphasis added]

35. Those who prefer View 2 believe that not to apply the scope paragraphs in IAS 39 to the entire contract would seem to render the criterion in IAS 39.11(c) moot in some instances. That paragraph states that if a contract as a whole is measured at fair value through profit or loss, any derivatives that are embedded in the contract would not have to be accounted for separately. Consequently, if an entity could split a contract into its components and conclude that only some of the components are within the scope of IAS 39, then there would not be a

need to determine (for the purpose of IAS 39.11(c)) whether the contract as a whole is measured at fair value through profit or loss. This is because, by definition, the contract would have already been split into its constituent components before that paragraph would be applied.

36. In rebuttal, supporters of View 2 would refer to IAS 39.9-10 and argue that a (not closely related) derivative that is embedded in an executory contract for delivery of a non-financial item would have to be bifurcated only after it is determined that the executory contract is outside the scope of IAS 39.[3] Consequently, the assessment of whether an instrument in its entirety is within the scope of IAS 39 must be made before the assessment of whether the instrument contains any embedded derivatives that require separation. In most cases, the guidance on embedded derivatives is irrelevant, because if the whole contract is within the scope of IAS 39 it is likely that it will be measured at fair value through profit or loss, because it meets the definition of a derivative.

37. Proponents of View 2 also note that the pricing of the forward component and written option component are inextricably linked in what is one contractual arrangement. The entity that has the flexibility under these contracts to take additional quantities of the commodity typically does not make an up-front payment for that flexibility. Instead, the entity negotiates that the consideration for the flexibility (the option premium) forms part of the price of the forward component. To those who support View 2, this is further evidence that not only the form, but also the economics of these contracts are single arrangements, and that these contracts should therefore be assessed as being within or outside the scope of IAS 39 on that basis.

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[3]IAS 39.10 states in part:

> An embedded derivative is a component of a hybrid (combined) instrument that also includes a **non-derivative** host contact […] [Emphasis added]

IAS 39.9 defines a 'derivative' as:

> A financial instrument or other contract **within the scope** of this Standard (**see paragraphs 2-7**) with all three of the following characteristics: […] [Emphasis added]

38. **View 3.** The purpose of the 'own use' exception in IAS 39.5-7 is to exclude from the scope of IAS 39 some fixed volume contracts for the purchase or sale of non-financial items. The wording in IAS 39.7 is equally clear that standalone written option contracts to buy or sell non-financial items are within the scope of IAS 39 when the underlying commodity in the contract is readily convertible to cash. However, supporters of View 3 believe that the wording in IAS 39.5-7 lacks clarity on what constitutes a written option when a contract combines written optionality and a non-optional component as in the case of Example 1 and Example 2. Given the lack of guidance on this issue in IAS 39, those who hold View 3 believe that both View 1 and View 2 are acceptable accounting policies under IAS 39. These proponents would require consistent application of one of the two views to all similar contracts.

Staff view on the issue

39. **The staff agrees with View 2 for the reasons given by the supporters of that view in paragraphs 31-37.**

40. The staff has some sympathy with the argument put forth by the supporters of View 1 that two entities that have the same contractual rights and obligations and are thus in an economically identical position should recognise the same assets and liabilities, regardless of whether those rights and obligations are in a single contract or in two separate contracts.

41. However, IAS 39 is a form-based standard and thus it matters greatly how a transaction is structured in form. For that reason, the staff agrees with supporters of View 2 that it is **clear** that the unit of account in IAS 39 is the contract *in its entirety* and that only when it is determined that the contract in its entirety does not meet any of the scope exceptions (and thus is in the scope of

the Standard) might it qualify to be split into components, but then only if the contract in its entirety does not qualify to be fair valued through profit or loss.[4]

42. The staff could support View 1, (by invoking IAS 39.10), if the written option component were attached to the forward component so that each of the components could be transferred independently of each other. Paragraph 10 states, in part:

> A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument or has a different counterparty from that instrument, is not an embedded derivative but a separate financial instrument.

43. However, in light of the way these contracts are priced (ie the option premium forms part of the price of the forward) the staff believes that it is unlikely that the components can be separated contractually without the parties to the contract renegotiating the terms of the arrangement.

44. The staff also is concerned that View 1 (and thus also View 3) might have implications beyond those for forward contracts with volumetric optionality. For example, could a forward contract that the counterparty could settle *partially* net in cash be split into a forward on those units that must be gross settled (and that then might qualify for the 'own use' exception in IAS 39.5) and a forward on those units that the counterparty can net-cash settle (and that then would be in the scope of IAS 39)?

45. As an illustration, consider a forward contract with the following terms:

    (a) It requires Entity A to deliver (sell) to Entity B 100 units of a commodity for CU1,000 in one month (assume that the commodity is readily convertible to cash).

    (b) On settlement of the forward, Entity B *must* take delivery of 70 units (and pay the fixed forward price of CU700). As to the other 30 units,

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[4]In support of his assertion that IAS 39 is a contract-based standard, the staff points to the references to some sample paragraphs in IAS 39 in paragraphs 33-34 of this paper. In support of his assertion that a contract can be split into its components only if as a whole it does not qualify to be fair valued through profit or loss, the staff refers to IAS 39.11(c) and also to the analysis in paragraphs 15-16 of this paper.

Entity B can *either* take delivery of the 30 units (and pay the fixed forward price of CU300) or pay or receive in cash the difference between the market price of the 30 units and the CU300 fixed forward price).

46. In this example, should Entity A be able to assess the forward contract as two separate forward contracts: one for 70 units that must be physically settled, and one for 30 units that the counterparty can physically or net-cash settle? If so, the consequence might be that Entity A would account for the forward on only the 30 units as a derivative at fair value through profit or loss (this would be because Entity A does not control whether Entity B will take delivery or not), but that the forward on the 70 units might qualify for the 'own use' exception and thus be outside the scope of IAS 39.

47. The staff suspects that in this instance many would not be comfortable splitting the forward into two components, but rather would agree that the appropriate unit of account is the forward as a whole.

48. The staff notes that View 2 is also consistent with the staff analysis underlying the IFRIC's decision in March 2007 not to add to its agenda a request for guidance on how IAS 39.7 should be applied to energy supply contracts with retail customers. These contracts are very similar to those illustrated in paragraph 7 of this paper, the main difference being that the entity that is required under the supply contract to take delivery of the energy is a retail customer that (by its nature and also by the nature of the commodity) does not have the ability to readily convert the energy to cash.

49. Agenda Paper 7 discussed at the IFRIC meeting in December 2006 states in part:

> Staff analysis showed that [energy supply contracts to retail customers in their entirety] would meet the definition of a written option for the purposes of paragraph 7 of IAS 39, because the delivery or non-delivery of the non-financial item (such as energy) was dependent on the actions of the customer (whether to switch the light bulb on or not) and the writer of the option could not control whether such delivery has occurred.

> However, as such contracts are for the delivery of non-financial items, they would only be accounted for under IAS 39 if they met the net settlement criteria in that standard (set out in paragraph 5). Such contracts would only meet the net settlement criteria if the underlying non-financial item were considered to be readily convertible to cash. When considered in a contract specific context, the energy supplied to the retail customer is not readily convertible to cash, and (based upon such an interpretation) the contract does not meet the net settlement criteria.
>
> […]
>
> This additional analysis means energy supply contracts to retail customers are not accounted for under IAS 39 because they do not meet the net settlement criteria in the standard. Therefore the fact that they would meet the definition of a written option is irrelevant.

50. Because the staff sides with View 2 and not View 1, it cannot logically support View 3. In addition, the staff believes that giving entities an accounting policy choice in interpreting standards is suboptimal, in particular in this case, in which the impact on the financial statements could be dramatic. Think of two entities in the same industry that have many of these forward contracts with volumetric optionality, and where one entity accounts for the contracts in their entirety as a derivative while the other entity accounts for only the written option component as a derivative. The balance sheet and income statement for these two entities would look quite different and arguably would be difficult for users to understand and compare easily.

Assessment of the agenda criteria

51. Paragraph 24 of the IFRIC *Due Process Handbook* lists the following criteria that the IFRIC uses to assess whether it should add an item to its agenda.

    (a) The issue is widespread and has practical relevance.

    (b) The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The IFRIC will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.

(c) Financial reporting would be improved through elimination of the diverse reporting methods.

(d) The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process. The issue should be sufficiently narrow in scope to be capable of interpretation, but not so narrow that it is not cost-effective for the IFRIC and its constituents to undertake the due process associated with an Interpretation.

(e) It is probable that the IFRIC will be able to reach a consensus on the issue on a timely basis.

(f) If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC requires to complete its due process.

52. It is worth highlighting that according to the *Handbook* an item does not have to satisfy all criteria to qualify to be added to the agenda.

53. The staff's analysis of whether the agenda submission meets the criteria in paragraph 24 of the *Handbook* is laid out in the following paragraphs.

54. **Criterion (a): The issue is widespread and has practical relevance.** This criterion is met. Contracts to buy and sell non-financial items that contain volumetric optionality and for which the non-financial item is readily convertible into cash are very common in some industries (eg energy).

55. **Criterion (b): The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The IFRIC will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.** This criterion is *not* met. The staff believes that IAS 39 is clear on the appropriate unit of account when assessing whether a contract is within the scope of that Standard or not.

56. The staff acknowledges that (as asserted in the submission) different views on this issue have been adopted in practice. Nevertheless, the staff believes that a reading of IAS 39 (in particular of paragraphs 2, 5-7, and 9-11) and also of IAS 39 IG A.2 do not support any other view but View 2.

57. **Criteria (c): Financial reporting would be improved through elimination of the diverse reporting methods**. This criterion is met. Two entities that have identical contractual rights and obligations, and thus are in an identical position economically, could account for those rights and obligations differently because they have applied IAS 39.5-7 differently.

58. **Criterion (d): The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process. The issue should be sufficiently narrow in scope to be capable of interpretation, but not so narrow that it is not cost-effective for the IFRIC and its constituents to undertake the due process associated with an interpretation**. This criterion is met. One might say that the IASB *Framework* has yet to address unit of account and thus in light of the lack of guidance in the Framework, the issue in this submission cannot be resolved at the standard-setting level. However, the staff disagrees with this view. IAS 39 already provides guidance on units of account that must be applied to the contracts that are the subject of the submission.

59. In the staff's opinion, the question is whether, for the purpose of determining if a contract is in the scope of IAS 39, one can apply a unit of account that is different than that for the contract as a whole. This is because if it is determined that a contract is within the scope of IAS 39, it is clear that the unit of account is the contract as a whole and that only in limited cases can the entire contract be separated into components. Some of those cases are addressed in IAS 39.10-11:

    (a) A component might be embedded in a contract but legally can be transferred independently of the contract. In this case the component is considered a separate instrument.

    (b) A component might be embedded in a contract but legally cannot be transferred independently of the contract. Nonetheless, the component might be required to be treated as if it were a separate contract.

60. Having framed the issue on that basis, the staff believes that it is narrow enough in scope to be resolved efficiently and to be capable of interpretation.

61. **Criterion (e): It is probable that the IFRIC will be able to reach a consensus on the issue on a timely basis**. This criterion is met. Because the issue in the agenda submission is quite narrow, the staff believes that the IFRIC could reach a consensus on a timely basis.

62. **Criterion (f): If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB activities. The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period that the IFRIC requires to complete its due process.** This criterion is met. The IASB currently has a project on its agenda to replace IAS 39. The Board has split the project into three phases of which none encompass the scope of IAS 39 (the phases are: classification and measurement, impairment methodology, and hedge accounting). While the Board could decide to consider the scope of IAS 39 as part of a later phase of the IAS 39 replacement project, the staff does not expect the Board will make that decision soon.[5]

63. If the Board were to decide to modify the scope of the IAS 39, the staff believes that by the time the Board had made that decision, and by the time the modified scope had been incorporated into a final standard, the IFRIC would have long since completed its due process for this issue (assuming that it decides to bring the issue onto its agenda at this meeting).

64. In summary, criteria (a) and (c)-(f) are met. However, criterion (b) is not met. That criterion clearly states '*the IFRIC will not add an item to its agenda if IFRSs are clear*'.

65. We grant that if IFRSs are clear, one would not expect diversity in practice to develop. However, for the issue in the submission, diversity in practice has

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[5]Paragraph BC7 of Exposure Draft ED/2009/7 *Financial Instruments: Classification and Measurement*, issued in July 2009, states:

> The Board has not yet reconsidered the scope of IAS 39. The scope of IAS 39 and its interaction with other standards have resulted in some application and interpretation issues. However, the Board believes that the issue of scope should be addressed comprehensively rather than only in the context of classification and measurement. Moreover, the scope of IAS 39 has not been raised as a matter of concern during the financial crisis and, hence, the Board believes that the scope of IAS 39 should be considered during a later phase to replace IAS 39.

developed. That said, the staff believes that the IFRIC should consider 'diversity in practice' in its assessment of whether or not to take on an issue onto the agenda *only* if the analysis of the issue on the basis of *technical* merits supports more than one 'acceptable' interpretation of the IFRS.

66. For this submission, this is not the case. The submission provides two arguments for View 1. One argument is that the parties could have executed the contract as two separate contracts. They certainly could have done so, but the fact of the matter is they did not. In addition, this is not an argument that references any of the paragraphs in IAS 39 or any application guidance of that Standard.

67. The other argument concedes that the contract as a whole is not in the scope of IAS 39 but points out that if it were within the scope of that Standard, the written option component would qualify to be separated from the forward host contract. As noted in paragraph 16 and also paragraph 36, this reasoning is flawed because the contract in its entirety would qualify to be accounted for as a derivative at fair value through profit or loss and hence it would not be appropriate to separate the 'embedded' written option component.

68. Consequently, the staff believes that the arguments put forth for View 1 (and by extension for View 3) are not convincing.

Staff recommendation

69. The staff recommends that the IFRIC not take the issue of this submission onto its agenda.

70. For the IFRIC's consideration, the staff has proposed wording for a tentative agenda decision in Appendix A to this paper.

Question
Does the IFRIC agree with the staff recommendation in paragraph 69? If not, why not and what approach would the IFRIC like to follow?

[Appendix A has been omitted from this observer note]

Appendix B — IFRIC agenda submission

Suggested agenda item: splitting a contract to buy or sell a non-financial item that can be net settled in cash or another financial instrument or by exchanging financial instruments into a written option and non-optional component for the purposes of applying IAS 39.7

It has come to our attention that there are differences of opinion in the application of IAS 39.7 in determining whether a part (instead of all) of a contractual arrangement is considered a written option.

The issue

The issue is whether a contract can be split into two when applying IAS 39.7. Specifically, whether a contract that contains written optionality with respect to volume can be split into a written option component and a non-optional component (forward contract). IAS 39.7 states:

> *"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, in accordance with paragraph 6(a) or (d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements."*

The relevant sections of IAS 39.6 are:

> *"6. There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:*
>
> *(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;*
>
> *(…)*

> (d) *when the non-financial item that is the subject of the contract is readily convertible to cash."*

Examples

The issue is best illustrated by considering a number of examples:

Examples: volumetric optionality subject to a minimum (non deminimus) quantity to be delivered

Example 1

Entity A enters into a natural gas sale contract with Entity B that allows Entity B to buy up to 100 units of natural gas per day for a specific period at a fixed price subject to a minimum amount equal to 70 units per day. Entity B has volumetric flexibility over 30 units at a fixed price in addition to the minimum 70 units it must buy. The entire arrangement (both in respect of the minimum quantity and volumetric optionality) is executed as one contract. From the perspective of Entity A, economically, the contract can be viewed as containing an obligation to sell fixed volumes (70) at fixed forward prices over a specified period plus a written option to sell additional volumes (30) at the same price in the same period structured as a single contract.

Example 2

Entity C enters into a contract under which it will deliver a set quantity of a gas to Entity D for a fixed price over a specified period. The contract also contains a provision giving Entity D the right but not the obligation to extend the term of that contract by requiring the delivery of additional specified quantities of gas over an additional period at the same pre-set price. The entire arrangement is contained within one contract. From the perspective of Entity C, the arrangement is, economically, an obligation to sell fixed volumes at fixed forward prices over a specified period plus a written option to Entity D to sell additional volumes at pre existing fixed forward prices over an additional pre-specified period structured as a single contract.

For Examples 1 and 2, assume:

- gas is a non-financial item that is readily convertible to cash (IAS 39.7(d));
- Entities A, B, C or D are not retail customers. Therefore, reflecting the March 2007

IFRIC rejection notice *Written Options in Retail Energy Contracts* that the contracts are capable of net settlement as laid out in IAS 39.6, and

- Entity A and C consider the arrangements to be entered into for the purpose of delivery in accordance with its expected sales requirement.

Question

Is the entirety of contracts such as in the above Examples within the scope of IAS 39 due to the inclusion of a written option over non-financial items that can be settled in cash or another financial instrument or by exchanging financial instruments in accordance with 6(a) to (d)?

Alternative views

Three alternative views are identified below which we understand are applied in practice.

View 1

No.

The contracts in the above examples contain two features that need to be analysed separately.

Using Example 1 to illustrate. The arrangement contains two features from the point of view of Entity A:

(1) a forward contract to supply 70 units of natural gas that is outside the scope of IAS 39 as although the contract is capable of net settlement it is entered into and continues to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the Entity A's expected sale requirements (IAS 39.5), and

(2) a written option over the supply of a further 30 units of natural gas that is within the scope of IAS 39 as a written option to sell a non-financial item that can be settled net which cannot be entered into for the purposes of delivery in accordance with the entity's expected sale requirements (IAS 39.7).

Proponents of View 1 argue that this is consistent with the treatment which would apply had Entity A entered into two contractually separate arrangements equivalent to feature (1) and feature (2). Another argument advanced by supporters of this view is that in splitting what

is one contractual arrangement into two features for accounting purposes it is appropriate to analogise to the guidance in IAS 39 regarding separation of non-closely related embedded derivatives from host contracts (IAS 39.11). Under this argument the forward contract feature is seen as akin to an executory host contract outside the scope of IAS 39 with the written option feature embedded in that host contract. As the written option has one sided risk its risks and economic characteristics are not closely related to the host contract and thus it needs to be separated out and accounted for within the scope of IAS 39 as a derivative.

View 2

Yes.

The feature in the above Examples cannot be analysed separately.

IAS 39 is a contractual based standard. If it is concluded that a contract such as those outlined in the Examples above contain an other than de minimus written option feature then the whole contract must be treated as a written option.

Using Example 1 to illustrate. Example 1 should be considered a single contract of over 100 units. It is not permitted to split the arrangement into (1) a forward contract over 70 units classified as a normal usage requirements contract outside the scope of IAS 39, and (2) a written option over 30 units in the scope of IAS 39. Instead the whole contract is a written option to sell a non-financial item (gas) that can be net settled and is therefore within the scope of IAS 39.

Whilst supporters of this view acknowledge that the accounting result would be different had the two features been entered into as two separate contracts they believe this outcome is consistent with the fact that IAS 39 is a contractually based standard and the contract is either in IAS 39 or it is not. Proponents of this view also do not believe that the analogy to the embedded derivative guidance in IAS 39 is appropriate. An executory contract for delivery of a non-financial item may have an embedded derivative requiring separation only after it is determined that the executory contract is outside the scope of the IAS 39, i.e. the determination of whether the instrument is in the scope of IAS 39 is needed before assessing whether embedded derivatives need to be separated. In most cases the embedded derivative guidance is irrelevant as proponents of View 2 note that if the whole contract is in the scope of IAS 39 it will likely be measured as at fair value through profit or loss as it meets the definition of a derivative.

In addition, proponents of this view note that the pricing of the economic forward contract element and written option element are inextricably linked in what is one contractual arrangement. As the price paid for the non-financial item under the 'forward contract' or 'written option' is the same the option premium forms part of the price of the non-optional component. This is further evidence that the form as well as the economics of the contract are a single arrangement and should be assessed as being in or outside the scope of IAS 39 on that basis.

View 3

Depends on accounting policy choice selected.

The purpose of the own use exception in IAS 39.5-7 is to scope out of IAS 39 certain fixed volume contracts for the purchase or sale of non-financial contracts. The wording in IAS 39.7 is equally clear that a standalone written option contracts to buy or sell non financial items are within the scope of IAS 39 when the underlying in the contract is readily convertible to cash. However, the wording in IAS 39.5-7 lacks clarity on what constitutes a written option when a contract combines written optionality and a non-optional component as outlined in the above Examples. Given the lack of guidance on this issue in IAS 39 proponents of View 3 believe that both View 1 and View 2 are acceptable accounting policies under IAS 39. Supporters of this view would require consistent application of one of the two views to all similar contracts.

Reasons for IFRIC to Address the Issue

Preparers, auditors and users of financial statements would benefit if IFRIC provided timely guidance on this issue. As described elsewhere in this agenda submission, significantly diverging interpretations already exist in practice and the difference in accounting treatment is significant. Moreover, the issue has widespread application as volumetric optionality over non-financial items that are readily convertible into cash is common in contractual arrangements such as supply contracts. We also note that there is no ongoing project to provide the necessary clarification as the IASB's project to replace IAS 39 does not extend to the scope of IAS 39 and therefore the paragraphs in question will be unchanged on completion of that project.