IFRS

IASB Meeting Agenda reference **18A**

Staff Paper Date **Week beginning 18 October 2010**

Project	**Financial Instruments: Replacement of IAS 39**
Topic	**Hedge accounting and the 'own use' scope exception—the issues**

Introduction

Background

1. During the course of our outreach activities on hedge accounting, we learnt how commodity processors and some types of commodity broker-traders use derivatives to hedge their net commodity price exposure and what the accounting implications are. We learnt that the accounting for commodity contracts under IFRSs can create an accounting mismatch, may not be in line with how these entities manage risk and may not provide useful information to users of financial statements.

2. This issue has also been highlighted over a number of years by such companies to the Board, and has also (indirectly) been the subject of a number of discussions at the IFRS Interpretations Committee (formerly known as the IFRIC).

Purpose

3. The purpose of this paper is to provide to the Board:

   (a) a description of how certain types of commodity broker-traders and processors manage commodity risk; and

   (b) an analysis of the accounting implications.

4. This paper does not ask the Board for a decision. Agenda paper 18B contains:

(a) the alternatives for how the Board could proceed;

(b) the staff recommendation; and

(c) the question to the Board.

Contracts to buy or sell commodities

5. The following section describes how commodity processors and *service providing* commodity broker-traders use derivatives to manage their net commodity price exposure as a result of entering into contracts to buy or sell non-financial items. This section also describes the activities of *market making* commodity broker-traders and how their business model differs from those of the commodity processors and service providing broker-traders.

Commodity processors

6. Commodity processors typically purchase the commodities and perform some form of transforming process over the commodities (eg crushing, refining etc). In many instances, the 'finished' products have robust, liquid markets themselves (eg sugar, canola oil etc) or are priced based on a commodity benchmark plus some form of processing margin. Commodity processors would typically hedge their exposures to commodity prices as their business model is to profit from a processing margin.

> Example A
>
> At t0 a soybean crusher enters into a contract to purchase 100 million bushels of soybeans at $10.00 with delivery in t1. The crushed soybeans would be sold in t3 at the spot price + 0.5% processing margin. To protect itself from the price changes of soybeans, the soybean crusher would at t0 lock in a price by selling 100 million bushels of exchange-traded soybeans futures contracts to be settled in t3.

7. These entities typically manage sale or purchase contracts, commodity inventories and derivatives on a fair value basis. Derivatives are used to hedge

any commodity risk net position to ensure that that the risk position is as close to zero as possible.

Service providing commodity broker-traders

8. These commodity broker-traders typically engage in facilitating the procurement process between entities that use the commodity as a source of input in their production process and suppliers of the commodity. Like the commodity processors, they profit from a form of stable margin[1] for providing services (eg transportation, storage, sourcing suppliers/buyers etc). They typically hedge their exposure to the changes of the commodity price that results from entering into contracts to buy or sell commodities.

> Example B
>
> An iron ore broker-trader enters into a sales contract to sell 50,000 tonnes of iron ore to a steel mill in t9 for USD 140 per tonne. To hedge its exposure to the fair value changes of iron ore, the iron ore broker-trader enters into offsetting futures contracts to buy 50,000 tonnes of iron ore at a fixed price in t9. At t3, the broker negotiated with a miner who would supply 50,000 tonnes of iron ore in t6 for USD 120 per tonne. The iron broker-trader would typically close out the futures contracts at t3 (because it is no longer exposed to the fair value changes of iron ore prices as it has secured a buyer and a seller both at fixed prices).

9. Like in the case of the commodity processors, the commodity inventories, the sale or purchase contracts and the derivatives are also all managed on a fair value basis. As the composition of the risk position changes, these entities typically also adjust one or more offsetting components in order to maintain a net commodity risk position that is as close to zero as possible.

[1] The objective of these service providing commodity broker-traders is to maintain their margin as stable as possible. The margin maybe affected by fuel prices, freight rates, etc. If changes in such factors result in margin volatility they may hedge these risks separately.

Entities that are both a processor and a service providing commodity broker-trader

10. Some entities operate as a commodity processor as well as a service providing broker-trader. These entities typically manage their fair value exposure to changes in commodity prices on a net basis even though the two business units may operate independently from each other. Generally, these entities analyse and monitor their net commodity risk position on an entity wide basis and also aim to maintain a net commodity risk position of zero.

Market making commodity broker-traders

11. Market making commodity broker-traders differ from processors and service providing broker-traders in that they typically take a view on the direction of the price movement of the commodity price and seek to profit from the fluctuations in commodity prices. Although this type of broker-trader may take physical delivery under the purchase contracts, it would typically seek to sell any physical stock in a short period with a view of generating profit from short term price fluctuations or dealer's margin (ie the bid/ask spread).

> Example C
>
> A copper broker-trader takes the view that copper prices will likely be higher than USD 3.60 per tonne within a short period. It buys 25,000 tonnes of copper now (ie t0) at USD 3.60 per tonne and enters into a sales contract to sell 25,000 tonnes of copper within a short period at the spot price. It seeks to profit from the potential upward price movement of copper and hence (unlike a service providing commodity broker-trader) does not take out a derivative to hedge its exposure to the fair value changes of copper prices.

Staff analysis of the issue

12. This section provides an analysis of the accounting for contracts to buy or sell commodities under IAS 39 *Financial Instruments: Recognition and Measurement* and the implications. The accounting under US GAAP is also set out for the Board's reference.

13. IAS 39 applies to contracts to buy or sell a non-financial item that can be net cash settled[2]. (This type of settlement referred to as 'net settled' in the remainder of this paper.) Many commodity contracts may meet the net settlement criteria because in many instances commodities are readily convertible to cash.[3]

14. Hence, it is not uncommon for a commodity contract to be within the scope of IAS 39 and meet the definition of a derivative[4] **unless it meets the scope exception.**

15. **The scope exception** to IAS 39 is that contracts for a non-financial item that can be settled net are **not** within the scope of IAS 39 if they 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 or usage requirements[5] (ie the 'own use' scope exception).

Market making commodity broker-traders

16. For market making broker-traders, the commodity contracts do not qualify for the 'own use' exception in IAS 39[6] and hence they are accounted for as derivatives. For the market making broker-traders their business is to profit from the fluctuations in the commodity price or dealer's margin. Hence, the economic risk exposure is appropriately reflected under IFRSs in accordance with the business model by accounting for the executory contracts as derivatives with fair value changes recognised in profit or loss.

---

[2] IAS 39.5

[3] IAS 39.6 provides that there are many ways in which a contract can be considered as settled net including when the non-financial item that is subject of the contract is readily convertible to cash (IAS 39.6(d)). IAS 39 does not define what readily convertible to cash means. However, in practice, most entities rely on the US GAAP definition of readily convertible to cash which states a non-financial item would be considered readily convertible to cash if it consists of largely fungible units and quoted spot prices are available in an active market that can absorb the quantity held by the entity without significantly affecting the price. A lot of commodities meet this definition.

[4] The definition of a derivative is met because the fair value of the contract changes in respect to commodity price, it requires no initial net investment and it is settled at a future date (IAS 39.9).

[5] IAS 39.5.

[6] IAS 39.6(c).

Commodity processors and service providing broker-traders

17. For commodity processors and service providing broker-traders, the commodity contracts are entered into in accordance with the entity's expected purchase sale or usage requirements (commodity *supply* contracts). Hence they fall under for the 'own use' exception (assuming the entity does not have a practice of net settlement) and are not recognised under IAS 39.

18. The feedback from our outreach activities is that for commodity processors and service providing broker-dealers the 'own use' exception in IAS 39 today creates an accounting mismatch as the profit or loss volatility from the derivative[7] is not offset by the fair value changes from the commodity supply contracts. (See examples A and B in which the contracts for the commodities are not recognised, while the futures contracts are accounted for at fair value through profit or loss.)

Fair value hedge accounting

19. To eliminate the accounting mismatch, commodity processors and service providing broker-traders could apply hedge accounting and designate the commodity supply contracts which meet the definition of firm commitments as hedged items in a fair value hedge relationship. The commodity supply contracts would be measured at fair value and the changes would offset the changes in fair value of the derivative instruments (to the extent that they are effective).

20. Feedback from the outreach activities indicate that hedge accounting in these circumstances is administratively burdensome and often produces a less meaningful result than fair value accounting.

21. It is not uncommon for commodity processors and service providing broker-traders to enter into large volumes of commodity contracts[8] and within the large

---

[7] The derivative is used to hedge the risk exposure that arises as a result of entering into commodity supply contracts (or long positions of commodity inventory).

[8] Their business model is to profit from the processing/service margin and hence the greater number of contracts entered into the more profit they can generate.

volume of contracts some positions may offset each other. Hence these types of entities typically hedge on a net basis (see paragraphs 7, 9 and 10). The net position is typically monitored, rebalanced and managed in many instances on a daily basis.

22. Due to the frequent movement of the net position and hence the frequent adjustment of the net position to zero, entities would have to frequently designate, dedesignate and redesignate the fair value hedge relationship if the entities were to apply hedge accounting.

23. The staff also note that only some (the extent of the net open position) but not all of the executory contracts would be measured at fair value under fair value hedge accounting. In contrast, many of these commodity processors and service providing broker-traders manage all commodity contracts on a fair value basis (see paragraphs 7, 9 and 10).

24. Hence IAS 39 today does not appropriately reflect the risk management strategy for these types of entities where the net exposure to commodity risk is managed on a fair value basis.

US GAAP

25. Under US GAAP, the 'own use' scope exception is an *election*. Hence, in effect, entities can elect to account for commodity contracts as derivatives[9]. The hedging derivatives and all of the executory contracts can be recorded at fair value. Hedge accounting is no longer required because there is no accounting mismatch.

26. Feedback from outreach activities indicate that applying fair value accounting to commodity supply contracts provides an accurate reflection of the risk management strategy of these entities. This election is further analysed in agenda paper 18B.

[9] ASC 815-10-15-39

27. As explained in paragraph 4, the alternatives for how the Board could proceed, the staff recommendation and question to the Board are included in paper 18B.