Project: **Financial Instruments: Replacement of IAS 39**

Topic: **Hedge accounting and the 'own use' scope exception—the alternatives**

Introduction

Background and purpose

1. Agenda paper 18A sets out how the accounting for contracts to buy or sell non-financial items in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* today may not reflect the risk management strategy, and may not provide useful information to users of financial statements.

2. Paper 18A describes this for some commodity processors and service providing broker-traders who use derivatives to hedge their commodity price net exposure that arises as a result of entering into contracts to buy or sell commodities as well as long positions in physical commodity inventory.

3. The purpose of this paper is to:

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

    (b) provide the Board with a staff recommendation; and

    (c) ask the Board for a decision.

Alternatives

4. This section of the paper sets out the alternatives for how the Board could proceed with accounting for contracts to buy or sell non-financial items that meet the 'own use' exception.

5. The staff think the Board has at least the following alternatives:

   (a) **alternative 1:** retain the current requirement in IAS 39;

   (b) **alternative 2:** make the ‘own use’ scope exception elective (similar to US GAAP); or

   (c) **alternative 3:** apply derivative accounting to contracts that meet the ‘own use’ exception UUUif that is in accordance with the entity’s fair value-based risk management strategy. Under a fair value-based management strategy, the *entire* business is managed on a fair value basis and the net exposure is as close to zero as possible (see paragraphs 5 to 10 of paper 18A).

6. The following table provides a summary of the 3 different alternatives:

TABLE I: Summary of alternatives for contracts that meet the 'own use' exception *at inception*

	Alt 1: IAS 39	**Alt 2: similar to US GAAP**	**Alt 3: Risk management test**
Inception	Apply 'own use' scope exception (purpose based)	Apply 'own use' scope exception or derivative accounting (optional)	Apply 'own use' scope exception or derivative accounting (based on the business wide fair value-based risk management strategy)
Subsequent change of accounting			
'Own use' scope exception → derivative accounting	Mandatory if similar contracts are settled net	Prohibited	Mandatory if contracts are settled net
'Derivative accounting → 'own use' scope exception	Prohibited	Optional	Mandatory if circumstances change

Staff analysis

Alternative 1: retain the current requirement in IAS 39

7. Alternative 1 is to retain current requirement in IAS 39 for contracts to buy or sell non-financial items that meet the 'own use' exception[1] .

8. The 'own use' exception is based on the *purpose* for which the contracts are entered into and continue to be held from the entity's perspective. This perspective is on a 'deemed basis' though because paragraph 6 of IAS 39 provides guidance on various facts and circumstances that determine whether the contracts are entered into for the purpose of 'own use'. For example, a practice of net settlement provides a non rebuttable presumption that the business purpose for which the contract is entered into is not for the purpose of 'own use'[2].

9. In determining the treatment of contracts to buy or sell non-financial items, alternative 1 (and IAS 39) does not fully consider how these contracts are managed. Alternative 1 considers the *purpose* for which the contract is entered into. The actual type of settlement (ie net cash versus delivery of underlying) is conclusive of the *purpose* and the accounting treatment under this alternative.

10. Paragraphs 17 to 24 of agenda paper 18A discuss the implications of alternative 1 for commodity processors and service providing broker-traders.

Alternative 2: option to elect the 'own use' scope exception

11. Alternative 2 is to provide entities with an option to elect the 'own use' scope exception or derivative accounting at inception or at a later date. Once the entity

[1] IAS 39 provides that contracts for non-financial item that can be settled net in cash 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 (ie the 'own use' exception).
[2] IAS 39.6(b).

has elected to apply the scope exception it cannot change its election and switch to derivative accounting.

12. Alternative 2 allows commodity processors and service providing broker-traders to apply fair value accounting to commodity contracts, which would provide an accurate reflection of how commodity risks are managed by these entities.

13. Alternative 2 is in line with US GAAP but has many differences with IAS 39. The accounting treatment under IAS 39 today is dependent on the purpose (whether it is for 'own use' or otherwise) for which the contracts to buy or sell non-financial items are entered into (and continue to be held for) (see paragraphs 7 to 9). Under alternative 2, the treatment of these contracts is in effect a choice in all cases[3]

14. Alternative 2 and IAS 39 also differ in their requirement for subsequent changes to accounting (see table I).

15. Under IAS 39, if similar contracts have been net settled, the contract must be accounted for as a derivative (see paragraph 8). Under alternative 2 however, even though other similar contracts have been net settled, the contract must be continued to be accounted for as an executory contract (ie off-balance sheet) and not as a derivative.

16. Alternative 2 allows entities by election to subsequently apply the scope exception to a contract that has been previously accounted for as a derivative. Under IAS 39, once a contract is accounted for as a derivative, the scope exception cannot be subsequently applied.

Alternative 3: apply derivative accounting for contracts that meet the 'own use' exception if it is in accordance with the entity's fair value-based risk management strategy

17. Alternative 3 is to apply derivative accounting to contracts that meet the 'own use' exception if it is in accordance with the entity's underlying business model

[3] ASC 815-10-15-39

and how the contracts are managed. This means applying derivative accounting would result in more relevant information because a group of contracts is managed on a fair value basis (and this would at the same time eliminate an accounting mismatch because all items of a net position that is managed on a fair value basis are measured consistently).

18. Under alternative 3, commodity processors and service providing broker-traders would apply fair value accounting to commodity contracts, providing an accurate reflection of how commodity risks are managed by these entities. The underlying business model for these entities is to manage their exposure to commodity prices using a fair value-based risk management strategy for their entire business so that the net open position is as close to zero as possible (see paragraphs 5 to 10 of paper 18A).

19. Alternative 1 (IAS 39) solely considers the *purpose* for which the contract is entered into and the actual type of settlement is conclusive of the *purpose* and the accounting treatment (see paragraphs 8 and 9).

20. Alternative 3 considers how the contract is managed in the context of the entity's overall operations (which includes other items such as derivatives and inventory as well as the contracts to buy or sell non-financial items). Hence the actual type of settlement is not conclusive (where as it is under alternative 1) for the evaluation of the appropriate accounting treatment. Alternative 3 extends the approach in IAS 39 to looking not only at the *purpose* (based solely on the actual type of settlement) but also how the contracts are being managed.

21. Under alternative 3, if the entity's underlying business model changes (as a result of a business combination for example) and the entity is no longer managing these commodity contracts on a fair value basis, the contracts would fall back into the 'own use' exception (similar to IFRS 9 the subsequent change in accounting applies to all affected contracts and is not a contract-by-contract evaluation).

22. During our outreach, some constituents noted that the rationale and criteria for alternative 3 are similar to those of the fair value option for financial

instruments, ie eliminating an accounting mismatch or if the financial instruments are managed on a fair value basis[4].

23. Alternative 3 combines the purpose for which the contracts to buy or sell non-financial items are entered into and continue to be held for (ie IAS 39 today) and also how they are being managed. This better reflects the contracts' effect on the entity's financial position and performance, and more useful information (based on outreach with investors).

Staff recommendation

24. In the staff's view, alternative 1 (IAS 39 today) creates an accounting mismatch for commodity processors and service providing broker-traders and cannot portray how these entities manage commodity risk s (see paragraphs 17 and 18 of agenda paper 18A). The staff note that applying hedge accounting in these situations is operationally burdensome and produces a less meaningful result that may not fully reflect how commodity risk is managed (see paragraphs 19 to 24 of agenda paper 18A). The staff also note that the hedge accounting framework in IFRSs may not always accommodate how entities manage risk (for example when entities manage risk on a dynamic open book net basis[5]). Hence, for the above reasons, the staff do not recommend alternative 1.

25. Alternative 2 can provide an accurate reflection of how commodity risks are managed by these entities. However, alternative 2 is a significant departure from the current IAS 39 scope exception (see paragraphs 13 to 16 and Table I). The staff note that adopting alternative 2 would significantly affect the scope of IAS 39, which is not part of the hedge accounting phase of the project to replace IAS 39. The staff note that this phase of the project is about hedge accounting and should addresses hedge accounting related issues (such as surrogates).

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[4] IAS 39.9.

[5] This can also be observed in the Board's discussion on net positions.

26. The staff also note that a mere documentation-based choice does not ensure alignment with an entity's underlying business model, which is arbitrary. Also, the fact that ending executory contract accounting is prohibited even if an entity starts trading in contracts previously documented as 'own use' undermines the usefulness of the information compared to both other alternatives (see Table I). Hence the staff do not recommend the Board adopts alternative 2.

27. Alternative 3 extends the purpose test (regarding the actual type of settlement) that is currently in IAS 39 today to also take into account the ways in which the contracts that meet the 'own use' scope exception are managed.

28. Alternative 3 alleviates the operational burden in complying with the hedge accounting requirements (see paragraphs 19 to 24 of agenda paper 18A) and at the same time it provides an accurate reflection of how commodity risks are managed by these entities. Hedge accounting does not provide an appropriate reflection of the risk management strategy for entities where all items (both financial and non-financial) are managed on a fair value basis. The staff believes that, based on outreach with investors, that Alternative 3 will provide more useful information than either of the other two alternatives.

29. Alternative 3 is also consistent with the notion of the business model in IFRS 9 *Financial Instruments* and also the rationale and criteria for designating financial instruments at fair value through profit or loss.

30. For the reasons in paragraphs 27 and 28 above, the staff recommend alternative 3. That is, to apply derivative accounting to contracts that meet the 'own use' scope exception if it is in accordance with the entity's fair value-based risk management strategy.

Question– Contracts that meet the 'own use' scope exception
Does the Board agree with the staff recommendation as set out in paragraph 30 above? If the Board does not agree, which alternative does the Board prefer and why?