



# STAFF PAPER

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## IFRS® Interpretations Committee meeting

Project	Physical settlement of contracts to buy or sell a non-financial item (IFRS 9)		
Paper topic	Agenda decision to finalise		
CONTACT	Gustavo Olinda Elizabeth Figgie	<a href="mailto:golinda@ifrs.org">golinda@ifrs.org</a> <a href="mailto:efiggle@ifrs.org">efiggle@ifrs.org</a>	+44 (0) 20 7246 6481 +44 (0) 20 7246 6410

This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee (Committee) and does not represent the views of the International Accounting Standards Board (Board), the Committee or any individual member of the Board or the Committee. Comments on the application of IFRS Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Decisions by the Board are made in public and reported in IASB® *Update*. Decisions by the Committee are made in public and reported in IFRIC® *Update*.

## Introduction

- At its November 2018 meeting, the IFRS Interpretations Committee (Committee) discussed a submission about how an entity applies IFRS 9 *Financial Instruments* to particular contracts to buy or sell a non-financial item in the future at a fixed price. The submission describes two fact patterns in which an entity accounts for such contracts as derivatives at fair value through profit or loss (FVPL) but nonetheless physically settles the contracts by either delivering or taking delivery of the underlying non-financial item.
- IFRS 9 must be applied to contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if those contracts were financial instruments, with one exception. That exception applies to contracts that were entered into and continue to be held for the purpose of the receipt or

delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements ('own use scope exception' in paragraph 2.4 of IFRS 9)<sup>1</sup>.

3. In the fact patterns described in the submission, the entity concludes that the contracts are within the scope of IFRS 9 because they do not meet the own use scope exception. Consequently, the entity accounts for the contracts as derivatives measured at FVPL. The entity does not designate the contracts as part of a hedging relationship for accounting purposes.
4. At the settlement date, the entity physically settles the contracts by either delivering or taking delivery of the non-financial item. In accounting for that settlement, the entity records the cash paid (in the case of the purchase contract) or received (in the case of the sale contract). In addition, the entity:
  - (a) recognises inventory for the non-financial item at the amount of the cash paid plus the fair value of the derivative on the settlement date (in the case of the purchase contract); or
  - (b) recognises revenue for the sale of the non-financial item at the amount of the cash received plus the fair value of the derivative on the settlement date (in the case of the sale contract). The submission assumed the entity has an accounting policy of recognising revenue on a gross basis for such contracts.

This accounting results in the entity recognising inventory or revenue at the market price of the non-financial item on the settlement date.

5. The submitter asks whether, in accounting for the physical settlement of these contracts, the entity is permitted or required to make an additional journal entry that would:
  - (a) reverse the accumulated gain or loss previously recognised in profit or loss on the derivative (even though the fair value of the derivative is unchanged); and

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<sup>1</sup> An entity also considers the additional requirements in paragraphs 2.6 and 2.7 of IFRS 9 in determining whether a contract to buy or sell a non-financial item is within the scope of IFRS 9.

- (b) recognise a corresponding adjustment to either revenue (in the case of the sale contract) or inventory (in the case of the purchase contract).

The additional journal entry would result in the entity recognising inventory or revenue at the cash paid or received on settlement.

6. For ease of reference, Appendix A to this paper describes the two fact patterns and the accompanying journal entries that were included in the submission.
7. In November 2018 the Committee published a tentative agenda decision. In that tentative agenda decision, the Committee observed that the additional journal entry described in the submission would effectively negate the requirement in IFRS 9 to account for the contract as a derivative because it would reverse the accumulated fair value gain or loss on the derivative without any basis to do so. The Committee concluded that IFRS 9 neither permits nor requires an entity to make the additional journal entry. The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to conclude on whether it is permitted or required to make the additional entry described in the submission. Consequently, the Committee tentatively decided not to add the matter to its standard-setting agenda.
8. The objective of this paper is to:
  - (a) analyse the comments on the tentative agenda decision; and
  - (b) ask the Committee whether it agrees with our recommendation to finalise the agenda decision.

## **Structure of the paper**

9. This paper is structured as follows:
  - (a) Comment letter summary;
  - (b) Staff analysis of main comments; and
  - (c) Staff recommendation.

10. There are three appendices to this paper:
  - (a) Appendix A—Fact patterns and journal entries described in the submission;
  - (b) Appendix B—Proposed wording of the agenda decision; and
  - (c) Appendix C—Staff analysis of other comments.
11. Agenda Paper 11A for this meeting reproduces the comment letters.

### **Comment letter summary**

12. We received 17 comment letters on the tentative agenda decision. The comment letters are available on our [website](#) and have been reproduced in Agenda Paper 11A for ease of reference.
13. Eight respondents agree with the Committee's analysis and conclusions. These respondents comprise three standard-setters, two preparers (one from banking and one from the oil and gas sector), two accounting firms and one academic body.
14. Nonetheless some of these respondents express concerns about the scope and potential effects of the agenda decision in some circumstances. In particular:
  - (a) Mazars says that the interaction between IFRS 9, IFRS 15 *Revenue from Contracts with Customers* and IAS 2 *Inventories* is unclear when an entity accounts for a contract to buy or sell a non-financial item as a derivative but nonetheless physically settles the contract by either delivering or taking delivery of the underlying item. It also expresses concern about the effect of the Committee's analysis and conclusions on some entities—mainly in the energy sector—and thus recommends the Committee not finalise the agenda decision but instead undertakes a more comprehensive project that could lead to standard-setting.

- (b) the Organismo Italiano di Contabilità (OIC) expresses concern that the Committee’s analysis and conclusions described in the tentative agenda decision may conflict with the requirements in IAS 2 in some cases.
15. The Autorité des Normes Comptables (ANC) says that it ‘does not disagree’ with the tentative agenda decision but expresses concern about its effect on the energy industry. It suggests the International Accounting Standards Board (Board) reconsider, as part of its standard-setting activity, the accounting requirements for contracts to buy or sell a non-financial item that do not meet the own use scope exception but are not held for trading and are physically settled by either delivering or taking delivery of the underlying non-financial item.
16. Eight respondents disagree with the Committee’s analysis and conclusions. These respondents say the accounting outcome does not reflect the economic substance of the transaction and express concern about the potential effect of the tentative agenda decision in some circumstances. These respondents recommend that the Committee not finalise the tentative agenda decision. These respondents comprise one standard-setter and seven preparers—three from the energy sector (including one representative body), three from the oil and gas sector and one who operates in multiple sectors.
17. Further details about the comments raised by respondents, together with our analysis, are presented below.

## **Staff analysis of main comments**

### ***Structure of our analysis***

18. Because of the diverse nature of comments, we have separately analysed the main comments that relate to:
- (a) the Committee’s analysis and conclusions (paragraphs 20–39);

- (b) the usefulness of information provided to users of financial statements when IFRS 9 is applied to contracts to buy or sell a non-financial item; and (paragraphs 40–45); and
  - (c) the potential effect of the agenda decision (paragraphs 46–55).
19. Appendix B to this Agenda Paper analyses other comments raised.

***Committee's analysis and conclusions***

20. As summarised in paragraph 3 of this paper, in the fact patterns described in the submission, the entity concludes that the contracts are within the scope of IFRS 9 because they do not meet the own use scope exception. Consequently, the entity accounts for the contracts as derivatives measured at FVPL. The submission asks whether, in accounting for the physical settlement of such contracts, the entity is permitted or required to make a journal entry (additional journal entry) that reverses the accumulated gain or loss previously recognised in profit or loss on the derivative even when the fair value of the derivative is unchanged.
21. The Committee concluded that IFRS 9 neither permits nor requires an entity to make the additional journal entry described in the submission. The Committee observed that the additional journal entry would effectively negate the requirement in IFRS 9 to account for the contract as a derivative because it would reverse the accumulated fair value gain or loss on the derivative without any basis to do so. The additional journal entry would also result in the recognition of income or expenses that do not exist.

## Summary of comments

### General comments

22. Several respondents<sup>2</sup> disagree with the Committee's analysis and conclusions set out in the tentative agenda decision. These respondents say that IFRS Standards do not provide specific requirements for the contracts described in the submission—ie contracts to buy or sell a non-financial item that are within the scope of IFRS 9 because they do not meet the own use scope exception but nonetheless are physically settled by the entity either delivering or taking delivery of the non-financial item. Therefore they express the view that an entity applies IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to develop an appropriate accounting policy and applies that accounting policy consistently.

### Comments specific to contracts to sell a non-financial item and the interaction between IFRS 9 and IFRS 15

23. Several respondents say that IFRS 9 sets out the requirements for recognising and measuring contracts within its scope but does not include requirements for presentation or disclosure. Most of these respondents agree that, applying IFRS 9, an entity is required to account for the contract to sell a non-financial item described in the submission as a derivative measured at FVPL. They also agree, in accounting for the settlement of such a contract, the entity records the cash received and derecognises the derivative. However, while they acknowledge that the entity must remeasure the derivative at fair value and recognise changes in fair value over the life of the contract, they say that IFRS Standards do not require the entity to derecognise the derivative balance on the settlement date against the top line in the income statement (or prohibit them from doing so).
24. More generally, several respondents say the Committee has not fully considered the interaction between IFRS 9 and IFRS 15. Specifically, these respondents say the

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<sup>2</sup> Throughout this paper, we used the term 'some respondents' to refer to five respondents or less, and the term 'several respondents' to refer to more than five respondents.

Committee has not considered whether an entity applies IFRS 15 when it physically settles a contract to sell a non-financial item that is within the scope of IFRS 9. These respondents say if an entity applies the principles and requirements in IFRS 15 to the contracts described in the submission, then it would recognise revenue at an amount equal to the contract price (ie the cash received) because that is the transaction amount (as defined in IFRS 15).

25. Some of these respondents say this outcome is appropriate because, when such contracts are physically settled, they are within the scope of IFRS 15 and no longer within the scope of IFRS 9. Other respondents say if such a contract is not within the scope of IFRS 15, then an entity may nonetheless apply the principles of IFRS 15 when it develops an appropriate accounting policy applying IAS 8 (see paragraph 22).

#### **Comments specific to contracts to buy a non-financial item and the interaction between IFRS 9 and IAS 2**

26. Some respondents say the Committee has not fully considered the interaction between IFRS 9 and IAS 2. These respondents observe that IAS 2 requires inventories to be measured at the lower of cost and net realisable value. In the fact pattern described in the submission, they disagree that the cost of inventory is the sum of the cash paid and the fair value of the derivative on the settlement date. Some of these respondents say, applying IAS 2, the cost of the inventory is equal to the cash paid and does not include the fair value of the derivative on the settlement date. BP suggests that IAS 2 is unclear in this regard.

#### **Other comments**

27. Most of the comments from respondents that disagree with, or express concerns about, the tentative agenda decision relate to the measurement of revenue (in the case of the sales contract) or inventory (in the case of the purchase contract) on the settlement date, as described above. However, a few respondents also express views on how an entity would measure the derivative and recognise fair value gains and losses. The International Energy Accounting Forum (IEAF) expresses the view that ‘the development and unwind

of the [derivative's] fair value should be reported in the same profit or loss line item'. Similarly an anonymous international energy group (IEG) expresses the view that, when the contract is physically settled, there should be no value attributed to the derivative because the entity cannot separately enforce any 'theoretical' gain or loss. As a result, IEG says that the entity remeasures the derivative to have a zero value and reverses the accumulated gain or loss previously recognised.

### ***Staff analysis***

28. As described in Agenda Paper 3 for the November 2018 meeting and summarised in paragraphs 1–6 of this paper, the Committee received a submission about how an entity applies IFRS 9 to particular contracts to buy or sell a non-financial item in the future at a fixed price. The submitter describes two fact patterns. In both cases, the submitter says the entity has concluded that the contracts are within the scope of IFRS 9 because they do not meet the own use scope exception. Consequently, the submitter says that the entity accounts for the contracts as derivatives measured at FVPL. The entity does not designate the contracts as part of a hedging relationship for accounting purposes. The submitter provides journal entries to illustrate the entity's accounting for those derivatives from contract inception to settlement. The submitter does not ask the Committee to reconsider that accounting or the accompanying journal entries.
29. The submitter asks only whether, in accounting for the physical settlement of these contracts, the entity is permitted or required to make an additional journal entry that would reverse the accumulated gain or loss previously recognised in profit or loss on the derivative (even though, in the fact patterns submitted, the fair value of the derivative is unchanged) and recognise a corresponding adjustment to either revenue (in the case of the sale contract) or inventory (in the case of the purchase contract).
30. In its discussions, the Committee intentionally considered only the specific question submitted; that is, whether the entity is permitted or required to reverse the accumulated gain or loss previously recognised in profit or loss on the derivative even though the fair value of the derivative is unchanged. The Committee did not reconsider any of the

submitter's assumptions about the accounting described in the fact patterns (for example, the assumption that the contracts are within the scope of IFRS 9 because they do not meet the own use scope exception or the assumption that entity has an accounting policy of recognising revenue on a gross basis), nor did it analyse the other journal entries described in the submission.

31. In this regard, the Committee observed that, in the case in which IFRS 9 applies to the derivative (as assumed), IFRS 9 neither permits nor requires an entity to reverse the accumulated gain or loss previously recognised in profit or loss on the derivatives described in the submission. Such an entry would effectively negate the requirement in IFRS 9 to account for the contract as a derivative because it would reverse the accumulated fair value gain or loss on the derivative without any basis to do so. Such a journal entry would result in recognition of income or expense on the derivative that do not exist.
32. We continue to think that IFRS 9 neither permits nor requires an entity to make the additional journal entry described in the submission. That is because, in the fact patterns submitted, the derivative is required to be accounted for at FVPL so there would be income or expense on the derivative on the settlement date only if the derivative's fair value changed on that date, which would require the price of the underlying non-financial item to change. But that is not the fact pattern that was submitted to the Committee. Instead, according to the fact pattern, the price of the non-financial item and the fair value of the derivative are unchanged.
33. Immediately prior to settlement, the derivative's fair value is CU10. The change in the carrying amount of the derivative (to nil) results from the derecognition of the derivative, ie the fact that the derivative is settled. In the fact patterns submitted, the contract was settled by the receipt (or delivery) of the non-financial item with a fair value of CU110 in exchange for a derivative of CU10 and cash of CU100. Accordingly, we continue to think that the derecognition of the derivative on settlement does not give rise to further income or expense.

34. However we agree that while IFRS 9 sets out the requirements for recognising and measuring contracts within its scope, it does not provide presentation or disclosure requirements. We think an entity is required to present gains and losses on the derivative, and disclose information about those amounts, in accordance with the relevant IFRS Standards, such as IAS 1 *Presentation of Financial Statements* and IFRS 7 *Financial Instruments: Disclosures*. In determining what line items are presented on the face of the income statement, the requirements in IAS 1 (including those related to aggregation) are applicable. These do not include explicit requirements for the presentation of the amount related to the remeasurement of the derivative. However paragraph 20(a)(i) of IFRS 7 sets out disclosure requirements related to net gains or net losses on financial assets or financial liabilities that are mandatorily measured at FVPL in accordance with IFRS 9. For these purposes, in the fact patterns submitted, there is no net gain or loss on the derivative caused by settlement. Similarly the entity is required to apply relevant IFRS Standards to determine how to present any other revenue amounts that arise from the contracts described in the submission, and what information must be disclosed about those amounts.
35. We propose amending the tentative agenda decision as indicated in Appendix B to clarify the Committee has not considered how an entity presents gains or losses on the derivative or how an entity presents other revenue amounts that arise from the contracts described in the submission.

#### Interaction with IFRS 15

36. The submitter did not ask the Committee to consider whether the contract to sell a non-financial item described in the submission is within the scope of IFRS 15. As noted in paragraph 30 of this paper, the Committee intentionally considered only the specific question submitted; that is, whether the entity is permitted or required to reverse the accumulated gain or loss previously recognised in profit or loss on the derivative (even though the fair value of the derivative is unchanged). The Committee did not reconsider any of the submitter's assumptions about the other accounting described in the fact

patterns, including the assumption that the entity has an accounting policy of recognising revenue on a gross basis.

37. We think this matter is beyond the scope of the question submitted. In addition, we think it is not necessary to address the interaction between the scope of IFRS 9 and the scope of IFRS 15 in order to answer the question asked. Accordingly, we recommend no changes to the agenda decision in this respect.

#### Interaction with IAS 2

38. The submitter did not ask the Committee to consider the interaction between IFRS 9 and IAS 2. However, consistent with the Committee's discussion at the November 2018 meeting and the wording in the tentative agenda decision, we think the cost<sup>3</sup> of the inventory acquired (in the case of the purchase contract described in the submission) is the amount of cash paid plus the fair value of the derivative on the settlement date. Respondents have not provided any new information beyond that considered by the Committee when reaching its tentative agenda decision.
39. Accordingly, we recommend no changes to the agenda decision in this respect.

#### ***The usefulness of information provided to users of financial statements when IFRS 9 is applied to contracts to buy or sell a non-financial item***

40. In the tentative agenda decision, the Committee observed that the accounting for contracts that do not meet the own use scope exception in IFRS 9 (and are accounted for as a derivative) is different from the accounting for contracts that meet that exception (and are not accounted for as a derivative). The Committee also observed that those differences in accounting reflect differences in the respective requirements and IFRS 9
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<sup>3</sup> Applying paragraphs 9–11 of IAS 2, an entity measures inventories at the lower of cost and net realisable value. Cost of inventories comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. Finally, costs of purchase comprise the purchase price, import duties and other taxes, and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services.

neither permits nor requires an entity to reassess or change its accounting for a derivative solely because the contract is ultimately physically settled.

*Summary of comments*

41. Several respondents say that the accounting described in the tentative agenda decision would not reflect the substance, business purpose or cash flows of the contracts described in the submission. In addition, several respondents say that applying the tentative agenda decision to contracts that an entity expects to, and ultimately does, physically settle would not provide useful information to users of the financial statements for the following reasons:
  - (a) the amount at which an entity has been able to fix its cash flows is more relevant to its financial performance (and has more predictive value) than the market price on the settlement date.
  - (b) contracts that are very similar from a business perspective can have very different accounting outcomes based on whether they meet the own use scope exception in IFRS 9.
  - (c) the substance of fixed-price contracts is to secure and realise a contractually agreed price or an expected margin. Therefore, revenue (and cost of goods sold) should not include gains or losses resulting from accounting for such contracts as derivatives.
42. Some respondents also express the view that entities will use more non-GAAP measures to communicate their performance if the Committee confirms the accounting set out in the tentative agenda decision.

*Staff analysis*

43. Consistent with the Committee's discussion at the November 2018 meeting, we acknowledge that the accounting for contracts that do not meet the own use scope exception in IFRS 9 (such as the contracts described in the submission) is different from the accounting for contracts that meet that exception. Those differences reflect

differences in the respective accounting requirements. The specific and detailed scope requirements in IFRS 9, which are summarised in paragraph 2 of this paper, are necessary because IFRS Standards require different accounting for such contracts. The Board considered how best to reflect the substance of, and provide useful information about, contracts to buy or sell a non-financial item when it developed those specific and detailed scope requirements.

44. In addition, as discussed in paragraph 3 of this paper, in the fact patterns described in the submission, the entity concludes that the contracts are within the scope of IFRS 9 because they do not meet the own use scope exception. The submitter does not ask the Committee to reconsider that conclusion.
45. Consequently, we recommend no change to the agenda decision in this respect. However we think that the changes that we have proposed to the tentative agenda decision to clarify that the Committee has not considered how an entity presents gains or losses on the derivative, or how an entity presents other revenue amounts that arise from the contracts described in the submission, may address some of respondents' concerns about the usefulness of information provided to users of financial statements when IFRS 9 is applied to contracts to sell a non-financial item.

### ***Potential effects of the agenda decision***

#### *Summary of comments*

46. Several respondents say many entities in the energy sector record the additional entry described in the submission (or have accounting policies that result in a similar outcome). Several respondents also say that implementing the tentative agenda decision will require significant effort, including changes to systems, processes and internal controls. For example, some respondents say it would require changes to entities' systems, which are currently set-up to recognise revenue from sale contracts at the contract price and measure the fair value of the derivative only at the end of each reporting period (and not immediately prior to delivery).

47. BP says the timing of the submission is unfortunate because, although the matter does not arise as a result of the application of IFRS 9 and IFRS 15, many companies have recently completed their implementation projects for those Standards.
48. Accordingly, several respondents say the Committee should not finalise its agenda decision. Some of these respondents say:
  - (a) any final agenda decision should meet the Board's cost/benefit threshold for standard-setting and, if it meets that threshold, allow a reasonable time for implementation.
  - (b) the Board should undertake a more comprehensive project as part of its standard-setting activities.

#### *Staff analysis*

49. Based on our analysis in this paper, we think the matter does not require standard-setting or consideration in a more comprehensive project. We note that the Board considered the scope of IFRS 9 (including the own use scope exception) during the development of that Standard. As explained in paragraph BC2.1 of the Basis for Conclusions on IFRS 9, the Board decided that the scope of IFRS 9 should be based on that of IAS 39 *Financial Instruments: Recognition and Measurement*. Consequently, the scope of IAS 39 was carried forward to IFRS 9 and changed only as a consequence of other new requirements. Some amendments were made to the accounting for contracts to buy or sell a non-financial item but a broader question about the scope of own use contracts was not raised.
50. In publishing an agenda decision, the Committee is not undertaking standard-setting. Instead, it is explaining the reason for its decision that standard-setting is not needed to address the question submitted. Accordingly, the assessment of costs and benefits undertaken in a standard-setting project does not apply in publishing an agenda decision.
51. Respondents to the Committee's tentative agenda decision on 'Liabilities in relation to a joint operator's interest in a joint operation' raised similar concerns about the potential effects of finalising an agenda decision. Paragraphs 52–53 of Agenda Paper 9 for this

meeting explain why we think it is important for the Committee to respond to questions submitted to it in a timely manner.

52. In considering the matter in this paper, the Committee tentatively decided not to add it to the standard-setting agenda because it concluded that the requirements in IFRS Standards provide an adequate basis for an entity to determine the appropriate accounting. Based on our analysis in this paper, we continue to agree with the Committee's conclusions and, on that basis, recommend finalising the agenda decision<sup>4</sup>.
53. As discussed in paragraphs 55–58 of Agenda Paper 9 for this meeting, we acknowledge that the explanatory material in the agenda decision might provide an entity with new information which could result in an entity determining that it needs to change its previous accounting policy. We understand that this might take some time to implement. Our recommendation in that agenda paper is that the Committee include the Board's view on the timing of implementing an accounting policy change that results from an agenda decision in *IFRIC® Update*.
54. We recommend including wording along the lines of the following:

The process for publishing an agenda decision might often result in explanatory material that provides new information that was not otherwise available and could not otherwise reasonably have been expected to be obtained. Because of this, an entity might determine that it needs to change an accounting policy as a result of an agenda decision. It is expected that an entity would be entitled to sufficient time to make that determination and implement any change (for example, an entity may need to obtain new information or adapt its systems to implement a change).

55. Consequently, we recommend no change to the agenda decision in this respect.

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<sup>4</sup> See paragraph 57 of this paper for our recommendation

## Other comments

56. Appendix C to this paper summarises other comments received together with our analysis of those comments. Based on our analysis, we recommend no changes to the agenda decision.

## Staff recommendation

57. On the basis of our analysis, we recommend that:

- (a) the agenda decision is finalised as published in *IFRIC Update* in November 2018, with the changes noted in paragraph 35 of this paper. Appendix B to this paper sets out the proposed wording of the final agenda decision.
- (b) *IFRIC Update* include wording similar to that in paragraph 54 of this paper to address the timing of implementing any change in accounting policy.

### Question for the Committee

Does the Committee agree with our recommendation to:

- (a) finalise the agenda decision as set out in Appendix B to this paper?
- (b) include wording similar to that in paragraph 54 of this paper in *IFRIC Update*?

## **Appendix A—Fact patterns and journal entries described in the submission**

- A1. The submitter set out the following two fact patterns, with accompanying journal entries, to illustrate the accounting for the contracts described in the submission.

### **Purchase contract**

- A2. On 1 December 20X1, Entity A enters into a contract to purchase a commodity at a fixed price of CU100 on 5 January 20X2. At inception the contract is at the money and its fair value is nil. Entity A's reporting period ends on 31 December 20X1. On that date, the forward price of the commodity has increased and, as a result, the fair value of the contract has increased by CU10. Therefore, Entity A recognises a derivative asset of CU10 and a gain of CU10:

Dr	Derivative asset	CU10
CR	Other operating income/expense <sup>5</sup>	CU10

- A3. On 5 January 20X2, Entity A settles the contract by taking delivery of the commodity and paying CU100 in cash. The fair value of the contract has not changed between 31 December 20X1 and 5 January 20X2. Entity A makes the following journal entry to recognise the receipt of inventory and the settlement of the derivative asset:

Dr	Inventory	CU110
CR	Derivative asset	CU10
CR	Cash	CU100

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<sup>5</sup> Or other appropriate line item in the statement of profit or loss.

**Sale contract**

- A4. The facts are the same as the purchase contract described above, except Entity A sells the commodity instead of purchasing it. On 31 December 20X1, the forward price of the commodity has increased and, as a result, the fair value of the contract has decreased by CU10. Therefore, Entity A recognises a derivative liability of CU10 and a loss of CU10:

Dr	Other operating income/expense <sup>6</sup>	CU10
CR	Derivative liability	CU10

- A5. On 5 January 20X2, Entity A settles the contract by delivering the commodity and receiving CU100 in cash. The fair value of the contract has not changed between 31 December 20X1 and 5 January 20X2. Entity A has an accounting policy of recognising ‘gross revenue’ on physical settlement to reflect the sale of the inventory. Following this policy, Entity A makes the following journal entry:

Dr	Cash	CU100
Dr	Derivative liability	CU10
CR	Revenue	CU110

**Additional journal entry**

- A6. As explained in paragraph 5 of this paper, the submitter asked whether, in addition to the journal entries set out in paragraphs A1–A5, Entity A should or could make an additional journal entry. That additional journal entry would reverse the accumulated gain or loss previously recognised in profit or loss on the derivative and adjust either inventory (in the case of the purchase contract) or revenue (in the case of the sale contract) so that they are

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<sup>6</sup> Or other appropriate line item in the statement of profit or loss.

recognised at the fixed price set out in the contract (ie the amount of cash paid or received on the settlement date).

- A7. To illustrate using the fact patterns set out above, the submitter asks whether the following journal entry could or should be made for the purchase contract and the sale contract, respectively:

Dr      Other operating income/expense    CU10  
CR      Inventory                                  CU10

(Additional entry for the purchase contract)

Dr      Revenue                                      CU10  
CR      Other operating income/expense        CU10

(Additional entry for the sales contract)

## Appendix B—Proposed wording of the agenda decision

B1 We propose the following wording for the final agenda decision (new text is underlined and deleted text is struck through).

### **Physical settlement of contracts to buy or sell a non-financial item (*IFRS 9 Financial Instruments*)**

The Committee received a request about how an entity applies IFRS 9 to particular contracts to buy or sell a non-financial item in the future at a fixed price. The request describes two fact patterns in which an entity accounts for such contracts as derivatives at fair value through profit or loss (FVPL) but nonetheless physically settles the contracts by either delivering or taking delivery of the underlying non-financial item.

IFRS 9 must be applied to contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if those contracts were financial instruments, with one exception. That exception applies to contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements ('own use scope exception' in paragraph 2.4 of IFRS 9).

In the fact patterns described in the request, the entity concludes that the contracts are within the scope of IFRS 9 because they do not meet the own use scope exception. Consequently, the entity accounts for the contracts as derivatives measured at FVPL. The entity does not designate the contracts as part of a hedging relationship for accounting purposes.

At the settlement date, the entity physically settles the contracts by either delivering or taking delivery of the non-financial item. In accounting for that settlement, the request explains that the entity records the cash paid (in the case of the purchase contract) or received (in the case of the sale contract) and derecognises the derivative.

In addition, the entity:

- a. recognises inventory for the non-financial item at the amount of the cash paid plus the fair value of the derivative on the settlement date (in the case of the purchase contract); or

- b. recognises revenue for the sale of the non-financial item at the amount of the cash received plus the fair value of the derivative on the settlement date (in the case of the sale contract). The request assumes the entity has an accounting policy of recognising revenue on a gross basis for such contracts.

~~This accounting results in the entity recognising inventory or revenue at the market price of the non-financial item on the settlement date.~~

The request asks whether, in accounting for the physical settlement of these contracts, the entity is permitted or required to make an additional journal entry that would:

- a. reverse the accumulated gain or loss previously recognised in profit or loss on the derivative (even though the fair value of the derivative is unchanged); and
- b. recognise a corresponding adjustment to either revenue (in the case of the sale contract) or inventory (in the case of the purchase contract).

~~The additional journal entry would result in the entity recognising inventory or revenue at the cash paid or received on settlement.~~

The Committee observed that, in the fact pattern described in the request, the contracts are settled by the receipt (or delivery) of a non-financial item in exchange for both cash and the settlement of the derivative asset or liability. The Committee also observed that the accounting for contracts that do not meet the own use scope exception in IFRS 9 (and are accounted for as a derivative) is different from the accounting for contracts that meet that exception (and are not accounted for as a derivative). Similarly, the accounting for contracts designated in a hedging relationship for accounting purposes is different from the accounting for contracts that are not designated in such relationships. Those differences in accounting reflect differences in the respective requirements. IFRS 9 neither permits nor requires an entity to reassess or change its accounting for a derivative contract ~~solely~~ because that contract is ultimately physically settled.

~~Accordingly, t~~The additional journal entry described in the request would effectively negate the requirement in IFRS 9 to account for the contract as a derivative because it would reverse the accumulated fair value gain or loss on the derivative without any basis to do so. The additional

journal entry would also result in the recognition of income or expenses on the derivative that do not exist.

Consequently, the Committee concluded that IFRS 9 neither permits nor requires an entity to make the additional journal entry described in the request. However, the Committee observed that an entity is required to present gains and losses on the derivative, and disclose information about those amounts, in accordance with relevant IFRS Standards, such as IAS 1 *Presentation of Financial Statements* and IFRS 7 *Financial Instruments: Disclosures*. In determining what line items are presented in profit or loss, the requirements in IAS 1 (including those related to aggregation) are applicable. These do not include explicit requirements for the presentation of amounts related to the remeasurement of derivatives. However paragraph 20(a)(i) of IFRS 7 sets out disclosure requirements related to net gains or net losses on financial assets or financial liabilities that are mandatorily measured at FVPL applying IFRS 9. For these purposes, in the fact patterns submitted, there is no net gain or loss on the derivative caused by settlement. Similarly the entity is required to apply relevant IFRS Standards to determine how to present any other revenue amounts that arise from the contracts described in the submission, and what information must be disclosed about those amounts.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to conclude on whether it is permitted or required to make the additional journal entry described in the request. Consequently, the Committee {decided} not to add the matter to its standard-setting agenda.

## Appendix C—Staff analysis of other comments

A8. The table below outlines other comments, together with our analysis and conclusions.

Comments	Staff analysis and conclusions
<p><i>1. Committee's outreach activities</i></p> <p>Some respondents say they are concerned the Committee's tentative agenda decision has been made without conducting appropriate outreach with the users and preparers of financial statements of the affected sectors. For example, BP says the Committee would have benefitted from such broader outreach to fully understand the context in which entities undertake physical commodity transactions and what users of financial statements of such entities consider useful information.</p>	<p><i>We recommend no change to the agenda decision in this respect.</i></p> <p>When we perform outreach on submissions to the Committee, the main information we seek to obtain is information about practice—typically, whether the transaction/fact pattern submitted are common in some or many jurisdictions or industries and, if so, what is the predominant accounting treatment that entities apply to that transaction/fact pattern. This information is helpful in assessing whether the matter has widespread effect and has, or is expected to have, a material effect on those affected.</p> <p>The outreach conducted by the Committee confirmed that the fact pattern submitted was common. It also provided information about the industries in which it is common and the reasons why some entities make the additional journal entry. The responses to the tentative agenda decision have confirmed this understanding.</p> <p>Based on our analysis, we recommend no change to the agenda decision in this</p>

Comments	Staff analysis and conclusions
	respect.
<p>2. <i>Fact patterns and assumptions in the submission</i></p> <p>Some respondents say the examples the Committee considered are too simple and not reflective of the high complexity and economic rationale of physically settled contracts that are within the scope of IFRS 9. For example:</p> <p>(a) IEG mentions contracts in the energy sector in which delivery occurs continuously over a period as an example of a more complex contract.</p> <p>(b) BP says the example discussed in the Committee's November meeting fails to recognise the context in which entities often enter into such transactions. They say physical commodity sales fall within the scope of IFRS 9 often because they are included within a risk management framework and hedged with financial derivatives. The example does not include the related</p>	<p><i>We recommend no change to the agenda decision in this respect.</i></p> <p>We limited our analysis to the fact pattern as described in the submission. Although we acknowledge that more complex fact patterns may exist in practice, these were not part of the submission. Entities should apply judgement in determining whether and how the conclusions reached by the Committee would apply to their particular facts and circumstances. Furthermore, although the additional information provided by BP helps in understanding the background in which the transactions happen, it does not change our analysis and conclusions on the matter submitted.</p>

<b>Comments</b>	<b>Staff analysis and conclusions</b>
<p>hedging gains and losses and therefore does not represent the complete picture.</p>	
<p><i>3. Other (broader) issues outside the scope of the submission</i></p> <p>Some respondents request that the Committee address the following aspects:</p> <p>(a) IEG says that the agenda paper should be clear on whether all-in-one hedges are still permissible applying the requirements in IFRS 9 for hedge accounting because the guidance have not been carried to IFRS 9 from IAS 39. They say entities would have designated all-in-one hedges to achieve a more relevant accounting outcome if they had known the guidance can still be applied.</p> <p>(b) IEG says the agenda paper did not consider how to account for contracts with embedded derivatives,</p>	<p><i>We recommend no change to the agenda decision in this respect.</i></p> <p>We have not performed further analysis nor recommend changes to the agenda decision because we think these comments either:</p> <ul style="list-style-type: none"> <li>(a) ask a different question than that addressed by the Committee; or</li> <li>(b) represent variations of the fact pattern described in the submission.</li> </ul> <p>Therefore, we think these comments relate to matters that are beyond the scope of the Committee's consideration of the submission. However we note that although the Board decided not to carry forward any of the hedge accounting related Implementation Guidance that accompanied IAS 39, paragraph BC6.95 of IFRS 9 explains that not carrying forward the Implementation Guidance did not mean that the Board had rejected that guidance.</p>

Comments	Staff analysis and conclusions
<p>which may arise where customer demands flexible deliveries. They say such features are common in the energy sector.</p> <p>(c) BP says that many of its contracts span multiple years, and that they may move between asset and liability positions between inception and physical delivery. They say it is not clear what the intent of the tentative agenda decision is in respect of income statement presentation of derivative gains and losses on a cumulative or discrete-year basis and how that relates to gross revenue.</p> <p>(d) The Global Financial Reporting Committee (GFRC) says it would be helpful if there was a requirement for entities to disclose the number of contracts and related amounts which are accounted for as derivatives and then physically settled.</p>	

<b>Comments</b>	<b>Staff analysis and conclusions</b>
<p><i>4. Wording suggestions</i></p> <p>(a) The GFRC suggest that, instead of using the term 'additional journal entry', the tentative agenda decision could refer simply to reversing the accumulated gain or loss and recognising an adjustment to revenue or inventory.</p> <p>(b) The OIC suggest clarifying that the conclusions reached are limited to the fact pattern described in the submission and should not be applied by analogy to similar fact patterns.</p>	<p><i>We recommend no change to the agenda decision in this respect.</i></p> <p>(a) We think the agenda decision should still use the term 'additional journal entry' because it is consistent with the specific question asked in the submission.</p> <p>(b) We think such clarification is not necessary, as it applies to any agenda decision published by the Committee.</p>
<p><i>5. Other comments</i></p> <p>(a) The Accounting Standards Committee of Germany (ASCG) says the wording in the tentative agenda decision seems to suggest that entities who have followed a different line of thinking are not complying</p>	<p><i>We recommend no change to the agenda decision in this respect.</i></p> <p>(a) As for any agenda decision that includes explanatory material, this agenda decision sets out the Committee's analysis in reaching its conclusion that the requirements in IFRS Standards provide an adequate basis for an entity to determine its accounting in the fact pattern described in the submission. As</p>

Comments	Staff analysis and conclusions
<p>with the requirements in IFRS 9. They say this is an inappropriate conclusion because if the Committee acknowledges existing diversity, it should not assume that entities are consciously taking decisions against the literature. Some respondents also say that the accounting treatment adopted by these companies have never been challenged from auditors or enforcement authorities.</p> <p>(b) The Canadian Accounting Standards Board (AcSB) asks whether the tentative agenda decision would apply to commodity broker-dealers and recommend that the Committee amend the agenda decision to clarify whether this is the case.</p>	<p>discussed in paragraph 53, we think the explanatory material in the agenda decision might provide an entity with new information, which could result in the entity determining that it needs to change its previous accounting policy.</p> <p>(b) The submission did not specify whether the entity in the fact pattern is a commodity-broker dealer and, as discussed in paragraph 38, the Committee did not specifically consider the measurement of inventory applying IAS 2. Therefore, considering the application of the tentative agenda decision to commodity broker-dealers is beyond the scope of the submission.</p>