Technical Accounting Alert

Accounting for commodity contracts

Introduction

The purpose of this alert is to provide general guidance on accounting for commodity contracts, with a particular focus on determining whether such contracts are within the scope of IAS 39.

Commodity contracts

This Alert focuses on contracts to buy or sell a commodity such as iron ore, crude oil, coal, ethanol, sugar, soybeans, aluminium, rice, wheat, gold or silver. The issues discussed, and the related requirements of IAS 39, also apply to contracts to buy or sell any non-financial item. However, most of the practical and interpretive issues arising in practice relate to commodity contracts.

Contracts that require payments linked to a commodity price or index, but are not contracts to buy or sell the underlying commodity, are likely to be derivative financial instruments or financial instruments with embedded derivatives. An example is a debt contract with interest payments linked to the price of gold. These types of contract are not addressed in this TA alert.

Note

On November 12 2009, the IASB published IFRS 9 Financial Instruments (IFRS 9). IFRS 9 addresses the classification and measurement of financial assets. The publication of IFRS 9 represents the completion of Phase 1 of IASB's project to replace IAS 30. However, at this stage IFRS 9 only addresses the classification and measurement of financial assets. Financial liabilities therefore continue to be accounted for in accordance with IAS 30. Work has begun on phases 2 and 3 of the project which addresses impairment and hedge accounting, respectively. Also, a separate project is underway to replace IAS 39's requirements on derecognition.

IFRS 9 WAS ISSUED IN AUSTRALIA AS AASB 9 FINANCIAL INSTRUMENTS WITH AN EFFECTIVE DATE OF 1 JANUARY 2013 AND THEREFORE AASB 9 REQUIREMENTS HAVE NOT BEEN CONSIDERED FOR THE PURPOSE OF THIS ALERT.

Relevant Australian Standards

References in this TA alert are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 39 Financial Instruments: Recognition and Measurement	AASB 139 Financial Instruments: Recognition and Measurement
IAS 37 Provisions, Contingent Liabilities and Contingent Assets	AASB 137 Provisions, Contingent Liabilities and Contingent Assets

Overview

Most contracts to buy or sell a commodity do not meet the definition of a financial instrument. Nonetheless IAS 39.5 specifies that IAS 39 applies to contracts to buy or sell a non-financial item that:

- can be settled net in cash; or
- can be settled by exchanging financial instruments;

unless such contracts 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 [emphasis added]. This requirement is commonly referred to as the "own-use" exemption.

This guidance is summarised in the Appendix to this TA alert and discussed in more detail below.

Guidance

General

Determining whether a commodity contract is within the scope of IAS 39 can be a complex exercise and may involve judgement. It is however important to reach the correct conclusion because contracts to which IAS 39 applies will mainly be derivatives measured at fair value through profit or loss (FVTPL). Contracts to which IAS 39 does not apply will not usually be recognised in the financial statements until delivery takes place (unless they are onerous contracts).

In part, the complexity reflects the diversity of commodities markets and the many different features of commodity contracts. However, IAS 39's requirements also give rise to a number of interpretative questions (some of which have been considered by the IFRIC). Fortunately, in many cases determining whether IAS 39 applies is straightforward and reasonably intuitive. It is likely that an entity in the commodities trading business will enter into contracts that are within IAS 39's scope. Conversely, companies that buy commodities solely for use in production are less likely to be required to apply IAS 39 to their purchase contracts. An initial analysis of whether IAS 39 applies therefore involves distinguishing between:

- contracts entered into for trading, speculative and hedging purposes; and
- normal purchase or sale contracts.

Especially in more difficult cases, a careful analysis of the contracts' terms and conditions, the purpose for which they are held and the manner in which they will be settled is necessary. The following paragraphs provide additional explanation and guidance on factors to consider in performing this analysis.

Can the contract be settled net in cash?

IAS 39.6 specifies **four** ways in which a contract to buy or sell a non-financial item can be settled net in cash:

- the contract terms permit **net cash settlement** (IAS 39.6(a));
- the contract terms do not explicitly permit net cash settlement, but the entity has a **past practice of settling similar contracts** net in cash (IAS 39.6(b));
- the entity has a past practice for similar contracts of taking delivery of the underlying item and **selling it within a short period of time** to generate a profit from short-term price fluctuations or a dealer's margin (IAS 39.6(c));
- the non-financial item is **readily convertible into cash** (IAS 39.6(d)).

If any of these conditions apply, the contract is regarded as capable of net cash settlement. The four different ways are considered in turn below.

Contract terms permit net cash settlement

The normal way of settling a contract to buy or sell a non-financial item is by exchanging the item for the agreed price (described as "gross physical settlement"). However, some contracts are "net cash settled". Net cash settlement is the process of one party paying the other an amount of cash equivalent to the value of the contract, with no physical delivery of the underlying item. A commodity contract that includes an option allowing for one or both parties to net cash settle is within the scope of IAS 39 unless the own-use exemption applies (see below).

Net cash settlement

An entity enters into a contract to supply 1,000 barrels of crude oil for $100/barrel ($100,000) in 3 months time. The contract permits the supplier to pay or receive an amount of cash equal to the difference between $100,000 and the value of 1,000 barrels of crude oil at the West Texas Intermediate (WTI) spot price.

This contract permits net cash settlement and is therefore within the scope of IAS 39 unless the own-use exemption applies.

A net cash settlement option is by its nature usually readily identifiable in the contract. An issue that arises in practice is whether contracts that include break fee clauses (ie payments to cancel the contract) or penalties for non-performance should be regarded as being capable of net cash settlement. The substance of such clauses should be assessed. In Grant Thornton's view a clause that has the purpose and effect of compensating the counter-party for non-performance should be distinguished from an option to settle the value of the contract net in cash. A key feature of a net cash settlement provision is likely to be that the settlement payment is linked to the value of the underlying non-financial item.

Break clause

A steel manufacture signs a contract to supply 50 tonnes of standard plate steel for delivery in six months. The contract permits either party to cancel in the first 60 days for a one-off fee of $50,000 (intended to compensate the other for administrative costs).

In Grant Thornton's view, a fixed sum break clause of this nature is not a net cash settlement provision. However, a break fee that varies based on changes in value of the underlying steel would be a net cash settlement provision.

Past practice of net cash settlement

Even if a contract does not explicitly permit net cash settlement, the buyer and seller might agree to net cash settle. If the entity has a **past practice** of net cash settling **similar contracts**, all contracts in this class are regarded as net cash settled. These contracts cannot be own use contracts, even if some of the contracts will be physically settled (IAS 39.6).

For this purpose, net cash settlement includes:

- net cash settlement with the counterparty;
- entering into one or more offsetting contracts; and
- selling the contract prior to its exercise or lapse (IAS 39.5(b)).

This form of net cash settlement gives rise to a number of issues on which IAS 39 has little or no guidance. In particular, judgement is required to determine:

- whether specific circumstances amount to a "past practice" of net cash settlement; and
- how to interpret the term "similar contracts".

The term "past practice" should be interpreted quite strictly. We consider that a past practice is established by net cash settling more than an insignificant portion of contracts in the class under review. A past practice is not established as a result of highly infrequent net cash settlements or settlements that are demonstrably a consequence of unforeseen circumstances.

Past practice of net settlement - unforeseen event

A bread manufacturing company enters into forward purchase agreements for a portion of its expected wheat requirements. It intends to take physical delivery of the wheat for use in its operations. However, after signing the contracts the company experiences an outbreak of contamination at one of its major factories, forcing it to shut down pending investigation and clean-up. The company therefore negotiates a net cash settlement with its supplier rather than taking delivery of wheat that it will be unable to use.

This cash settlement is clearly attributable to an unforeseen (and hopefully one-off) event. Accordingly, the company has not established a past practice of net cash settlement.

Past practice of net settlement - settlement of portion of contract portfolio

A glass manufacturing company is anxious to ensure it has adequate supplies of zirconium - an essential commodity for which demand has exceeded supply in recent years. Accordingly, the company routinely contracts to purchase 125% of its expected annual requirement in advance. As its actual requirements become apparent, it enters into offsetting sale agreements for the excess quantities. The purchase contracts are indistinguishable, and the company does not attempt to segregate them.

In this example, the company routinely net cash settles approximately 20% of its commodity contracts (a not insignificant proportion). The contracts are similar and are not segregated into trade and physical contracts at inception. The entire portfolio of contracts is therefore within the scope of IAS 39. None of these contracts is eligible for the own use exemption.

Determining whether the contracts in a group of contracts are "similar" requires judgement based on specific facts and circumstances. However, contracts for traded commodities are often in a standard form and are therefore clearly "similar" (eg LME Copper Grade A Futures Contracts).

In Grant Thornton's view the similarity or otherwise of a group of contracts depends on the business purpose for which the contracts are held as well as the terms of the contracts. If an entity has some contracts for trading (net cash settlement) purposes and other similar contracts for physical settlement, it is in Grant Thornton's view appropriate to consider these as separate portfolios **if the entity segregates the contracts at inception**. The contracts held for physical settlement may then be outside IAS 39's scope (based on the own-use exemption). Such an approach would however be undermined if the entity subsequently decides to net cash settle more than an insignificant amount of the contracts in the physical settlement portfolio.

Similar contracts held for different purposes

A company in the coffee business has a manufacturing operation and a trading operation. It enters into similar coffee bean purchase contracts for both operations. Management intends to take delivery of the coffee beans in some cases for the manufacture and sale of ground coffee. Other contracts acquired for trading purposes will be closed out by entering into offsetting sale contracts. Management designates each contract at inception based on its intended purpose. The two contract portfolios are managed and monitored separately.

In this example, the contracts in the trading portfolio are within the scope of IAS 39. The contracts in the physical delivery portfolio will be outside the scope of IAS 39 provided the designation is not "tainted" by net cash settlement.

If management decided not undertake the work involved in separate designation and monitoring, all of the contracts would be within the scope of IAS 39.

Taking delivery of the underlying item and selling it within a short period

Contracts that will result in physical delivery are within the scope of IAS 39 if the buyer sells the commodity within a short period to generate a dealing or trading profit. Such contracts cannot be own-use contracts.

Although IAS 39 does not provide detailed guidance on application of this requirement, it will normally be clear whether the activities of an entity that takes delivery of a commodity are of a trading nature. Some commodity exchanges, such as the London Metals Exchange (LME), provide warehousing facilities to assist traders in taking delivery. A characteristic of trading is that there is no conversion of the underlying commodity ie the commodity is sold in the form in which it was purchased.

Trading or wholesaling?

Trading activities should be distinguished from wholesaling and distribution. Although a wholesaler does not convert the product, it typically adds value by purchasing commodities in larger lots and repacking and redistributing them in smaller lots. An example of wholesaling involving a commodity might be the supply of fuel oil to commercial and domestic customers. Contracts to buy or sell a commodity for wholesale purposes are not in Grant Thornton's view caught by IAS 39.6(c). Such contracts are therefore outside the scope of IAS 39 if they are for own-use.

Non-financial item is readily convertible into cash

Even if an entity takes delivery of the underlying commodity, the contract is regarded as net cash settled if the commodity is readily convertible into cash. It is of course **possible** to convert almost any commodity into cash. In applying this requirement it is therefore important to consider whether a specific commodity is **readily** convertible into cash. In Grant Thornton's view a commodity is almost always readily convertible into cash if it is traded in an active market with the characteristics set out in IAS 39.AG 71 (quoted prices readily available, regularly occurring market transactions) etc. This assessment should take into consideration:

- the grade and quantity of the commodity; and
- the delivery location specified in the contract.

This is because active markets in commodities usually specify the grades and quantities and sometimes delivery points. Commodities of a grade that is not traded may not be readily convertible. Similarly, some commodities might be readily convertible in a "trading hub" but not in other locations.

Grade and quantity

The LME facilitates trading in a range of metals including copper. LME copper contracts specify trading in **"Grade A cathodes conforming to BSEN 1978:1998 in lot sizes of 25 tonnes".** Accordingly, copper of this grade and quantity is readily convertible into cash. However, copper and copper alloys are also bought and sold commercially in numerous other standard grades, specifications and quantities. Most of these forms of copper are not traded in active markets and would not therefore be considered readily convertible into cash for the purpose of IAS 39.6(d).

Location

Coal is commonly bought and sold at a number of trading hubs around the world such as ARA (Amsterdam-Rotterdam-Antwerp), Richards Bay (South Africa) and Newcastle (Australia). Quoted coal prices commonly refer to the grade, location and shipping terms (eg FOB Richards Bay (6,000 kcal/kg). This contract specifies the calorific content of the coal and that the seller is responsible for delivery of the coal to the buyer's specified carrier in Richards Bay). In Grant Thornton's view a contract for Richards Bay 6,000 kcal/kg coal will always be capable of net cash settlement because there is an active market for this product in this location. By contrast a contract for delivery of coal to a location that is not a trading hub (from which shipping costs to the nearest hub are significant) might not be regarded as being capable of net cash settlement under IAS 39.6(d). Such a contract might of course be capable of net cash settlement for other reasons.

Is the contract for "own use"?

Contracts that are capable of being net cash settled because:

- the contract terms permit **net cash settlement; or**
- the non-financial item is **readily convertible into cash**

are outside the scope of IAS 39 if, and only 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. Contracts that are exempt from IAS 39 on these grounds are commonly referred to as "own use contracts". Important matters to note concerning own use contracts include:

- contracts cannot be own use if the entity has a past practice:
  - **of settling similar contracts** net in cash;
  - for similar contracts, taking **delivery of the underlying item and selling it within a short period of time** to generate a profit from short-term price fluctuations or a dealer's margin;
- a contract that is regarded as net cash settled and is also a written option cannot be an own-use contract (IAS 39.7) (see below).

The conditions to meet the own use exemption include that the contract "**continues to be held** for the purpose of receipt or delivery …" [emphasis added]. The assessment of own use therefore requires an ongoing evaluation of the purposes for which contracts are held. Management representations that certain contracts are own use would be called into question if a significant number of similar contracts are subsequently net cash-settled. This is primarily an audit matter.

Receipt or delivery

Application of the own use exemption has led to questions concerning the meaning of "receipt or delivery" for this purpose. It is clear that this condition should be met if the supplier physically delivers the commodity to the customer (assuming that IAS 39.6(c) does not apply). The position is less clear when:

- market structure interposes an intermediary between the supplier and the end-customer, such as a grid operator in some electricity markets; or
- the supplier fulfils its obligations by arranging for another party to deliver the commodity.

The IFRIC has considered the first question and published the following rejection note in August 2005:

> "The IFRIC considered the application of the 'own purchase, sale or usage requirements' scope exemption in paragraph 5 of IAS 39 where:
>
> a) the market design or process imposes a structure or intermediary (eg a gold refiner or an electricity market operator) that prevents the producer from physically delivering its production to the counterparty of the hedge pricing contract; and
>
> b) in some cases, physical delivery is to the intermediary for the spot price, even if the producer is protected from spot price risk by a separate contract that effectively sets a fixed price for the producer's production.
>
> The IFRIC noted that 'delivery' for the purposes of the paragraph 5 exemption is not necessarily restricted to the physical delivery of the underlying to a specific customer, as physical delivery is not a condition of the exemption. The IFRIC was of the view that delivery of gold to a refiner in return for an allocation of an equivalent quantity of refined gold was not delivery, but that allocation of that refined gold to a customer's account could be considered delivery. [The IFRIC] decided not to develop guidance on the meaning of 'delivery' as it was not aware of any evidence of significant diversity in practice.
>
> [The IFRIC indicated] that a synthetic arrangement that results from the linking of a non-deliverable contract entered into with a customer to fix the price of a commodity with a transaction to buy or sell through an intermediary would not satisfy the paragraph 5 scope exemption."

In the second situation (the supplier arranging for another party to deliver), we consider that an evaluation of the substance of the arrangement is required. An entity in the commodities broking or trading business might take sales orders from customers and then enter into contracts with suppliers to deliver the commodity direct to the customer. In this scenario the broker/trader is acting as principal, is not delivering from its own production and is not carrying out any conversion of the commodity. For those reasons, in Grant Thornton's view these sale and purchase contracts are not in substance own use contracts for the broker/trader (although this is ultimately a matter of interpretation).

By contrast, a mining entity might forward sell part of its expected production but later experience an unexpected production shortfall. The mining entity might decide to discharge its commitments by subcontracting to a third party. In contractual terms, the sale and purchase contracts relating to these excess commitments are similar to the broker/trader's contracts. However, we consider that there is a stronger argument that the contracts are own use in this case.

Aluminium trader

An aluminium trader's business model involves:

- entering into physically settled aluminium supply contracts with commercial and industrial users throughout the world; and
- arranging delivery by entering into purchase contracts for delivery direct to the customer.

It is likely that aluminium is readily convertible into cash. Accordingly, these contracts should be assessed to determine if they fall within the IAS 39.5 own use exemption. Although it could be argued that the contracts are entered into for the entity's own purchase and sale requirements, we consider that this does not reflect the substance of this entity's activities. The trader does not produce or consume aluminium in its operations and does not convert the commodity in any way. We therefore believe that both the sale and the purchase contracts are within the scope of IAS 39.

Written options

IAS 39.7 states that a written option contract that can be settled net in cash (ie has a net cash settlement provision or the underlying item is readily convertible into cash) **cannot** be an own use contract. IAS 39 therefore applies to such contracts). These contracts cannot be own-use because an entity that grants another party an option to buy or sell a commodity cannot decide whether the option is exercised (and therefore whether delivery will occur). Accordingly, an entity in this position cannot argue that the contract is primarily intended to meet its sale, purchase or usage requirements.

This requirement has led to questions over what is meant by a "written option" for this purpose. In Grant Thornton's view, this requirement is intended to capture contracts containing volumetric optionality (ie contracts with an option over how much of the underlying commodity is bought or sold). We do not believe it is intended to address contracts with embedded price caps, floors or other features that might be economically equivalent to cash-settled, embedded options. Contracts that contain such pricing features should be assessed to determine:

- whether these features are embedded derivatives; and
- if so, whether the embedded derivative should be separated from the host contract for accounting purposes (see IAS 39.AG33(b) in particular).

Many commentators also take the view that a contract should be regarded as a written option only if the entity that writes the option receives a net premium. This is based on the guidance in IAS 39.IG.F1.3. However a net premium may not always be readily apparent, as it might be incorporated into the contract pricing (instead of being paid upfront).

Electricity contract with volumetric variability

An electricity generator enters into a supply contract with a commercial customer. No cash is paid or received on signing the contract. The contract is for the supply of 1,000MWh of electricity at $50/MWh over the next 6 months, but also entitles the customer to take an additional 250MWh at the same price in this period. A similar contract without this volume flexibility would be priced at $48/MWh. Electricity is regarded as readily convertible into cash in this market.

This contract contains volume variability, which is at the option of the customer. Also, the customer is paying a premium for this flexibility in the form of a higher price per unit. This contract is therefore within the scope of IAS 39 (given that the underlying item is readily convertible into cash in this market).

In Grant Thornton's view, the entire contract should be accounted for in accordance with IAS 39. We do **not** consider that it is appropriate to split the contract into a fixed portion of 1,000 MWh and a written option portion of up to 250MWh.

Electricity contracts have given rise to many questions. This is partly because electricity cannot normally be stored economically. The sector has therefore developed practices intended to continuously balance supply and demand. Many such contracts contain volume variability and contracts are often cash settled in order to keep supply commitments in line with production. The IFRIC made the following comments concerning energy supply contracts to retail customers in a rejection note in March 2007:

> "Under paragraph 7 of IAS 39 a written option to buy or sell a non-financial item that can be net settled (as defined in paragraph 5) cannot be considered to have been entered into for the purpose of meeting the reporting entity's normal purchase, sale and usage requirements. The application of this paragraph is illustrated in the current guidance.
>
> The submission was primarily concerned with the accounting for energy supply contracts to retail customers.
>
> Analysis of such contracts suggests that in many situations these contracts are not capable of net cash settlement as laid out in paragraphs 5 and 6 of IAS 39. If this is the case, such contracts would not be considered to be within the scope of IAS 39.
>
> In the light of the above, the IFRIC expected little divergence in practice and therefore decided not to take the item on to the agenda."

Accounting consequences of being within or outside IAS 39's scope

Contracts within IAS 39's scope

Most contracts with the scope of IAS 39 will meet the definition of a derivative in IAS 39.9. Commodity contracts normally have no initial investment, and their value will vary in accordance with the value of the commodity in question.

A commodity contract within IAS 39's scope that is also a derivative is accounted for at FVTPL.

Contracts accounted for as derivatives but physically settled

Sometimes a contract that is within IAS 39's scope is physically settled. This could occur if, for example, the entity net cash settles other similar contracts. Assuming the contract is accounted for as a derivative through FVTPL, the contract will be recognised immediately prior to settlement at the difference between the contract price and the spot price of the underlying commodity (adjusted as appropriate for other factors such as delivery obligations). On delivery, sale and purchase of inventory also need to be accounted for. The following example illustrates this from the vendor's perspective.

Gold contract accounted for net and settled gross

On 1.1.X1 a gold refiner contracts to deliver a fixed quantity of gold for $1m in six months time. The contract Is assessed in accordance with IAS 39.5 -7 and is considered to be a derivative within the scope of IAS 39. On 30.6.X1, the market price of this quantity of gold has fallen to $900,000. The contract is settled by physical delivery of the gold on 30.6.X1. The cost of the inventory is $875,000.

At 30.6.X1, the contract has a fair value to the refiner of $100,000 (asset).

Analysis

During the 6 months to 30.6.X1 the refiner will record a net gain of $100,000 representing the increase in the fair value of the contract. This should not be presented as revenue.

On delivery on 30.6.X1 the refiner:

- records a new financial receivable of $1m (assuming no discounting is required) for the consideration due;
- recognises revenue;
- derecognises inventory and records the costs of sale; and
- de-recognises the derivative financial asset.

There is a question where the debit entry corresponding to the de-recognition of the derivative asset should be recorded. We suggest that it is recorded as an adjustment to revenue. The "sale" is thus characterised as a delivery of gold at fair value on the delivery date. The proceeds are characterised as $100,000 to settle the derivative and $900,000 for the gold. The accounting effect is the same as if the contract price is fair value at the delivery date and the refiner enters into a separate derivative to offset price changes from the contract date to the delivery date.

Accounting entries from 1.1.X1 to 30.6.X1	Debit	Credit
Derivative financial asset	100,000	
Income statement gain		100,000

Accounting entries on 30.6.X1	Debit	Credit
Financial asset (receivable)	1,000,000	
Derivative financial asset		100,000
Revenue		900,000
Inventory		875,000
Cost of sales	875,000	

Contracts outside IAS 39's scope

Contracts to buy or sell a commodity that are outside the scope of IAS 39 will not normally be recognised in the financial statements until delivery. On delivery a sale or an inventory purchase is recognised in the normal way. However, if a commodity contract is or becomes onerous, a provision is recorded in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

In Grant Thornton's view a commodity contract should not be considered onerous solely on the grounds that it is unfavourable to market (eg for the seller the agreed price is less than current market prices). A contract is onerous if the economic benefits to be received are less than the unavoidable costs of the contract obligations.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au

Appendix

Decision tree to determine if a contract to buy or sell a non-financial item is within the scope of IAS 39