Stage 3—
‘Forward’ contracts:
the Woody case study
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Woody case study

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Chipem

Chipem is listed on the Afriganistan Stock Exchange. All entities listed on the Afriganistan Stock Exchange are required to prepare and file their consolidated annual financial statements in accordance with International Financial Reporting Standards (IFRS).

Chipem manufactures paper from pine wood chips of a particular quality (wood chips) in an energy-intensive process. Its functional currency is the Afriganistan dollar (A$).

On 1 January 20x1 Chipem enters into a commodity forward contract to buy 500 tonnes of wood chips in each of the two years after the contracting date (terminating on 31 December 20x2), at a fixed price (A$100 per tonne).

During 20x1, the price of wood chips declined significantly due to a combination of both reduced demand for paper and an oversupply of wood chips. The outlook over the next 12 months is for a continuation of both low wood chip prices and low demand. At 31 December 20x1 commodity (forward) contracts with one-year time frame, that are otherwise identical to Chipem’s contract, have a significantly lower fixed price (A$40 per tonne).

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Growem

Growem is also listed on the Afriganistan Stock Exchange. It grows pine trees for harvesting sawn pine logs (pine logs). In accordance with IAS 41 Agriculture Growem measures its standing timber at fair value less costs to sell. It holds, on average, an inventory of pine logs for one week’s supply. In accordance with IAS 2 Inventories, it measures its pine logs inventory at the lower of cost\(^2\) and net realisable value.

On 1 January 20x5 Growem enters into a contract to sell 1,000 tonnes of pine logs of the type grown by Growem a year at A$100 per tonne (fixed price) until 31 December 20x6.

During 20x5, the price of pine logs increases significantly as a result of supply shortages following widespread fires in a competitor’s pine forests. Domestic demand can currently only be met through imports of pine logs at a substantially higher price. Consequently, an identical new contract (except with a one-year time frame) entered into on 31 December 20x5, has a significantly higher fixed price (A$150 per tonne). In other words, the market now expects that the contract will (in effect) result in Growem receiving significantly lower than market price.

**Some IFRS issues for class discussion**

1. What are the economics/finance of forward contracts of the type entered into by Chipem and Growem? Your answer should explore, for example, the reasons why entities enter into forward contracts and how forward contracts are priced.

2. Before their maturity do fixed price contracts of the type entered into by Chipem and Growem give rise to: an asset; a liability (ie a single element); both an asset and a liability (ie two separate elements); or neither an asset nor a liability? (use the element definitions in the Conceptual Framework)

3. What information about contracts of the type entered into by Chipem and Growem is relevant to primary users of the financial statements of these entities—existing and potential investors, lenders and other creditors, who cannot demand such information directly from Chipem and Growem—in order to make decisions about providing resources to the two entities?

\(^2\) At the point of harvest sawn logs are measured at fair value less costs to sell. Such measurement is the cost at that date when applying IAS 2.
4. For each scenario presented, does IFRS (as applicable on 1 January 2015 with Chipem early applying all available new IFRS requirements)\(^3\) specify Chipem recognise any asset or liability in its statement of financial position at 31 December 20x1 in respect of the non-cancellable contract?

**Scenario 1:** the contract must be settled net in cash.

**Scenario 2:** the contract is entered into and continues to be held in accordance with Chipem’s expected wood chip purchase requirements and must be settled by physical delivery of wood chips.

**Scenario 3:** the contract can, at Chipem’s discretion, either be settled by physical delivery of the wood chips (like Scenario 2) or net in cash (like Scenario 1).

**Scenario 4:** the facts are the same as in Scenario 1, except that Chipem entered into the commodity forward contract to hedge the price risk of a highly probable forecast transaction to buy wood chips. In accordance with the *forecast transaction*, in December 20x2 Chipem expects to receive 500 tonnes of wood chips in exchange for cash.

5. How, if at all, in its 31 December 20x5 statement of financial position should Growem account for the contract that it is party to in accordance with IFRS (as applicable on 1 January 2015 with Growem early applying all available new IFRS requirements)\(^4\)?

**Scenario 1:** the contract must be settled net in cash.

**Scenario 2:** the contract cannot be settled net in cash and is entered into and continues to be held in accordance with Growem’s expected sales of pine logs.

**Scenario 3:** the contract can, at Growem’s discretion, either be settled by physical delivery of the pine logs (like Scenario 2) or net in cash (like Scenario 1).

6. Would your answer to Question 5 change if:
   (a) Growem wants to use hedge accounting?
   (b) At 31/12/20x5 an otherwise identical contract entered into on 31/12/20x5 with a one-year time frame has a significantly lower fixed price (say A$50 per tonne)?

7. What judgements and estimates would be made in determining whether the contracts in the Woody case study (Chipem and Growem) have become onerous?

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\(^3\) In particular, Chipem has elected to apply early the requirements of IFRS 9 *Financial Instruments* (2014) and IFRS 15 *Revenue from Contracts with Customers*.

\(^4\) In particular, Growem has elected to apply early the requirements of IFRS 9 *Financial Instruments* (2014) and IFRS 15 *Revenue from Contracts with Customers*. 

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