Stage 3—
‘Forward’ contracts:
Teaching notes that accompany
the Woody case study
Teaching notes for discussion facilitators using the Woody case study

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Under no circumstances should these teaching notes be made available to students. Use of these teaching notes is limited exclusively to those teaching IFRS Standards because the efficacy of the case study as a tool to develop students’ ability to make IFRS judgements will be greatly impaired if the students have access to the teaching notes. Completing the case study will help students to develop their ability to make judgements and estimates when applying IFRS Standards to unfamiliar economic phenomena (transactions, conditions and events). It is not an exercise in short-term memory recall.

The notes set out below are not intended to be complete. In other words, the notes provide the authors’ selection of some issues that might provide interesting discussion in class when using this case study.

Furthermore, in the absence of facts to the contrary, when determining the correct accounting treatment for a transaction or series of transactions, all the relevant facts need to be taken into account. A case study such as this one, because of its brevity, can only present a certain collection of those facts. Although IFRS requirements are usually clear, the conclusions arrived at in this material are based on the assumption that there are no relevant facts that, if they had been considered, might have altered that conclusion. As a result, these can only be considered likely conclusions, and cannot be considered to be determinative, without full consideration of all the facts that would be present in a real-life scenario.

Moreover, the authors encourage those using this case study to enhance class discussion by adding facts to the case study (or otherwise changing the facts presented in the case study) to extend the discussion to include how those new or otherwise changed facts affect the likely conclusions about a particular issue. The authors believe that such enriched discussions are likely to further develop students’ ability to make the judgements that are necessary when applying IFRS Standards.
### General

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<th>Some IFRS issues for class discussion</th>
<th>Notes for discussion facilitators</th>
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<tr>
<td>1. What are the economics/finance of contracts of the type entered into by Chipem and Growem?</td>
<td><strong>Why do entities enter into forward contracts?</strong></td>
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<td>Reasons for entering into forward contracts include:</td>
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<td>(a) to hedge economic risks (for example, a retailer might protect against financial loss through decreasing prices of its inventory);</td>
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<td>(b) to secure future access to a scarce resource;</td>
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<td></td>
<td>(c) to build customer relationships (lock-in customers on both price and volume) or to assure the sale of goods at an economic price to the seller (forward sale contracts); and</td>
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<td>(d) speculation on price movements of the underlying commodity.</td>
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<td><strong>How are forward contracts priced?</strong></td>
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<td>A commodity-based forward contract is an agreement to buy or to sell a specified quantity of a commodity at a future date, at a price agreed upon when entering into the contract (the ‘forward price’).</td>
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<td>Rational pricing theory implies that for non-perishable commodities, securities and currencies arbitrage opportunities cause the relationship between forward and spot prices to depend mainly on interest rates (the time value of money) and counterparty credit risk. However, other cash flows must be adjusted for in pricing (for example, dividends and storage costs).</td>
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<td>To illustrate rational pricing theory—assuming that today:</td>
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<td>• spot price of gold = $1,000 per ounce;</td>
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<td></td>
<td>• risk-free interest rate = 10 per cent (simple interest—compounded annually);</td>
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Today, a 12-month forward rate to buy gold would rationally be priced at $1,100 per ounce. ‘Proof’: if the forward rate was priced higher (say $1,200) then:

• an arbitrager would borrow $1,000 to buy an ounce of gold and immediately enter into a 12-month forward contact to sell that gold for $1,200. Result: arbitrage profit = $100 ($1,200 income less $1,000 cost of gold sold less $100 finance cost);
• put another way, rather than using a forward to hedge the risk that the price of gold will rise, borrow $1,000 from the bank today to buy today the gold that will be needed in 12 months at $1,000 and pay $100 interest on the loan (ie total cash flow $1,100).

Forward contracts can have a variety of forms. For example, the terms of the contract might specify net settlement in cash, physical gross settlement or give one or both parties to the contract the choice of settling net or gross. The effect of such terms is discussed below.

Teachers might want to extend the discussion to other variations on the conventional forward contract. For example, discuss a ‘take or pay’ contract whereby the purchaser is required to pay for a specified quantity at a fixed price regardless of whether it is able to use, or take delivery of, that specified quantity.

### 2. Before their maturity do fixed price contracts of the type entered into by Chipem and Growem give rise to:

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<th>an asset;</th>
<th>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 elements definitions in the Conceptual Framework)</th>
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**Background information**

This question has vexed standard-setters and others for many years.

Assets and liabilities are defined in the *Conceptual Framework* (see paragraph 4.4). A key attribute of the liability is the existence of a present obligation.

The *Conceptual Framework* observes that in practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet transferred) are generally not recognised as liabilities in the financial statements (see...
paragraph 4.46). However, the IASB staff’s thinking about element (for example, liability) existence in respect of enforceable\(^1\) forward contracts is evolving (see the Appendix).

**Some discussion questions**

Does the answer to the question—does an asset or a liability, or both, arise from the rights and obligations in a commodity contract?—depend on the terms of the contract and the economic circumstances?

Does the answer to the question—does an asset or a liability, or both, arise from the rights and obligations in a commodity contract?—depend on the possible remedies that a court could award if for example, action were taken for breach of contract?

Does the answer to the question—does an asset or a liability, or both, arise from the rights and obligations in a commodity contract?—depend on whether one party has the ability not to perform if the other party fails to perform?

In exploring these questions class discussion would likely cover a range of purposes for which contracts are entered into (see above) and a variety of contractual terms that exist within commodity contracts including:

(a) enforceable rights to terminate wholly unperformed contracts without penalty, including when:
   (i) each party to the contract has the unilateral termination right; and
   (ii) when only one party has the termination right.

(b) non-cancellable contracts including, for example, Scenarios 1–3 of the Chipem case study and similar scenarios for the commodity contract in the Growem case study.

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\(^1\) Wholly unperformed contracts, if each party to the contract has the unilateral enforceable right to terminate the contract without penalty, give rise to neither enforceable rights (asset) nor present obligations (liability).
Overall observed discussion groups’ conclusion

The contractual terms are determinative. For examples, see the conclusions for the variety of contractual terms that are set out below.

Observed discussion groups’ conclusion—termination rights

Wholly unperformed contracts, if each party to the contract has the unilateral enforceable right to terminate the contract without penalty, give rise to neither enforceable rights (asset) nor present obligations (liability). Those contracts would not affect an entity’s financial position or performance until either party performs.

In contrast, there could be an effect on an entity’s financial position and performance if only one party could terminate a wholly unperformed contract without penalty. For instance, if only the customer could terminate the wholly unperformed contract without penalty, the entity is obliged to stand ready to perform at the discretion of the customer. Similarly, if only the entity could terminate the wholly unperformed contract without penalty, it has an enforceable right to payment from the customer if it chooses to perform (see paragraph BC50 of the Basis for Conclusions on IFRS 15).

However, even in this last scenario, the entity’s right is contingent on it extinguishing the performance obligations (for example, by supplying to its customer the goods specified in the contract). Consequently, the IASB staff thinks that “an enforceable executory contract contains a right and an obligation to exchange economic resources (or to pay or receive the difference in values between two economic resources if the contract will be settled net). The combined right and obligation constitute a single asset or liability.” (paragraph 3(a)(i) of Agenda Paper 10D, June 2014 IASB meeting). However, the staff believes that there may be circumstances in which the terms of a forward contract to purchase a resource give the purchaser control of that resource. In such circumstances, they believe that the purchaser should identify both an asset (the underlying resource that it already controls) and a liability (its obligation to pay for the resource) because, in these circumstances, the contract is not
executory: the seller has substantively performed its obligations. (paragraph 3(a)(ii) of Agenda Paper 10D, June 2014 IASB meeting).²

**Observed discussion groups’ conclusion—only one party has performed**

When only one party to the contract has performed in full—for example, the consideration has been paid or control of the goods has passed, but not both—the remaining rights and obligations are unconditional. For example:

- upon accepting delivery of a consignment of wood chips from its supplier, Chipem has an unconditional obligation (a liability) to pay at the fixed price for the quantity delivered; and
- upon delivery, Growem has an unconditional right (an asset) to receive payment at the fixed price for the quantity delivered to its customer.

**Observed discussion groups’ conclusion—enforceable contract that must be settled net in cash**

A wholly unperformed commodity contract that must be settled net in cash (for example, Scenario 1 in the Chipem case study) does not result in a transfer of the underlying primary commodity on inception of the contract, nor does such a transfer take place on maturity of the contract. Such commodity forward contracts embody both a right and an obligation to pay or receive the difference between the value of two resources at the future date. Because the terms are determined on inception of the derivative instrument, as prices in financial markets change, those terms may become either favourable or unfavourable. In other words, such contracts give rise to either a right to receive cash (if accumulating unrealised gains) or an obligation to pay cash (if accumulating unrealised losses)—a single asset or a single liability.

² the Board agreed with the staff (see IASB Update June 2014) and has exposed these views for comment in its May 2015 Exposure Draft [Proposed] Conceptual Framework for Financial Reporting (see paragraphs 4.40–4.42 and BC4.82–BC4.92 ).
When an entity becomes a party to a commodity forward contract (rather than on the date on which settlement takes place) the fair value of the commodity forward contract is usually zero. In such cases, there is, in effect, no asset or liability for either party to the commodity forward contract to recognise.

A commodity forward contract that has a zero fair value at its inception may become a net asset or a net liability in the future depending mainly on the value of the underlying assets (for example wood chips in Chipem’s case).

Between inception and the settlement date, economic circumstances change—for example, an increase in the market price of the underlying (the commodity that is the subject of the contract, ‘the goods’) results in a single asset for the ‘purchaser’ (and a single liability for the ‘seller’)—in effect, the market price change creates a difference between the values of the two underlying resources. Had the market price declined, the ‘purchaser’ would have a liability and the ‘seller’ an asset.

To illustrate using the contracts in the Woody case study—there is a liability in respect of a commodity forward contract that must be settled net in cash—a present obligation to pay cash to the counterparty. For example, to satisfy its liability, at the reporting date:

(a) Chipem would have to pay an amount calculated with reference to the difference between A$100 per tonne (the fixed ‘purchase price’ specified in the contract) and the lower current forward purchase price for the outstanding quantity of identical wood chips specified in the contract;\(^3\) and

(b) Growem would have to pay an amount calculated with reference to the difference between A$100 per tonne (the fixed ‘selling price’ specified in the contract) and the higher current forward market price to sell the specified outstanding quantity of identical pine logs.\(^4\)

Similarly, had the market prices moved in the opposite direction, there would be an asset in respect of an ‘in-the-money’ commodity forward contract that the counterparty must settle net in cash.

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\(^3\) Adjustments would be made for other factors that market participants would consider when pricing the forward contract, for example, the time value of money.

\(^4\) Adjustments would be made for other factors that market participants would consider when pricing the forward contract, for example, the time value of money.
Observed discussion groups’ conclusion—enforceable contract that must be settled by (gross) physical delivery

We observe that most discussants find the question—a single net asset/liability or a separate asset and a separate liability?—vexing when the terms of the supply contract specify that payment is conditional on the delivery of the goods. When the entity can avoid performance because the counterparty has not performed, some discussants argued that the entity has a single net asset or single net liability. Others disagree—they see a separate ‘stand ready’ obligation to deliver (a liability) and a separate right to receive (an asset).

In its 2015 Exposure Draft *The Conceptual Framework for Financial Reporting* (paragraph 4.41) the IASB proposes “An executory contract establishes a right and an obligation to exchange economic resources. .... That right and obligation to exchange economic resources are interdependent and cannot be separated. Hence, the combined right and obligation constitute a single asset or liability. The entity has an asset if the terms of the exchange are favourable; it has a liability if the terms of the exchange are unfavourable.”

Extending the case study
Teachers might want to extend the discussion to variations on the conventional supply contract. For example, a ‘take or pay’ contract whereby the purchaser is required to pay for a specified quantity at a fixed price regardless of whether it ultimately takes delivery of that specified quantity.

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

Background information
The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to primary users—existing and potential investors, lenders and other creditors that cannot require the reporting entity to provide information directly to them—in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit (see paragraphs OB2 and OB5 of the *Conceptual Framework*).

To assess an entity’s prospects for future net cash inflows, existing and potential investors,
<table>
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<th>about providing resources to the two entities?</th>
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<td>[Note to teachers: we observe that personalising this question tends to foster discussion. For example, telling students “you are considering investing in Chipem and Growem” and then asking them “what information about the commodity forward contracts that they are party to would you find useful in informing your investment decision?”]</td>
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<th>lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources (see paragraph OB4 of the Conceptual Framework).</th>
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<tr>
<td>Information about a reporting entity’s financial performance during a period, reflected by changes in its economic resources and claims other than by obtaining additional resources directly from investors and creditors (see paragraph OB21 of the Conceptual Framework), is useful in assessing the entity’s past and future ability to generate net cash inflows.</td>
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<td>That information indicates the extent to which the reporting entity has increased its available economic resources, and thus its capacity for generating net cash inflows through its operations rather than by obtaining additional resources directly from investors and creditors (see paragraph OB18 of the Conceptual Framework).</td>
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<td>Information about a reporting entity’s financial performance during a period may also indicate the extent to which events such as changes in market prices or interest rates have increased or decreased the entity’s economic resources and claims, thereby affecting the entity’s ability to generate net cash inflows (see paragraph OB19 of the Conceptual Framework).</td>
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<tr>
<th>Relevant information: commodity forward contract settled net in cash</th>
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<tr>
<td>The value of a commodity forward contract that must be settled net in cash changes in response to changes in the underlying commodity price. Measuring such derivatives (the commodity forward contract) at fair value provides users with a current measure of the expected future cash flows from that contract.</td>
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<tr>
<td>Observed discussion groups’ conclusion—reporting changes in the fair value of a cash settled forward contract in an entity’s financial performance during a period of that change indicates the extent to which changes in market prices have increased or decreased the entity’s</td>
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5 If an asset—fair value is the price that would be received to sell the contract in an orderly transaction between market participants at the measurement date. If a liability—fair value is the price that would be paid to transfer the contract in an orderly transaction between market participants at the measurement date.
economic resources and claims, thereby affecting its ability to generate net cash inflows.

**Does physical delivery for expected purchase, sale or usage requirements change the information need?**

Further background information relevant to this question can be found in some of the instances in which the IASB and its predecessor (the IASC) considered related issues. For example:

- When setting IAS 41 the International Accounting Standards Committee (IASC)\(^6\) concluded that it is logical to measure a fixed price forward sale contract at fair value to the extent that a related biological asset\(^7\) (the underlying) is also measured at fair value (see paragraph B50 of the Basis for Conclusions on IAS 41). However, because the scope of that project did not extend to situations in which the underlying was measured using a cost based measure, amongst other reasons, the IASC refrained from specifying fair value measurement for such forward contracts (see paragraph B51 of the Basis for Conclusions on IAS 41).

- In their 2008 Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* the boards\(^8\) proposed that to measure revenue, an entity would first measure its contract asset or contract liability and then assess contractual performance from the changes in the measurement of the contract position from one financial statement date to the next (see paragraph 5.12). They considered two alternatives for measuring performance obligations under a non-cancellable contract with a customer—a current exit price (for example, fair value) and the original transaction price (see paragraph 5.14). The boards rejected fair value because:
  - they were uncomfortable with an approach that allows an entity to recognise revenue before the entity transfers to the customer any of the goods and services that are promised in the contract (see paragraph 5.20):

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\(^6\) The predecessor to the IASB.

\(^7\) In accordance with paragraph 16 of IAS 41 (and IFRS 13 *Fair Value Measurement*) the forward contract prices are not necessarily relevant in determining fair value and that the fair value of a biological asset or agricultural produce is not adjusted because of the existence of a contract.

\(^8\) IASB and FASB, which pursued this project jointly.
o noted that the remeasurements for price changes would be unnecessarily complex for most contracts with customers; and
o that changes in prices are not significant in most contracts with customers because the values of promised goods and services promised in contracts are not inherently volatile or of short duration (see paragraph 5.39).

Nevertheless, remeasurement was proposed for instances when forward contracts become onerous.

- Similarly, in 2014, when developing IFRS 15 the boards specified that contracts with customers should be measured at the original transaction price. If such contracts become onerous then the losses are recognised in accordance with other IFRSs (for example, IAS 37) (see paragraphs BC294–BC296 of the Basis for Conclusions on IFRS 15).
- In the 2013 Discussion Paper A Review of the Conceptual Framework for Financial Reporting the IASB suggested understanding the effect of decisions on whether to recognise the rights and obligations under forward contracts, it is worth considering how those rights and obligations might be measured. They then document observed current practice for the measurement of such contracts (see paragraphs 3.111 and 3.112).
- In June 2014 the IASB staff presented their thinking on a possible approach to measurement of executory contracts to the IASB as part of its Conceptual Framework (as set out in paragraphs 39–42 in the extract from Agenda Paper 10D (see the Appendix).

Many of the instances cited above were considered from the perspective of the seller. However, in a footnote to paragraph 2.23 of their 2008 Discussion Paper, the boards noted:

A contract also conveys rights to and imposes obligations on a customer, the combination of which can be an asset or a liability to the customer. However, accounting for the customer’s net position in a contract is outside the scope of this project and is not discussed in this Discussion Paper.

[To generate discussion, present some scenarios to your students that are ‘more extreme’ than those presented in this case study. For example, ask students—would it affect your decision whether to invest in an entity, if that entity has entered into fixed price forward contracts to
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<th>7. What judgements and estimates would be made in determining whether the contracts in the Woody case study (Chipem and Growem) have become onerous?</th>
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**Observed discussion groups’ conclusion**—we observe that most discussants indicate that they believe that fair value measurement of forward contracts provides the most relevant information to inform primary users’ resource allocation decisions. This view is almost unanimous when the underlying is related to an existing asset of the entity that is measured at fair value (for example, Growem’s contract). On the other hand, we observe that many discussants find it counterintuitive to measure at fair value contracts, for example, to acquire a good that the entity will account for using a cost model (like Chipem’s contract). They generally seem to think that fair value information is more relevant (particularly when presented with more extreme cases) but find such measurement difficult to reconcile with the subsequent accounting for the underlying asset once that physical asset is recognised by the entity.

**Extending the discussion**—teachers might want to extend the discussion to variations on the conventional supply contract. For example, a ‘take-or-pay’ contract whereby the purchaser is required to pay for a specified quantity at a fixed price regardless of whether it ultimately takes delivery of, that specified quantity.

**Background information**
Paragraph 68 of IAS 37 Provisions, Contingent Liabilities and Contingent Assets specifies that a contract is onerous when the unavoidable costs (ie the lower of the cost of fulfilling the contract and any compensation or penalties arising from failure to fulfil it) of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

[Note to teachers—the literature from some of the bigger accounting firms includes worked examples that illustrate their interpretation of which costs are considered to be unavoidable]
for determining whether supply contracts that are entered into and continue to be held to meet expected usage requirements are onerous.\(^9\) That material might be useful in initiating class discussions.]

**Observed discussion groups’ conclusion**

Because onerous is ‘loosely’ defined in some cases it requires considerable judgement to determine whether a contract is onerous—judgements include determining which costs are unavoidable and in estimating the expected future benefits under a contract.

**Extension discussion question**—assuming that the seller of a biological asset in agricultural activity (for example, Growem) does not account for the sale contract at its fair value, how does the seller determine whether the contract is onerous?

There appears to be a range of interpretations of when such contracts become onerous.\(^10\) Some might consider the contract is onerous whenever today’s forward price is higher than the forward price specified in the contract because, for example, Growem cannot avoid delivering pine logs whose carrying amount at 31 December 20x5 measured in accordance with IAS 41 or purchased at fair value in the open market has a greater value than the proceeds that it will receive upon completion of the contract.\(^11\) For EY’s view see .EY, *International GAAP 2015*, p2830 and for PwC’s view see PwC *Manual of Accounting IFRS 2013*—Volume 2, p32008

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\(^9\) The guidance of the bigger accountancy firms sets out their interpretations of onerous. For example, see KPMG’s *Insights into IFRS 2014/2015*, p726–733.

\(^10\) “IAS 37 requirements and guidance on identifying and measuring onerous contract liabilities are brief and, in the absence of robust concepts, have given rise to differing interpretations.” (paragraph 8 of Agenda Paper 10D, June 2014 IASB meeting)

\(^11\) The fair value of a biological asset or agricultural produce is not adjusted because of the existence of a contract (see paragraph 16 of IAS 41).
### Chipem

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<tr>
<td>4. For each scenario presented, does IFRS (as applicable on 1 January 2015 applying early all available new IFRS requirements) require Chipem to recognise any asset or liability in respect of the non-cancellable contract?</td>
<td>The ‘decision tree’ below summaries the process for identifying the requirements that apply in each of the scenarios discussed in more detail below.</td>
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'Forward' contract to buy a non-financial asset (Chipem)

- Contractual terms: must be settled net in cash or another financial instrument? (Scenarios 1 and 4)
  - Yes: Apply IFRS 9 Financial Instruments
  - No: Contractual terms: can be settled net in cash or another financial instrument? (Scenario 3)
    - Yes: 'Own-use' exemption: contract entered into for the purpose of meeting normal purchase requirements?
      - Yes: Choose fair value measurement to address an accounting mismatch?
        - Yes: Asset/liability accounting policy objective = most relevant information that can be faithfully represented etc
        - No: Liability measurement objective = best estimate of extent to which contract is onerous
      - No: Is the contract onerous?
        - Yes: Apply IAS 37 Provisions, Contingent Liabilities and Contingent Assets
        - No: Is underlying readily convertible into cash? (Scenario 2)
          - Yes: Measure 'forward' contract asset/liability at fair value. Present effective hedge portion of fair value changes in other comprehensive income (OCI) and ineffective portion in profit or loss (see paragraph 6.5.11 of IFRS 9 for 'lower of' test)
          - No: Measure 'forward' contract asset/liability at fair value. Present changes in fair value with changes in fair value presented in profit or loss

- Contract hedges the price risk of a highly probable forecast transaction that qualifies for cash flow hedge accounting and the entity elects to use it? (Scenario 4)
  - Yes: No
  - No: No
Scenario 1: the commodity forward contract must be settled net in cash

Background information

The commodity forward contract satisfies the definition of a derivative—its value changes in response to the change in a specified commodity price (ie wood chips); it requires no initial net investment; and it is settled at a future date (ie two years later).\(^\text{12}\)

Observed discussion groups’ unanimous conclusion

The commodity forward contract in Scenario 1 must be settled net in cash. Consequently, it must be accounted for in accordance with IFRS 9 (see paragraphs 2.1 of IFRS 9).\(^\text{13}\) The contract gives rise to either a single (net) asset (the right to receive cash, if it is accumulating unrealised gains) or a single net liability (the obligation to pay cash, if it is accumulating unrealised losses).

However, at inception (ie when an entity becomes a party to a commodity forward contract, rather than on the specified ‘delivery’ on which settlement takes place), the fair value of the commodity forward contract is usually zero. In such cases, there is, in effect, no asset or liability for either party to the forward contract to recognise initially.

Between initial recognition and the ‘delivery’ date, economic circumstances change—for example, a decrease in the market price of the underlying (wood chips—the subject of the contract) results in a single liability for Chipem—in effect the market price change decreased the value of the net right to receive the wood chips without a corresponding decrease in the value of the obligation to pay for those goods.

To illustrate, at 31 December 20x1 Chipem has a liability in respect of the accumulated unrealised losses arising from the commodity forward contract that must be settled net in cash. In accordance with IFRS 9 that liability would be measured at its fair value—in effect, how much would Chipem have to pay to transfer its obligations under the contract to an independent third party. If there is no quoted price for such commodity forward contracts then its fair value could be measured, for example, by discounting the difference between

\(^{12}\) see Appendix A of IFRS 9 Financial Instruments (if Chipem had not applied early IFRS 9 then paragraph 9 of IAS 39 Financial Instruments: Recognition and Measurement would have applied).

\(^{13}\) If Chipem had not applied early IFRS 9 then paragraphs 5 and AG10 of IAS 39 would have applied to the same effect.
A$100 per tonne (the fixed ‘purchase price’ specified in the contract) and the lower current forward purchase price multiplied by the outstanding quantity of identical wood chips specified in the contract.\(^\text{14}\) Chipem would recognise the change in the fair value of the contract in profit or loss for the year ended 31 December 20x1—in the period of the change (see paragraph B3.1.2(c) of IFRS 9).\(^\text{15}\)

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<th>Scenario 2: the commodity contract cannot be settled net in cash and is entered into and continues to be held in accordance with Chipem’s expected wood chip purchase requirements (expect physical delivery of wood chips)</th>
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**Background information**

Paragraph AG20 of IAS 32 *Financial Instruments: Presentation* explains that “contracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset.” Consequently, in Scenario 2, Chipem’s contractual right to receive wood chips (a non-financial item) is not a financial instrument. Even if the contract is in a standardised form and traded on an organised market (in much the same fashion as some derivative financial instruments) Chipem and seller in the contract are, in effect, trading the underlying commodity. The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity do not alter the fundamental character of the contract in a way that creates a financial instrument. Nevertheless, some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are within the scope of IAS 32 as if they were financial instruments (see paragraph 8 of IAS 32). Similarly, in accordance with paragraph 2.6(d) of IFRS 9\(^\text{16}\), although (in this scenario) the contract to buy the wood chips does not provide for net settlement in cash, if the non-financial item that is the subject of the contract (wood chips) is readily convertible to cash then, for the purpose of applying IFRS, the contract is explicitly considered to be of the

\(^{14}\) The discount rate would reflect the time value of money and other factors that market participants would consider pricing the forward contract.

\(^{15}\) Formerly paragraph AG35(c) of IAS 39.

\(^{16}\) Formerly paragraph 6(d) of IAS 39.
Paragraph 2.4 includes such contracts that can be ‘settled net in cash’ in the scope of IFRS 9 as if the contracts were financial instruments. Furthermore, the definition of a derivative (see IFRS 9 Appendix A) is a financial instrument or other contract within the scope of IFRS 9 with all three of the following characteristics—its value changes in response to the change in a specified commodity price (ie wood chips); it requires no initial net investment; and it is settled at a future date (ie up to two years later).

However, paragraph 8 of IAS 32 and paragraph 2.4 of IFRS 9 go on to exclude from the scope of those Standards (by exception) such 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 (sometimes called ‘the own use exception’).

Nevertheless, to eliminate or significantly reduce an ‘accounting mismatch’ that would otherwise arise from not recognising such a contract because it is excluded from the scope of IFRS 9, at inception of the contract (in accordance with paragraph 2.5 of IFRS 9) a contract to buy a non-financial item that can be settled net in cash may be irrevocably designated as measured at fair value through profit or loss even if it was entered into for the purpose of the receipt of a non-financial item in accordance with the entity’s expected purchase or usage requirements. This option is available only if this would result in eliminating or reducing an accounting mismatch.

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17 Formerly paragraph 5 of IAS 39
18 Formerly definition of a derivative in paragraph 9 of IAS 39
19 Note: this limited option to avoid an ‘accounting mismatch’ by accounting at fair value through profit or loss for ‘own use’ forward contracts does not apply to those contracts that do not satisfy the criteria to be classified as ‘can be settled net in cash’ as set out in paragraph 2.6 of IFRS 9. This is perhaps more easily explored further when discussing with the class Growem (as set out below).
Observed discussion groups’ conclusion

Irrespective of whether wood chips are readily convertible to cash,\(^\text{20}\) the contract is excluded from the scope of IAS 32 and IFRS 9 because Chipem entered into and continues to hold the contract for the purpose of delivery of the wood chips (a non-financial item) in accordance with its expected purchase or usage requirements (see paragraph BA.2 of IFRS 9)\(^\text{21}\) unless such wood chips are judged to be readily convertible into cash AND to eliminate or significantly reduce an accounting mismatch, Chipem at inception chooses to irrevocably designate such a contract as measured at fair value through profit or loss (in accordance with paragraph 2.5 of IFRS 9).

If not in the scope of IFRS 9, then if the contract is onerous it must be accounted for in accordance with IAS 37 (see paragraph 1(a) of IAS 37). Paragraph 68 of IAS 37 specifies that a contract is onerous when the unavoidable costs (ie the lower of the cost of fulfilling the contract and any compensation or penalties arising from failure to fulfil it) of meeting the obligations under the contract exceed the economic benefits expected to be received under it. (See the notes above, under the heading ‘General’ about the judgements and estimates in determining whether a contract is onerous).

Consequently, if at 31 December 20x1 the contract is onerous, (see paragraph 68 of IAS 37) Chipem would recognise a liability for the extent to which the contract is onerous at 31 December 20x1 and recognise the corresponding increase in that liability as an expense in profit or loss in 20x1.\(^\text{22}\)

If the contract is not onerous (ie the economic benefits expected to be received under the contract exceed the unavoidable costs of meeting the obligations under it), it is accounted for

\(^{20}\) In this scenario, only if the specified wood chips are judged to be readily convertible into cash would the forward contract be categorised as ‘can be settled net in cash’ (see paragraph 2.6(d) of IFRS 9).

\(^{21}\) Formerly paragraph AG10 of IAS 39

\(^{22}\) If an executory contract has become onerous, that does not mean that a new liability has arisen at that point. The liability arose when the entity entered into the contract, but until it became onerous it was measured at zero, which had the same practical effect as non-recognition until that point (see paragraph 3.111(a)(ii) of the Discussion Paper A Review of the Conceptual Framework for Financial Reporting (July 2013)).
as an executory contract. However, IFRS does not explicitly specify how to account for executory contracts that are not onerous.\(^{23}\) Consequently, in accordance with paragraph 10 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, management must use its judgement in developing and applying an accounting policy for such contracts that results in information that is, amongst other things, relevant and faithfully represented.

A scope exception does not preclude an entity from applying by analogy the accounting in another IFRS that in accordance with IAS 8 paragraph 11 management judges to be similar and related. However, the exception (scope exclusion) means that it is not mandatory to do so. Consequently, in the authors’ view Chipem could choose to account for the forward contract (in the situation described in Scenario 2) at fair value through profit or loss by analogy to IFRS 9. Similarly, Chipem could consider accounting for the contract with its supplier, by analogy to IFRS 15 Revenue from Contracts with Customers, measured based on consideration as performance obligations are satisfied. Nevertheless the IASC, and more recently the IFRS Interpretations Committee, have observed that in the context of current IFRS, executory contracts are generally not accounted for.\(^{24}\) In its July 2013 Discussion Paper A Review of the Conceptual Framework for Financial Reporting, in the context of understanding the effects of the decisions on whether to recognise rights and obligations arising under forward contracts, the IASB staff observed current practice as measuring at zero wholly unperformed contracts that will result in the receipt by the entity of assets that will be measured on a cost basis (see paragraph 3.111(a)).

If Chipem’s accounting policy is to account for such commodity contracts at fair value by analogy to financial instruments (IFRS 9), at 31 December 20x1 Chipem would measure the liability at fair value and recognise the increase in fair value of the liability as an expense in profit or loss in 20x1.

However, if Chipem’s accounting policy is to account for such wholly unperformed commodity contracts (that are not judged to be onerous) by analogy to IFRS 15, at

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\(^{23}\) One reviewer noted that developing an accounting policy under IAS 8 permits application of Standards by analogy only if an item or transaction is outside the scope of all other Standards. Therefore one would consider the requirements of other Standards such as IFRS 9 only if you conclude that the contract to buy wood chips is outside the scope of IAS 38 Intangible Assets.

\(^{24}\) See, for example, paragraph BC28 of the Basis for Conclusions on IFRIC 4 Determining whether an Arrangement contains a Lease.
31 December 20x1 Chipem could measure the liability at nil. Nevertheless, the IASC, the IFRS Interpretations Committee and the IASB have observed that current practice is not to account for such a wholly unperformed contract or to measure it at zero (unless the contract has become onerous).\(^{25}\)

### Scenario 3: the commodity 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)

**Observed discussion groups’ conclusion**

The accounting depends on Chipem’s intentions and actions. Intentions—the contract is within the scope of IFRS 9 unless it was entered into and continues to be held for the purpose of delivery of the wood chips (a non-financial item) in accordance with Chipem’s expected purchase or usage requirements (see paragraphs 2.1 and BA.2\(^{26}\) of IFRS 9)—ie the ‘own use exception’ applies (see paragraph 2.4 of IFRS 9). Actions—nevertheless as the contract can be settled net in cash, Chipem can at inception choose to irrevocably designate such a contract as measured at fair value through profit or loss provided that doing so eliminates or significantly reduces an accounting mismatch (see paragraph 2.5 of IFRS 9).

If in the scope of IFRS 9, see the accounting and reporting set out in Scenario 1 above. If outside the scope of IFRS 9\(^{27}\), see the accounting and reporting set out in Scenario 2—in short: IAS 37 applies if the contract is onerous; if the contract is not onerous, Chipem, in accordance with the IAS 8 Hierarchy (see paragraphs 10 to 12 of IAS 8), develops its accounting policy for such contracts.

### Scenario 4: Chipem entered into the commodity forward contract to hedge price risk of a highly probable forecast transaction to buy wood chips\(^{28}\)

**Some discussion points before discussing hedge accounting**

What is the rationale for hedge accounting overriding ‘normal’ accounting?

Which forms of hedge accounting are available to Chipem—cash flow hedge accounting, fair

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\(^{25}\) See, for example, paragraph 4.46 of the Conceptual Framework, paragraph BC28 of the Basis for Conclusions on IFRIC 4 and paragraphs 3.110(c)(ii) and 3.111(a) of Discussion Paper A Review of the Conceptual Framework for Financial Reporting (July 2013).

\(^{26}\) Formerly paragraphs 5 and AG10 of IAS 39.

\(^{27}\) because Chipem intends to settle the contract by taking delivery of the wood chips and has no history for similar contracts of settling net in cash or of taking delivery of the wood chips and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer’s margin

\(^{28}\) We encourage teachers to extend the case study to further scenarios. For example, teachers could initiate a class discussion about a scenario in which the highly probable forecast transaction becomes a firm commitment.
In accordance with the *forecast transaction*, in December 20x2 Chipem expects to receive 500 tonnes of wood chips in exchange for cash.

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<th>value hedge accounting, or both?</th>
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**Observed discussion groups’ conclusion—the rationale for hedge accounting**

Hedge accounting is not the same as economic hedging. The latter is the *activity* of hedging. Chipem’s highly probable forecast transaction for the purchase of wood chips exposes Chipem to the risk of future changes in price of those wood chips changing its future cash flows. For example, if the market price of wood chips were to increase, then the cash outflow for the purchase of those chips would increase.

In this scenario Chipem seeks to mitigate the price risk of such changes in its future cash flows by using a derivative (a cash-settled fixed-price commodity forward contract) to effectively fix the price of the 500 tonnes of wood chips that it expects to buy at A$100 per tonne—the derivative’s cash flows are expected to offset changes in the cash flows expected from the forecast transaction to purchase of the wood chips. Such hedging arrangements are called cash flow hedges—the commodity forward contract to buy wood chips is the ‘hedging instrument’; and the highly probable forecast transaction to buy wood chips is the ‘hedged item’.

Without hedge accounting the commodity forward contract, that must be settled net in cash, would, in accordance with IFRS 9, be accounted for as a derivative—at fair value through profit or loss. Applying cash flow hedge accounting results in Chipem recognising the effective portion of the gain or loss of the derivative in other comprehensive income. The cash flow hedge reserve is adjusted to the lower of (the absolute amounts of) the cumulative gain or loss on the hedging instrument from inception of the hedge and the cumulative change in fair value of the hedged item from inception of the hedge. When wood chips are initially recognised by Chipem, it removes the accumulated associated gains and losses from the cash flow hedge reserve and includes them in the carrying amount of the wood chips inventory asset (see paragraph 6.5.11(d)(i) of IFRS 9). However, if that amount is a loss and Chipem expects that all or portion of that loss will not be recovered, Chipem would immediately recognise in profit or loss (as a reclassification adjustment) the amount
that is not expected to be recovered (see paragraph 6.5.11(d)(iii) of IFRS 9).

*Observed discussion groups’ conclusion—cash flow hedge accounting*

Provided Chipem complies with the conditions specified in IFRS 9, it would qualify for cash flow hedge accounting.

As explained for Scenario 1 above, the cash-settled commodity forward contract meets the definition of a derivative—its value changes in response to the change in a specified commodity price (ie wood chips); it requires no initial net investment; and it is settled at a future date (ie two years later). Because the contract must be settled net in cash it must be accounted for in accordance with IFRS 9 (see Scenario 1 above). Consequently, the entity must recognise as an asset or a liability at inception (albeit measured at nil), rather than waiting until the date on which settlement takes place. However, at inception, the fair values of the right and obligation are often equal, so that the net fair value of the commodity forward contract is usually zero. ²⁹

At 31 December 20x1 Chipem would measure the derivative (hedging instrument) at its fair value (see Scenario 1 above) of say CU35,000:

- if it qualifies for hedge accounting (assuming perfect hedge effectiveness): recognise CU35,000 loss (change in fair value of the derivative) as an expense in other comprehensive income (OCI) in 20x1
- if it does not qualify for hedge accounting: recognise CU35,000 expense (change in fair value) in profit or loss in 20x1 (ie cannot be recognised in OCI).

²⁹ If the net fair value of the right and obligation is not zero at the commitment date the contract is recognised as an asset or liability. (paragraph B3.1.2(c) of IFRS 9 (formerly AG35(c) of IAS 39)).
Growem

The ‘decision tree’ below summaries the process for identifying the requirements that apply in each of the scenarios discussed in more detail below.
'Forward' contract to sell a non-financial asset (Growem)

Contractual terms: must be settled net in cash or another financial instrument? (Scenario 1)

- Yes: Apply IFRS 9 Financial Instruments
- No: Contractual terms: can be settled net in cash or another financial instrument? (Scenario 3)

- Yes: 'Own-use' exemption: contract entered into for the purpose of meeting normal purchase requirements?
  - Yes: Choose fair value measurement to address an accounting mismatch?
    - Yes: Measure 'forward' contract asset/liability at fair value. Present changes in fair value in profit or loss
    - No: Contract hedges the price risk of a recognised asset that qualifies for fair value hedge accounting and the entity elects to use it? (Question 6(a))
  - No: Is the contract onerous?
    - Yes: Measure 'forward' contract asset/liability at fair value. Present changes in fair value in profit or loss
    - No: Is the underlying readily convertible into cash? (Scenario 2)
      - Yes: Apply IFRS 15 Revenue from Contracts with Customers
      - No: Apply IAS 37 Provisions, Contingent Liabilities and Contingent Assets

- No: Contractual terms: can be settled net in cash or another financial instrument? (Scenario 3)

- Yes: Measure 'forward' contract asset/liability at fair value. Present changes in fair value in profit or loss
- No: Is the contract onerous?

Recognise revenue measured based on customer consideration as performance obligations are satisfied

In addition to, in accordance with IFRS 15, recognising revenue measured based on customer consideration as the performance obligation is satisfied; recognise a liability (provision) in accordance with IFRS 37. Provision measurement objective = best estimate of extent to which contract is onerous.
5. How, if at all, should Growem account for the contract that it is party to in accordance with IFRS (as applicable on 1 January 2015 with early applying all available new IFRS requirements)?

It depends:

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

*Observed discussion groups’ conclusion*—the commodity forward contract meets the definition of a derivative—its value changes in response to the change in a specified commodity price (ie pine logs); it requires no initial net investment; and it is settled at a future date (ie over each of the next two years). In Scenario 1, because the contract must be settled net in cash it must be accounted for in accordance with IFRS 9 (see paragraphs 2.1\(^{30}\) of IFRS 9). The contract gives rise to either an asset (the right to receive cash, if accumulating unrealised gains) or a liability (the obligation to pay cash, if accumulating unrealised losses).

However, at inception (ie when Growem becomes a party to the forward contract, rather than on the date on which settlement takes place), the fair values of the forward contract is usually zero. In such cases, at inception there is, in effect, no asset or liability for Growem to recognise (see paragraph B3.1.2(c) of IFRS 9)\(^ {31}\).

As the expected maturity date price of the specified quality of pine logs increases, the net fair value of the right and obligation is not zero. Consequently, Growem would recognised the net fair value of this forward as liability with changes in its fair value recognised in profit or loss in the period of the change. For example, at 31 December 20x5 Growem would measure the derivative liability at its fair value with the change in fair value recognised as an expense in profit or loss in 20x5.

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

*Observed discussion groups’ conclusion*—provided that the pine logs are readily convertible

\(^{30}\) Formerly paragraph 5 IAS 39

\(^{31}\) Formerly paragraph AG35(c) of IAS 39.
into cash (see the discussion for Chipem Scenario 2 above) the contract meets the definition of a derivative—its value changes in response to the change in a specified commodity price (ie sawn pine logs); it requires no initial net investment; and it is settled at a future date (ie up to two years later).

However, irrespective of whether pine logs are readily convertible to cash, the contract is (subject to the following paragraph) excluded from the scope of IFRS 9. The contract is excluded because Growem entered into and continues to hold the contract for the purpose of delivering the pine logs (a non-financial item) in accordance with its expected sale requirements. Consequently, by exception, it is not accounted for as a derivative—ie the ‘own use exception’ applies (see paragraph 2.4 of IFRS 9).

Nevertheless, if the pine logs are judged to be **readily convertible to cash**,\(^{32}\) if it eliminates or significantly reduces an ‘accounting mismatch’ that would otherwise arise, at inception of the contract (in accordance with paragraph 2.5 of IFRS 9) a contract to sell a non-financial item may be irrevocably designated as measured at fair value through profit or loss if it was entered into for the purpose of the delivery of a non-financial item in accordance with Growem’s expected sale requirements.

Otherwise (ie if not within the scope of IFRS 9), because the forward contract is a contract with a customer of Growem, the contract would be accounted for in accordance with IFRS 15 *Contracts with Customers* (see paragraph 5 of IFRS 15). In accordance with paragraph 31 of IFRS 15, Growem will recognise revenue when (or as) it satisfies a performance obligation by transferring control of the promised timber to its customer.

While the non-cancellable contract is wholly unperformed Growem’s rights and obligations in it would be measured at the same amount and offset, therefore no amount would be recognised in its statement of financial position in respect of the contract (see paragraph BC51 of the Basis for Conclusions on IFRS 15).\(^{33}\) However, if the contract is onerous a

\(^{32}\) ie a contract that can be settled net in cash (in accordance with paragraph 2.6(d) of IFRS 9) Note: this limited option to avoid an ‘accounting mismatch’ by accounting at fair value through profit or loss for ‘own use’ forward contracts does not apply to those contracts that do not satisfy the criteria to be classified as ‘can be settled net in cash’ as set out in paragraph 2.6 of IFRS 9.

\(^{33}\) In other words, the entity would, in effect, not recognise the contract (Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* (2008) paragraph 2.26).
provision (liability) would, in accordance with paragraph 66 of IAS 37, be recognised by Growem.

When either party to a contract has performed, Growem must, in accordance with paragraph 105 of IFRS 15, present the contract in its statement of financial position as a contract liability, a contract asset, or a receivable depending on the relationship between Growem’s performance and the customer’s payment. For example:

(a) if Growem transfers control of the timber to its customer before the customer pays the consideration, Growem presents the contract as a receivable if its right to consideration is unconditional (ie nothing other than the passage of time is required before payment of that consideration is due (see paragraph 107 of IFRS 15)).

(b) if a customer pays consideration or an amount of consideration is due before Growem transfer control of the timber, Growem presents the contract as a contract liability—its obligation to transfer the timber to its customer for which Growem has received consideration from the customer (see paragraph 106 of IFRS 15).

Nevertheless, to the extent that the contract is unperformed by Growem, because of the considerable change in the price of pine logs (the underlying), at 31 December 20x5, the contract is likely to be considered to be onerous, and therefore accounted for in accordance with IAS 37 (see paragraph 1(a) of IAS 37 and paragraphs BC294–BC296 of the Basis for Conclusions on IFRS 15). For more information about the judgements to be made to determine whether a contract is onerous, see the teaching notes above under the heading ‘General’ on determining whether a forward contract is onerous.

Unlike for Chipem, Growem does not apply the IAS 8 Hierarchy (see paragraphs 10 to 12 of IAS 8) to its contract because the accounting for Growem’s contract (when not in the scope of IFRS 9) is in the scope of IFRS 15.

Scenario 3: the contract can be settled net in cash or by physical delivery (ie gross settlement)

Observed discussion groups’ conclusion—the accounting depends on Growem’s intention—the contract is within the scope of IFRS 9 unless it was entered into and continues to be held

34 Note that in this scenario of a ‘normal’ forward contract the authors assume that there is no variable consideration to which the IFRS 15 constraint would apply.
for the purpose of delivery of the pine logs (a non-financial item) in accordance with Growem’s expected sale requirements (see paragraphs 2.1 and BA.2 of IFRS 9) and Growem has not elected that it be in the scope of IFRS 9.

If in the scope of IFRS 9, see the accounting and reporting set out in Scenario 1 above.

If outside the scope of IFRS 9, see the accounting and reporting set out in Scenario 2—in short: IFRS 15 applies, and if the contract is onerous, those aspects of IAS 37.

For a discussion of the judgements and estimates in determining whether the contract has become onerous, see the teaching notes for Question 7 under the heading ‘General’ above.

<table>
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<th>6(a) Would your answer to Question 5 change if Growem wants to use hedge accounting?</th>
<th>First, some discussion points</th>
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<td>What is the rationale for hedge accounting overriding ‘normal’ accounting?</td>
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<td>Which forms of hedge accounting are available to Growem—cash flow hedge accounting, fair value hedge accounting or both?</td>
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<td>Does Growem qualify for hedge accounting? To answer that question first evaluate whether the forward contract in scope of IFRS 9? To answer that question, is the contract classified as ‘can be settled net in cash’ either because of its contractual terms or because of the underlying is judged to be readily convertible into cash? How does the option to elect to scope in ‘own use’ contracts apply?</td>
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<td>Observed discussion groups’ conclusion—hedging</td>
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<td>Hedge accounting is not the same as economic hedging.</td>
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|  | Growem’s asset (growing pine trees) exposes Growem to the risk of changes in fair value of those trees. Growem might seek to mitigate the risk that the fair value of its trees could decline by using a derivative (for example, a cash-settled fixed-price forward sale contract—like in Scenario 1) whose fair value is expected to offset changes in the fair value of its
growing pine trees. Such economic hedging arrangements are called fair value hedges. If perfectly effective\(^{35}\), the change in the fair value of the growing timber asset would offset exactly the equal and opposite change in the fair value of the forward contract derivative liability.

Because IFRS requires the change in the fair value of both the growing timber asset (in accordance with IAS 41) and the forward contract derivative liability (when in the scope and thus accounted for in accordance with IFRS 9) to be recognised in profit or loss in the period that changes, the economic hedge is automatically reflected in the IFRS financial reporting.

6(b) Would your answer to Question 5 change if 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)?

**Observed discussion groups’ conclusions**

When setting IAS 41 the IASC stated that it is logical to measure a sales contract at fair value to the extent that a related biological asset is also measured at fair value (see paragraph B50 of the Basis for Conclusions on IAS 41). However, it concluded that it would not be appropriate in its project on agriculture to require fair value measurement for a contract to sell agricultural produce because, amongst other reasons, it would be beyond the scope of the project on agriculture when that produce does not yet exist and when that fair value accounting would continue after harvest when the agricultural produce would be measured at historical cost (see paragraphs B51–B54).

IFRS 15 (as applied early by Growem) now specifies accounting for such contracts with customers that are outside the scope of IFRS 9.\(^{36}\)

However, that accounting would result in an ‘accounting mismatch’ because:

1. Growem’s standing timber would in accordance with IAS 41 be measured at its fair value.

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\(^{35}\) Note: because the standing timber is growing its fair value is driven by an additional factor (its biological transformation—usually growth but could be degeneration due to drought or disease) in addition to the drivers of the fair value of the contract (eg sawn log prices and discount rates). Consequently, the change in the fair value of the contract is unlikely to exactly offset the change in the fair value of the standing timber.

\(^{36}\) Growem’s contract would be in the scope of IFRS 9 (and consequently outside the scope of IFRS 15) if:

- Scenario 1: the contractual terms specify that the contract must be settled net in cash; or
- the contract is classified as ‘can be settled net in cash (either because the contractual terms provide Growem with the option to settle the contract net in cash (Scenario 3) or because the underlying is readily convertible into cash (a judgement when considering Scenario 2)) and although the ‘own use exemption’ applies, to address the accounting mismatch, Growem elects to account for the ‘forward’ contract at its fair value.
(measured without reference to the forward contract) less costs to sell;

- while the forward contract would in accordance IFRS 15 be recognised in profit or loss as Growem satisfies the performance obligation by transferring control of the promised timber to its customer.

Put another way, the decline in fair value of the standing timber is (in accordance with IAS 41) recognised in profit or loss today, but ‘gain’ on higher fixed price sales contract is (in accordance with IFRS 15) recognised only on future delivery.

Provided that the timber that is the subject of the contract is readily convertible into cash (see paragraph 2.6(d) of IFRS 9), Growem can avoid the accounting mismatch by, at inception of the contract, designating the contract as measured at fair value through profit or loss in accordance with paragraph 2.5 of IFRS 9. Doing so would result in the contract being excluded from the scope of IFRS 15.

Nevertheless, as explained below, if at inception of the contract Growem chose not to use the exception provided by paragraph 2.5 of IFRS 9, the contract would be in the scope of IFRS 15. Because the contract is outside the scope of IFRS 9, Growem could not then use the hedge accounting requirements in IFRS 9 to overcome the accounting mismatch that would otherwise result from fixing the measurement of the rights and obligations arising from the commodity forward contract in the scope of IFRS 15 while at the same time accounting for the growing timber, from which the pine logs are expected to be harvested to fulfil the commodity forward contract, at fair value through profit or loss.

37 or if the timber that is the subject of the contract is not readily convertible into cash and therefore the option in paragraph 2.5 of IFRS 9 was not available to it.
APPENDIX: Evolution in IASB thinking about element existence in an executory contract

The Conceptual Framework observes that in practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements (see paragraph 4.46). However, the IASB staff’s thinking about element (for example, liability) existence in respect of enforceable38 forward contracts is evolving:

- In its Discussion Paper: A Review of the Conceptual Framework for Financial Reporting (July 2013) the IASB considers these matters further. Under a forward purchase contract, the purchaser’s resource is the right to compel the counterparty to sell the underlying asset at a future date. The purchaser also has an obligation to pay the consideration (see paragraph 2.14(c)). The purchaser’s asset is not the underlying asset, it is the right to receive the underlying asset or, perhaps, depending on the circumstances, a single net right and obligation to exchange cash for the underlying asset (see paragraphs 3.109–3.112). When a single (net) right or a single (net) obligation exists in a particular case, the entity has only a single asset or a single liability. In contrast, offsetting arises when an entity has both an asset and a liability and recognises and measures them separately but presents them as a single (net) amount (possibly with disclosure of the separate asset and liability; see paragraph 3.13).

- In its 2008 Discussion Paper Preliminary Views on Revenue Recognition in Contracts with Customers the IASB expressed its preliminary view as follows:
“After contract inception, an entity’s performance obligations arising from a forward contract change for various reasons. The most obvious reason is the entity’s transfer of goods to the customer. Performance obligations also may be affected by changes in the quantities or prices of the goods and services required to satisfy those performance obligations. Therefore, the initial measurement of the performance obligations in a contract must be updated if it is to continue to provide a useful depiction of the entity’s obligations to provide goods and services in accordance with the contract.” (paragraph 5.37)

- In June 2014 the IASB staff suggested:
“an enforceable executory contract contains a right and an obligation to exchange economic resources (or to pay or receive the difference in values between two economic resources if the contract will be settled net). The combined right and obligation constitute a single asset or liability.” (paragraph 3(a)(i) of Agenda Paper 10D, June 2014 IASB meeting).

However, the staff explained further that:

38 Wholly unperformed contracts, if each party to the contract has the unilateral enforceable right to terminate the contract without penalty, give rise to neither enforceable rights (asset) nor present obligations (liability).
“if an entity enters into a forward contract to purchase a resource at a future date, the entity’s asset is normally its right to buy the underlying resource, not the underlying resource itself. However, there may be circumstances in which the terms of a forward contract to purchase a resource give the purchaser control of that resource. In such circumstances, the purchaser should identify both an asset (the underlying resource that it already controls) and a liability (its obligation to pay for the resource). In these circumstances, the contract is not executory: the seller has substantively performed its obligations.” (paragraph 3(a)(ii) of Agenda Paper 10D, June 2014 IASB meeting).

- In its 2015 Exposure Draft: The Conceptual Framework for Financial Reporting (paragraph 4.41) the IASB proposes “An executory contract establishes a right and an obligation to exchange economic resources. ... That right and obligation to exchange economic resources are interdependent and cannot be separated. Hence, the combined right and obligation constitute a single asset or liability. The entity has an asset if the terms of the exchange are favourable; it has a liability if the terms of the exchange are unfavourable.”

In June 2014, as part of the IASB’s Conceptual Framework project, the IASB staff analysed different views about such forward contracts and set out their thinking on those executory contracts.

Extract from Agenda Paper 10D for the June IASB meeting

“THE NATURE OF THE ASSETS AND LIABILITIES IN EXECUTORY CONTRACTS

13. This section analyses different views of, and reaches tentative conclusions on, the nature of the assets and liabilities in executory contracts. It explores the following questions:

a. What are the rights and obligations in executory contracts that will be settled by exchanging economic resources?

b. Do a right and an obligation to exchange resources give rise to a separate asset and liability, or a single asset or liability?

c. How do the assets and liabilities differ from those identified in (a) if the contract will be settled net, rather than by exchanging economic resources?

d. When does the exchange occur if the parties perform at different times?

e. Are there circumstances in which the resource to be received and the resource to be transferred should be presented as an asset and a separate liability?
What are the rights and obligations in executory contracts that will be settled by exchanging economic resources?

View 1—a right to receive one resource and an obligation to transfer another resource

14. Executory contracts are often described as a combination of:
   a. a right to receive one economic resource; and
   b. an obligation to transfer a different economic resource.

15. An implication of this description is that an entity with an enforceable executory contract that will be settled by exchanging resources has both an asset (the right to receive a resource) and a liability (the obligation to transfer a resource).

Illustration 1—Right to receive and obligation to transfer resources

An entity enters into a contract to purchase a resource for 100 currency units ('CU'). The value of the resource at the time of exchange is expected to be CU100. Assume that the time value of money is immaterial.

The entity would identify:

**An asset:** Right to receive resource  
CU100

**A liability:** Obligation to transfer cash  
CU100

16. Identifying both an asset and a liability within an executory contract does not imply that the asset and liability would have to be recognised, measured and presented separately. They, like other assets and liabilities that arise from a single source, could be combined into a single unit of account. In the Conceptual Framework Discussion Paper, the IASB expressed a preliminary view that the unit of account should normally be decided when the IASB develops or revises particular Standards and that, in selecting a unit of account, the IASB should consider the qualitative characteristics of useful financial information.\(^{39}\)

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View 2—a right and an obligation to exchange resources

17. An alternative view is that an executory contract contains a right and an obligation to *exchange* economic resources. IAS 32 *Financial Instruments—Presentation* applies this description in its definitions of financial assets and financial liabilities:

a. it defines the term ‘financial asset’ to include:

“(c) a contractual right:

(i) to receive cash or another financial asset from another entity, or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity.”

b. it defines the term ‘financial liability’ to include:

“(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity, or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.”

Staff analysis and conclusions

18. The staff note that the entity’s rights and obligations under an executory contract are highly interdependent:
a. the entity’s right to receive one resource is conditional on it fulfilling its obligation to transfer the other resource, and its obligation to transfer the other resource is conditional on it receiving the first resource; and
b. there is only a net inflow or outflow of resources when the parties perform their obligations: each party transfers one resource but receives another resource in exchange.

19. In some (relatively uncommon) cases, a court may enforce ‘specific performance’ of a contract—ie the court may rule that a party in breach of its obligations must perform those obligations, instead of paying compensation or penalties. However, even in these cases, the court would not enforce performance by one of the parties without also enforcing performance by the other party (except perhaps if one party is in insolvent liquidation).

20. The staff think that the right to receive one resource and the obligation to transfer another resource are so interdependent that they are not separable. Consequently, we conclude that the entity’s right and obligation are to exchange resources.

**Do a right and an obligation to exchange resources give rise to a separate asset and liability, or a single asset or liability?**

21. If we view an executory contract as a right and an obligation to exchange economic resources, we have to consider whether:
   (a) the right to exchange resources on favourable terms is an asset, and the obligation to exchange resources on unfavourable terms is a separate liability (paragraphs Error! Reference source not found.-Error! Reference source not found.); or
   (b) the combined right and obligation constitute a single asset or liability (see paragraphs Error! Reference source not found.-Error! Reference source not found.).

**View A—separate asset and liability**

22. One view is that the right and obligation to exchange economic resources give rise to a separate asset and liability. A rationale for this view is that the right to exchange resources is equivalent to a purchased option, and the obligation to exchange resources is equivalent to a written option.
23. Viewed in isolation, a purchased option gives rise to an asset and a written option gives rise to a liability. Consequently, analysing an executory contract as a combination of two options implies that the entity has a separate asset (the purchased option) and a separate liability (the written option). Unless there is zero probability of the exchange being favourable for the option holder, both options have a value prior to the exchange date.

Illustration 2—Combination of purchased and written option

The facts are the same as in Illustration 1: the entity enters into a contract to purchase a resource for CU100. The value of the resource at the time of exchange is expected to be CU100.

Suppose that this value of CU100 reflects the following expectations about the market price at the date of exchange:

<table>
<thead>
<tr>
<th>Possible market price</th>
<th>CU80</th>
<th>CU90</th>
<th>CU100</th>
<th>CU110</th>
<th>CU120</th>
</tr>
</thead>
<tbody>
<tr>
<td>Probability*</td>
<td>10%</td>
<td>20%</td>
<td>40%</td>
<td>20%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Assuming, for simplicity that the time value of money and effects of risk are not material, the value of an option to exchange could be estimated by reference to the expected value of the outcomes in which the exchange is favourable to the party holding the option:

Purchased option

\[(\text{CU110} - \text{CU100}) \times 20\% + (\text{CU120} - \text{CU100}) \times 10\% = \text{CU4}\]

Written option

\[(\text{CU90} - \text{CU100}) \times 20\% + (\text{CU80} - \text{CU100}) \times 10\% = \text{CU-4}\]

*Strictly speaking, the probabilities used in this calculation are those implied by market prices.
The entity would identify:

**An asset:** Right to exchange \( \text{CU} \)

**A liability:** Obligation to exchange \( \text{CU} \)

*View B—single asset or liability*

24. An alternative view is that the entity’s combined right and obligation to exchange resources constitute a single asset or liability. The entity has an asset if the terms of the exchange are expected to be favourable; it has a liability if the terms of the exchange are expected to be unfavourable. The terms are favourable (or unfavourable) if, at the time of the exchange, the value of the economic resource that the entity receives is greater (or less) than the value of the economic resource that the entity transfers or grants to the other party.

25. A rationale for this view is that the rights and obligations in executory contracts are not the same as options. An option gives the holder the right *either* to make an exchange (if it turns out to be favourable) *or* to withdraw from the exchange without penalty (if it turns out to be unfavourable). In contrast, neither party to an enforceable executory contract has the right to avoid an unfavourable outcome. There is only one outcome under the terms of the contract—the exchange will occur. If the exchange is expected to be on favourable terms, it is an asset; if it expected to be on unfavourable terms, it is a liability.

**Illustration 3—Single asset or liability**

The facts are the same as in Illustration 1: the entity enters into a contract to purchase a resource for \( \text{CU} \)100. The value of the resource at the time of exchange is expected to be \( \text{CU} \)100. The entity would identify a single asset or liability. In this illustration, there is no difference between the values of the resources to be exchanged, so the asset or liability would be measured at zero. (Paragraphs *Error! Reference source not found.* discuss in more detail the measurement of this type of asset or liability.)
Staff conclusion

26. For the reasons in paragraph Error! Reference source not found., the staff conclude that the combined right and obligation to exchange resources constitute a single asset or liability.

How do the assets and liabilities differ from those in paragraphs Error! Reference source not found.-Error! Reference source not found. if the contract will be settled net, rather than by exchanging economic resources?

27. If a forward contract will be settled net, the entity does not have a right and an obligation to exchange resources at a future date. Instead, it has a right and an obligation to pay or receive the difference between the value of two resources at the future date. Like a right and an obligation to exchange resources, this right and obligation to pay or receive the difference in value of two resources could be viewed as giving rise to:
(a) an asset (akin to a purchased option) and a liability (akin to a written option); or
(b) a single asset or liability.

28. Here too, the staff think that the right and obligation are not the same as purchased and written options, because they do not give either party the right to avoid an unfavourable outcome. Consequently, the staff conclude that the combined right and obligation to pay or receive the difference in the values of the two resources (like a combined right and obligation to exchange resources) constitute a single asset or liability.

When does the exchange occur if the parties perform at different times?

29. The parties to an executory contract that is settled by the exchange of economic resources may be required to perform their obligations (transfer the underlying resources) at the same time or at different times. Even if the parties perform their obligations at different times, there is a simultaneous exchange, which occurs when the first party performs its obligations. At that time, the first party transfers one resource (the first underlying resource) and simultaneously receives another.
resource (a right to receive the second underlying resource from the second party). Before the first exchange (ie while the contract remains executory), each party has the right and the obligation to make this first exchange.

Illustration 4—the parties perform at different times

4A  Purchase contract with deferred payment

At time $T_0$, an entity enters into a contract to purchase equipment. It will receive the equipment at time $T_1$ and pay for it a later time $T_2$.

An exchange will occur at time $T_1$: the entity will receive equipment, and the supplier will receive a financial asset (a right to receive cash). Before $T_1$, while the contract is executory, the entity and the supplier have a right and an obligation to make this first exchange.

4B  Purchase contract with advance payment

At time $T_0$, an entity enters into a contract to purchase equipment. It will pay for the equipment at time $T_1$ and receive it a later time $T_2$.

An exchange will occur at time $T_1$: the entity will receive a right to receive equipment, and the supplier will receive cash. Before $T_1$, while the contract is executory, the entity and the supplier have a right and an obligation to make this first exchange.
Are there circumstances in which the resource to be received and the resource to be transferred should be presented as an asset and a separate liability?

30. The general conclusions that the staff have reached so far in this paper are that an enforceable executory contract contains a right and an obligation to exchange economic resources (or to pay or receive the difference in values between two economic resources if the contract will be settled net). The combined right and obligation constitute a single asset or liability. Possible exceptions are discussed below.

A purchase agreement gives the purchaser control of the resource it will be purchasing

31. If an entity enters into a forward contract to purchase a resource at a future date, the entity’s asset is normally its right to buy the underlying resource, not the underlying resource itself. However, there may be circumstances in which the terms of a forward contract to purchase a resource give the purchaser control of that resource.

32. The staff think that, in such circumstances, the entity should identify both an asset (the underlying resource that it controls) and a liability (its obligation to pay for the resource). However, we do not view this treatment as an exception to the general principle that executory contracts give rise to a single asset or liability to exchange resources. We think that in these circumstances, the forward contract is not executory: the seller has substantively performed its obligation to deliver the underlying asset.

33. Whether a purchase agreement is sufficient to give an entity control of the underlying asset would need to be judged by reference to the facts and circumstances of the transaction. The staff suggest that requirements and guidance applicable to specific types of transaction should be developed in individual Standards, rather than in the Conceptual Framework. Some factors that might indicate that a particular type of purchase agreement gives control of an asset to the purchaser might include, for example:
   (a) the contract being of a type for which the courts would enforce specific performance; and
   (b) the seller being unable to substitute an equivalent asset. In such a situation, the seller could have lost the practical ability to sell to another party the specific asset that it has contracted to sell to the purchaser.

34. Paragraphs Error! Reference source not found. consider a forward purchase transaction from the perspective of a purchaser. If the same principles applied to the seller, the seller would derecognise the resource, and recognise its right to receive payment for the resource. However, IFRS
requirements for derecognising assets do not always mirror the requirements for identifying and recognising assets. Concepts for derecognition are being developed as part of the Conceptual Framework project and these concepts would apply when the IASB develops new IFRSs or reviews existing IFRSs that address sale agreements.
The entity has to perform its obligations first

35. Some executory contracts require the entity to perform its obligations first, i.e., to transfer one underlying resource to the other party before the other party transfers a different underlying resource to the entity. In the period between the two transfers, the entity will be exposed to default risk for the full amount of the resource to be received. This period could be long (for example, if the contract is a commitment to provide a long term loan to a customer). Alternatively, it could be very short (for example if the contract is for the exchange of financial assets, with the transfers clearing at different times on the same day).

36. During this period, the entity will be exposed to default risk for the gross amount that it has a right to receive. However, while the contract remains executory, this gross exposure will not be recognised in the statement of financial position if the asset or liability recognised reflects only the difference in the values of the resources being exchanged. Some might argue that in these circumstances, the executory contract asset or liability should be ‘grossed up’ to reflect the entity’s full exposure.

37. However, the staff think that an entity has the same type of right and obligation irrespective of the order in which the two parties perform their obligations. As explained in paragraph Error! Reference source not found., the entity’s right and obligation is to make the exchange that occurs when the first party performs its obligations, whichever party that is. The staff suggest that the statement of financial position is not meant to portray future gross exposures; it is meant to portray existing rights and claims. Information about the nature and amounts that could be at risk in future could be disclosed in the notes to the financial statements.”

In June 2014 the IASB staff also presented their thinking on a possible approach to measurement of executory contracts to the IASB as part of its Conceptual Framework (as set out below in the extract from Agenda Paper 10D).

“A possible approach to measurement

39. Paragraph Error! Reference source not found. suggests that an entity has an asset (or a liability) if the value of the economic resource that the entity will receive is expected to be greater (or less) than the value of the economic resource that the entity will transfer or grant to the other party. An implication is that the measure of the asset or liability would:

(a) reflect the expected difference between the values of the resources exchanged; and hence

(b) depend on the bases used to measure the ‘value’ of each of the resources.
40. The IASB might decide that a particular Standard should apply the same measurement bases for executory contract assets or liabilities as it specifies for the assets and liabilities that arise when one of the parties subsequently performs its obligations, ie when the contract is no longer executory. Applying this approach to existing Standards, many executory contract assets and liabilities would be measured at zero (and hence need not be recognised) unless the contracts were onerous:

Illustration 5—measurement bases for executory contracts that would be consistent with those for executed contracts

5A Contracts for the purchase of inventories

Applying IAS 2 Inventories, inventories are measured at the lower of cost and net realisable value. To be consistent, an executory contract for the purchase of inventories would be measured by comparing:

(a) the cash to be transferred (the contract price), and

(b) the lower of the cost of the inventories (the contract price) and their net realisable value.

The difference is zero unless the net realisable value of the inventories is expected to be lower than their cost. In this latter case, the executory contract is onerous and the liability would be measured as the difference between the cost and net realisable value of the inventories.

5B Loan commitments

Applying the classification and measurement requirements currently being finalised for IFRS 9 Financial Instruments, some financial assets would be measured at amortised cost with a loss allowance for expected credit losses. To be consistent, a commitment to provide a loan that gives rise to such a financial asset would be measured at zero, with a liability for expected contract losses determined applying the same impairment model as that specified for the related financial assets.
Applying IFRS 9, other financial assets resulting from loan commitments are measured at fair value through profit or loss. To be consistent, a commitment to enter into such loans would also be measured at fair value through profit or loss.\(^{42}\)

5C **Contracts for the sale of goods or services**

Applying the requirements of IFRS 15 *Revenue from Contracts with Customers*, an entity would measure obligations to transfer goods or services to customers at the transaction price, with any additional onerous contract liability being recognised and measured applying the requirements of IAS 37.\(^{43}\) To be consistent, an executory contract for the sale of goods or services would be measured at zero, unless the contract is onerous, as defined in IAS 37. If onerous, the executory contract liability would be measured applying the measurement requirements of IAS 37.

*Cancellation penalties could cap the amount of the asset or liability*

41. It could be argued that, for any enforceable executory contract, the amount of the entity’s liability (or asset) is no more than the compensation or penalties that the entity (or the other party) could be required to pay if it breached its obligations under the contract. In some cases, penalties might be stated in the contract, and could provide a cap on the measure of the asset or liability.

42. If the contract is of a type for which the courts would enforce specific performance, the entity would not have an opportunity to pay compensation or penalties in lieu of performance. Accordingly, the asset or liability would always be measured by reference to the relative values of the resources being exchanged.”

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\(^{42}\) To simplify the accounting for issuers and holders of loan commitments, existing and proposed requirements for some loan commitments are different from those for the related loans. For example, it is proposed that IFRS 9 will not require a loan commitment to be measured at fair value through profit or loss if it relates to a structured loan that would fail the cash flow characteristics condition in IFRS 9 (and hence should be measured at fair value through profit or loss) when it is drawn down. For such a commitment, a liability would be recognised for expected credit losses.

\(^{43}\) IFRS 15 *Revenue from Contracts with Customers*, paragraph 46 and consequential amendments to paragraph 5 of IAS 37.