STAFF PAPER

March 2019

IFRS® Interpretations Committee meeting

Project	**Physical settlement of contracts to buy or sell a non-financial item (IFRS 9)**
Paper topic	Comment letters

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Introduction

1. For ease of reference, this paper reproduces comment letters received on the tentative agenda decision published by the IFRS Interpretations Committee in November 2018 on 'Physical settlement of contracts to buy or sell a non-financial item'.

IEAF International Energy Accounting Forum

IFRS Interpretations Committee
Sue Lloyd, Chair
IFRS Interpretations Committee
Columbus Building
7 Westferry Circus
Canary Wharf
London
United Kingdom
E14 4HD

Brussels, January 31, 2019

Tentative agenda Financial Instruments—Physical settlement of contracts to buy or sell a non-financial item (Agenda Paper 3) (IFRS 9)

Dear Ms Lloyd,

We are pleased to write this letter concerning the IFRS Interpretations Committee's publication in the November IFRIC Update of the tentative decision not to take onto the Committee's agenda the request for clarification on the accounting treatment of physical contracts that are accounted for as derivatives in the scope of IFRS 9 Financial Instruments.

The International Energy Accounting Forum (hereafter "IEAF") consists of the major European energy companies (see the list of our members in appendix 2). The goal of the IEAF is to discuss and formulate best practices, to reduce areas of difference in accounting in the sector, to advocate the energy industry's point of view, and to make specialist energy industry knowledge available to the International Accounting Standards Board and other standard setters.

We believe that that the IFRIC paper and the underlying agenda decision negate the complexity of commodity transactions and do not consider the interaction between standards (IFRS 9, IFRS 15 and other IFRSs). In particular, we do not believe that the approach set out in the staff's paper on this topic is the only accounting policy that might be applied. Rather, a reporting entity is required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to develop an appropriate accounting policy for the recognition and measurement of revenue arising from physically settled derivatives and apply it consistently. We would also like to highlight that our accounting practices have never been subject to issues from the auditors or the enforcement authorities to the extent that IFRS 9 is silent about where the derivative P&L should flow.

We are also concerned that the tentative decision has been made without conducting appropriate outreach with the users and preparers of financial statements in the affected industry sectors and has not considered the potentially significant time, effort and expense that would be required to implement such an approach.

We are therefore of the opinion that the tentative decision should not be finalized and we urge the Committee to give further consideration to its consequences. We would also like to formally raise our interest to make our experience available to the IFRS Interpretations Committee and its staff when it undertakes its outreach sessions as we believe that this would ensure the quality of the IFRS Interpretations Committee due process, especially when it is addressing so particular and complex topics.

Our detailed comments are set out in the appendix to this letter. If you require any clarification or information, please do not hesitate to contact us.

Yours sincerely,

On behalf of the International Energy Accounting Forum,

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Appendix 1: detailed answer

(a) Absence of divergence in accounting practice (including when transition to IFRS 9 and IFRS 15 was made)

While the technical points are discussed below, we would also like first to address our concern that this topic is arising suddenly without any audit firms having ever raised any audit issues to the preparers while it is pretty clear that there is no or very few diversity in practice; at least in the – based on the staff's view – highly affected energy sector. We also note that this topic has not raised any implementation issue when IFRS 9 and IFRS 15 were applied for the time on 2018, January 1st. Additionally the accounting and reporting treatment in the past and currently applied in the energy sector has never raised any issues with our auditors nor any enforcement authorities, though with regard to the affected guidance on the scope (IAS 18 / 39 or IFRS 9 / 15 ; derivative accounting being excluded from the revenue guidance) and on the own-use exemption which remained unchanged. It should also be highlighted that any accounting and reporting treatment / accounting policy choice would be disclosed in accordance with IAS 1.117.

(b) Due process, outreach and implementation effort

We also believe that the participants (see para. 16 of the staff paper) invited during the outreach activities were not widespread enough, since preparers and especially the highly affected industry sectors were left out.

Significant implementation effort, time and expense would be required to meet the objectives of the tentative agenda decision. Accordingly, at the very least, we believe that any final decision on this issue should meet the Board's cost/benefit threshold and, if met, allow a reasonable time-frame for implementation. In our view, therefore, a conclusion on this issue cannot be reached through an agenda decision of the Committee.

(c) Commenting the fact pattern and addressing the complexity of commodity transactions (including considerations on the risk management activities)

We note that the fact patterns of the staff paper indicate that "*the entity has concluded that both contracts are within the scope of IFRS 9 because they do not meet the own use scope exemption. Consequently, the entity accounts for the contracts as if they were financial instruments and recognises them as derivatives measured at FVPL. The entity does not designate the contracts as part of a hedging relationship for accounting purposes*".

What is not sufficiently clear to us, with regard to the submission as well as to the guidance provided by the staff, is what kind of physically settled contract the submitter/ staff have in mind.

a) The contracts may be generally financially settled, but have an option for physical settlement; such contracts also may have a rather derivative financial instrument characteristic / intention to enter into.
b) On the other hand these may be contracts that have to be physically settled and also any net-settlement will take place by buying and selling the physical commodity and where net-settlement takes place only in very limited circumstances and is not intended, when initially entering into such contracts; i.e. due to market fluctuations the credit-risk exposure has been exceeded and the deals must be settled or clients production site broke down and therefore energy needs to be repurchased.

In the latter, the substance has never been to treat the physically settled contract as a derivative, but it needs to, due to IFRS guidance. Our understanding is that the submitter refers to contracts mentioned under a) since the basic posting (para 13 and 15 of the staff's paper) has the substance of a derivative intention for the contract.

When IFRS 9 was developed, the own use (few) principles remained unchanged compared to IAS 39 (with the exception of the fair value option which in practice is not so often applied since being able to demonstrate the removal or the significant decreasing of the accounting mismatch is pretty rare in practice).

Having said that, we strongly believe that the described fact pattern negates the complexity of what a commodity transaction can be. When a commodity transaction cannot qualify for own use accounting (for any reasons which we would be very happy to explain further[1]), it is nevertheless important to identify the management purpose of the contract being entered into (in the specific fact pattern, a physically settled contract – that needs to be accounted and measured as a derivative).

Generally speaking, Energy companies face many risks, some of which may be mitigated through hedging activities, some may be mitigated through additional controls, and some cannot be mitigated at a reasonable cost. Each entity must continually assess the risks it is facing and the costs of mitigating those risks against its risk appetite. Additionally, the types of instruments available to hedge a risk exposure may be numerous or limited, perfect or imperfect, and/or traded in liquid or illiquid (or less liquid) markets. Risk management is complex, requires significant judgments and needs the flexibility to adjust to changing conditions. The combination of all these parameters forces each entity to make accounting choices (hedge accounting is not mandatory) and to adapt the presentation of its results in a manner that is more consistent with its strategy and actual risk management activities.

[1] All details can also be found in the various comment letters and communications we have addressed to the IASB in respect of the IFRS 9 project.

A transaction that is entered into for trading purposes (not hedging purposes) is usually accounted for on a net basis in the income statement and should an inventory be recognised (case 1 of the staff paper), it would be usually considered as a broker/manufacturer inventory, i.e. measured at fair value through profit or loss. Typically, this transaction could arise when the entity's sole purpose is to make a margin from the bid less ask price and / or to take a long and short positions to benefit from short-term market price fluctuations. When this is the case, we believe that the instrument (a derivative in the scope of IFRS 9) should be recognised always on the same P&L line and does not require any adjustments when the deal matures.

Other transactions can be entered into for hedging purposes. Hedge accounting remains optional under IFRS 9 and its application is not always feasible in practice. Indeed, there may be situations where the risk mandate of the entity applies to the hedging of a net position; IFRS 9 only authorises the designation of a gross position that may not comply with the hedging risk management activities of the entity, hence leading to a hedging designation difficult to apply in practice[2].

For such type of management purpose, when a physical contract qualifies as a derivative within the scope of IFRS 9 *Financial Instruments*, it shall be subsequently measured at fair value through profit or loss and in our opinion, the development and unwind of the fair value should be reported within the same P&L line.

(d) <u>Illustrating the risk management activities through examples</u>

<u>*Illustrative example 1:*</u>

- *Entity is owning a nuclear power plant.*
- *Entity aims to secure its future nuclear production by entering into a physical forward contract to sell electricity at fixed price ("Transaction 1"). Transaction is concluded under the EFET framework agreement that foresees a mandatory physical settlement of the transaction.*
- *Since the Entity would manage its exposure to the commodity price risks in accordance with its own risk limits, Entity may enter into additional transactions that would preclude Transaction 1 from being accounted for as own use (as the transaction may be net settled in cash and Entity has a practice of net settling similar transactions in cash; though not for trading purposes but from internally documented and applied risk policies[3]). In other words, Transaction 1 is accounted for and measured as a derivative at fair value through P&L pursuant to IFRS 9.*

[2] All details can also be found in the various comment letters and communications we have addressed to the IASB in respect of the IFRS 9 project

[3] Net settlement is not due to contractual rights/parameters (foreseeing by terms of the contract a settlement either net in cash or physically) but there is a practice of net settlement (although there can be a mandatory physical settlement, for instance through EFET framework agreement

- *This transaction is not designated in a CFH hedging relationship in accordance with IFRS 9 (although from EMIR perspective, this transaction is documented as risk-reducing).*

Assume that Transaction 1 has the following contractual features:

- *Forward price is 100 CU and is to be settled in Y2*
- *At the end of Y1, FV of the contract equals -10 CU.*

While the transaction can be viewed as an all-in-one-hedge, i.e. the instrument includes both the hedged item (the future sale transaction) and the hedging instrument (fixing the price provides with a protection against the swings in future commodity market prices), we agree that it cannot be accounted for as such in the absence of an explicit designated hedging relationship.

However, the business reality of this deal is that the transaction is a physical transaction which is mainly used for economic hedging purposes, where the substance of the transaction is to secure and realise the contractually agreed price. Its transaction price equals 100 CU (by analogy, securing the cash flows through an own use transaction would have given rise to a contractual revenue of 100 CU to be accounted for in accordance with IFRS 15 purposes). If the substance of an entity / transaction would be to participate in any market / spot-price fluctuations there would be no need to enter into such fixed-price contracts. Having a different amount in the operating revenue (i.e. 110 CU as suggested in the staff paper) would deny a crucial core part of the energy company's activities from a presentation in the operating section of the profit/loss and ban it to the non-operating section. Indeed this would not lead to a faithful representation of the real operating performance of the entity as well as the substance of the fixed-price transaction.

Most of the energy players – as well as analysts – believe that the amount at which the entity has been able to fix its future cash flows is relevant when communicating about financial and economic performance to the market (and the information systems have built on such a scheme). Any accounting volatility (implied by the economic hedging instrument being the sole leg recognised at fair value through profit or loss in the absence of a formal [but often impracticable] hedging designation) cannot interfere with the performance to be communicated. One outcome scenario would most likely be, that entities would have to start to distinguish between operating revenue and non-operating revenue as non-GAAP/ Alternative Performance Measure to disclose figures that are in line with the substance of the transaction. Additionally there would be more distortion between earnings and cash-flows (i.e. the period when realised) and underlying / hedged earnings will be hard if not even impossible to analyse without significant increased non-GAAP disclosures and reconciliations.

Illustrative example 2:

- *Entity is owning a gas storage.*
- *Entity wants to secure its margin (summer-winter-spread) by entering into a physically settled forward contract to purchase gas at fixed price (20CU) for delivery month June*

("Transaction 1"). Entity sells the gas by entering a physically settled forward contract to sell gas at fixed price (25CU) for delivery month December ("Transaction 2"). Both transactions were concluded in January.

- *Due to a cold summer the spot price in June is 23CU and due to a warm winter the December spot price is also 23CU.*
- *Entity has to designate the contracts as measured at fair value through profit and loss, since it had the practice to net settle certain contracts of that kind e.g. due to its risk policy (i.e. the fair value of the position with a single counterparty became too high; no trading propose).*

In its Q1 closing Entity presents a derivative asset and a corresponding non-operating derivative P&L impact of 1CU due to already rising June prices (21CU). The December forward price moved sideways.

Based on staff's proposal, in June transaction 1 is settled and Entity receives gas and accounts for inventory at a spot price of 23CU. The derivative asset is offset with the remaining delta of 3 CU (23CU – 20CU) because entity only pays cash in the amount of the initially agreed 20CU. The non-operating derivative P&L is +3CU because December prices remained unchanged.

Based on staff's proposal, in December transaction 2 is settled and Entity sells gas at the current spot level of 23CU and accounts for a related revenue. At the same time, a cost of goods sold is booked for an amount of 23CU. The non-operating derivative P&L shows a +5CU impact (+3CU resulting from the increased June price and +2 from the decreased December price).

Based on staff's proposal, Entity would recognise no gross-margin (i.e. 0CU), since gas will be both purchased and sold at 23CU, though a cash margin of 5CU has been hedged and secured, in entering into the above mentioned transactions 1 and 2. The hedged margin has been fluctuating through non-operating earnings (random non-cash fluctuations not representing the intention of the transactions), biasing finally the operating results and thereby distorting the Entity's performance. While the basis adjustment cannot apply similarly when hedge accounting is not applied, the energy entities would typically make sure that the operating profits accounted for represent their performance, i.e. 5CU in the example above.

Capturing the spot price within revenue may lead to a situation, where revenues may even be below cost of materials in case of selling produced power. The company would then suggest to make a loss within operating performance, although it has hedged a profitable margin, which has fluctuated randomly over the past periods. This may especially be the case for power plants with low fuel costs as nuclear or lignite, where only the sale contract has to be fair valued.

In case of power plants with significant fuel costs, a closed forward buy and sell position leads to realised margin of zero within revenue, if both transactions are accounted as supposed by the staff. Finally, the company's hedging performance is only included in the mark-to-market result, when the margin is locked in, i.e. before or at the delivery period. As we said above, a presentation based on a single line whatever the position is open or closed might be suitable for

commodities trading companies, but not for utilities (i.e. companies that are entering into commodity market transactions in the value of a specific industrial value chain).
Finally, in our view the spot price revenues would not depict neither the revenues generated in the ordinary course of business (i.e. a revenue from a contract with customer in the sense of IFRS 15). The fact pattern describes a situation with no further fair value changes in year 2 whereas in practice, the derivative has expired and the entity needs to account for a fixed price contract with a volume of commodity (gas, electricity…) being physically delivered.

If the preparers were considering all the economic hedges in their operating profit (i.e. not readjusting the operating profits by the effects of the hedges), this would require significant system changes that would not be achievable in a short period of time and would significantly distort the operating performance as a huge and unjustified P&L volatility would then be included there. We believe that the financial statements users benefit most when accounting presentation and economic/business decisions are closely aligned to the greatest extent possible with hedged / cash-effective results.

Appendix 2: Members of the International Energy Accounting Forum

Alpiq	www.Alpiq.de
Axpo	www.axpo.ch
EDF	www.edf.com
EnBW	www.enbw.com
Engie	www.engie.com
EWE	www.ewe.de
Fortum	www.fortum.com
Gas Natural	www.gasnatural.com
Gazprom Marketing & Trading	www.gazprom-mt.com
Iberdrola	www.iberdrola.es
Innogy SE	www.innogy.com
OMV	www.omv.com
Royal Dutch Shell	www.shell.com
RWE	www.rwe.com
Scottish Power	www.scottishpower.com
Solvay Energy Services	www.solvay-energy.com
Tennet	www.tennet.eu
Unesa	www.unesa.es
Vattenfall	www.vattenfall.com
Verbund	www.verbund.com
Veolia	www.veolia.com

1 February 2019

Ms. Sue Lloyd
Chair
IFRS Interpretations Committee
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Dear Ms. Lloyd

IFRS Interpretations Committee Tentative Agenda Decisions

The Malaysian Accounting Standards Board (MASB) welcomes the opportunity to provide comments on the following Tentative Agenda Decisions published in IFRIC Update December 2018:

(1) Credit enhancement in the measurement of expected credit losses (IFRS 9 *Financial Instruments*).

(2) Curing of a credit-impaired financial asset (IFRS 9 *Financial Instruments*).

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

(4) Sale of output by a joint operator (IFRS 11 *Joint Arrangements*).

(5) Customer's right to access the supplier's software hosted on the cloud (IAS 38 *Intangible Assets*).

We agree with the Committee's decision not to take these issues onto its agenda and we agree with the Tentative Agenda Decisions.

If you need further clarification, please contact the undersigned by email at beeleng@masb.org.my or at +603 2273 3100.

Thank you.

Yours sincerely,

TAN BEE LENG
Executive Director

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1 February 2019

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Dear Ms Lloyd,

IFRS Interpretations Committee tentative agenda decision on Physical settlement of contracts to buy or sell a non-financial item (IFRS 9 Financial Instruments) – November 2018

We welcome the opportunity to comment on the tentative agenda decision made by the IFRS Interpretations Committee (the Committee) at its November 2018 meeting in relation to Physical settlement of contracts to buy or sell a non-financial item (IFRS 9 *Financial Instruments*) that do not meet the own-use exemption, as the issue is highly significant to the oil and gas markets in which BP operates. We have discussed this topic with other industry participants and agree with many of the comments made in the letter submitted to the Committee by the International Energy Accounting Forum.

In the case of physically settled sales, we do not believe that the approach set out in the staff's paper on this topic is the only accounting policy that might be applied. Rather, a reporting entity is required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to develop an appropriate accounting policy for the recognition and measurement of revenue arising from physically settled derivatives and apply it consistently. We also believe that applying different measurement bases for physically settled sales for contracts within the scope of IFRS 9 and those within the scope of IFRS 15 is not useful for users of the financial statements.

We see some conceptual merit in the conclusion reached by the Committee as it relates to physically settled purchases but acknowledge that an alternative interpretation of 'cost', being the amount paid to the supplier, is also possible when applying IAS 2.

In both cases, therefore, we believe that the Committee has not fully considered the interaction between IFRS 9 and other IFRSs in making its tentative agenda decision.

We are also concerned that the tentative decision has been made without conducting appropriate outreach with the users and preparers of financial statements in the affected industry sectors and has not considered the potentially significant time, effort and expense that would be required to implement such an approach.

We are firmly of the view, therefore, that the tentative decision should not be finalized, and we urge the Committee to give further consideration to its consequences.

Our detailed comments are set out in the appendix to this letter. If you wish to discuss any of the comments in this letter, we would be happy to do so.

Yours sincerely,

/s/ Jayne Hodgson

Appendix

(a) Separate consideration of the effect on sales and purchases

<u>Sales</u>
While contracts to buy or sell physical commodities that can be net settled are in the scope of IFRS 9, we do not believe the standard was developed with physical contracts in mind, certainly not beyond the stage of them being accounted for as derivatives. As we note below, the questions arising from the application of IFRS to physical commodity contracts are not new. Industry practice was developed under IAS 18 *Revenue* and IAS 39 *Financial Instruments: Recognition and Measurement* and has continued under IFRS 15 *Revenue from contracts with customers* and IFRS 9.

If a sales contract is settled by physical delivery of an underlying commodity, many entities account for the delivery gross in revenue offset by a cost of sales. We note that the Committee chose not to consider the circumstances in which physical settlement of a sales contract should be presented gross or net, nor whether gross revenue is (momentarily) within the scope of IFRS 15, focusing only on the measurement of any gross revenue recognized and inventory purchased.

Sales of physical commodities that do not meet the own-use exemption are in the scope of IFRS 9 and therefore outside the scope of IFRS 15. As IFRS 9 provides no guidance on revenue recognition for such sales and the accounting is not specifically addressed by other IFRSs, preparers are required to develop appropriate accounting policies under the IAS 8 hierarchy. Whether the transaction is in the scope of IFRS 15 or not, it is necessary to determine the point in time at which revenue should be recognized in order to determine the point at which the contract ceases being accounted for as a derivative under IFRS 9, inventory is derecognized, and a receivable is recognized. Analogy to the control-based principles set out in IFRS 15 is one way of determining that timing.

While an accounting policy choice that leads to the accounting entries set out in paragraph 15 of the staff paper may be one acceptable outcome, we also consider an accounting policy of recognizing revenue at contractual amount to be appropriate. BP recognizes revenue from the sale of oil, oil products and natural gas under both IFRS 15 (where those contracts are outside the scope of IFRS 9) and under the principles set out in the preceding paragraph (where the contracts are in the scope of IFRS 9). Where revenue is recognized in accordance with IFRS 15 the amount of revenue recognized is equal to the transaction price. We believe it would be unhelpful to the users of financial statements for revenue in respect of otherwise similar transactions to be measured at different amounts – i.e. for IFRS 15 sales to be recognized at the contractual price and IFRS 9 sales to be recognized at market price.

Further, many of our contracts are long-term in nature, spanning multiple years. Contracts may move from assets to liabilities and back (or vice versa) between contract inception and the physical delivery. It is not clear what the intent of the tentative decision is in respect of income statement presentation of derivative gains and losses on a cumulative or discrete-year basis and how that relates to gross revenue presentation.

<u>Purchases</u>
IAS 2 *Inventories* requires entities to measure inventory at cost and, in our view, different interpretations of what is included in a measure of cost are possible. The cost of inventory can be argued to include the carrying amount of the derivative asset or liability at the time of inventory recognition. It may also be argued, however, that the cost of inventory is simply the amount paid to the supplier, not its fair value at the time of purchase. Whether these approaches result in a practical difference will depend on the pricing terms of the purchases in question – where purchases are at a market price, or are priced as a floating index plus a fixed differential, the impact would normally be fairly insignificant.

Risk management and optimisation
The example presented at the November meeting fails to recognise the context in which transactions of this nature are often entered into. Where a physical commodity sale falls within the scope of IFRS 9 it is often because the transaction is included within a risk management framework and hedged with financial derivatives. Physical flows may be optimised using financial derivatives, but the underlying business objective is to sell at a contractual price higher than the price paid on the purchase side. In such scenarios the example discussed in the staff analysis is missing the related hedging gains or losses which should be considered to understand the complete picture.

(b) Due process and outreach

We understand that the issue was submitted by one of the large accounting firms and as part of the Committee's due process it has obtained input from the International Forum of Accounting Standard Setters, securities regulators, and large accounting firms. However, we feel that the Committee would have benefited from outreach or consultation with preparers (or representative industry bodies) to fully understand the context in which physical commodity transactions are undertaken, and what is considered useful information by users of financial statements of entities that engage in physical commodity transactions.

(c) Implementation effort

Many established systems and processes are currently configured such that a contract price is a key attribute for reporting income from physical commodity sales. We believe that the requirement to present a derivative result separate from the underlying contract price would require significant widespread implementation effort, time and expense to meet the requirements of the tentative agenda decision. Accordingly, at the very least, we believe that any final decision on this issue should meet the Board's cost/benefit threshold and, if met, allow a reasonable time-frame for implementation. In our view, therefore, a conclusion on this issue cannot be reached through an agenda decision of the Committee.

(d) Transition to IFRS 9 and IFRS 15

Many companies transitioned to IFRS 9 and IFRS 15 in 2018 and will report their annual results under those standards for the first time in the first half of 2019. We do not believe that the issues addressed by the tentative agenda arise because of the new standards (i.e. the same issues arose under IAS 39 and IAS 18) and the timing of the referral is particularly unfortunate since many preparers would have already largely completed their IFRS 9 and IFRS 15 implementations at the time of the November 2018 Committee meeting.

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4 February 2019

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Comments on the Tentative Agenda Decision
-Physical settlement of contracts to buy or sell a non-financial item-

We welcome the opportunity to comment on the IFRS Interpretations Committee's tentative agenda decision relating to "Physical settlement of contracts to buy or sell a non-financial item".

General Comments

- ✓ The Tentative Agenda Decision(TAD) was published by IFRS Interpretations Committee, stating that "additional journal entry*" as described in the request should not be made for "contracts to buy or sell a non-financial instruments at a fixed price in the future" which the IFRS 9 "Financial Instrument" are applied.

  * The additional journal entry reverses the "accumulated gain or loss on derivatives" previously recognized through profit or loss, and recognize a corresponding adjustment to "Revenue" (Derivative PL/Revenue).
- ✓ The TAD focuses only on the accounting treatment when IFRS 9 is applied as stated in the "Request", and does not consider the appropriateness or necessity of applying any accounting treatments other than IFRS 9 (specifically, IFRS 15 "Revenue from Contracts with Customers") when there is a physical settlement. We believe that it is not discussed sufficiently whether such transaction has to be accounted for in accordance with IFRS 9 or not, and thus, do not agree with the TAD.
- ✓ The conclusion of the TAD is understandable if it is based on a premise that contracts to sell non-financial instruments which IFRS 9 are applied shall all be accounted for within the scope of IFRS 9 even at the time of physical delivery. However, depending on the business model of the entities, we consider that the amount of "Revenue" that presents the actual business situation and cash flow more appropriately will be the contract price of such contracts. If the "additional journal entry" is not permitted and the presentation of revenue at the contract price will not be accepted according to the TAD (based on IFRS 9), our concern is that the revenue presentation would not be relevant for users.

- ✓ As described in the following "Specific Issues", taking the purpose and nature of the business into consideration, we regard it is appropriate to derecognize measurement by IFRS 9 and apply IFRS 15 to recognize "Revenue" at contract price when sales contracts are settled by physical delivery.
- ✓ While IFRS does not specify which standards shall be applied to such transactions, some entities have actually been recognizing "Revenue" based on IFRS 15 for the sake of the faithful presentation that will reflect the actual business situation and cash flow. In other words, it can be said that they have selected to present "Revenue" by contract price as an accounting policy. When the contracts are settled by physical delivery, it should be permitted to change the scope (in terms of revenue recognition) from of IFRS 9 to IFRS 15 as an accounting policy, and such exemption should be newly introduced into the accounting standards if it cannot be read so.
- ✓ In the TAD, it accepts that some entities have an accounting policy of recognizing "Revenue" on a gross basis when a contract is settled by physical delivery, and we assume this is accepted since it is considered that the presentation of "Revenue" should reflect the actual situation of such transactions. If so, contract price measured by IFRS 15 will be more consistent when "Revenue" is recognized on a gross basis, and at least should be permitted as an accounting policy.
- ✓ In addition, if any accounting treatment other than IFRS 9 is not permitted, entities which have been recognizing revenue based on IFRS 15 will be forced to change the current accounting treatment and also the process of book keeping including the system design, which will be a serious burden in current practice. Comparison of costs and benefits must be considered in all standard settings, and it should be considered in this case as well.

Specific Issues

(1) Consideration of the "Presentation of Revenue" in IFRS 15

- Even if contracts are treated as derivatives in accordance with the requirements of IFRS 9, depending on the business model of the entities *1, there is little difference between the commodities that are treated as derivatives and those that are not, from the aspect of purpose or nature of the business.*2 (except for feature of high liquidity and relatively short delivery intervals)

  *1 These business models have also been observed in jurisdictions other than Japan.

  *2 The substance is the same in light of the existence of actual customers, physical delivery of goods, and gross settlement based on contract prices, accompanied with actual commodity needs. Ultimately, physical delivery of goods to customers is recognized as the performance obligation of the contractors (entities), and the purpose of the business is to receive the consideration by fulfilling the obligation.

- Although such contracts are measured at fair value based on IFRS 9, some entities believe that applying IFRS 15 and recognizing "Revenue" at contract price at the time of physical delivery of goods will contribute to the fair presentation of business situations and the correct understanding of cash flows, and provide useful information to users. This is consistent with the disclosure objectives required by IFRS 15.

(Reference) Disclosure objectives required by IFRS 15

> IFRS 15.1 The objective of this Standard is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer.
>
> IFRS 15.2 To meet the objective in paragraph 1, the core principle of this Standard is that an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.
>
> IFRS 15.3 An entity shall consider the terms of the contract and all relevant facts and circumstances when applying this Standard. An entity shall apply this Standard, including the use of any practical expedients, consistently to contracts with similar characteristics and in similar circumstances.
>
> IFRS 15.110 The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following.

- If the accounting treatment based on IFRS 9 is always required at the time of physical delivery (i.e. "additional journal entry" is not accepted), the financial statements may not depict the actual business situations of the entity and it could even mislead the users from the following viewpoints.

a. The amount of revenue is presented at fair value instead of the contract price, despite absence of significant differences in business models.
b. The amount of revenue at fair value does not match with the actual cash flow from customers. (It could deviate significantly depending on fair value at the settlement date.)

➢ In addition, IFRS 15 requires entities to disclose "Revenue from contracts with customers (IFRS 15)" separately from "Revenue from other sources (revenue outside of IFRS 15)" (IFRS 15.113). If revenues are disclosed as outside of IFRS 15 when a contract is treated as a derivative regardless of the substance of the business, it does not comply with disclosure objectives of IFRS15 which requires entities to provide the users of financial statements with useful information depicting actual business situations appropriately.

➢ The adequacy of the "additional journal entry" has not been clearly discussed before, and in our view, this is because entities have judged the necessity of "additional journal entry" and applied consistently as an accounting policy* according to their business model and also their auditors have approved such practice. In other words, it is considered that their revenue presentation has always been relevant for users to comprehend the financial statements.

* The objective of the financial statements is to provide the results of the resources entrusted to management with its users for their useful decision-making. It is considered to be appropriate that the current practice in which preparers apply accounting policies based on "relevance to user's economic decision-making needs" when the accounting standards to be applied are not clear.

(2) Comments on the basis of conclusion regarding the "additional journal entry"

➢ The TAD states that "additional journal entry" is neither required nor permitted and concludes that "additional journal entry" is inconsistent with IFRS 9, which measures derivatives at fair value (FVPL).

➢ This basis of conclusion includes the followings:

a. Derivative assets/liabilities are settled at the time of physical delivery of goods. (so that, no additional gains or losses are incurred when derivative assets/liabilities are settled)
b. It is not appropriate to treat a settlement by physical delivery of goods as if it were an "own use scope exception."

➢ If it is determined that such contracts should always be accounted for consistently even at the time of physical delivery of goods based on IFRS 9, we agree that above conclusion might be the case. However, it is not apparent that accounting for the physical delivery of goods in a "contract to buy or sell non-financial instruments at a fixed price in the future" was discussed sufficiently at the time of standard settings of IFRS 9. In addition, although the Committee observed that the contracts are settled by the physical delivery of a non-financial item in exchange for both cash and the derivative assets or liabilities at the physical delivery of goods, we believe it is only one of the interpretations and IFRS 9 does not specify such accounting clearly.

- In respect of the settlement of derivative assets and liabilities, while general derivatives through the market do not incur any additional gains or losses at the time of the settlement because they are actually settled in cash at fair value, in the cases discussed, their nature is not the same since derivative assets and liabilities are recognized from the contracts deemed as derivatives (in accordance with IFRS 9 criteria) but actually settled in cash at the contract price.
- The TAD are based on the premise that it is permitted to recognize "Revenue" on a gross basis as an accounting policy. If it is permitted to recognize "Revenue" on a gross basis depending on the actual businesses, it should also be permitted to recognize "Revenue" on a gross basis in contract price in accordance with IFRS15 to depict the actual business transactions. If current provisions are not clear or cannot be read that the transaction will be within the scope of IFRS15 instead of IFRS9 for the revenue recognition, the standards should be amended.
- More precisely, although such contracts are measured at fair value as derivatives from the initial recognition until the physical delivery of goods in accordance with IFRS 9, we believe that the accounting standards should include an exemption that allows to derecognize the contracts under IFRS 9 (and become within the scope of IFRS15) at the time of physical delivery of goods in order to present "Revenue" in accordance with the business model of each entity as accounting policies. (This treatment would confirm the current accounting practice that each entity considers to be appropriate.)
- The adequacy of such accounting treatment can be explained as follows, (focusing on differences from general derivatives);
  - When such contracts are settled by physical delivery of goods, it is clear that no inflows or outflows of economic benefits from derivative assets/liabilities will occur.
  - As a result, the derivative assets/liabilities are derecognized (since it will not meet the conditions of financial assets or liabilities recognition), and profits or losses are recognized by the reversal. *

    * The TAD states that the " additional journal entry" should not be recognized because the accumulated gains or losses related to derivatives should not be reversed without any reasons and that revenue or expenses that do not exist should not be recognized. However, we believe that this treatment itself is not specified in IFRS 9, and is only one of the interpretations. In addition, this "additional journal entry" is a matter of presentation rather than the recognition of additional profit or loss.
- This means that although such contracts are measured at the fair value as derivatives in accordance with the requirements of IFRS 9 until just before the physical delivery of goods, "Revenue" shall be recognized at the contract price in accordance with IFRS 15 at the timing of physical delivery of

goods (i.e. the scope of the transaction will be changed from IFRS 9 to IFRS 15).

(3) The practical burden from not accepting "additional journal entry"

- For preparers who believe that the presentation of "Revenue" in accordance with IFRS 15 is appropriate, there are no differences between commodities for which contracts are accounted for as derivatives in accordance with IFRS 9 and those that are not, not only in the purpose or nature of the business but also in the view point of collecting the consideration. (e.g. account receivables are recognized at the contract price at the timing of physical delivery for the settlement with customer.)
- In order to present "Revenue" at fair value at the time of physical delivery of goods as stated in the TAD, it is necessary to change the current accounting treatment, figure out the fair value at each physical delivery of goods, and change operating process including the systematic design, which results in serious practical burden. Both the practical workload (cost) and the benefit to be obtained (including whether it can be obtained or not) should be reviewed in case "additional journal entry" is not permitted. *

  * While the conceptual framework(QC35) states that the cost of reporting financial information are justified by the benefits of that, the cost of changing the current treatment in accordance with the TAD will be significant but the relevance of the revenue presentation will be impaired in some entities.

Yours, sincerely,

YUZO NOUCHI

General Manager
Corporate Accounting Department
Mitsubishi Corporation

KIMIRO SHIOTANI

Managing Officer, Global Controller
Global Controller Division
Mitsui & Co., Ltd.

POSITION PAPER

IASB Tentative Agenda Decision — Physical settlement of contracts to buy or sell a non financial item

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ESBG (European Savings and Retail Banking Group)
Rue Marie-Thérèse, 11 - B-1000 Brussels

ESBG Transparency Register ID 8765978796-80

28.01.2019

WSBI

ESBG

WSBI-ESBG welcomes the opportunity to comment on the IFRS Interpretations Committee's tentative decision on physical settlement of contracts to buy or sell a non-financial item.

We share the Committee's view and conclusions on the specific application of IFRS 9 on this issue.

About WSBI (World Savings and Retail Banking Institute)
(Boiler plate)

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Published by WSBI-ESBG. [Date]

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5 February 2019

Re: IFRS Interpretations Committee tentative agenda decisions published in the November 2018 IFRIC Update

Dear Ms Lloyd,

We are pleased to have the opportunity to provide our comments on the IFRS Interpretations Committee ("the Committee") tentative agenda decisions included in the September 2018 IFRIC Update.

Our comments refer to the following issues:

a. *Physical settlement of contracts to buy or sell a non-financial item (IFRS 9 Financial Instruments);*
b. *Customer's right to access the supplier's software hosted on the cloud (IAS 38 Intangible Assets);*
c. *Curing of a credit-impaired financial asset (IFRS 9 Financial Instruments).*

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

We agree that in the fact pattern described in the tentative agenda decision IFRS 9 neither permits nor requires an entity to make the additional journal entries that would result in recognising inventory or revenues at the cash paid or received on settlement. However, we suggest to consider whether IAS 2 applies to the inventory received. In the case of an entity, which is also a broker-trader, we think that the conclusion reached in the tentative agenda decision is consistent with IFRS 9 and IAS 2, which permits broker-traders to measure their inventories at fair value.

Additionally we note that this tentative agenda decision could be read to imply that the cost of an asset (financial or non-financial) is the cash paid plus the fair value of the derivative on the settlement date (in the case of a purchase contract). We would disagree with this assertion.

Consequently, we:

- think that this broader issue (ie whether the cost of an asset include the fair value of a derivative on settlement date) should be addressed by the Committee or the IASB; and
- suggest the Committee to clarify in the final agenda decision that the conclusions reached are limited to the fact pattern described in the request and should not be applied by analogy to similar fact patterns.

[...]

Should you need any further information, please do not hesitate to contact us.

Yours sincerely,

Angelo Casò
(Chairman)

Ms Sue Lloyd
Chair
IFRS Interpretations Committee
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United Kingdom

February 6, 2019

Tentative Agenda Decision - Physical settlement of contracts to buy or sell a non-financial item (IFRS 9 Financial Instruments)

Dear Ms Lloyd

Royal Dutch Shell plc is writing to comment on the IFRS Interpretations Committee's (the 'Committee') tentative agenda decision *Physical settlement of contracts to buy or sell a non-financial item – IFRS 9 Financial Instruments* ('tentative agenda decision'). We appreciate the opportunity provided by the Committee to comment on this tentative agenda decision.

Question for respondents

The question put to the Committee concerns how an entity applies IFRS 9 *Financial Instruments* to particular contracts to buy or sell a non-financial item in the future at a fixed price. The question included a fact pattern in which an entity accounts for such contracts as derivatives at fair value through profit or loss but nonetheless physically settles the contracts by either delivering or taking delivery of the underlying non-financial item. Two possible outcomes were considered as to how the gains/losses on the derivative at date of settlement be presented.

The question focussed on instances where contracts are settled by the receipt or delivery of a non-financial item. The Committee also observed that the question focussed on contracts that do not meet the own use scope exception in IFRS 9 *Financial Instruments* and are not in a designated hedging relationship.

The Committee concluded that cumulative gains/losses of the derivative at date of settlement be included within revenues (in the case of sales contract) or in inventory (in the case of a purchase contract).

The Committee also considered that the principles and requirements in IFRS Standards provide an adequate basis of an entity to conclude on the appropriate treatment. As such the Committee does not intend to add the matter to the standard setter's agenda.

Response

We have concerns about the Committee's tentative agenda decision as we believe that the Committee attempts to answer a very specific scenario of which the broader underlying question is effectively "should physically delivered sales or purchases be recorded at market price or the actual transaction amount paid or received"? The tentative agenda decision ignores this broader question and as a result ignores the interaction between the fair value accounting requirements in IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from contracts with customers* or IAS 2 *Inventories* in relation to contracts to buy or sell a non-financial item. We feel that the Committee has not given sufficient consideration to the fact that once these contracts settle physically, they are in the scope of IFRS 15 *Revenue from contracts with customers* or IAS 2 *Inventories*, where the dominant measurement principle changes from full fair value through profit or loss accounting to transaction price or cost accounting.

Currently accounting systems are set up to record revenue from physical commodity sales based on the contract price. Additionally, these systems measure and record derivative valuations only at start/end of each reporting period and not immediately prior to the derivative maturing. As such, the tentative agenda decision will have an impact on the established and widely applied industry practices in relation to the accounting for these types of arrangements. In effect, it leads to conflicts with other relevant accounting standards and principles with far reaching implications.

We would therefore urge the Committee not to finalise this tentative agenda decision and instead reconsider the decision, taking into consideration a wider view on the implications. We would also welcome the opportunity to engage on such fundamental concepts at an early stage and preferably at an industry level.

The more detailed considerations that lead us to this conclusion are set out in the attachment.

We appreciate your consideration of the concerns raised in this letter. If you have any questions or would like additional information on the recommendations and comments that we have provided, please contact us directly.

Yours sincerely,

/s/ Martin J. ten Brink

Executive Vice President Controller

Attachment

Further analysis

Background

Contracts to buy or sell non-financial items ("commodity contract") do not meet the financial instruments definition in paragraph 32.11 of IAS 32 *Financial Instruments: Presentation* ('IAS 32'), as neither are financial assets nor liabilities; however, they are in the scope of IAS 32 and IFRS 9 *Financial Instruments* ('IFRS 9')[1] under certain circumstances IFRS 9 2.4-2.6:

> *IFRS 9. 2.4: This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments [⋯].*

These commodity contracts were originally scoped into IAS 39 *Financial Instruments: Recognition and Measurement* ('IAS 39') paragraphs 5-6[2] to reflect the fact that many of these contracts are not settled through physical delivery by preparers but used to generate a profit through price differences, and thus can display similar economic traits as financial derivatives in the scope of IAS 32/IFRS 9.

If a commodity contract can be net settled, as described in IFRS 9 2.4-2.6, and does not meet the test of being entered into and continuing to be held for the purpose of receipt or delivery of non-financial items to meet the entity's expected purchase, sale or usage requirements (known as 'own-use commodity contracts'), they are treated as derivatives and recognised at fair value at inception and consequently fair valued through profit and loss.

Once a contract to buy or sell a non-financial item is settled through physical delivery, in our view the commodity contract does not meet the net settlement criteria in IFRS 9 2.4-2.6 any longer, hence is not in the scope of IFRS 9 and the subsequent treatment will depend on the accounting policy of the preparer for the measurement of inventory and revenue in line IAS 2 *Inventories* ('IAS2') and IFRS 15 *Revenue from Contracts with Customers* ('IFRS 15'). We in Royal Dutch Shell plc ('RDS') have chosen to measure inventory at historical cost applying the 'first in first out' ('FIFO') approach in accordance with IAS 2.10 and IAS 2.25, as explained below.

In contrast, a financial derivative remains subject to full fair value accounting even after settlement through physical delivery e.g., an option to acquire a publicly listed equity share in three-months' time, the fair value of the option will be added to the acquisition price of the share and immediately

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[1] Contracts to buy/sell a non-financial item were originally only in the scope of IAS 39, not IAS 32, as they are not meeting the financial instrument definition.

> IFRS9 BCZ2.18
> *'Before the amendments in 2003, IAS 39 and IAS 32 were not consistent with respect to the circumstances in which a commodity-based contract meets the definition of a financial instrument and is accounted for as a derivative. The IASB concluded that the amendments should make them consistent on the basis of the notion that a contract to buy or sell a non-financial item should be accounted for as a derivative. [...]*

[2] IAS39.5 -"

> *"This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, with the exception of contracts that 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".*

The wording of IAS39.6 is the same as in IFRS 9 2.6

revalued to full fair value through profit and loss[3], and therefore is subject to the same continuing full fair value measurement principle.

Contracts to buy (Inventory/IAS 2)

Inventory is currently recorded at 'cost of purchase'[4] in accordance with IAS 2.10 and 11 and FIFO principles are applied. To then include mark-to-market movements for commodities into the inventory valuation process would be in contradiction of the valuation principles set out in IAS 2.25 as currently applied by RDS. It is also notable that inventory can in practice be acquired through spot market purchases as well as under forward contracts. The direct application of the principles in the agenda paper would result in differing inventory carrying values (depending if inventory acquired under spot or forward contracts) for two otherwise identical inventory items for which the same cash payment has been made. We consider that such an outcome is not beneficial for users of accounts.

Contracts to sell (Revenue/IFRS 15)

IFRS 15.7 provides requirements for arrangements partially within the scope of IFRS 15 and partially within the scope of other standards. We are of the opinion that components of a contract to buy or sell a commodity are in the scope of IFRS 15 and partially in the scope of another standard, IFRS 9.

The components that are within the scope of IFRS 15, are currently recognised at transaction price once the performance obligation has been satisfied. Recognising revenue from commodity contracts at market price is in contradiction with IFRS 15.47, which defines the transaction price as *"the amount of consideration to which an entity expects to be entitled in exchange for transferring promise goods or services [..]"*[5]. Our view is that the transaction price is the amount received upon its sale as this is the amount to which the seller expects to be entitled when signing the contract. We do not consider the transaction price to be the market value of the commodity at the settlement date when we have satisfied our performance obligations. Consequently, we conclude that recording revenue at the market value of the commodity at physical settlement date is in not in line with the requirements in IFRS15.

Practical considerations

In practice we value open forward contracts at the balance sheet date and take all movements (between this and valuation on the preceding date) to income. Such movements include price changes and roll-off of existing contracts. This is computed on a portfolio basis and achieves the same accounting outcome that would be reached had the aforementioned "additional journal" been posted. However, because of the above outlined approach it is not currently possible to simply elect to cease posting the additional journal to achieve the outcome envisaged by the Committee.

We consider that the above balance sheet driven approach to valuing derivatives is common practice in industry. To achieve the proposed outcome of the Committee's tentative agenda

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[3] IFRS9 5.2.1 (c)

[4] Conceptual Framework, Chapter 4, 4.55 refers to historical cost as: *'[..] the amount of cash or cash equivalents paid, or the fair value of the consideration given to acquire them at the time of their acquisition [...]*

[5] As IFRS15 BC186 sets out, that *"the transaction price should include only amounts [...] to which the entity has rights under the present contract"*.

decision, would require significant changes in systems and additional manual processes that would need to deliver:

1. a valuation of the derivative to be determined at settlement date (even if mid-month);
2. a process to compare the derivative's settlement valuation to previous reporting period valuation and book movement to unrealised gains/losses;
3. a method to assign the value of the derivative at settlement to inventory parcels (whose cost is currently determined with reference to amounts paid in cash); and
4. a method to track these inventory parcels and determine which inventory parcels have been sold at end of the period.

In addition, it is notable that the process (and teams involved) in booking and valuing inventory are typically distinct from the process to value derivative contracts and thus impacting the former for derivative movements likely would require additional manual interfaces, creating risk and delay in close process.

Recommendation

We consider that answering this narrow question based on very specific assumptions about the accounting policies elected by a specific preparer would not be helpful for a wider group of preparers. We also believe that the proposal has a number of unintended consequences including practical ones that would impact many preparers. We therefore recommend for the Committee to look at this topic more holistically given the importance and wide scope of interaction between cost measurement and fair accounting and to also reach out to a wider group of preparers.

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February 5, 2019

Submitted electronically via ifric@ifrs.org

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Dear Sirs,

Re: Tentative agenda decision on IFRS 9 *Financial Instruments* Physical settlement of contracts to buy or sell a non-financial item

This letter is the response of the staff of the Canadian Accounting Standards Board (AcSB) to the IFRS Interpretations Committee's tentative agenda decision on physical settlement of contracts to buy or sell a non-financial item. This tentative agenda decision was published in the November 2018 IFRIC® Update.

In formulating the views expressed in this letter, we discussed elements of the tentative agenda decision with members of the AcSB's IFRS® Discussion Group at its January 10, 2019 meeting (see Cryptocurrencies – Other Considerations). The Group consists of members with a range of backgrounds and experience, including preparers, users and auditors of financial statements prepared in accordance with IFRS Standards.

We agree with the Committee's decision not to add this item to its agenda for the reasons set out in the tentative agenda decision. Based on the limited facts included in the submitter's request, we think that the principles and requirements in IFRS Standards provide an adequate basis for an entity to conclude on the appropriate accounting.

However, the tentative agenda decision is unclear whether it is intended to apply to a situation involving a commodity broker-trader. Therefore, we recommend that the IFRIC amend the tentative agenda decision to clarity whether it is intended to encompass the activities of commodity broker-traders.

We would be pleased to elaborate on our comments in more detail if you require. If so, please contact me at +1 416 204-3490 (e-mail lcheng@acsbcanada.ca), or, alternatively, Andrew White, Senior Principal, Accounting Standards at +1 416 204-3487 (e-mail awhite@acsbcanada.ca).

Yours truly,

Lester Cheng

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centrica

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Group Chief Accountant
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Tentative agenda Financial Instruments—Physical settlement of contracts to buy or sell a non-financial item (Agenda Paper 3) (IFRS 9)

Dear Ms Lloyd,

Thank-you for the opportunity to comment on the IFRIC tentative agenda decision related to the Physical settlement of contracts to buy or sell a non-financial item.

Whilst we understand the theory of the tentative decision, we would like to offer a dissenting view based on the "own use" classification issues within IFRS 9, the fact the vast majority of readers of the accounts will not understand the proposed treatment (in the context of an energy business), and the significant practical application difficulties that would ensue if the decision was ratified.

As it stands, IFRS 9 is silent on the P&L geography of gains or losses and consequently many companies have taken this to mean that they have discretion over the way IFRS 9 transactions, particularly physical commodity trades, are reflected in the income statement. Consequently, companies are able to ensure the P&L recognition reflects the substance of the transaction entered into. The tentative decision reached would take away this discretion and likely drive the majority of European Energy companies to use non-GAAP measures to ensure performance was reported appropriately - thereby undermining the usefulness of IFRS as a reporting standard.

IFRS 9 Own Use Criteria

The IFRIC noted that the accounting for contracts that do not meet the own use exemption is different from the accounting for contracts that do meet the exemption but having reached this conclusion then failed to consider whether there were deficiencies in the own use criteria that fundamentally govern this distinction.

When IFRS 9 replaced IAS 39, no changes were made to the "own use" exemption criteria. Accordingly, contracts entered into and continuing 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 were outside the scope of IFRS 9. Crucially, however, this classification is not available where an entity has a practice of net settling similar contracts or a practice of taking delivery of the underlying and selling within a short period to make profits.

For large energy companies, with trading arms that dynamically manage a portfolio of positions, it is virtually certain that there will be some market trades that are net settled. As a consequence, any market trades that are fundamentally undertaken for the purpose of receipt (e.g. to meet downstream load demand) or delivery (e.g. to sell the output of a field or power station) are then automatically tainted and must be marked-to-market within the scope of IFRS 9. Indeed, the own use classification is only really possible for bilateral trades.

Following the tentative decision, this would result in the recognition of different ultimate amounts of Revenue (for asset output) or Cost of Sales (for load procurement) for contracts that are, in substance, exactly the same but only have a different accounting treatment because of a technicality in the standard (and potentially just because of the wider business interests of the Group of entities it resides in).

Accordingly, we urge the IFRIC to consider this issue, including whether it is possible to base the own use rules on underlying intention rather than the existing arbitrary "similar contract" tainting rules (e.g. akin to the recent relaxation in cashflow hedge accounting criteria).

Performance Reporting

In general, energy companies are doing two main things:

(i) Procuring commodity to satisfy their Downstream customer demand and/or

(ii) Selling the commodity output of their assets (e.g. power stations, oil and gas fields)

They may also have trading arms which use their expertise in the energy markets to make money but this is an added benefit/business associated with being in the energy value chain.

Now most energy companies and analysts believe that the amount at which the entity has been able to fix its cash flows for procuring commodity to satisfy customer demand, or to sell the output of their assets, is relevant when reporting its financial performance to the market.

Conceptually, if you have an asset that produces commodity and you sell it for 100 then surely Revenue should be 100 (over its life)? And if you purchased commodity for 100 to then deliver to your customer then surely your Cost of Sale should be 100 (over its life)? The fact the trades may be in scope of IFRS 9 (e.g. due to tainting because of similar contract net settlement) should not obviate the need to reflect the substance of the transaction. Indeed, the conceptual framework now makes clear that faithful representation should reflect the economic substance. Therefore, this tentative decision would appear to make it impossible for energy companies to achieve this by removing their discretion over the P&L recognition of such transactions.

Practical Application issues

In the "Sale Contract" example, an entity is selling commodity for 100 and it moves out of the money by 10 in Year 1 and then realises in the following period with fair value staying constant during Year2. The paper suggests that the correct P&L recognition is:

Year 1 Dr: Other operating income 10

Year 2 Cr: Revenue (110)

And no further P&L entries should be made. However, in the real world, the fair value will move in Year 2, and so entities would have to mark-to-market all of their IFRS 9 physical contracts to the point of delivery. Currently most energy companies don't do this for physical trades because they only really care about the realised cash price for the commodity and not the theoretical fair value on delivery. To change to the latter would require significant system change, whereby daily (possibly half-hourly) pricing and FX rates are required for physical trades to ensure a mark-to-market can be calculated exactly at the point of delivery. Currently, mark-to markets are calculated at period ends and then the cashflows are used to drive the accounting on settlement. This will no longer be possible because the P&L entries would then fundamentally diverge from the cashflows associated with those transactions.

In conclusion, we urge the IFRIC to consider this tentative decision more carefully and, at a minimum, conduct more extensive outreach before ratification. Ultimately, the tentative decision would make IFRS financial reporting for energy companies significantly less intuitive for readers of the accounts and ultimately less relevant. Non-Gaap measures would become more widespread so as to circumvent the issues of performance reporting and the practical application.

Yours Sincerely

Matthew Blake
Group Chief Accountant
Centrica Plc

International Energy Group February 2019

IFRS Interpretations Committee
Sue Lloyd, Chair
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Canary Wharf
London
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E14 4HD

Dear Ms. Lloyd

Comment letter regarding IFRS IC's tentative agenda decision "Physical settlement of contracts to buy or sell a non-financial item (IFRS 9 *Financial Instruments*) - Agenda Paper 3" (28th Nov 2018)

We, as an international energy group, appreciate the opportunity to comment on the beforementioned IFRS Interpretation Committee's (IFRS IC) tentative agenda decision.

We have reasonable concerns in respect to the tentative agenda decision on physical settlement of contracts to buy or sell a non-financial item (IFRS 9). We think that the very broad tentative decision on the submitted, very special question (if some specific journal entries enquired by the submitter are appropriate or at least allowable) may have collateral, adverse effects on a wide range of contract types that are not yet fully analysed (i.e. not addressed) in detail when the staff prepared the tentative decision.

IFRS 9 provides guidance on recognition and measurement but hardly contains any presentation guidance, and neither did IAS 39 *Financial Instruments: Recognition and Measurement*. We believe the tentative agenda decision does not reflect that no specific guidance exists and thus, the tentative decision is a too short catch-all response to the request ("IFRS 9 neither permits nor requires"). By this we have the concern that it extents to other transactions and ignores the resulting distorted representation of economic facts of commodity transactions under IFRS 9 with physical settlement when following the tentative decision. The unambiguity of the tentative decision does not reflect the lack of disclosure guidance in IFRS 9 and negates the consequent corresponding application of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, under which an entity is required to develop an appropriate accounting policy according to other relevant IFRSs (here IFRS 9, IFRS 15 *Revenue from Contracts with Customers*, IAS 1 *Presentation of Financial Statements*, IAS 2 *Inventories*) if no detailed disclosure guidance is provided (and it is <u>not</u> in IFRS 9).

Whilst we acknowledge that an entity must measure the contract (if it falls under IFRS 9 although it foresees a physical settlement to buy or sell a non-financial item) at fair value and record changes in fair value in profit or loss over the term of the contract, we fail to read anything in IFRS 9 (nor in IAS 39) that would require derecognizing the final derivative balance against the top line in the income statement (or prohibit an entity from doing so).

In contrast, we believe, that apart from the approach proposed by the staff other accounting policies may be reasonably applied and correspond to the existing IFRS guidance for contracts to buy or sell a non-financial item with physical settlement but within the scope of IFRS 9 if looking at the economic facts of these transactions:

A seller has a contract with a customer for a specific quantity of goods (e.g. power, gas etc.) at a specified price. However, the seller did by no means contract a derivative financial instrument, and neither has the other party to the contract – it is only a fictitious treatment under IFRS 9 during the tenor of the contract. However, when it comes to delivery, we think that the substance of the transaction would be misrepresented if the derivative treatment impacted the presentation of revenue to be recognized from the contract with the customer on time of delivery – which to our understanding the tentative agenda decision suggests when requiring that revenues be presented at spot price rate instead at the contracted forward price (leading effectively to a gross presentation).

Without a doubt, upon settlement of the contract (i.e. on delivery of the non-financial item) the final derivative balance needs to be derecognized. At the same time, cash received as well as the revenue earned is to be recognised. If revenue were to be presented at the spot rate rather than the forward price, one would implicitly assume that the cash coming from the customer would be received for settling a derivative – which is not the case. The full amount of cash is received/paid for the physical delivery/receipt of goods as specified in the contract. Thus, and in the absence of any specific requirement in IAS 1, IAS 32, IFRS 9 and IFRS 15, we see no basis for not allowing entities to present the difference between the spot and the forward price outside of the revenue line (a net presentation).

It becomes even more relevant when the goods received are recognised as inventory – then it becomes decisive at which price the goods must be recognized initially. That should be, under IAS 2 (and IFRS 9 does not state anything regarding this) the contract price, i.e. the forward price.

It therefore seems imperative to us, before any decision becomes final, that these topics be fully revisited. We would also like to offer our support and share our experience with the IFRS IC and its staff when it undertakes its outreach sessions as we believe that this may improve the quality of the IFRS IC due process. Though IFRSs or Interpretations should not be written for specific sectors, we are of the opinion, that these in the same manner should not ignore economic reality.

Please find following a summary of our main technical concerns:

- We believe, when it comes to contracts with (mandatory) physical settlement that are in scope of IFRS 9, there is no explicit or conceptual basis in IFRS 9 for key aspects of the tentative decision and/or these may be inconsistent with issued and adopted IFRSs (esp. IFRS 15 and IFRS 9 as well as IAS 2 and the interaction between these IFRSs).
- We believe that the examples given in the staff paper are too simple and negate the high complexity and economic rationale of contracts within the scope of IFRS 9 but with physical settlement within the energy sector. Energy companies enter into contracts with continuing deliveries instead of a single just in time delivery (that leads operationally to some follow-up questions when applying spot rates for revenue recognition).

- We see a risk that information which shareholder and stakeholder will receive from the financial statements based on the tentative agenda decision will be adversely impacted and that resulting revenues will not provide a true and fair view of the purpose of transactions (substance over form). This bears the risk that an entity might not be able to report any reconcilable revenue figures under IFRS anymore and might foster to report another non-GAAP measure (for revenue, e.g. non-operating revenue) to overcome this.

Some more detailed comments are set out in the appendix to this letter. If you require any clarification or information, please do not hesitate to contact us.

Yours sincerely.

Appendix 1: detailed answer

1. IFRS 9/ IFRS 15

a. Revenue recognition (IFRS 9 vs. IFRS 15)

Introductory, we believe it may be supportive to provide the IFRS IC and its staff with some background as to why physically settled commodity contracts are accounted as if they were financial instruments.

Contracts to buy or sell non-financial items like power, gas, coal or CO2-certificates are in scope of IFRS 9 solely because they meet the provisions of the criteria of a fictitious net-settlement in IFRS 9.2.6, though never foresee or allow a financial net settlement. Many commodities are readily convertible to cash because they are traded on active markets or fail the own-use exemption since it cannot be excluded that (physical forward) buy-backs have to concluded during the tenor of the original contract (for technical or economic reasons). However, this "failed own-use treatment" does neither change the contractual terms (rights and obligations to deliver physically) nor the main intention (substance) of a contract, from a fix price to a spot price contract. That is a reason why many energy fix price physical forward contracts are in scope of IFRS 9 as if they were financial instruments (i.e. "fictitious" financial instruments), and hence are mandatorily measured subsequently at fair value through profit and loss –though clear and intended settlement remains physical.

The staff paper does not provide guidance if contracts to buy or sell a non-financial item in scope of IFRS 9 can result in IFRS 15 revenues, which leads to a major uncertainty compared to current understanding within the energy sector. We understand, that the staff creates two contracts for accounting purposes (one derivative and one physically settled spot deal) out of one legal contract. Since the undefined revenue from the physical delivery in the staff paper is measured at spot price, we understand that the staff's opinion is to account for the spot value in accordance with IFRS 15 being the only IFRS dealing with revenue. As of our understanding one contract (without bifurcation/ partition based on IFRS guidance for accounting purposes) cannot be accounted for under two different IFRSs simultaneously, i.e. at the same point in time, as if these were both real contracts with separate rights and obligations. Therefore, we would like to better understand under which guidance a gross-settlement of the derivative without any contractual basis and therefor no cash-settlement may be assumed. Without this assumption accounting for the physical delivery at spot prices would not be feasible. The embedded derivative guidance would not lead to a bifurcation of a derivative from the physical host contract based on the fact pattern in the staff paper. Such solution also seems contradictory to the terms of a standard energy fix price forward contract (e.g. under an EFET master agreement) which does not specify an energy delivery at spot prices and an embedded fix-for-floating swap but arranges a settlement at a contractually agreed fix price.

We believe that the current practice of dividing a single contract into two chronologically consecutive parts – the commitment transaction (IFRS 9; i.e. fictitious derivative since it does not arise from contractual rights and obligations but purely for accounting purposes) and the contracted underlying physical settlement transaction (IFRS 15) – best depicts the substance of such physically settled contracts failing the own-use exemption and combines both IFRS 9 and IFRS 15 guidance as we see it required by IAS 8.10 - 8.12. Measuring the fictitious derivative at fair value during its lifetime (commitment transaction) best depicts the financial position of the entity for that timeframe since the contract may be net settled and if so any potential claims/obligations are recognized on the balance sheet. But upon physical delivery there is no value attributed to the fictitious derivative – since any theoretical gain is not separately enforceable by the selling entity. So it is measured at zero (i.e. reversed from the balance sheet) and the physical transaction is accounted for and measured in accordance with IFRS 15.47 (i.e. at the transaction price the entity expects to be entitled to, which means the contractually agreed price).

If the entire contract has to be accounted under IFRS 9, energy companies would present only a small share of their business as revenue and cost of materials, which would severely impair the meaningfulness of the IFRS financial statements. At the same time, a reasonable revenue prognosis is not possible any more.

A further question arises with respect to the interaction between IFRS 9 and IFRS 15 when it comes to the need to distinguish the accounting and reporting treatment of two identical sales transactions involving future physical settlement with the same contracting party, under the same master agreement (EFET, which provides for mandatory physical settlement). Based on our understanding of the staff's view this would require different revenue recognition methods for the same entity if one contract (A) generates revenue at the contract price (because the own-use scope exception applies), while the other contract (B) is within the scope of IFRS 9 solely because of a "net settlement" fiction under IFRS 9.2.6b–d and thus, according to the tentative decision, would require revenue recognition at the spot price. Physical portfolio optimizations in the energy sector (especially electricity and gas) often result in only some portions of the portfolio qualifying for the own-use scope exception under IFRS accounting, with fair value measurement according to IFRS 9 having to be applied for other portions (mandatory requirements, not opportunistic choices). In the aforementioned example, if transaction (A) were unquestionably to generate IFRS 15 revenue, the same should – based on the "substance over form" principle – apply to transaction (B), since for both the economic purposes, the revenue-influencing characteristics and contract parameters are exactly the same. However, according to the staff's tentative decision, it must be questioned whether earnings under IFRS 9 can still be IFRS 15 revenue at all and therefore identical contracts would be measured and reported differently.

Considering that contract (B) in the example described above is a derivative, or contains an embedded derivative (due to the virtual creation of a spot price purchase contract and a fix-for-floating swap), the closely-related provisions for an (embedded) derivative must not be fulfilled to account for the derivative separately. We believe that the contract in the staff paper does not include an embedded derivative to be bifurcated because the fictional derivative would change cash flows of the host contract based on the host's commodity price and therefore be closely related. Therefore, additionally, we do not see any basis for a settlement of an embedded derivative.

In our opinion, the interaction between IFRS 9 and IFRS 15 for contracts to buy or sell a non-financial item is a crucial but at the same time not adequately addressed topic in the staff paper. We kindly ask the staff to provide clear guidance and explanation on the interface between IFRS 9 and IFRS 15 for complex physically settled non-own-use contracts (e.g. commodity contracts). In particular, we would like to understand how the measurement of revenue based on the spot price corresponds to IFRS 15 guidance. Without further clarification, we believe that the staff's tentative decision will lead to high uncertainty and may lead to diversity in practice especially within the energy sector.

b. All-in-one-hedges (IFRS 9 vs. IAS 39)

In the summary of its outreach activities, the staff quotes a respondent as saying that the outcome of the additional journal entry resembled the accounting treatment of an all-in-one hedge according to Question F2.5 in the IAS 39 IG. Subsequently the staff rejects this argument on the basis that the entity did not in fact designate the contract in a hedging relationship, which may be interpreted as if all-in-one hedges are permissible under IFRS 9 guidance.

Since IFRS 9 does not include any reference to all-in-one hedges and it superseded IAS 39 guidance, it seems questionable if the designation of all-in-one-hedges is still permissible without being explicitly mentioned under IFRS 9. Therefore, we believe that the staff should be clear what is meant, as we find it confusing that the staff indirectly hints at all-in-one hedge accounting under current guidance (IFRS 9), when such guidance has not been included in IFRS 9 (i.e. deleted from past guidance). Upon initial application of IFRS 9, many entities could have, and would have, designated all-in-one hedges to achieve a more relevant accounting outcome if they had known about the continued availability of this type of hedge accounting – especially if they had known it to be the only possible technique that results in revenues and costs being recognised at contract prices.

c. Posting Logic for revenue recognition

The submitter sets out a fact pattern which does not reflect the established accounting process of contracts which are measured at FVTPL, at least not for energy contracts. At our group, the "additional journal entry" is not made. Due to the established cash-based process for issuing invoices revenues for a physically settled contract are recognised at an amount equal to the nominal value (volume * contract price) of the contract and thereby the invoice amount to which the entity is expected to be entitled (IFRS 15.47). The fictitious derivative asset/liability is on delivery continuously unwound through other operating expense/income, since this fictitious accounting component "expires" and therefore ceases to exist without any cash exchange.

In addition, we believe the proposed revenue recognition method cannot be implemented for rolling supply contracts in upstream (energy trading) systems within a short timeframe and in the manner proposed by the staff. A one-year band contract for base load electricity or gas comprises 365 × 24 = 8,760 delivery hours (i.e. 8,760 relevant spot prices). These would have to be logged in the trading system every hour, and finally aggregated to arrive at an "average" spot price for revenue recognition. The figure thus determined could not be matched to the cash flows (not even over the total period), nor could it be reconciled with the associated accounting documents (invoices, account statements).

Changing currently implemented and audited processes would therefore require intensive re-engineering of energy trading & risk management, accounting and payment systems in advance.

2. Inventory Accounting (IFRS 9 vs. IAS 2)

In case of a fix price physical purchase contract of a non-financial item (e.g. gas) the buyer would need to recognise inventory at its spot price instead of the contractually agreed and to be paid price in accordance with the staff's view. In case of increased spot prices on the day of delivery compared to the contractually agreed price, we see the following consequence.

Applying the spot price to forward transactions within the scope of IFRS 9.2.6b–d (especially (c) and (d)) that are (and contractually are always required to be) physically settled, means to initially recognise inventory at fair value (with a basis adjustment without applying hedge accounting) instead of at cost in accordance with IAS 2.11 (i.e. cash flows of acquisition, as well directly attributable costs). If the entity does not apply the broker-trader exception of IAS 2.3b, this would lead to the initial recognition of unrealized gains within inventory at non-broker-traders, contrary to the cost principle of IAS 2.11. Subsequent measurement, however, would then be at cost or at lower net realizable value. The basis to derive "cost" in accordance with IAS 2.11 is the purchase price (i.e. amount payable) which is the contractually agreed contract price. Therefore, we would be grateful, if the staff could provide more guidance on how the spot price may meet the definition of cost. This is – based on our understanding – only achievable by assuming that part of the payment would be assigned to the derivative, though the only right in the contract is to receive a non-financial good and the only obligation is to pay the contractual amount for that good and not to settle any derivative. In our view, same as in the revenue chapter no rights and obligations arise from the fictitious derivative on delivery.

3. Deterioration of information usefulness

The objective of IFRS financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. A guidance that would force an entity to recognise revenue/cost of materials for a major part of its standard product portfolio at randomly fluctuating spot prices instead of contracted (i.e. based on the substance of the transactions and economically hedged) prices, would have a significant adverse impact on the presentation as well as interpretation of underlying revenue/expenses and ultimately of its financial statements.

Illustrative Example: The entity enters into two power contracts, with the physical deliveries on the same date. The contracts are a fix price purchase contract at CU20, a fix price sales contract at CU22 and the spot price on delivery is CU24. Based on our understanding of the staff paper, the entity would not show any operational margin, since both need to be recognised at the spot price of CU24. The entity would only present a gain resulting from the derivative transactions of CU2 (CU4 and CU-2).

We believe the entity should, instead, realise revenue of CU22 (consideration it expects to receive based on its contractual right; IFRS 15.47) and a cost of materials *of CU20 (both contract prices) but no realised result from derivatives as they have matured without being settled; i.e. no cash has been exchanged and there is no contractual basis to realise a derivative. Therefore, we believe an operational margin of CU2 provides a true and fair view of the transaction and its substance. We believe users of financial statements are more interested in a contracted operational margin (i.e. cash flows) than in a randomly fluctuating derivative result from a fictitious derivative.*

Therefore, we think the accounting practice proposed by the staff would, if followed, make it impossible to report predictable revenues or operational margins based on IFRS figures for the majority of (hedging) transactions involving settlement through future physical deliveries at spot prices. Entities would presumably introduce yet more non-GAAP measures and especially a non-operating revenue to exclude the difference between the contractual and the spot price. We strongly disagree with being forced to implement such measures within our revenue line item. The staff's very restrictive view also leads to an arbitrary differentiation in the presentation of entirely similar (both economically and contractually) transactions solely based on an accounting rule. In our opinion, spot-price-based revenue recognition contradicts the economic background of the transactions, their cash flow profiles and their contract parameters, as well as the actual document situation and, ultimately, the understanding of users of financial statements.

4. Examples not considered in the staff paper

As mentioned in the introduction, we believe, that following the staff's guidance on the very simple example provided by the requestor may have a collateral effect on similar types of more complex contracts without considering such contracts in the analysis.

Please find following a sample of contract types that would be affected. Since these were neither included in the request nor the staff's analysis, we believe that these should be taken into consideration within a broader outreach before taking any decision.

Contrary to the example submitted, in which the underlying contract apparently provided for both financial and physical settlement and physical settlement has now (exceptionally?) taken place (i.e. the contract parameters actually include a real financial instrument component – the element of financial settlement), the response also extends to all contracts providing exclusively for mandatory physical settlement which, owing to the provisions of IFRS 9.2.6b–d (previously IAS 39.6b–d), are removed from the own-use exception and are now within the scope of IFRS 9 (previously IAS 39). We wonder if and how this have been given sufficient consideration in the staff's assessment.

The fact pattern submitted to the staff deals with an extremely simplified example. It outlines an example in which a commodity is purchased or sold at a fixed price and at a certain point in time. But energy forward contracts are usually contracts that are delivered over a period (e.g. one month, three months, a half year, a full year etc.; see also "C. Posting Logic for revenue recognition"). That means that market prices constantly change during the delivery of a contract. Moreover, there is not one simple realisation, but such contracts are continuously realised while at the same time prices changes for the volumes that are still not delivered. This adds a huge complexity to a topic that the staff's tentative decision does not consider.

Moreover, the staff paper does not consider how to deal with embedded derivatives where the host contract is not in scope of IFRS 9, e.g. because the entity can apply the own-use exemption to the host contract. Contracts where customers demand flexible deliveries, e.g. a minimum delivery (own-use exemption applicable; IFRS 15) plus an option to purchase a higher quantity at a fixed price (IFRS 9) are very common in the energy sector. In such cases it could be that a customer receives the minimal quantity (own-use, recognition with contract price) on some days of the month and on other days of the month the customer orders up to the maximum amount (derivative; recognition with spot price). However, the entity only would issue one invoice for the month with the total invoice amount and this invoicing is linked to revenue.

We agree with the staff that complexity should not override the accounting requirements in IFRS 9. However, we believe this complexity must be recognised and taken into account by a broader outreach before a decision considering only a very limited contractual scope without considering energy specific products is taken. We would therefore appreciate more complex illustrative examples, e.g. for embedded derivatives, a one-year baseload contract, considering year-end closings to enable energy companies to apply IFRS 9, IFRS 15 and IAS 2 correctly.

Again, we would like to offer our support and share our experience with the IFRS IC and its staff when it undertakes its outreach sessions, as we believe that this may improve the quality of the IFRS IC due process, especially when it addresses topics that may have impacts on a wide range of entities and prove to become very complex.

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6 February 2019

Sue Lloyd
Chair
IFRS Interpretations Committee
Columbus Building
7 Westferry Circus
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London
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E14 4HD

Dear Ms Lloyd

Tentative agenda decision – IFRS 9 *Financial Assets*: Physical settlement of contracts to buy or sell a non-financial item

Deloitte Touche Tohmatsu Limited is pleased to respond to the IFRS Interpretations Committee's publication in the November IFRIC Update of the tentative decision not to take onto the Committee's agenda the request for clarification on the recognition of gains and losses on fixed price contracts for the sale or purchase of non-financial items that are accounted for under IFRS 9.

We agree with the IFRS Interpretations Committee's decision not to add this item onto its agenda for the reasons set out in the tentative agenda decision.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 20 7007 0884.

Yours sincerely

Veronica Poole
Global IFRS Leader

Deutsches Rechnungslegungs Standards Committee e.V.

Accounting Standards Committee of Germany

DRSC

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Berlin, 06 February 2019

Dear Sue,

RE: The IFRS IC's tentative agenda decisions in its November 2018 meeting

On behalf of the Accounting Standards Committee of Germany (ASCG), I am writing to comment on the tentative agenda decisions taken by the IFRS Interpretations Committee (IFRS IC) and published in the November 2018 IFRIC Update.

We agree with four of the tentative agenda decisions. However, in respect of two tentative agenda decisions we have concerns with the decision and the reasons cited, namely the tentative decisions on physical settlement of contracts (IFRS 9) and cloud computing (IAS 38).

Please find our detailed comments in the appendix to this letter. If you would like to discuss our views further, please do not hesitate to contact Jan-Velten Große (grosse@drsc.de) or me.

Yours sincerely,

Andreas Barckow

President

Appendix – Detailed Comments

IFRS 9 – Physical settlement of contracts to buy or sell non-financial items

Whilst we acknowledge that the tentative agenda decision is *one* possible conclusion for the issue submitted, in the absence of specific presentation requirements we do not agree that it is the *only* conclusion possible and that other views may be equally appropriate. We therefore disagree with the tentative decision and with the robust way it is formulated. As we see it, there are two issues that, whilst interrelated, we believe be better addressed separately:

(a) the question of how the amount of revenue from contracts with customers is to be determined in cases where the delivery mechanism occurs in such a way that the promise is treated as a derivative financial instrument because of explicit or de facto net settlement options per IFRS 9.2.6, yet the contracts are never settled net, but are settled physically at the amount specified in the contract with the customer; and

(b) whether or not the specific journal entries enquired by the submitter are appropriate or at least allowable.

On the first issue, treating a commodity contract for the delivery of goods and services as a financial instrument rather than under the revenue recognition literature seems entirely appropriate where such a contract is settled net in cash rather than through physical delivery. The core idea behind the provisions in IFRS 9 (and IAS 39 before) was to scope in contracts that, while taking the legal form of a commodity contract, are, in substance, financial contracts that are referenced to a commodity price. And that idea is clearly appropriate as long as the commodity contracts are settled net in cash.

The issue becomes more complicated as soon as the contract – whilst *allowing* for net settlement – is *actually settled* physically for the stated quantity in exchange for the contracted amount (and even more so for contracts that *mandatorily foresee physical delivery*). Where we do agree with the Committee is that an entity first has to judge whether or not the contract meets the own use exemption. If that is not the case, the contract is deemed a derivative financial instrument and treated as such per IFRS 9. However, IFRS 9 is a standard on recognition and measurement and is almost completely silent on presentation: Whilst we acknowledge that the entity has to mark the contract to fair value and record changes in fair value in profit or loss over the term of the contract, we fail to see anything in the literature that would require entities to derecognize the final derivative balance against the top line in the income statement (or prohibit them from doing so).

We would even go a step further: The seller has a contract with a customer for a specific quantity of goods and services at a specified amount; the seller has not contracted a derivative financial instrument and neither has the other party to the contract. We believe that the substance of the transaction could be misrepresented if the derivative treatment impacted the presentation of revenue to be recognised from the contract with the customer – which the tentative agenda decision seems to suggest when requiring that the revenue amount be presented at the spot price rather than the contracted forward price (effectively a net presentation). Clearly, upon settlement of the contract the entity needs to derecognise the derivative and to recognise the cash received as well as the revenue earned. However, if revenue were to be presented at the spot rather than the forward price, there would be an implicit assumption that the cash coming from the customer would be received for settling a derivative with the customer – which is not the case. The cash is received for providing goods and services, as specified in the contract with the customer. Hence, and in the absence of any specific requirement in IAS 1, IAS 32, IFRS 9 and IFRS 15, we see no basis for not allowing entities to present the difference between the spot and the forward price outside of the revenue line (a gross presentation).

If one follows our line of thinking, the second issue would become void, as there simply would be no reversals that would have to be recorded: Measurement of the derivative and presentation of its fair value changes would be kept separate from the accounting for the contract with the customer. Whilst this might be perceived odd from proponents of the financial instruments literature, we reiterate our point that provisions around derivative accounting in IFRS 9 and IAS 39 had been drafted with a different scenario in mind, being net settled contracts. For contracts that are not settled net but settled physically there is a gap in the literature as to what the appropriate presentation would be, as IFRS 9 and IAS 39 are silent on this issue. We therefore believe that entities are required to determine an appropriate basis of accounting (including presentation) and apply that basis consistently following IAS 8.

From outreach conducted we understand that both a net and a gross settlement treatment exist, though generally not within a specific industry. For instance, we are aware of the fact that the energy sector in Germany (and Europe) applies the gross treatment presentation mentioned above and, to our knowledge, have never been scrutinized by their auditors or enforcement bodies for doing so. We therefore believe that the agenda decision unduly emphasises one possible view without appropriately considering the other line of argument. In this regard we note that the wording in the tentative agenda decision seems to suggest that those entities who have followed a different line of thinking are not complying with the requirements in IFRS 9 – which we find an inappropriate conclusion: If the Committee acknowledges existing diversity, it should refrain from assuming that entities are consciously taking decisions against the literature. If the literature is not entirely clear and can be interpreted in different ways, some of which the Committee deems unacceptable, we believe that an agenda decision is the wrong means to address this behavior.

Hence, we request the Committee reconsider their tentative decision and either change their wording or take the issue onto its agenda and deal with it with the normal due process in place. If the Committee came to the conclusion that they would like to see further facts to better understand how the other view is applied in practice, we stand ready to assist the Committee and staff and share our evidence.

Global Financial Reporting Collective
incorporating the Pacioli Initiative

globalfrcollective@gmail.com

4 February 2019

IFRS Interpretations Committee
IFRS Foundation
Columbus Building
7 Westferry Circus
Canary Wharf
London
E14 4HD
United Kingdom

The Global Financial Reporting Collective is pleased to offer its comments on the Tentative Agenda Decision—Physical settlement of contracts to buy or sell a non-financial item.

The fact pattern seems to be clear that the contracts do not meet the own-use exception but the entity concludes on settlement that the assets will, now, be used for their own use. Our initial reaction was that either the initial assessment, or the test, is flawed or the entity has made an error.

We therefore concur with the tentative Agenda Decision. The most important sentence is:

> "Consequently, the Committee concluded that IFRS 9 neither permits nor requires an entity to make the additional journal entry described in the request."

We think it would be helpful if there was a requirement for entities to disclose the number of contracts (and the related amounts) which are accounted for as derivatives but then physically settled. We realise that this would require an amendment to an IFRS Standard, but we are also aware that the IASB is reviewing disclosures in IFRS Standards more generally. There is academic research to indicates that disclosure requirements can influence behaviour. Having information to help users of the financial statements assess the credibility of the entity's initial assessments or assertions could have a positive effect on those decisions.

The tentative Agenda Decision refers in several places to an "additional journal entry". This appears to have come from the submission you are considering. Although we don't object to the use of the term (and found the examples with journal entries in the submission helpful) it seems an unusual term to use in an Agenda Decision. We are not aware of any IFRS Standards that use the term to describe the accounting requirements. It might be more succinct to refer simply to reversing the accumulated gain or loss and recognising an adjustment to revenue or inventory.

Thank you for considering our comments.

Global Financial Reporting Collective

Global Financial Reporting Collective

4 February 2019

About the Global Financial Reporting Collective

The **Global Financial Reporting Collective** is a coalition of academics who support global financial reporting standards and who are motivated to help the IASB to develop high quality standards. The Collective does not have a jurisdictional base. It operates as a virtual, global network.

The Collective was established in 2018. In its initial phase it is managed by a small group of volunteers who analyse IASB proposals and collate comments into comment letters to the IASB. In the second phase the Collective plans to develop a website that will enable a broader range of academics, and practitioners, to provide analysis of proposals. Any comments and input received will not be attributed to an individual. We plan to provide mechanisms to allow individuals to make observations which can then be assessed on their merits, rather than be influenced by the reputation of the submitter—a blind review process.

The primary focus of comments from the Collective is on the clarity and internal and conceptual consistency of proposals, mainly informed from experience with teaching from IFRS Standards or applying them in practice. The Collective does not represent any sector and will not lobby on behalf of any entity or sector to support a particular view.

The purpose of the **Pacioli Initiative** is to make research and learning resources available to the broader community of people using global financial reporting standards. A portal for sharing these resources is being developed as part of the second phase of the Collective. We welcome any input on IFRS-related matters that could be helpful to those who teach or research in this area.

Madrid, 6 February 2019
IFRS Interpretations Committee
Columbus Building
7 Westferry Circus
London E14 4HD
United Kingdom

Dear Sir/Madam,

Re: Tentative Agenda Decision - *Physical settlement of contracts to buy or sell a non-financial item*

Repsol is very pleased to provide comments on the tentative agenda decision on '*Physical settlement of contracts to buy or sell a non-financial item'*, raised by the IFRS Interpretations Committee at its November meeting.

Further information about the Repsol Group and its activities is available on our Website: www.repsol.com.

Thank you for your attention.

Yours sincerely,

Ramiro Tomás Rodríguez

Financial Reporting and Corporation Economic& Administrative Director

Tentative Agenda Decision—*Physical settlement of contracts to buy or sell a non-financial item*

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

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

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

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

In addition, the entity:

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

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

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

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

a. reverse the accumulated gain or loss previously recognised in profit or loss on the derivative (even though the fair value of the derivative is unchanged); and

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

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

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

Accordingly, the additional journal entry described in the request would effectively negate the requirement in IFRS 9 to account for the contract as a derivative because it would reverse the accumulated fair value gain or loss on the derivative without any basis to do so. The additional journal entry would also result in the recognition of income or expenses that do not exist.

Consequently, the Committee concluded that IFRS 9 neither permits nor requires an entity to make the additional journal entry described in the request.

Due to the limited information included in the request received by the IFRS IC, we believe that it would not be adequate to take an Agenda Decision in the terms described in November 2018 IFRIC Update. We believe that this issue should only adequately be addressed through an appropriate outreach or consultation process with users and preparers, contemplating the interaction of IFRS 9 *Financial Instruments* and other standards, the different possible business models (including supply and commercialization activities, traders-brokers activities, hedging activities, short-term operating activity, or long-term contracts with multiple deliveries, etc.)

Notwithstanding the foregoing, if the IFRS IC decides to answer the request through the issuance of an Agenda Decision, we believe that it should be taken into account that it is an issue not explicitly addressed in IFRS 9, but an issue to be assessed in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Error,* considering the following issues:

a) Faithful representation of the transaction

- In accordance with the criterion of the tentative Agenda Decision, there would be a single unit of account at inception, a firm commitment to buy or sell a non-financial item in the future at a fixed price. This firm commitment is accounted for as a derivative instrument because at inception it does not meet the IFRS 9´s own use scope exception. In accordance with the tentative Agenda Decision, this single unit of account is split into two different units of account at the settlement date:

  (i) a derivative (based on the initial presumption –rebutted– of net settlement) in the scope of IFRS 9; and

  (ii) the contract that has been physically settled, which it is supposed to be accounted under IAS 2 / IFRS 15 scope, but taking the spot price of settlement date (and not the contractual price) as the reference price for accounting purposes.

- We believe that the fair value through profit or loss accounting criterion applicable to firm commitments outside the own use exception is justified during the valuation period of a firm commitment, but once the facts and circumstances shows that the contract has not been settled net, this rule-based accounting criterion seems to be difficult to be justified in accordance with the principles in the *Conceptual Framework for Financial Reporting*, as long as that the contract has been finally settled for the purpose of the receipt or delivery of the commodity in accordance with the entity´s purchase, sale or usage requirements. In this sense, we do not consider appropriate to present as a derivative result a portion of the outcome of a contract that has not been settled net, because in our view this would not provide a faithful representation of the economic substance of the transaction.

- The unit of account issue is directly related with cash flows, because there is only one real cash flow, which is the gross fixed price payment or collection (if the contract is not settled net) or a net amount (if the contract is settled net in cash). We believe that the information presented in the statement of profit or loss from a contract that has not been settled net should be consistent with the information included in the statement of cash flows.

- For these reasons, we believe that the additional journal entry recognising inventory or revenue at the cash paid or received on settlement would be justified in terms of identification of the real transaction carried out and its corresponding unit of account, showing the financial performance of the entity reflected in past real cash flows.

- In addition, we believe that it is relevant to consider that companies entering in firm commitments to buy or sell a commodity, use to enter into derivatives instruments in accordance with their risk management policy. In our view, the accounting outcome of the proposed tentative Agenda Decision, would not provide the most relevant information in such cases in which the entity does not apply hedge accounting, because there would be a result from the derivative instrument entered into by the entity and the result from derivative instrument as a consequence of the rule-based accounting referred above. This final accounting outcome would not show the risk management activity performed by the entity and in would make it difficult to understand this activity based on the accounting records.

b) Interaction of the tentative Agenda Decision and other IFRS

Additionally, it is no clear for us the interrelation of the tentative Agenda Decision with other Standards, specifically with IAS 2 *Inventories* and IFRS 15 *Revenue from contracts with customers*.

- In accordance with IAS 2, inventory should be measure at the lower of cost and net realisable value. In our view, in accordance with the fact pattern described in the request, the cost of inventories would be the contractual fixed price, provided that the contract had not been settled net.

- As regards of IFRS 15, the Standard establishes that to determine the transaction price an entity shall consider the terms of the contract and the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. In this sense, it is not clear for us how revenue recognition under the accounting treatment proposed by the tentative Agenda Decision match with IFRS 15 criteria, in those cases in which the contract is not settled net.

- In addition, there is another issue not addressed in the tentative Agenda Decision that perhaps should be also taken into account, specifically the gross vs. net presentation of revenue depending on facts or circumstances.

c) Implementation costs

Finally, we would like to note that the implementation of a new accounting policy based on the tentative Agenda Decision could have a greater impact for many entities than that considered by the IFRS IC, including issues related changes in IT systems and internal controls. This is an additional reason not to support the resolution of this request through an Agenda Decision without a previous outreach or consultation process.

For the reasons stated above, if the IFRS IC decides to answer the request through the issuance of an Agenda Decision, we believe that it should be based on the application of the IAS 8 criteria and it should be focused on providing relevant and reliable information about the economic substance of each transaction, and not only in the application of an rule-based accounting criteria that do not address subsequent real facts and circumstances. This answer should clarify the interrelation between the scope of IFRS 9 and the scope of IFRS 15/ IAS 2, and, in addition, it should be symmetrical as regard of the accounting treatment applicable both to purchases and sales.

Rio de Janeiro, February 06, 2019

CONTRIB 0011/2019

Ms Lloyd
International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London
E14 4HD, UK.

Subject: Tentative agenda decision

Reference: Physical settlement of contracts to buy or sell a non-financial item

Dear Ms Lloyd,

Petróleo Brasileiro S.A. - Petrobras welcomes the opportunity to comment on the IFRS Interpretations Committee's tentative agenda decision - Physical settlement of contracts to buy or sell a non-financial item. We believe this is an important opportunity for all parties interested in the future of IFRS and we hope to contribute to the progress of the Board's activities.

We generally agree with the Interpretations Committee's conclusion and we support the decision not to add this item to its agenda.

If you have any questions in relation to the content of this letter please do not hesitate to contact us (contrib@petrobras.com.br).

Respectfully,

/s/Rodrigo Araujo Alves

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Rodrigo Araujo Alves

Chief Accounting and Tax Officer

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Chairman

Paris, 6 February 2019

Mrs Lloyd
IFRS Interpretations Committee Chair
7 Westferry Circus, Canary Wharf
London, UK, E14 4HD

November 2018 - IFRS-IC tentative agenda decisions

Dear Mrs Lloyd, Dear Sue,

I am writing on behalf of the Autorité des Normes Comptables (ANC) to express our views on the IFRS-IC tentative decisions published in November 2018 IFRIC Update regarding IFRS 9 – *Physical settlement of contracts to buy or sell a non-financial item*, IAS 38 – *Customer's right to access the supplier's software hosted on the cloud* as well as IFRS 9 – *Curing of a credit-impaired financial asset*. This letter sets out some of the most critical comments raised by interested stakeholders involved in ANC's due process.

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

ANC does not disagree with the tentative decision. ANC notes however that in the energy industry, when neither the own-use exception nor the hedge accounting is applied, entities often manage contracts measured at fair value through P&L (IFRS 9.2.5) to achieve an economic hedge. Upon physical settlement, there is a common practice to present the accumulated fair value gain or loss on the derivative on one line in the P&L that differs from the one where the sale/purchase is recorded (at contract's value instead of the fair value retained in the fact pattern).

ANC understands that this current accounting practice reflects the way performance is analysed, both by management and by external users of the financial statements. The Committee's suggested accounting treatment might have significant impact on this current practice and be disruptive. ANC is concerned that this could result in increasing the use of non-GAAP information to meet user's expectations.

The issue is partially linked to the dual practice in the industry to settle net and physically. ANC suggests that IASB considers, as part of its standard-setting activity, the accounting treatment of these contracts that are neither held for trading nor eligible to the own-use exception and that are eventually physically settled.

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[...]

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Kind regards.

Yours sincerely,

Patrick de Cambourg

MAZARS

Mrs Sue Lloyd
IFRS Interpretations Committee
Columbus Building,
7 Westferry Circus, Canary Wharf
London E14 4HD
United Kingdom

La Défense, February 6, 2019

Tentative Agenda Decisions – IFRIC Update November 2018

Dear Sue,

MAZARS is pleased to comment on the various IFRS Interpretations Committee tentative agenda decisions published in the November 2018 IFRIC Update.

We have gathered all our comments as appendices to this letter, which can be read separately and are meant to be self-explanatory.

We would like to draw your attention to two issues that are worth considering:

- The tentative decision on physical settlement of contracts to buy or sell a non-financial item (see Appendix 2 to this letter) is contrary to the practice applied by large companies in the energy sector, and we think it necessary to undertake a comprehensive analysis of the issue and the rationale for their current practice before finalizing any decision;
- The issue of the accounting for the curing of a credit-impaired financial asset is not an easy one, and when diving into examples, it appears that there exist within IFRS 9 some unclear requirements or even inconsistencies between the definitions involved. We have tried to develop examples evidencing those difficulties, and we stand ready to present them and our concerns in a dedicated meeting with IFRS IC Staff / members.

Should you have any questions regarding our comments on the various tentative agenda decisions, or should you want us to participate in a meeting as proposed above, please do not hesitate to contact Michel Barbet-Massin (+33 1 49 97 62 27) or Edouard Fossat (+33 1 49 97 65 92).

Yours faithfully

Michel Barbet-Massin
Financial Reporting Advisory

Edouard Fossat

MAZARS

Appendix 2

Physical settlement of contracts to buy or sell a non-financial item (IFRS 9 **Financial Instruments***)—Agenda Paper 3*

We agree with the technical analysis conducted by the Interpretations Committee and the conclusion that, applying IFRS 9 to those contracts that do not meet the own-use exception, no additional accounting entries aiming at reversing the accumulated gain or loss previously recognised on the derivative should be made. We concur with the Interpretations Committee that the physical settlement of such contracts should lead to the recognition of revenue (in the case of a sale contract) or inventory (in the case of a purchase contract) at the market price of the non-financial item on the settlement date.

We nevertheless believe that there is a need for clarification of the interactions between IFRS 9, IFRS 15 and IAS 2, when a derivative on a non-financial item is physically settled. In particular, it is not clear whether the physical settlement triggers for an accounting on a gross basis in the Statement of Profit or Loss, and whether the physical delivery (in the case of a sale contract) is within the scope of IFRS 15.

We note that this lack of clarity on how to account for those contracts from inception to the final physical delivery has led companies – mainly in the energy sector – to develop accounting practices that, to their opinion, fairly portray their performance and how they manage it. These accounting practices do not comply with the conclusion in the Tentative Agenda Decision, but seem to be (according to the comment letter sent by IEAF) common practices consistently applied in the energy industry without significant diversity.

Applying the requirements in the Tentative Agenda Decision would represent for these companies significant implementation costs, together with a dramatic change in their measurement of performance. We believe that such a change cannot be imposed through a simple Agenda Decision, and that it would be better addressed through a comprehensive analysis, including outreach sessions with the relevant industry representatives, while making a link with the performance part of the Primary Financial Statements project.

We therefore recommend to the Interpretations Committee not to finalise the Agenda Decision, but rather to undertake a more comprehensive project that could lead to standard setting activities.