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Accounting for physical settlement of commodity contracts

Contracts to buy or sell commodities are accounted for as financial instruments in terms of IFRS 9 *Financial Instruments*, except if these contracts are entered into by the entity to deliver or receive the underlying commodities. It may happen that a commodity contract is accounted for in terms of IFRS 9, but is ultimately physically settled. The IFRIC published an agenda decision in March with its view on how the physical settlement of such a contract should be accounted for. This article provides an overview of the alternatives considered and the position taken by the IFRIC.

IFRS 9 *Financial Instruments* ('IFRS 9') governs the accounting treatment of financial instruments. This standard however also applies to certain commodity contracts, as discussed in more detail below. The IFRS Interpretations Committee finalised an agenda decision on a matter relating to the accounting treatment of these contracts during its March 2019 meeting. This article briefly recaps the principles applicable to such contracts and provides an overview of the agenda decision published by the IFRIC.

Relevant principles

Although a contract to buy or sell commodities is not financial instrument, as defined in IFRS 9, such a contract must be accounted as if it is a financial instrument if it can be settled net in cash or another financial instrument or by exchanging financial instruments. This contract is accounted for as a derivative financial instrument at fair value through profit or loss.

Contracts to buy or sell commodities must not be accounted for as if they were financial instruments if the reporting entity intends to settle the contract by way of physical delivery of the commodities in accordance with the entity's own expected purchase, sale or usage requirements. When the contract is settled by physical delivery the transaction to purchase or sell the commodity should be accounted for when it occurs and at the price agreed in terms of the commodity contract. (This accounting treatment may be affected if hedge accounting or the commodity broker-trader exception in IAS 2 Inventory is applicable, but this discussion is beyond the scope of this article.)

Recent agenda decision

The matter considered by the IFRIC dealt with a scenario where a contract to buy or sell a commodity was accounted for as if it was a financial instrument (i.e. the own use exception did not apply), but is then subsequently settled by means of physical delivery of the commodity. The IFRIC's outreach found that these contracts, and therefore by implication the possibility of the above scenario, is common in industries such as commodities trading, extractives, agriculture, energy, utilities and fish farming.

The specific question considered was whether the correct accounting treatment was to account for the contract:

- in a similar manner as one that was an own use contract since its inception (i.e. reverse fair value adjustments and effectively account for the purchase or sale transactions at the contract price), or
- as a purchase or sale of the commodity at the current fair value (effectively as a settlement of the financial instrument which would imply that the gains or losses recognised on re-measurements are not reversed).

The main ground for the first-mentioned treatment was that the accounting treatment should ultimately reflect the transaction (being for the entity's own use) if relevant information is to be provided to users of the financial statements.

Proponents of the latter treatment argued against reversal of the adjustments on the basis that a retrospective restatement was inappropriate if no error occurred. They also argued that accounting for the commodity transaction at its fair value (current spot price) follows through the accounting principles applied in a consistent manner upon settlement.

The IFRIC position published in the final agenda decision is that IFRS 9 does not permit or require an entity to reassess or change its accounting treatment of a commodity contract based on the ultimate mode of settlement. The physical settlement of the contract should therefore accounted at the fair value of the commodity at the date of settlement, with no further gain or loss adjustment at the date of settlement.