WHAT YOU SHOULD EXPECT

A question that requires candidates to determine whether the contract for the sale of a nonfinancial asset such as **agricultural produce** is a derivative to be accounted for under IAS 39/IFRS 9 e.g. June 2010 q3a (answer)

THE SCENARIO

Producer and counterparty buyer (speculator, manufacturer, retailer, consumer).

Usually comes with **options**: i) settled net (custom and practice); ii) own use purchase or sale exception (where contract was entered into and continue to be held for the purpose of receipt or delivery of nonfinancial items to meet the entity's expected purchase, sale or usage requirements)

REQUIRED

Discuss how the transaction should be accounted for in accordance with IFRS

STEPS IN ANSWERING QUESTIONS

Your task

i) Knowledge of a derivative financial instrument: a contract that allows speculation because of its inherent characteristics: a) value varies with the value of the underlying; b) acquired for zero or relatively low price compared with other types of contract that would be expected to have a similar response to changes in market factors; c) settled net at some point in the future.

ii) Clarify the issue: is the contract a derivative financial instrument or not? *Contracts for the sale of nonfinancial items can be classified as derivative financial instruments and accounted for under IAS 39 if they are "settled net" in: i) cash, ii) another financial instrument, or iii) by exchange of financial instruments*.

iii) Clarify the terms for a derivative: "settled net is key". Explain what this means. *A contract is settled net in cash (or equivalent value in other financial assets) if the entity receives from, or pays cash, to the counterparty equal to the net gain or loss that will arise from the settlement or exercise of the contract*.

iv) Assess the scenario to determine if the criteria of settled net apply: a) **look at the explicit terms** (does the contract permit either party to settle net in cash?; b) **custom and practice** (does the entity have a practice of settling similar contracts net in cash, whether with the counterparty, by offsetting or by selling the contract before it lapses or is exercised)); c) **taking delivery of the underlying and selling within a short time after taking delivery** for the purpose of making a profit from short-term fluctuations in prices or dealers margins; d) market available to readily convert the non-financial item into cash

v) Assess the intentions of the entity and the counterparty. These are usually explicit but they may be implied by practice that is unlikely to change (e.g. the entity has regularly sold commodity shortly after taking delivery)

vi) Draw a conclusion