



# IFRS IN PRACTICE

Accounting for commodity loans

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## INTRODUCTION

A reduction in the amount of funding available from equity markets, together with difficulty in obtaining loan finance, have meant that a number of developers and producers in the extractives industry have looked to other ways of obtaining finance. An increasingly common approach is to enter into a commodity loan under which a lender advances funds which, instead of being repaid in cash, may be repaid by the delivery of a quantity of a commodity during a specific period. These arrangements have become particularly common when they involve a commodity such as gold, which is traded on an active market.

As an example, producer X enters into a 'commodity loan' with financier Y. Producer X is advanced a loan of CU100m in cash, which will be repaid by producer X delivering the commodity. In many cases, the contract sets a fixed price for the commodity meaning that, instead of receiving a specified rate of interest, the lender's return is linked to future changes in the market price of the commodity.

In other arrangements, the lending agreement specifies that if the spot price of the commodity varies, the quantity of commodity to be delivered on each repayment date will be adjusted. That is, the amount of commodity delivered at each date will be the amount equal in value to the loan repayment being made. Interest may also be added to the funds advanced, with this also being settled by the delivery of the commodity.



## THE ACCOUNTING ISSUE

A key issue is whether the contract to deliver a non-financial item (the commodity) falls within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. Although IAS 39 would appear to apply only to financial assets and financial liabilities, certain contracts for non-financial items are also within its scope.

The same issue applies to those entities that have adopted IFRS 9 Financial Instruments early, as its scope is the same as that of IAS 39.

### The scope of IAS 39

In determining whether the transaction is within the scope of IAS 39, key guidance is set out in IAS 39.5-7. IAS 39.5 notes that

*'This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or in another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements.'*

Thus, in determining whether the contract falls within the scope of IAS 39, it is necessary first to determine whether the contract permits:

- Net settlement in cash or in another financial instrument; or
- Can be settled by exchanging financial instruments, as if the contract itself is a financial instrument.

An example of net settlement in cash is where a commodity producer enters into a contract to supply a specified amount of a commodity and, in addition, pays or receives an amount in cash based on the difference between the market price of the commodity on the date of its supply and the price stated in the contract.

Settlement by the exchange of financial instruments would occur where part or all of the contract can be paid in cash, instead of through the physical delivery of the commodity.

IAS 39.6 notes that there are various ways in which a contract to buy or sell a non-financial item, such as a commodity, can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:

- '(a) When the terms of the contract permit either party to settle it net in cash or in another financial instrument or by exchanging financial instruments*
- (b) When the ability to settle net in cash or in another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse)*
- (c) When, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and*
- (d) When the non-financial item that is the subject of the contract is readily convertible to cash.'*

The fact that IAS 39.6(d) states that net settlement includes all circumstances in which the non-financial item that is subject to the contract is readily convertible to cash means that the vast majority of commodity loans are considered to be capable of net settlement. This is because many commodities involved in these arrangements are traded on an active market on which they can be sold.

IAS 39.6 also notes that:

- *'A contract to which (b) and (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements, and accordingly, is within the scope of this Standard*
- *Other contracts to which paragraph 5 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements, and accordingly, whether they are within the scope of this Standard.'*

The test that needs to be applied is whether the contract will always be settled through the physical delivery of commodity which has been extracted by the producer as part of its own operations. If so then, the contract might fall outside the scope of IAS 39, on the basis that it meets the 'own use exemption', although the precise contractual terms still need to be reviewed in detail (for example, see 'Options' below). However, if the contract does fall within the scope of IAS 39, it will be accounted for as a financial instrument. This can give rise to significant differences in the accounting due to the remeasurement required by IAS 39 and IFRS 9, which are illustrated later in this publication.

# KEY CONSIDERATIONS IN DETERMINING WHETHER THE IAS 39 'OWN USE EXEMPTION' APPLIES

## The producer's own production facility

Although it might seem fairly obvious, it is essential that the commodity that is used for the purpose of deliveries under the terms of a commodity loan is extracted from the borrower's own mining facility. This means that there must be no prospect of the borrower settling part or all of the commodity loan by purchasing commodity on the open market, or from a third party. This is because the borrower would otherwise be unable to assert that the contract will be settled by the delivery of commodity according to its own expected sale requirements.

## Amount of expected future production

In addition to referring to a contract being entered into and continuing to be held for the purpose of delivery of the commodity, IAS 39 also refers to an entity's 'expected purchase, sale or usage requirements'. This means that it is necessary to analyse and link the delivery requirements of a commodity loan to the borrower's future expected production.

In some cases, this will be straightforward as the expected production from the mining facility will be greater than the amount of commodity required to settle the commodity loan (in some cases, substantially in excess). However, for an entity in the early stages of exploration or production, it may be difficult to predict with certainty that the amount of commodity required to settle the commodity loan will in fact be extracted. Consequently, due to this uncertainty, these latter arrangements will typically be accounted for as financial instruments.

## Timing of expected future production

A commodity loan may contain a clause that requires delivery of the commodity by a specified date. If delivery has not taken place, a cash settlement then becomes due. In these cases, both the amount (see above) and timing of expected production will need to be assessed. As with the amount of expected future production, for an entity in the early stages of exploration or production, it may be difficult to predict with certainty that the amount of commodity required to settle the commodity loan in each period will in fact be extracted.

## Intent and past practice

A producer may be able to demonstrate that the expected production from its own mining facility will be sufficient to settle the commodity loan. However, it is also necessary for the producer to be able to demonstrate that it intends to settle the loan. This could be through an analysis which indicates that the only realistic manner of settlement is physical delivery.

In addition, where a producer has previously entered into commodity loans, it will be appropriate to analyse the extent to which the producer delivered the commodity and did not either source commodity from third parties, or settle part or all of the arrangement in cash. While to an extent judgement will be needed, where a producer's past practice has not been to settle the loan through physical delivery of its own commodity, evidence will be needed to support an assertion that a new commodity loan will be settled through this physical delivery failing which the arrangement will fall within the scope of IAS 39.

## Options

A commodity loan may include an option for the borrower and/or the lender to require settlement in cash, instead of through physical delivery.

If the borrower, rather than the lender, has the choice of whether to settle through physical delivery or in cash, then provided that the producer can demonstrate that it does not intend to exercise the option to settle in cash then the arrangement will not fall within the scope of IAS 39. This could be through an analysis which indicates that the only realistic manner of settlement is physical delivery.

However, if the lender has an option to require settlement in cash, then the arrangement will automatically fail the assertion that it was entered into and continues to be held for the purpose of the delivery of the commodity, in accordance with the borrower's expected sale requirements. Consequently it will fail the 'own use exemption' and fall within the scope of IAS 39. This is because the existence of the option, which can be exercised at the lender's discretion, means that the borrower does not have control over whether the loan is settled through physical delivery of the commodity.

### Unit of account – is it the whole contract or a part of the contract?

A producer might enter into a contract which requires the physical delivery of 100 tonnes of commodity. Although the assessment on inception of the arrangement is that the amount of commodity will be in excess of 100 tonnes in the time period specified in the contract, the expected production subsequently falls to 80 tonnes. The original contract states that, in the event that the producer fails to deliver the required amount of the commodity in the relevant time period, a cash payment will be required for the shortfall.

In these circumstances, at the point at which the expected production falls to 80 tonnes, the entire contract will fail the IAS 39 'own use exemption' and, prospectively, will be accounted for in accordance with that accounting standard. This is because the unit of account is the contract. Consequently, the arrangement is assessed at that level; it is not appropriate to divide the contract into two components, with one being for 80 tonnes and the other 20 tonnes.

This demonstrates the importance of ensuring that estimates of future production are realistic. It may also mean that in some cases it may be desirable to enter into more than one contract with the lender, with one covering the amount of production that is almost certain, and the other covering the less certain portion.

### Changes in settlement terms

A contract which only permits settlement through physical delivery, and has been assessed to meet the IAS 39 'own use exemption' may have its terms altered, through which the producer and lender agree to gross settlement in cash.

From the point at which the parties agree to settle in cash, the contract will be recognised in accordance with IAS 39 as it no longer meets the criteria for the 'own use exemption'.

### Does future production failing to be sufficient to fulfil contractual requirements always result in failure to meet the 'own use exemption'?

As noted above, commodity loans may contain terms under which, if a producer fails to deliver sufficient quantities of the commodity, the producer will be required to settle the amount due in cash. While these terms need to be taken into account when considering whether the contract meets the IAS 39 'own use exemption', they do not necessarily mean that it is automatically failed. Instead, it is necessary to analyse the intentions of the producer, together with expected production on inception of the arrangement and subsequent changes. If a reduction in output and related cash settlement is due to an event that could not have been foreseen at inception of the arrangement (such as an unexpected breakdown at the production facility that meant production was stopped for an extended period), then the cash settlement that arises during this period would not result in the 'own use exemption' being failed. This is because the contract was not entered into with the intention of a possible net cash settlement. However, if a net cash settlement arose because a producer chose to sell its production to another third party, and settle its obligation under the commodity loan through a cash payment, this would result in failure to satisfy the requirements of the IAS 39 'own use exemption'.

### Effect of failing the IAS 39 'own use exemption' after initial recognition

A producer may enter into multiple arrangements that involve the IAS 39 'own use exemption'. Care will be required when assessing the likelihood of the producer continuing to meet the 'own use exemption'. This is because, in the event that the conditions are breached for one contract, the assertion that the remaining contracts continue to qualify for the 'own use exemption' is open to challenge.

The failure to meet the terms of the 'own use exemption' may be due to factors outside the producer's control (for example, an unexpected breakdown of equipment, resulting in an extended period of inactivity in addition to normal maintenance stoppage time). In these cases, provided the physical deliveries for other contracts are still expected to be made, the 'own use exemption' is not affected.

However, if the failure to deliver the commodity is due to the producer's choice, then other contracts under which it has asserted physical delivery of commodity are likely to need to be reclassified to be within the scope of IAS 39.

## DISCLOSURES IN FINANCIAL STATEMENTS

As illustrated below, the effect of the conclusion as to whether a commodity loan falls within the scope of IAS 39 can give rise to very significant differences in accounting. Consequently, in addition to disclosures about the arrangement itself, it is likely that the analysis carried out in determining whether an arrangement gives rise to a financial instrument within the scope of IAS 39 will need to be disclosed as a key judgement in accordance with IAS 1.22 (judgements that have the most significant effect on amounts reported in financial statements). Due to the significance of assumptions made about estimates of future physical deliveries of commodities, disclosure may also be required about estimation uncertainties (IAS 1.125).



## EFFECT OF CONCLUDING THAT A COMMODITY LOAN IS NOT A FINANCIAL INSTRUMENT

Producer X enters into a 'gold loan' with financier Y. Producer X is advanced CU100m in cash. The liability will be settled by producer X delivering gold that it has extracted from its mining facility. The contract sets a fixed sales price for gold at CU1,500/oz. That is, the CU100m will be settled through the delivery of the first 66,667 oz of gold that is extracted, regardless of the future market price. There is no time limit within which the gold is required to be delivered. This means that the financier's return will vary, depending on whether the market price of gold increases or falls and on the timing of delivery of gold. Producer X's forecasts indicate that the amount of gold expected to be extracted from its mining facility is substantially in excess of 66,667 oz.

Because the 'gold loan' can only be settled through the physical delivery of gold extracted from producer X's own mine, the contract meets the 'own use exemption' in IAS 39. Consequently, the loan will be accounted for as a prepayment for the future delivery of gold, and hence as an executory contract.

Illustrative accounting entries are as follows:

Initial recognition		
Dr Cash	CU100m	
	Cr Deferred revenue	CU100m

Receipt of cash and recording of associated deferred revenue

Subsequent accounting		
Dr Deferred revenue	CU100m	
	Cr Revenue	CU100m

Release of deferred revenue arising from settlement of the 'gold loan'

The example illustrates that, where a commodity loan is outside the scope of IAS 39 and is therefore accounted for as an executory contract, the cash received is classified as a prepayment and:

- No amounts are recorded in profit or loss until the commodity is delivered\*
- Revenue is recorded at the contract price for the commodity; and
- No amounts are recorded to recognise changes in the spot price of the commodity.

\*subject to the contract not becoming onerous due to an unexpected increase in the cost of extracting the gold, meaning that the sales proceeds of CU1,500/oz are less than the costs that are expected to be incurred to extract and deliver the commodity.

### Accounting for long term prepayments for supply contracts

As illustrated above, where a commodity loan is accounted for as an executory contract the accounting may be that a long term prepayment is recorded for the supply of the commodity. Questions may then be raised about whether the prepayment should be adjusted for a notional interest charge, with the amount received being accreted during the period up to the point at which physical delivery of the commodity takes place.

The topic of long term prepayments for inventory supply contracts was considered by the IFRS Interpretations Committee (the Committee) earlier this year (17-18 January 2012).

The Committee received a request seeking clarification on the accounting for long-term supply contracts of raw materials when the purchaser of the raw materials agrees to make prepayments to the supplier for the raw materials. The question raised was whether the purchaser/supplier should accrete interest on long-term prepayments by recognising interest income/expense, resulting in an increase in the cost of inventories/revenue.

The Committee observed that there is mixed practice on the issue submitted, and that current IFRSs do not provide clear guidance on this issue. However, it was also noted that the exposure draft *Revenue from Contracts with Customers* (the Revenue ED), published in November 2011, contained proposals that would require sellers to account for the time value of money if this adjustment would be significant.

It would appear that, if taken forward, the proposals in the original Revenue ED would require producers, which determine their commodity loans to be prepayments for inventory, to account for a financing cost in respect of those loans.

## EFFECT OF CONCLUDING THAT A COMMODITY LOAN IS A FINANCIAL INSTRUMENT

Producer X enters into a 'gold loan' with financier Y. Producer X is advanced CU100m in cash on 1 January 20X2. The liability will be settled by producer X delivering gold that it has extracted from its mining facility. The contract sets a fixed sales price for gold at CU1,500 oz (the present value of the one year forward price). That is, the CU100m will be settled through the delivery of 66,667 oz of gold in one year's time, regardless of the future market price. The financier's return will vary, depending on whether the market price of gold increases or falls.

Producer X's forecasts show that substantially in excess of 66,667 oz of gold is expected to be extracted during the period of one year from the date on which the contract is entered into with financier Y.

In addition, the contract contains an option for financier Y to demand repayment in cash instead of gold, to the extent that producer X extracts gold from its mining facility. The amount of cash paid would be calculated using the spot price of gold at the payment date; this would mean that, instead of the lender taking physical delivery of the gold and selling it on the market, the lender instead requires producer X to sell the gold and deliver the gross cash proceeds.

Because financier Y has an option to require gross cash settlement of part or all of the amounts that would otherwise be settled through the physical delivery of gold, the contract fails the IAS 39 'own use exemption'. As noted above, this is because producer X does not have control over whether the loan from financier Y is settled through physical delivery of gold, or in cash. Consequently, the contract is required to be accounted for as a financial instrument (or as a number of financial instruments, depending on the analysis of the contract).

The accounting analysis that is then required highlights one of the more complex areas of IAS 39. This is because it is first necessary to determine what type of financial instrument(s) result from the contract. In particular:

1. Does the contract result in a single financial instrument? If so, what is that instrument?
2. Does the contract result in more than one financial instrument? If so, what are they?
3. If the contract does result in more than one financial instrument, are there any accounting options available to producer X?

For question 1, the lending agreement does not create a single financial instrument. In particular, the lending agreement:

- Does not give rise to a simple loan, as the repayments are made either through the delivery of gold or through the delivery of cash where the amount paid is linked to the price of gold
- Does not give rise to a stand-alone derivative contract, because the lender prepays the purchase price for the gold. This means that the lending agreement fails the definition of a derivative, as the initial net investment (the amount paid) is not less than would be required for other types of contracts that have a similar response to changes in market factors.

For question 2, in certain circumstances IAS 39 requires a contract to be accounted for as giving rise to a 'host contract' such as a loan, together with one or more embedded derivatives. The 'host loan' would typically be measured at amortised cost; the embedded derivative(s) would be measured at Fair Value through Profit or Loss (FVTPL). The technical analysis of the example set out above is that it gives rise to a CU100m loan (the 'host contract') together with a total return swap linked to the future price of gold (the 'embedded derivative'). IAS 39 requires to following approach to be followed:

- The host contract is recorded as a fixed rate interest bearing loan. The interest rate used is the market rate of interest that would apply to a loan on a stand-alone basis (that is, without any embedded feature). Consequently, the implied fair value of the host loan is CU100m
- The embedded derivative is recorded as a swap contract under which a CU100m loan at a market rate of interest is swapped for an arrangement under which the lender receives a return based on the price of gold. The terms of the swap are set to result in the embedded derivative having a zero fair value on initial recognition. In order to achieve this, the inputs are set such that the discounted present value of the pay and receive 'legs' of the swap are identical. That is, the inputs are set so that the fair value of a CU100m loan at a market rate (the 'pay leg' of the swap) is the same as the fair value of the gold that is expected to be received by the lender (the 'receive leg' of the swap)

– For subsequent accounting, the host contract is accounted for on an amortised cost basis (meaning that notional interest will be accrued over the 12 month term of the loan). The embedded derivative will be accounted for at FVTPL.

The overall effect of the accounting entries will be that producer X will account for a fixed rate loan, with the interest charges and capital repayment amounts being modified depending on the future price of gold. If the price of gold increases, then producer X will transfer more value to the lender than under a plain 'capital and interest' loan, and so the fair value of the embedded derivative will increase with an associated charge to profit or loss.

For question 3, IAS 39 also contains a 'fair value option'. Under the fair value option when a contract contains one or more embedded derivatives that, under IAS 39's standard approach, would be required to be separated from a host contract and accounted for at FVTPL, that contract can instead be measured in its entirety at FVTPL. In practice, this can make the subsequent accounting simpler than if a contract is accounted for as giving rise to a host contract plus one or more embedded derivatives.

### Contract accounted for under the standard IAS 39 approach (host contract plus embedded derivative)

Under this approach, only the embedded derivative is remeasured to fair value at each reporting date. In contrast, the host loan is accounted for at amortised cost, meaning that its carrying amount is not adjusted for future changes in interest rates, or for future changes in producer X's own credit rating (and hence changes in interest rates that lenders would require to be paid on a new loan).

Illustrative accounting entries:

For the purposes of this illustration, assume that the market rate of interest on inception of the arrangement that would apply to a loan on a 'stand alone' basis is 10%.

#### Initial recognition

Dr Cash	CU100m	
	Cr Loan	CU100m
	Cr Derivative	-

#### Subsequent accounting

At the six month interim reporting date, no deliveries of gold have taken place. The present value of the forward price of gold is CU1,550/oz, an increase of CU50/oz compared with the amount at initial recognition. The accounting entries are:

Dr Finance expense	CU5.00m	
	Cr Loan	CU5.00m

Notional interest accreted on the host loan ( $10\% \times \text{CU}100\text{m} \times 6/12$ )

Dr Derivative	CU1.67m	
	Cr Finance income	CU1.67m

Change in the carrying amount of the embedded swap ( $\text{CU}1,550 \times 66,667 - (\text{CU}100\text{m} + (10\% \times \text{CU}100\text{m} \times 6/12))$ )

The embedded swap is an asset at this point, because the return implied by the present value of the forward price of gold is less than the return that would have been obtained from a loan at an open market rate of 10%.

Note: For the purposes of this example, it has been assumed that applicable interest rates have remained constant. If interest rates had not remained the same (for example, due to changes in market rates or a change in producer X's credit status) then the change in the derivative's fair value at the end of the interim period would have been different.

At the end of the financial year, the 'gold loan' is settled by the physical delivery of gold. At the time of delivery, the spot price is CU1,750/oz.

The accounting entries are:

Dr Finance expense	CU5.00m	
	Cr Loan	CU5.00m

Notional interest accreted on the host loan  $(10\% \times \text{CU}100\text{m} \times 6/12)$

Dr Finance expense	CU8.33m	
	Cr Derivative	CU8.33m

Change in the carrying amount of the embedded swap  $(\text{CU}1,750 \times 66,667) - (\text{CU}100\text{m} + (10\% \times \text{CU}100\text{m} \times 12/12)) + \text{CU}1.67\text{m}$

Note that the increase in the price of gold has resulted in the embedded swap gaining substantial value, with the adjustment resulting in a carrying amount of CU6.66m. The effect is that the lender has obtained a substantially greater rate of return than would have been obtained from a loan on a stand-alone basis.

The final journal entry at the financial year end is:

Dr Liability	CU110.00m	
Dr Derivative liability	CU6.66m	
	Cr Revenue	CU116.66m

Revenue arising from settlement of the 'gold loan'

Note: For illustrative purposes, the host contract liability and the embedded swap have been accounted for separately. In practice, these two components would typically be disclosed as a single amount on the face of the balance sheet (or statement of financial position).



This example illustrates that, where the commodity loan is within the scope of IAS 39 and is therefore classified as a financial liability:

- There is income statement volatility until the commodity is delivered
- Revenue is recorded at the spot price of the commodity when it is delivered
- An amount of finance expense / finance income is recorded, depending on future changes in the market price of the commodity.

In addition, while the fair value option would appear to result in a more straightforward approach to accounting for the arrangement, this can give rise to additional volatility in amounts reported in financial statements. This is because the effect of changes in market rates of interest are also reflected in changes in the fair value of financial liabilities.

In addition, where an entity's own credit status changes (which is common), further complexities arise. Where an entity reports in accordance with IAS 39, any associated change in the fair value of the financial liability will be recorded in profit or loss. However, if an entity has adopted IFRS 9, any change in the fair value of a financial liability that arises from changes in the entity's own credit status will almost always be recorded in Other Comprehensive Income. The reason for this change in approach is that, as an entity's own credit status declines the discount rate that is applied to its financial liabilities that are measured at fair value increases. This results in a reduction in the carrying amount of those financial liabilities. If this reduction is recorded in profit or loss, then the greater the decline in an entity's own credit status, the greater the credit to profit or loss. The IASB agreed that this is counter intuitive, and as a consequence amended the requirements of IAS 39 for financial liabilities when they were incorporated into IFRS 9. A similar amendment was not made to IAS 39 because, at that time, it was expected that IFRS 9 would be effective from 2013.

## ACCOUNTING WHEN A COMMODITY LOAN BEARS INTEREST BUT MEETS THE 'OWN USE EXEMPTION'

In practice, commodity loans bear 'interest', reflecting the time value of money and the financier's assessment of the credit risk of the producer. The fact that the amount of commodity to be delivered in future may increase by an amount which mirrors an interest charge that would be applied to a cash settled loan does not necessarily mean that it is impossible to meet the terms of the IAS 39 'own use exemption', and therefore account for the arrangement as an executory contract. A similar assessment to the examples above will be required, taking into account key terms of the arrangement (including those set out in the key considerations section above).

As an example, producer X enters into a 'gold loan' with financier Y. Producer X is advanced CU100m in cash, which attracts interest at 10%. The liability will be settled by producer X delivering gold that it has extracted from its mining facility. The contract sets a fixed sales price for gold at CU1,500 oz. That is, the CU100m and any accrued interest will be settled through the delivery of gold at CU1,500/oz, regardless of the future market price. The financier's return will vary, depending on whether the market price of gold increases or falls. There is no alternative settlement option in the contract, except for circumstances in which producer X's mining facility stops production for an extended period in which part or all of the amount due is required to be settled in cash. However, the potential for this to happen is considered very remote.

It is anticipated that the gold will be delivered at the end of 2 years from the date on which the CU100m is advanced. Producer X's forecasts indicate that the amount of gold expected to be extracted from its mining facility is substantially in excess of the amount expected to be required to settle the commodity loan.

Because the 'gold loan' can only be settled through the physical delivery of gold extracted from producer X's own mine, the contract meets the 'own use exemption' in IAS 39. Although there is the potential for cash settlement, the potential for this to arise is very remote and, in consequence, this feature does not result in the contract failing the 'own use exemption' (although this needs to be kept under review during the term of the agreement). Therefore, the loan will be accounted for as a prepayment for the future delivery of gold, and hence as an executory contract.

The liability in oz of gold is as follows:

	Interest in oz	Liability in oz
Initial advance of the loan	-	66,667
First anniversary	6,667	73,333
Second anniversary	7,333	80,667

Because the arrangement is accounted for as an executory contract, the selling price of the related gold will be CU1,240/oz (CU100m/80,667oz), an amount significantly lower than both the 'spot' and the contract rates. This is because the 10% interest charge is not applied to the liability of CU100m (although see 'Accounting for long term prepayments for supply contracts' above for the IFRS Interpretations Committee's discussion about whether prepayments for the supply of a commodity should be adjusted to reflect the time value of money).

## LOANS WHERE THE COMMODITY PRICE IS ADJUSTED FOR SUBSEQUENT MOVEMENTS IN MARKET PRICES, SUBJECT TO LIMITS

A further issue to consider is that commodity loans frequently include provisions under which the commodity price is adjusted, in part or in full, for future movements in the market price of the commodity. This can be achieved by including 'caps', 'floors' or 'collars' in respect of the commodity price. A cap will restrict the maximum commodity price, while a floor restricts the minimum commodity price. A collar will set upper and lower limits to the price which is to be used.

Care is needed when analysing these provisions. This is because, even though the contract may meet the terms of the IAS 39 'own use exemption' and be scoped out of IAS 39, any embedded derivatives contained within the contract are not scoped out of IAS 39 and may need to be accounted for separately. If this is required, the embedded derivative(s) will be accounted for at fair value through profit or loss.

As examples of embedded derivatives that may or may not need to be accounted for separately:

- A cap on the selling price of the commodity would be expected to be accounted for as a separable embedded derivative. This is because a selling price cap provides 'one way' risk protection, in that there is (from the borrower's perspective) downside risk only
- Similarly, a floor on the selling price of the commodity would be expected to be accounted for as a separable embedded derivative. This is because the selling price floor provides 'one way' risk protection, in that (from the borrower's perspective) there is upside risk only
- A collar (that is, a combination of a price cap and price floor) would not necessarily be expected to be accounted for as a separable embedded derivative. This lack of a requirement to separate the embedded derivative applies only where the spot price at inception of the contract is between the cap and floor amounts, meaning that both the cap and floor are 'out of the money', and these features are not leveraged.

### Loan which meets the IAS 39 'own use exemption' and contains a price 'collar'

Producer X enters into a 'gold loan' with financier Y. Producer X is advanced CU100m in cash. The liability will be settled by producer X delivering gold that it has extracted from its mining facility. The contract sets a sales price for gold at CU1,500/oz. However, if the spot price of gold changes from CU1,500/oz, the quantity of gold to be delivered will be adjusted. If the price falls to CU1,400/oz or below then producer X will deliver 73,000 oz of gold. If the gold price increases to CU1,600/oz or more then producer X will deliver 60,000 oz of gold. There is no alternative settlement option in the contract.

It is anticipated that the gold will be delivered evenly over a 4 year period from the date on which the CU100m is advanced. Producer X's forecasts indicate that the amount of gold expected to be extracted from its mining facility is substantially in excess of the amount expected to be required to settle the commodity loan.

Because the 'gold loan' can only be settled through the physical delivery of gold extracted from producer X's own mine, the contract meets the 'own use exemption' in IAS 39. Consequently, the loan will be accounted for as a prepayment for the future delivery of gold, and hence as an executory contract.

Because both of the features that would result in a change in the amount of gold to be delivered are out of the money at inception of the contract, these features are determined not to require to be accounted for as separable embedded derivatives (by analogy to IAS 39.AG33(b)).

It is then necessary to consider the appropriate pattern of revenue recognition. This is because the assessment of the amount of gold to be delivered in return for the prepayment of CU100m will vary, depending on the future market price of gold.

The contract provides for three possible outcomes in respect of the quantity of gold to be delivered by producer X:

Price range	Quantity to be delivered
Below CU1,401/oz	73,000
CU1,401 to CU1,599/oz	66,667
Above CU1,599/oz	60,000

At the end of period 1, producer X has delivered 18,000 oz of gold, and forecasts total required deliveries to be 66,667 oz.

At the end of period 2, producer X has delivered 30,000 oz of gold, and forecasts total required deliveries to be 73,000 oz.

At the end of period 3, producer X has delivered 45,000 oz of gold, and forecasts total required deliveries to be 60,000 oz.

At the end of period 4, producer X has settled its liability by delivering 66,667 oz of gold.

The revenue to be recognised in each period and the average price per oz is shown below:

	Oz delivered in period	Oz delivered cumulative	Estimated cumulative percentage delivered	Revenue recognised	Revenue per oz (in period)
Period 1	18,000	18,000	27%	CU27m	CU1,500
Period 2	12,000	30,000	41%	CU14m	CU1,175
Period 3	15,000	45,000	75%	CU34m	CU2,260
Period 4	21,667	66,667	100%	CU25m	CU1,154
Total		66,667		CU100m	

As can be seen from the table above, although at first glance accounting for the 'gold loan' as an executory contract would appear to be simpler and give rise to less volatile earnings than would arise from the application of IAS 39, it can lead to quite dramatic effects on revenue recognition as the caps and floors are forecast to be effective. It is therefore essential that the terms of these loans are fully disclosed in the producer's financial statements.

**Loan which does not meet the IAS 39 'own use exemption' and contains a price 'collar'**

Assume the same contractual terms and analysis as in the example above, except that the arrangement is assessed not to meet the IAS 39 'own use exemption' due to an additional clause that permits the producer to 'buy out' of the contract. This additional clause results in the 'gold loan' failing the IAS 39 'own use exemption'.

In these circumstances, the entire arrangement would be accounted for as a single derivative contract. This is because, if the contract did not contain the price 'collar', it would be accounted for as a derivative. IAS 39 does not permit separate accounting for components of a contract that are all accounted for at fair value through profit or loss. Because derivatives are measured at fair value through profit or loss, the three derivative features (the sales contract itself, the price cap and the price floor) are accounted for as a single financial instrument.





## CONTACT

For further information about how BDO can assist you and your organisation, please get in touch with one of our key contacts listed below. Alternatively, please visit our IFRS page at [www.bdointernational.com](http://www.bdointernational.com) where you can find full lists of regional and country contacts.

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1209-02