KPMG

COVID-19 | Does a contract still meet the own use exemption?

26 March 2020

Colin Martin
Partner
KPMG in the UK

What's the issue?

A company may be required to account for a contract to buy or sell a non-financial item – e.g. commodities such as crude oil or metals – under IFRS® Standards for financial instruments as a derivative at fair value through profit or loss. *[IFRS 9.2.4]*

Financial instruments accounting applies if the contract can be settled net in cash or another financial instrument – which includes cases where the non-financial item is readily convertible into cash – unless the own use exemption applies. *[IAS 32.8, IFRS 9.2.4]*

The economic turbulence resulting from the COVID-19 coronavirus pandemic may mean that some of these contracts no longer qualify for the own use exemption.

Getting into more detail

To qualify for the own use exemption, a contract to buy or sell a non-financial item needs to be entered into and *continue to be held* to receive or deliver that non-financial item in accordance with the company's expected purchase, sale or usage requirements. In addition, if a company has a past practice of settling similar contracts net in cash, then a contract would not satisfy the own use exemption. *[IFRS 9.2.4, 2.6]*

The COVID-19 outbreak may cause:

- a decline in business activity and subsequent decreases in a company's expected purchase, sale or usage requirements;
- disruptions to supply chains that may impair a company's or counterparty's ability to effect physical settlement; and
- sudden decreases in demand (or supply) that may cause contracts to be closed out or terminated through net cash settlement without delivery.

These circumstances may undermine a company's ability to apply the own use exemption:

- *for a particular contract*, if holding it is no longer consistent with reduced expected purchase, sale or usage requirements – e.g. if there is an expectation of net cash settlement rather than physical settlement; and
- *for a group of similar contracts*, if the company has settled some of them net in cash.

The COVID-19 outbreak may affect when a company needs to account for a commodity contract as a derivative.

Judgement may be required to determine whether the company has developed a past practice of net settlement that precludes it from applying the own use exemption. This might not be the case if net settlements are infrequent and respond to events that could not have been foreseen at inception of the contract. *[Insights 7.1.210.40]*

In addition, a company needs to evaluate the notion of 'similar contracts' in the context of its own business practices. *[Insights 7.1.210.50]*

Actions for management to take now

Reassess whether derivative accounting may be required – i.e. because the own use exemption no longer applies – for sale and purchase contracts as a result of:

- decreases in expected sales, purchases or usage;
- expected net settlements arising from supply chain disruptions; or
- actual instances of net settlement.

References to 'Insights' mean our publication **Insights into IFRS**

Publication name: *Does a contract still meet the own use exemption?*

Publication date: March 2020

home.kpmg/ifrs-covid19