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Objective

- 1 The objective of this paper is to present an alternative model to the “own-use” exception in paragraph 2.4 (and others) of IFRS 9.

EFRAG Secretariat proposal Didrik Thrane-Nielsen alternative model, “alternative model” overview:

- 2 The alternative model features the main characteristics outlined below.
- 3 The assessment of the own-use exception is done for any part of a contract (that would have constituted a separate performance obligation if assessed in IFRS 15) and not only for the entire contract.
- 4 The assessment of the own-use exception is, in the alternative model, forward-looking only. History, including the situation at inception of the contract, is not relevant for the assessment at a point in time after the inception of the contract.
- 5 The model is dynamic, meaning that parts of a contract can enter and / or exit the scope of IFRS 9 from inception to the end of the life of the contract depending on increased or decreased expected own-use by the entity.
- 6 The alternative model only affects the own-use assessment and does not change the assessment of the “net settlement” as currently defined by IFRS 9.
- 7 When assessing the own-use, the model considers parts of the contract independently and the behaviour related to other contracts or other parts of the contract is considered irrelevant. Therefore, the model does not include an automatic overrule of own-use if the condition in paragraph 2.6(b) or (c) of IFRS 9 is fulfilled.
- 8 As in the current IFRS 9, P&L effects occurs when a contract or parts of a contract enter the scope of IFRS 9 and when they are within the scope of IFRS 9. No P&L effect occurs when a contract or parts of a contract are excluded from the scope of IFRS 9.

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- 9 The fair value related to the contract or part of a contract exiting the scope of IFRS 9 is included within the Balance Sheet and follows applicable IFRS guidance (treated similar to any other executory contract traded in a second-hand market).
- 10 As a simplifying features, the alternative model includes an option not to reassess for (net settlement or) own-use contracts fully or partly within the scope of IFRS 9.
- 11 The alternative model introduces the disclosure requirements of paragraph 33 of IFRS 7 to all contracts or parts of contracts scoped out of IFRS 9 due to the own-use exemption (the new disclosure requirement does not apply to contracts assessed not to have net settlement). Contracts for own-use are currently exempted from the disclosure requirements in IFRS 7.
- 12 The alternative model contains options that will allow entities to come to the same conclusions on IFRS 9 scope (own-use) as under the current guidance.
- 13 A further explanation on the intended reasons for the amendments, additions and deletions of each paragraph included within the alternative model are provided below.

Alternative model - proposals and reasoning

14 Amend paragraph 2.4 of IFRS 9:

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, with the exception of contracts, or parts of contracts, that ~~were entered into and continue to be~~ are 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. However, this Standard shall be applied to those contracts that an entity designates as measured at fair value through profit or loss in accordance with paragraph 2.5A.

- 15 The alternative model is intended to be forward-looking in its assessment of own-use. Thus, references to prior assessments are deleted.
- 16 The alternative model is assessing own-use for parts of contract. Thus, a contract can be held partly for own-use and partly not for own-use. The part held for own-use will, unless optioned out, be treated as an executory contract outside of scope of IFRS 9, while the part not held for own-use will be treated as a separate financial instrument within the scope of IFRS 9. The meaning of a "part of a contract" should be assessed as what would have constituted a separate performance obligation if assessed in IFRS 15.

17 Add new paragraph 2.4A of IFRS 9:

When entering the scope of the Standard subsequent to initial recognition, a contract or a part of a contract should be measured at its fair value at that time.

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If a contract or a part of a contract exits the scope of this Standard because, subsequent to inception it starts 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 requirement, it shall be measured at fair value upon exit.

- 18 As the assessment of own-use in the alternative model is forward-looking and considered for parts of a contract, the assessment may be assumed to change over the life of a contract. It is thus necessary to regulate how to account for part of a contract entering or exiting from the scope of IFRS 9.
- 19 The proposed solution is that entering into the scope of IFRS 9 is a remeasurement event that may, taking into consideration the concepts in paragraph B5.1.2A of IFRS 9, create gains or losses. This is assumed to be the solution currently applied in IFRS 9 when own-use is failed subsequent to the inception of a contract.
- 20 On the other hand, exiting the scope of IFRS 9 is a change of measurement from fair value to (deemed) cost that, except from the updating of the fair value measurement up to and including the time of exiting the scope, shall not create gains or losses.
- 21 The subsequent accounting for parts of contracts outside the scope of IFRS 9 are to be accounted for according to the relevant IFRS Accounting Standards (generally expected to be accounted for as deemed cost) and are not a part of the alternative own-use model.
- 22 **Add new paragraph 2.4B of IFRS 9:**

Contract or parts of contract held for the purpose of receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sales or usage requirements as described in paragraph 2.4 [amended], are to be reassessed as a minimum at the end of each financial reporting period. However, entities may, as an accounting policy choice, elect to not reassess contract or parts of contract already within the scope of this Standard. The accounting policy choice is applicable by class of underlying non-financial item.

- 23 The requirement to reassess whether parts of contract or contract are expected to be for own-use may be demanding on entities. Thus, the alternative model provides for an accounting policy choice to not reassess parts of contract or contract previously assessed not to be for own-use. To allow some flexibility, the accounting policy choice is applicable by class of underlying non-financial item.
- 24 **Delete paragraph 2.5 of IFRS 9.**

[The functioning of paragraph 2.5 of IFRS 9 will be replaced by a new paragraph 2.5A of IFRS 9.]

- 25 Paragraph 2.5 of IFRS 9 contains a limited option to include contracts with net settlement entered into and continuing to be held for own-use in the scope of IFRS 9. As the alternative

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own-use model includes an unlimited option to include contracts with net settlement into the scope of IFRS 9, this paragraph becomes obsolete and is deleted in the alternative own-use model.

26 Add new paragraph 2.5A of IFRS 9:

A contract 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 contract was a financial instrument, may be irrevocably designated as measured at fair value through profit or loss even if a part of that contract was entered into 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. This designation is available only at inception of the contract or if not at inception, the first time a contract can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contract was a financial instrument.

27 For operational simplification, and to allow for similar outcomes as in the current own-use model, the alternative own-use model includes an option to ignore own-use for a part¹ of a contract and scope the entire contract into IFRS 9. As the alternative own-use model assumes continuous assessment of net settlement (and own-use) the option is applicable the first time the contract is assessed to be net settled.

28 Amend paragraph 2.6 of IFRS 9:

There are various ways in which a contract to buy or sell a non-financial item 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 another financial instrument or by exchanging financial instruments;*
- (b) when the ability to settle net in cash or 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.*

~~*A contract to which (b) or (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 2.4 applies are evaluated to determine whether they were entered into and continue*~~

¹ A part of a contract may include the entire contract.

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~~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.~~

29 When assessing own-use, the model considers parts of the contract independently and the behaviour related to other contracts or other parts of the contract is considered irrelevant. Therefore, the model does not include an automatic overrule of own-use if the condition in paragraph 2.6(b) or (c) of IFRS 9 is fulfilled.

30 Paragraph 2.6 of IFRS 9 [amended] is still however applicable to determine if a contract has net-settlement feature. Once this assessment is performed, the normal course of action applies to further determine if the contract (or part of contract) comply with the own-use exemption requirements.

31 **Amend paragraph 2.7 of IFRS 9:**

A written option, or a part of a contract constituting a written option, to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 2.6(a) or 2.6(d) is within the scope of this Standard. Such a contract, or such part of a contract, cannot be 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.

32 As the alternative own-use model require concrete assessments of own-use for parts of contract, the impacts of net written options on own-use assessment should apply not only to contracts that are net written options but also to parts of contracts that are net written options.

33 **Amend paragraph 5 of IFRS 7:**

This IFRS applies to contracts, or parts of contracts, to buy or sell a non-financial item that are within the scope of IFRS 9. Paragraph 33 of this Standard applies to contracts or parts of contracts that are not within the scope of IFRS 9 because the contracts or parts of the contracts are 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 disclosures for such contracts shall be presented separately from the disclosures related to financial instruments for which the general disclosure requirements in this Standard applies.

Contracts with net settlement are considered to be different from contracts without net settlement because, unless they are assessed to be for own-use, they are inside the scope of IFRS 9. Own-use is an entity specific characteristic of a contract or a part of a contract, it does not change the risk characteristics of the contract itself. As such, the user need for information is not dependent upon the fact that parts of a contract are assessed to be for own-use. Qualitative disclosure requirements are relevant for contracts or parts of contracts fulfilling the own-use exception requirements.

Questions for EFRAG FRB

- 34 Do you have any comments or questions on the EFRAG's Secretariat alternative own-use model?
- 35 What are the FRB's views on further development of the alternative model (use of EFRAG's Secretariat resources)?