

## Wholesale energy and commodity market contracts – pitfalls of accounting treatment

*Many companies now use structured wholesale energy market contracts for the procurement of electricity and natural gas rather than full supply contracts. The wide range of contractual arrangements offered in the energy sector has increased significantly in recent years. These frequently offer the option of flexible price arrangements. This also allows SMEs to hedge their energy procurement costs at an early stage and to take into account price expectations in a manner that previously was only possible with the use of listed trading products. However, it is also important in this context to ensure that such contracts are recognised correctly in the financial statements.*

Many wholesale energy market contracts, also in the case of physical supply of the underlying, fulfil the requirements of a derivative pursuant to IAS 39.9 (value changes in response to the change in an underlying, no/low initial net investment, and settled at a future date). Therefore, they must always be measured at fair value. This requires regular fair value measurement and recognition, and results in corresponding fluctuations in profit or loss if hedge accounting is not applied. The same applies to other material procurement contracts as well as related sales contracts (e.g. metals, soft commodities). Therefore, this issue usually concerns companies with high energy requirements and those involved in the procurement and sale of commodities.

Classification as a derivative and thus recognition at fair value can – in exceptional cases defined by the standard – be avoided and the procurement contract nevertheless be treated as an unrecognised firm commitment, if certain conditions are fulfilled. Application of the so-called 'own use exemption' requires that the contract was entered into to cover operational energy requirements. Breach of these requirements may result in 'tainting' of the contract and all similar contracts and require immediate application of IAS 39.

In practice, when applying the own use exemption, it must be ensured that all contracted quantities are actually physically supplied and no financial settlement occurs prior to or at maturity. In line with direct cash settlement, offsetting transactions with third parties to close a position as well as short-term sale upon receipt of the goods are treated as adding no further value to the contract. This means in the case of wholesale energy market contracts that opening or closing previously price-fixed quantities to compensate for changes in fair market value is not permissible, even if this would be advisable from an economic perspective. Only in a few exceptional cases explicitly specified in the standard, such as rare and unforeseeable events, is a contract not considered tainted due to an exceptional event.

We recommend the following procedures to ensure the proper accounting treatment of contracts for the procurement and sale of goods:

- Implementing a process for the identification of commodity contracts that fulfil the requirements of a derivative. As such contracts typically are also concluded by Procurement and Sales, these departments have to be trained appropriately.
- Structured analysis of the relevant contracts as to whether they need to be recognised in accordance with IAS 39 (this also includes embedded derivatives) and application of the own use exemption
- Early establishment of a portfolio structure that separates contracts with expected cash settlement from own use contracts, so that the accounting implications are limited in the event of a decline in demand. For example, some of the procured volumes for which physical acceptance is not deemed certain can be allocated to a separate ledger through deliberate 'tainting' of recognition pursuant to IAS 39. Hedge accounting can then be used to even out profit or loss. In the event of non-acceptance, it is then possible to reverse the hedge easily without further consequences.

- Early coordination of any individual special items with the auditor and creation of all the necessary documentation as evidence of 'permissible evening up'.
- Implementation of a process for monitoring contracts with a view to cash settlement and appropriate steps of control.

The own use exemption rules remain largely unchanged under IFRS 9, so that extensive amendment will not become necessary.