IFRS

# STAFF PAPER

April 2020

## IASB® meeting

| Project | Maintenance and Consistent Application | | |
|---|---|---|---|
| Paper topic | Commodity Loans | | |
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This Agenda Paper was initially prepared for the Board's March 2020 meeting as Agenda Paper 12. However, it was not discussed at that meeting. This Agenda Paper is identical to Agenda Paper 12 for the March 2020 Board meeting.

## Introduction

1. In relation to a submission to the IFRS Interpretations Committee (Committee), the International Accounting Standards Board (Board) previously discussed a possible narrow-scope project on commodity loans and related transactions. The Board decided to consider at a future meeting the feasibility of such a project.

2. The purpose of this paper is:

   (a) to provide the Board with information obtained on the types of commodity loan transactions that occur as well as other transactions involving commodities; and

   (b) to ask the Board whether it would like to add a narrow-scope standard-setting project to its work-plan to address commodity loans.

3. This paper includes:

   (a) background information (paragraphs 4–9);

   (b) feedback (paragraphs 10–37), including

      (i) Committee outreach;

(ii) ASAF and EEG; and

(iii) other;

(c) staff analysis (paragraphs 38–46); and

(d) staff recommendation (paragraph 47).

## Background information

4. In response to a question submitted to it, the Committee published an agenda decision in March 2017[1] about a particular commodity loan transaction.

5. The submitter described a scenario in which:

(a) *Bank A* borrows a commodity (gold) from *Bank B* for 12 months (referred to as Transaction #1). On physical receipt of the commodity, legal title passes to Bank A. The commodity is fungible and can easily be replaced with a similar commodity (another bar of gold).

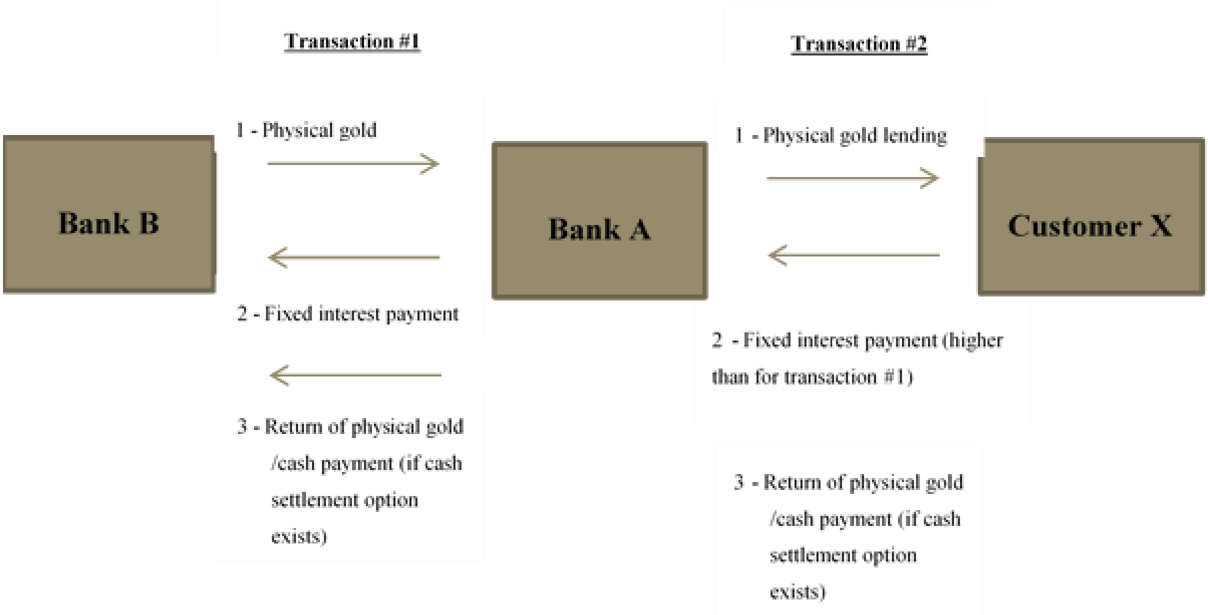
(b) There are no cash inflows or outflows at inception of Transaction #1. Instead, Bank A pays a fixed quarterly fee to Bank B for the duration of the contract based on (i) the value of the commodity at inception; and (ii) relevant interest rates at inception. At maturity, Bank A is obliged to deliver a commodity of the same type, quantity and quality to Bank B. Bank A may, or may not, have an option to settle its obligation in cash, on the basis of the spot price of the commodity at maturity.

(c) Bank A also enters into a similar transaction with *Customer X* (referred to as Transaction #2). In Transaction #2, legal title of the commodity is transferred to Customer X under the same terms and conditions described in Transaction #1, but for a higher fixed fee from Customer X to Bank A.

6. The diagram below illustrates the scenario. It is assumed that all three parties to the transaction are unrelated to each other. It is also assumed that Bank A negotiates each transaction independently of the other (ie Bank B and Customer X are unaware of the

[1] https://cdn.ifrs.org/-/media/feature/supporting-implementation/agenda-decisions/ias-1-ias-2-ias-8-ias-39-ifrs-9-commodity-loans-march-2017.pdf

other's transaction with Bank A), although Bank A is likely to have entered into both transactions in contemplation of the other.




7. The Committee was asked whether, for the term of the two contracts, Bank A recognises:

   (a) an asset representing the gold (or the right to receive gold); and

   (b) a liability representing the obligation to deliver gold.

8. The Committee observed that the particular transaction in the submission might not be clearly captured within the scope of any IFRS Standard. In the absence of a Standard that specifically applies to a transaction, an entity would apply paragraphs 10 and 11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in developing and applying an accounting policy to the transaction.

9. The Committee also observed that particular IFRS Standards would apply to other transactions involving commodities (for example, the purchase of commodities for use in an entity's production process, or the sale of commodities to customers).

## Feedback

### *Committee Outreach*

10. As part of the Committee's work on this submission, outreach was performed to find out whether the transaction is common in particular jurisdictions and how entities account for it. We sent an outreach request to members of the International Forum of Accounting Standard-Setters, securities regulators and large accounting firms, and also obtained feedback from two preparers.

11. Based on responses, we understand that the transaction described in the submission is common in Asia, Canada and South Africa. Respondents said all major banks in those jurisdictions enter into the type of transaction described in the submission (and other similar commodity transactions).

12. All of the respondents that identified the transaction as common reported differences in how entities account for the transaction. The differing approaches applied generally reflect entities developing their own accounting policies applying IAS 8, in the absence of an IFRS Standard that specifically applies to the transaction. Those approaches include the following:

    (a) Analogising to the requirements in IFRS 9 *Financial Instruments* because precious metals are readily convertible to cash.

    (b) Treating commodities similar to currency because they are fungible and highly liquid.

    (c) *Not* using financial instruments requirements because commodities do not meet the definition of a financial instrument. In most cases, entities applying this approach account for the commodity transactions applying IAS 2 *Inventories* and IFRS 15 *Revenue from Contracts with Customers*.

    (d) Applying the *Conceptual Framework* to determine whether to recognise assets and liabilities.

13. Respondents also said, in some cases, entities apply different requirements to different commodity transactions because the substance of each transaction is different.

Examples of transactions that respondents said might appropriately lead to accounting different from that described in paragraph 12 above include the following:

(a) A commodity transaction with a cash settlement option (rather than a requirement to return a physical commodity at maturity). In the transaction described in the submission, most respondents that commented said a cash settlement option would not change the accounting because the settlement amount of any option is based on the spot price of the commodity on the date of settlement (and thus both parties would be economically indifferent to the settlement method). However, most also said their response is limited to that transaction—for other transactions, the existence of a cash settlement option could change the accounting (for example, if the cash settlement price is fixed at inception).

(b) A commodity transaction for which cash is exchanged at inception.

(c) A commodity transaction similar to that described in the submission for which the two legs of the transaction are linked (for example, if the counterparty to both legs of the transaction is the same entity).

14. Many respondents also commented more generally on the lack of requirements in IFRS Standards for commodities. In their view, the Board should not undertake a project only, for example, on commodity loan transactions similar to that described in the submission; instead, they suggested the Board consider the accounting for commodities (and precious metals in particular) more broadly. Aspects of the accounting for commodity transactions that respondents suggested the Board consider include the following:

(a) Recognition and derecognition criteria for precious metals.

(b) How to measure commodities recognised as an asset and, if relevant, how to determine their fair value.

(c) Whether the transfer (or not) of legal title should affect the accounting for commodities.

(d) Whether the accounting would differ depending on the liquidity or fungibility of the commodity. For example, some suggested an entity might account for gold differently from agricultural commodities.

(e) Whether the accounting would differ for a commodity certificate of deposit compared to the commodity itself (eg for an entity that buys and sells such a certificate without ever receiving the physical commodity).

15. Few respondents commented on whether any difference in accounting would have a material effect on entities that enter into commodity transactions. One respondent said it could for banks entering into such transactions. This is because some banks might recognise an asset and liability on entering into the commodity loan transaction described in the submission, whilst others might not—they noted that the amount of assets recognised could affect a bank's regulatory capital requirements.

16. Some respondents described other commodity transactions that are more prevalent in their jurisdictions than the one described in the submission.

### *ASAF and EEG*

17. We obtained further feedback on the prevalence of commodity transactions from the Accounting Standards Advisory Forum (ASAF) in April 2018 and Emerging Economies Group (EEG) in May 2018.

18. ASAF members from the Australian Accounting Standards Board (AASB) and the New Zealand Accounting Standards Board (NZASB), the Financial Accounting Standards Board (FASB), the Asian-Oceanian Standard-Setters Group (AOSSG), the China Accounting Standards Committee (CASC) and the Organismo Italiano di Contabilità (OIC) said commodity transactions are common in their jurisdictions. Those members said transactions involving gold were particularly prevalent, including variants of the commodity loan transaction described in paragraph 5 of this paper.

19. Some ASAF members also said there are differences in how entities apply IFRS Standards to commodity transactions and suggested that the Board prioritise work on those transactions over any work on cryptocurrencies.[2]

[2] We asked ASAF and EEG members at the same meeting about the accounting for holdings of cryptocurrencies.

20. A number of EEG members said commodity transactions—in particular, those involving gold—are common in their jurisdictions. EEG members also said they are aware of entities that use the broker-trader exemption in IAS 2 when measuring holdings of gold.

### *Other feedback*

21. Since the Board last discussed the topic, we received information about commodity transactions from large accounting firms, banks, corporate commodity entities and a standard-setting body for precious metal trading.

22. Those stakeholders identified a range of transactions, which we have summarised as follows:

    (a) service-type arrangements (paragraphs 25–27);

    (b) sale and repurchase arrangements (paragraphs 28–29);

    (c) intermediary arrangements (paragraphs 30–32); and

    (d) arrangements that could be either service-type or sale and repurchase arrangements (paragraphs 33–37).

23. Some also said it is unclear when a commodity can be considered cash, noting that entities sometimes use gold or another highly-liquid commodity as if it were cash. Some highlighted commodity swaps, for which they said there is currently inconsistency in the application of IFRS Standards.

24. Stakeholders expressed differing views on whether the Board should undertake standard-setting on commodity transactions. For example, the precious metal trading standard-setter conducted a survey of its members. Most, but not all, respondents to that survey supported the Board undertaking some activity (but not necessarily standard-setting) on commodity transactions. Those that supported the Board undertaking standard-setting suggested different areas of focus—for example, commodity lending, commodity swaps, physically-settled transactions or a broader project on all commodity transactions.

### *Service-type arrangements*

25. Service-type arrangements are transactions for which an entity (typically a bank) offers clients a service involving a commodity.

26. Examples of service-type arrangements include:

    (a) asset management agreements—contractual relationships in which a bank acts as an 'asset manager' and agrees to schedule—for example—a customer's physical gas movements, including its pipeline capacity. Such agreements can often be accompanied by, or combined with, sale of (or access to) the pipeline capacity.

    (b) tolling transactions—a processing agreement for the conversion of an input product in exchange for a fee. This is common for liquified natural gas (LNG) and electricity. For example, such an agreement might involve the following: (i) a customer (sometimes a bank) provides an amount of natural gas to a tolling entity; (ii) the tolling entity converts that input into LNG; and (iii) the tolling entity then transfers that LNG to the customer.

27. Entities might account for a tolling transaction in different ways depending on the structure of the transaction. For example, stakeholders said:

    (a) the customer might first consider whether it leases from the tolling entity the assets used to convert the product.

    (b) if it determines there is no lease, the customer may consider whether the contract is a derivative to which IFRS 9 applies.

    (c) if it determines there is no derivative, the customer typically applies IFRS 15 in accounting for the transaction.

### *Sale and repurchase arrangements*

28. Sale and repurchase arrangements come in various forms, with gold swaps being the most common type that stakeholders mentioned. In a gold swap, an entity sells gold to a counterparty and, at the same time, enters into an agreement to repurchase that gold at a future date. Stakeholders mentioned a number of differences in the terms and conditions of gold swaps:

(a) the repurchase price might be (i) fixed at contract inception, or (ii) the market price at the time of repurchase.

(b) the entity might have an option, or be required, to repurchase the gold.

29. In other sale and repurchase arrangements, an entity initially sells a commodity (such as oil) before the commodity is put on a ship for transportation, and commits to repurchase the oil when it arrives at its destination.

*Intermediary arrangements*

30. Respondents also mentioned transactions in which an entity (typically a bank) acts as an intermediary. The commodity loan transaction described in the submission to the Committee (see paragraph 5 of this paper) is an example of such an arrangement. Those commodity loan transactions are typically for a fixed fee with an underlying exchange of physical commodities. However, as noted in paragraph 13, the terms and conditions of commodity loan transactions can vary.

31. Some banks mentioned another type of intermediary arrangement in which a commodity is sold, rather than lent. For example, if Entity A intends to sell a commodity to Entity B, a bank may act as an intermediary purchasing the commodity from Entity A and selling it to Entity B. Banks also highlighted variations on this basic fact pattern:

(a) in a flash title transfer, an entity sells a commodity to a bank in return for cash. The bank immediately sells the commodity to a third-party for cash but with deferred settlement. The price at which the bank sells to the third-party might be fixed at contract inception or the market price at the time of settlement. In some cases, the ultimate purchaser may be part of the same group as the seller.

(b) in other arrangements, a bank stores a commodity for a specified period of time before transferring it to a third-party.

32. Respondents said it is difficult to determine the accounting for intermediary arrangements involving the sale of a commodity applying IFRS Standards. Those

respondents said US GAAP has requirements in ASC 470-40[3] for some types of commodity transactions and suggested the Board could consider whether to amend IFRS Standards to include similar requirements.

*Arrangements that could be service-type or sale and repurchase arrangements*

33. Some commodity transactions could be service-type arrangements or sale and repurchase arrangements, depending on the terms and conditions—for example, storage agreements.

34. We understand storage agreements are common between a bank and commodity companies, and in particular are used for the storage of gas. The commodity company typically wants to store the commodity either to manage seasonal demand or in the hope of a better selling price in the future.

35. In a basic commodity storage agreement, the commodity company places the commodity at a specified location for withdrawal at an agreed date. The storage owner (often, a bank) is not generally entitled to sell or use the commodity stored in their facility. In other words, the commodity company retains control of the commodity.

36. However, in a virtual storage agreement the location is not specified. Instead:

    (a) the commodity company delivers the commodity to a particular location. This is legally a sale of the commodity to the storage owner for nil consideration.

    (b) the commodity company can then withdraw the commodity at short notice from any one of a number of locations at which the same type of commodity is stored on its behalf by the storage owner. The withdrawal is also a legal transfer of the commodity for nil consideration.

    (c) the commodity company pays the storage owner a ‘storage fee’ for the service, typically linked to the seasonal spread. Although the payment profile is similar to that of a service-type arrangement, the commodity

[3] ASC 470-40 applies to specified product financing arrangements—a product financing arrangement is defined as ‘a transaction in which an entity sells and agrees to repurchase inventory with the repurchase price equal to the original sale price plus carrying and financing costs, or other similar transactions.’

company transfers ownership of the commodity and later repurchases a commodity of the same type—in that way, a storage agreement is similar to a sale and repurchase arrangement.

37. Commodity companies said they typically account for such agreements (which can be settled net in cash) as a derivative applying IFRS 9. Those respondents said it can be difficult to determine an appropriate valuation and whether to derecognise inventory when they retain commodity price risk.

## Staff Analysis

38. When the Board last discussed commodity transactions, the Board asked us to research the feasibility of a possible narrow-scope standard-setting project to address commodity loan transactions.

39. A critical component, if not *the* critical component, of assessing whether such a project is feasible would be to determine the scope of any such project—which transactions should a narrow-scope project include within its scope and, consequently, which commodity transactions would not be addressed by that project?

40. The feedback received has provided us with helpful information about the nature and range of commodity loan transactions that entities enter into, and also the nature and range of other commodity transactions—some of which are similar to commodity loan transactions and others not. That feedback has confirmed that there are many different types of commodity transactions. However, without investing quite some additional time and effort, it is difficult at this stage to identify a population of commodity transactions on which we would suggest the Board undertake narrow-scope standard-setting.

41. For example, the Board could undertake a project on what we refer to in this paper as intermediary arrangements (see paragraphs 30–32). Limiting the scope of any project to those types of arrangement would address:

    (a) the commodity loan transaction submitted to the Committee; and

    (b) other intermediary arrangements to which stakeholders informed us they find it difficult to apply IFRS Standards.

42. However, in order to adequately assess the feasibility and expected benefits of any such project, we would need to understand better:

    (a) the application of existing IFRS Standards to the various types of commodity loan transactions for each party to the transaction. The accounting would very much depend on the specific terms and conditions of each transaction and could also depend on the nature of the entity. For example, two entities might account for the same commodity transaction differently if the commodity meets the definition of inventory for one entity but does not for the other. Therefore, some commodity loan transactions might already be within the scope of one or more IFRS Standards, whilst others might not. This work would be necessary in order to assess whether, and for which transactions, there is a need for standard-setting.

    (b) the significance and volume of the transactions for which the work in bullet (a) identifies a need for standard-setting.

    (c) any possible knock-on consequences for other commodity transactions or within IFRS Standards. As noted above, depending on the terms and conditions of a transaction, the transaction may (or may not) already be within the scope of a particular IFRS Standard. The variety of commodity loan transactions means that there would be a risk of unintended consequences.

43. We also note that stakeholders identified a number of different types of commodity transactions—beyond commodity loan transactions—that some suggest the Board consider. A project addressing only intermediary arrangements would not therefore address all those transactions. It is unclear from our research to date whether commodity loan transactions and other intermediary arrangements should be a higher priority for the Board than other transactions involving commodities.

44. Consequently, based on the information available to us at present (and summarised in this paper), we recommend that the Board not add a narrow-scope standard-setting project to its work plan on commodity transactions.

### *2020 Agenda Consultation*

45. We understand that some of the topics raised by stakeholders in our research are similar to those raised by a few stakeholders consulted in the Board's preliminary work on the 2020 Agenda Consultation.

46. We think the Board could gather more information as to which types of commodity transactions stakeholders view as a priority. Therefore, the Board could consider referring to commodity transactions as a potential project in its Request for Information on the 2020 Agenda Consultation. Doing so would also allow the Board to consider commodity transactions in the context of other possible standard-setting projects on its work plan.

## Staff recommendation

47. We recommend that the Board consider referring to commodity transactions in the list of potential projects to describe in the Request for Information on the 2020 Agenda Consultation. In our view, this would allow the Board to make an informed decision about whether to add a project on commodity transactions to its work plan.

| **Question for the Board** |
| --- |
| Does the Board agree with our recommendation:<br>a) not to add a narrow-scope standard-setting project to its work plan on commodity transactions at this time; and<br>b) to consider referring to commodity transactions in the list of potential projects to describe in the Request for Information on the 2020 Agenda Consultation? |