STAFF PAPER

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IASB Meeting

Project	**Commodity loans and related transactions**
Paper topic	Potential new research project

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Introduction

1. In March 2017, the IFRS Interpretations Committee (Committee) published an agenda decision in relation to a request about a particular commodity loan transaction[1]. The Committee observed in that agenda decision that the particular transaction might not be clearly captured within the scope of any IFRS Standard.

2. When discussing feedback from stakeholders, the Committee identified other commodity transactions that also might not be captured within the scope of any IFRS Standard. Some Committee members also said, in their view, the matter is broader than commodity transactions. Related topics identified by Committee members include digital currencies (sometimes referred to as cryptocurrencies). The Committee suggested that the Board consider the feedback received on this matter in determining whether it should add a research project to its agenda.

3. The objective of this paper is to present a summary of the Committee's discussions and feedback received relating to commodities. The paper also summarises a number of related areas identified as being of potential relevance to the Board in considering any further work to be done and the scope thereof. The Board will not be asked to make any decisions at this meeting.

4. This paper is organised as follows:

    (a) Commodities;

[1] http://www.ifrs.org/-/media/feature/news/updates/ifrs-ic/2017/ifric-update-march-2017.pdf

(b) Other relevant transactions;

(c) Research considerations; and

(d) Questions for the Board.

Commodities

Transaction discussed by the Committee

5. The request described a scenario in which:

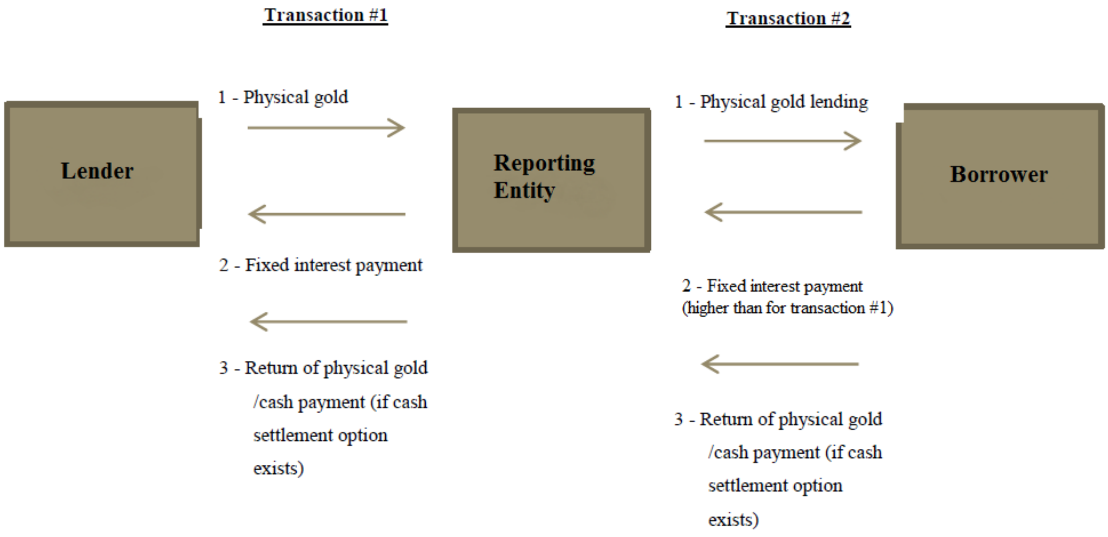
   (a) *Reporting Entity* (often a bank) borrows a commodity (gold[2]) from *Lender* (often another bank) for 12 months (referred to as Transaction #1). On physical receipt of the commodity, legal title passes to Reporting Entity. The commodity is fungible and can easily be replaced with a similar commodity (another bar of gold).

   (b) There are no cash inflows or outflows at inception of Transaction #1. Instead, Reporting Entity pays a fixed quarterly fee to Lender 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, Reporting Entity is obliged to deliver a commodity of the same type, quantity and quality to Lender. Reporting Entity 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) Reporting Entity then enters into a similar transaction with *Borrower* (referred to as Transaction #2). In Transaction #2, legal title of the commodity is transferred to Borrower under the same terms and conditions described in Transaction #1, but for a higher fixed fee from Borrower to Reporting Entity.

[2] The fact pattern described in the request was a gold transaction. The transaction could involve other liquid commodities. Thus the term ‘commodity’ is used, unless we are referring specifically to gold.

6. A diagram illustrating the transactions was included within the request and has been reproduced below.



7. It is assumed that all three parties to the transactions are unrelated to each other. It is also assumed that Reporting Entity negotiates each transaction independently of the other (ie Borrower and Lender are unaware of the other's transaction with Reporting Entity), although Reporting Entity is likely to have entered into both transactions in contemplation of the other.

8. The request asked whether Reporting Entity is required to recognise an asset and a liability in respect of these transactions.

9. The Committee observed that the particular transaction in the request 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 applies paragraphs 10–11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in developing and applying an accounting policy to the transaction.

10. The Committee concluded that it would be unable to resolve the question asked efficiently within the confines of existing IFRS Standards. The wide range of transactions involving commodities means that any narrow-scope standard-setting activity would be of limited benefit to entities and would have a high risk of unintended consequences. Consequently, the Committee decided not to add this matter to its standard-setting agenda.

Other commodity transactions

11. The Committee observed that particular IFRS Standards apply to particular types of transactions involving commodities. For example:

    (a) If an entity holds commodities for sale in the ordinary course of business, for use in the process of production or in the form of materials or supplies to be consumed in the production process, it applies IAS 2 *Inventories*.

    (b) Commodity broker-traders are permitted to measure commodity inventories at fair value less costs to sell applying paragraph 3(b) of IAS 2.

    (c) An entity applies IFRS 15 *Revenue from Contracts with Customers* to the sale of commodities to customers (unless IFRS 9 *Financial Instruments* applies to the contract).

    (d) Derivative financial instruments in the scope of IFRS 9 that change in value in response to a change in a specified commodity price.

12. In considering feedback on the agenda decision, the Committee members noted however that there are other types of transactions involving commodities that might not be captured within the scope of any IFRS Standard. The paragraphs that follow discuss such transactions and fact patterns.

13. In some cases, commodity transactions are speculative investment transactions—ie entities, that are not commodity broker-traders, may invest in commodities even though doing so is not a core component of their business model.

14. In other cases, entities invest in commodities as a store of value. For example, in our outreach on commodities, some respondents said there is debate as to how central banks account for any gold reserves they hold—respondents said such reserves have been treated either as a cash equivalent or as an available-for-sale financial asset applying IAS 39 *Financial Instruments: Recognition and Measurement*.

15. Other transactions identified by respondents are more complex, and involve liquid commodities being used in a similar way to cash (or other liquid financial assets). Examples include:

   (a) Repo-like transactions—For example, an entity buys (sells) a commodity in the spot market and simultaneously enters into a forward contract to sell (buy) the same commodity to the same counterparty at a future date. This may be done through separate trading desks. Some respondents said there is debate about whether an entity accounts for these transactions separately or as one transaction.

   (b) Lease and future sale—For example, Entity A leases a commodity to Entity B. Entity B concurrently enters into a forward purchase contract to purchase the same amount of the same commodity from Entity A at the end of the lease term. This purchased commodity is then used to return the leased commodity to Entity A. Typically there is no exchange of cash at contract inception but the lessee (Entity B) is required to pay a monthly fee over the lease term.

16. Many entities enter into commodity transactions for financing purposes. For example, respondents said some jewellers use commodity lease transactions to obtain gold or silver without an initial outlay of funds. They then use the precious metal to produce jewellery and use the sales proceeds to purchase gold or silver to return at the end of the lease term. Other manufacturers use commodity leasing for similar reasons—eg car manufacturers lease palladium (another precious metal) and nuclear power plant operators lease uranium.

17. Another type of commodity transaction identified involves an entity selling a precious metal (delivered to the customer at contract inception), but for which the consideration is based on the price on the London Metals Exchange 60 days after contract inception. Feedback indicated there is debate about whether, in this fact pattern, the contract contains an embedded derivative.

18. This is similar to a transaction the Board discussed in December 2015 (Agenda Paper 7H). The Board did not comment on whether the contract contains an embedded derivative; instead it considered the application of the requirements in paragraphs 56–58 of IFRS 15 (‘the variable consideration constraint’). The Board

noted that the variable consideration constraint would not apply to this transaction because when the entity transfers the commodity, it would have a receivable. The entity would account for the receivable applying IFRS 9.

19. The outreach performed by the Committee also identified other transactions using less liquid commodities, particularly food-based commodities. These include agreements between unrelated entities to swap oilseed or grain inventories to fulfil demand in a particular location. These transactions are not within the scope of IFRS 15, as specified in paragraph 5(d) of that Standard.

20. Commodity-based transactions are also common in Islamic finance. In particular, many Islamic finance banks use commodity murabaha or tawarruq in transacting with customers or for inter-bank liquidity. In these transactions, a bank purchases a liquid commodity (often gold or silver) from a metal broker at a spot price, and sells it to a customer or another bank for a deferred payment amount that is higher than the spot price. The customer then sells the commodity back to the metal broker (often using the originating bank as an agent) at the spot price, obtaining immediate funds. These transactions mimic conventional arrangements entered into by non-Islamic finance banks but avoid charging interest. We understand the Islamic Finance consultative group is considering the application of IFRS Standards to these transactions. However, if the Board were to develop new requirements for particular transactions that involve liquid commodities, in our view it would need to consider the effect of any new requirements on Islamic finance transactions.

Other transactions

21. The Committee's discussions included observations that the underlying matter to potentially be addressed could be broader than commodity transactions. Committee members mentioned the matter might extend to items not issued by a central bank but, are used in a similar way to cash, or, like commodities, held for speculative purposes. Accordingly, we have considered whether there are other transactions that are similar, in some respects, to some of the commodity transactions discussed in this paper. Two specific topics identified are digital currencies and emissions allowances, both are considered below.

Digital currencies

22. Digital currency refers to a form of exchange that exists only digitally and is not linked to any physical currency. The best-known example of a digital currency is bitcoin. However, there are many examples of digital currencies in existence today at different stages of maturity.

23. Since the origination of digital currencies around a decade ago, there has been some significant growth in recent years and, currently, the market capitalisation of digital currency is estimated to be around US$672 billion as at 11 January 2018[3]. Currently, there are no specific accounting requirements for digital currencies in IFRS Standards.

24. Some respondents to the Board's 2015 Agenda Consultation identified digital currencies as a potential new project. In 2016 when it determined its work plan, considering feedback on the Agenda Consultation, the Board decided not to add this matter to either its standard-setting agenda or research agenda .

25. In December 2016 the Accounting Standards Advisory Forum (ASAF) discussed digital currencies. The Australian Accounting Standards Board (AASB) presented Agenda Paper 5 at that meeting, which provided background on the history of digital currencies, the challenges in accounting for them using IFRS Standards and suggested possible standard-setting activity the Board could undertake to resolve these challenges. The paper discussed by ASAF stated that, in the absence of specific accounting requirements, in practice entities account for digital currencies as one of the following: cash, another financial asset, inventory or an intangible asset.

26. The AASB also said, in its view, an entity should measure digital currencies at fair value through profit or loss but, applying existing IFRS requirements, such an approach might not be viable. Instead, the AASB would expect entities to account for digital currencies applying either IAS 2 or IAS 38 *Intangible Assets*.

27. The AASB also noted that before 2001 entities accounted for investments applying IAS 25 *Accounting for Investments*. IAS 25 contained requirements for investments in financial instruments, investment property and other non-financial

[3] According to https://coinmarketcap.com/

investments. The IAS 25 requirements for other non-financial investments potentially may have applied to items such as digital currencies and some commodity transactions. However, when IAS 25 was withdrawn, those requirement were not replaced by a successor Standard.

28. A large number of ASAF members thought the use of digital currencies was still evolving at that time, and recommended that the Board continue to monitor developments in this area.

29. Since the December 2016 ASAF meeting, we are aware of the following developments:

(a) In March 2017, the Japanese government passed a law making digital currency a legal payment method. This prompted the Accounting Standards Board of Japan (ASBJ) to publish, in December 2017, an Exposure Draft outlining how to account for digital currencies applying Japanese GAAP.[4]

(b) In July 2017, the US Financial Accounting Standards Board (FASB) received a request from the Chamber of Digital Commerce to consider adding a project on digital currencies to its agenda. Digital currencies are included in a list of topics FASB staff performed research on during the period 1 July 2017 to 30 September 2017[5], however the FASB has yet to discuss that research.

(c) In 2017, there has been an increasing trend in financial markets for 'Initial Coin Offerings' (ICOs). These transactions are similar to initial public offerings but the entity sells newly created digital currencies or tokens rather than shares. In these transactions, entities sell digital currencies in exchange for fiat currency (ie currency a government has declared to be legal tender but is not backed by a physical commodity) or other, more established digital currencies.[6]

[4] https://www.asb.or.jp/en/wp-content/uploads/2017-1206_2_e.pdf

[5] http://www.fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1176169665221

[6] https://www.investopedia.com/terms/i/initial-coin-offering-ico.asp

(d) In December 2017, two of the world's largest derivative trading exchanges, the CME Group and Cboe Global Markets, began offering bitcoin futures.[7]

(e) At its meeting in January 2018, the IFRS Discussion Group of the Canadian Accounting Standards Board considered how cryptocurrencies work and the related accounting implications. A recommendation was made that the matter be referred to, and discussed further by, the Canadian Accounting Standards Board.

30. We also note that the South Korean government has said it plans to ban digital currency trading[8] and the Chinese government has closed bitcoin exchanges and is considering banning entities from mining bitcoin[9].

Emissions allowances

31. Many jurisdictions have emissions trading schemes. These schemes are set up to encourage businesses to reduce their greenhouse gas emissions. Under these schemes, the government generally imposes a cap on the quantity of emissions all participants in the schemes can emit and then issues the same quantity of emissions allowances.

32. Entities are able to trade emissions allowances, purchasing (selling) allowances from (to) other entities if they expect their emissions to exceed (be less than) the number of allowances held. Typically, entities will purchase and hold emissions allowances for compliance purposes to ensure they can produce their goods and services.

33. The Board and Committee have previously considered the accounting for emissions allowances used in the ordinary course of business. The Committee issued IFRIC 3 *Emission Rights* in December 2004, which was subsequently withdrawn in June 2005. In January 2015, the Board started a research project to further consider the accounting for emissions allowances. Research on emissions

[7] https://www.ft.com/content/877b867c-e18e-11e7-8f9f-de1c2175f5ce

[8] https://www.ft.com/content/0d5ff7d4-f67d-11e7-88f7-5465a6ce1a00

[9] https://www.ft.com/content/adfe7858-f4f9-11e7-88f7-5465a6ce1a00

allowances used in the ordinary course of business is currently part of the Board's research pipeline (the Pollutant Pricing Mechanisms project).

34. We are also aware that some entities invest in emissions allowances solely for speculative investment purposes. Previous discussions by the Board did not address speculative investment by entities in emissions allowances, although limited research suggests that entities may measure such speculative investments at fair value through profit or loss. If the Board were to consider emissions allowances held for investment purposes as part of any new project, that work would not replace the Board's pipeline research project on Pollutant Pricing Mechanisms. This is because it would not address the main questions being addressed as part of that research project.

Research Considerations

35. The examples of transactions involving commodities, and the other transactions and items discussed in this paper, in our view identify two possible areas the Board could address:

    (a) Investment transactions; and

    (b) Cash-like transactions.

36. A number of the transactions identified can be categorised as speculative investment transactions—ie entities may invest in commodities, digital currencies or emissions allowances, even though doing so is not a core component of their business model.

37. Other transactions are better categorised as cash-like transactions and relate more directly to the request submitted to the Committee. In particular, the transaction in the request (described in paragraphs 5-8 of this paper), and some of the other transactions identified in this paper, involve entities using liquid commodities in a similar way to cash. Entities structure those transactions so that the liquid item is used as cash might be in similar transactions, and the parties to the transactions are in essence subject to much the same risks as they would be if the transactions were to involve cash. However, if the item is not a financial instrument, the

transaction may not be within the scope of IFRS 9 as it would be if the underlying item were cash or another financial instrument.

38. Some of these cash-like transactions involve financial institutions operating as an intermediary between corporate entities. Because of this, any proposed solution would need to consider the accounting applied by both the financial institution intermediary and the corporate entity counterparties.

39. If the Board were to add a Research project on some or all of the transactions discussed in this paper, an important decision would be the scope of any such project. This paper mentions a broad range of transactions—the Board would need to consider whether particular transactions or items require attention more urgently or whether it would be necessary to undertake a more comprehensive project.

40. As part of its 2015 Agenda Consultation, the Board conducted outreach events with a number of stakeholders and advisory groups. Stakeholders did not identify commodities as being a priority project, however some suggested a project on digital currencies as mentioned in paragraph 24 of this paper.

41. The existence of the agenda consultation process does not prevent the Board from identifying urgent matters between consultation periods that it might add to its agenda. The Board will consider whether to begin active research on some of the projects in the research pipeline at a future meeting. Accordingly, at that time, we will ask the Board to consider whether a project on commodities or other transactions identified in this paper is a priority ahead of, or alongside, projects currently on the Board's active research agenda or research pipeline.

42. For reference we have listed the factors the Board used in determining the prioritisation of research projects as set out in paragraph 55 of the 2015 Agenda Consultation Request For Views:

(a) the importance of the matter to those who use financial reports;

(b) the urgency of the problem to be resolved;

(c) interactions with other current or possible projects;

(d) the complexity and breadth of the problem to be resolved, and the feasibility of possible solutions being developed;

(e) the availability of sufficient time from Board members and of staff resources;

(f) the overall balance of the work plan and the overall balance in the pipeline of research projects that may ultimately come forward to the Standards-level programme; and

(g) the capacity of stakeholders to respond to proposals, both as individual proposals and across the work plan as a whole.

Questions for the Board

43. This paper provides an overview of particular commodity transactions, and other types of transactions. We also described the two underlying themes we identified that link these transactions together—ie those entered into for investment purposes and those that involve non-financial assets being used in a similar way to cash.

44. We are not asking the Board to make any decisions at this meeting. However, we have the following questions for the Board members.

Questions for Board members
1) Do you have any questions or comments on the contents of this agenda paper? 2) Is there any additional information you would like to obtain before being asked whether to add a project on some or all of the transactions identified in this paper?