The Chair
19 January 2024
ESMA32-1283113657-1108

Bruce Mackenzie
Chair
IFRS Interpretation Committee
Columbus Building
7 Westferry Circus
Canary Wharf, London E14 4HD
United Kingdom

Agenda Item Request: Presentation of cash flows from margin calls for certain contracts for the sale or purchase of commodities (IAS 7)

Dear Mr Mackenzie,

The European Securities and Markets Authority (ESMA) is an independent EU Authority whose mission is to enhance the protection of investors and promote stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. In the context of ESMA's supervisory convergence work in the area of financial reporting, I would like to raise with you an issue related to the application of IAS 7 *Statement of Cash Flows*. ESMA has observed different views on the application of the requirements of IAS 7 in relation to the presentation of cash flows from margin calls for certain contracts to purchase or sell commodities at a predetermined price at a specified time in the future.

Accordingly, ESMA kindly suggests that the IFRS Interpretations Committee (IFRS IC) considers clarifying the relevant accounting requirements. A detailed description of the case is set out in the appendix to this letter. We would be happy to further discuss this matter with you.

In case you have any questions or comments regarding this letter, please contact Isabelle Grauer-Gaynor, Head of the Corporate Finance and Reporting Unit.

Yours sincerely,

<signed>

Verena Ross

APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1 Description of the issue

1. The issue relates to the presentation of cash flows related to margin calls on certain centrally cleared contracts to purchase or sell commodities at a predetermined price at a specified time in the future.

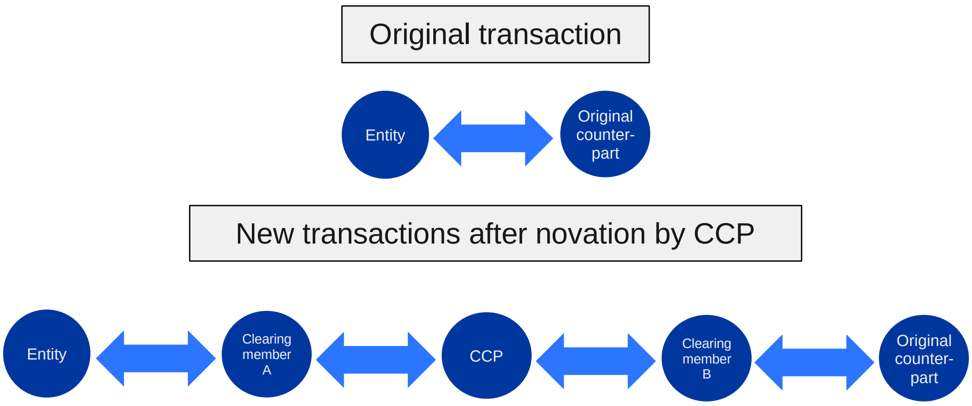
2. The contracts in question, which typically have a maturity up to three years, are entered into between entities that use commodities in their economic activities (e.g., producers of chemicals) and transacted through regulated commodity exchanges. These entities conclude the contracts for various reasons:

   a) Receipt of the commodity in accordance with the entity's expected usage requirements. Contracts are physically settled and accounted for in accordance with paragraph 2.4 of IFRS 9 *Financial Instruments* ('own use' contracts).

   b) Hedging of the exposure to fluctuations in commodity prices. These contracts are usually settled net and accounted for as hedging instruments in cash flow hedges.

   c) Trading purposes (generating a profit from short-term fluctuations in price). Contracts are measured at fair value through profit and loss in accordance with the requirements of IFRS 9.

3. After a new contract is entered into, for the purpose of settlement via a central counterparty (CCP), the contract is novated by CCP and Clearing members guarantee these contracts towards the CCP.[1]



[1] When a contract is novated, both parties of the contract agree that the responsibilities and obligations of one party are transferred from the original signee to a third party (the original contract ceases to exist and is replaced by another contract).

4. The novation results in each of the two original parties holding a contract vis-à-vis the clearing members, which in turn hold contracts subject to the same conditions vis-à-vis a CCP.

5. The contracts that are the subject of this submission are 'collateralised-to-market' contracts, which means that under the contractual agreement between the parties, daily payments made by the parties during the life of the contract, which cover fluctuations of the fair value of the contract (margin payments), represent transfers of cash[2] collateral and not partial settlement of the contract (as in the case with "settled-to-market' contracts).

6. In practice, any price difference will result in (variation) margin payments between the entity and the Clearing member correspond to the margin payments between the clearing member and the CCP.[3]

7. On the settlement date, the contract is settled in cash or physically. The settlement payment occurs between the entity and the Clearing member (mirrored by the payment between the Clearing member and the CCP). Upon settlement, the amount of the cash collateral transferred over the life of the contract is realised and thus the final payment[4] reflects the change in the market value of the contract between the date/time of the last margin call and the settlement date/time.

8. ESMA has observed that some entities present all cash flows related to margin calls over the life of the contracts within cash flows from financing activities in their statements of cash flows, regardless of the reason for which the contract was entered into (as outlined in paragraph 2 above), while other entities present those cash flows within cash flows from operating activities.

9. On the settlement date of the contract, entities that classify margin call cash flows as financing activities present the settlement payment as cash flows from operating activities. In addition, at the same time, they eliminate the cumulative amount of cash flows from margin calls for the settled contract previously classified as financing cash flows from the cash flows from financing activities and add this amount to cash flows from operating activities. As a consequence, cash flows from operating activities do not reflect the volatility stemming from the fair value changes during the life of the contracts.

10. ESMA notes that there are two views as to whether the presentation of cash flows related to contracts in the statement of cash flows as described above is consistent with the requirements of IAS 7 *Statement of Cash Flows*:

[2] Generally, any type of collateral acceptable by the CCP or the Clearing member can be posted for CTM variation margin calls but, in the presented fact pattern, cash collateral is deposited to cover both negative and positive price movements.
[3] More specifically, initial margin (IM) should be considered. Positive price differences result in credits reducing the IM so that less margin will have to be posted by the entity to Clearing member (and the clearing member to the CCP) with the IM being reduced to a ceiling of zero.
[4] In the case of cash-settled contracts. In the case of physically settled contracts, the underlying commodity is settled against the contractual price with a similar outcome.

View 1: The presentation of cash flows related to margin calls within cash flows from financing activities complies with the requirements of IAS 7

11. Proponents of View 1 point out that the collateral payments have a different legal character than the settlement payments and therefore give rise to different rights and obligations.

12. The payment of collateral is not a payment or cash flow on the related contract and, as a result, the classification of cash flows in the cash flow statement does not depend on the classification of the cash flows on the contract. During the period that the entity pays or receives cash through the margin account, the entity has a claim on the counterparty (Clearing member) in the amount of the collateral transferred. Often, the cash held in a margin account also earns interest, in which case it can be seen economically as an investment of the entity. Therefore, the classification of cash flows related to margin calls as cash flows from activities other than operating activities does not contradict the requirements of IAS 7.

13. Different presentation of the cash flows related to the margin calls and cash flows of the contract is also consistent with the presentation on the balance sheet of the entity. Receivables or payables recognised due to collateral payments to or from the clearing house are different financial assets or financial liabilities than corresponding financial liabilities or financial assets recognised for the contracts.

14. Although eliminating the cumulative amount of margin cash flows for the settled contract previously classified as financing cash flows from cash flows from financing activities and adding the same amount to cash flows from operating activities on settlement may look like a reclassification of cash flows, it is not a reclassification. On settlement of the contract, there are effectively two simultaneous cash flows between the entity and the Clearing member: (i) a collateral cash flow (from or to the margin account) and (ii) a cash flow to settle the contract. These cash flows are netted into the net payment instructions.

View 2: The presentation of cash flows related to margin calls within cash flows from financing activities does not comply with the requirements of IAS 7

15. Proponents of View 2 consider that all cash flows resulting from margin payments or receipts should be presented as cash flows from operating activities. In the paragraphs below, their reasoning is presented separately for (a) contracts treated as 'own use' contracts, (b) contracts designated in hedge accounting relationships and (c) contracts for trading purposes.

a) 'Own use' contracts

16. Proponents of View 2 acknowledge that IAS 7 does not provide guidance for the presentation of cash flows from margin calls for 'own use' contracts. However, as these cash flows are (i) inherently linked to the contracts, (ii) determined based on the fair value of the contracts, and (iii) taken into account when the settlement cash flow is determined, it is considered appropriate for the cash flows from the margin calls to be recognised

consistently with cash flows from the settlement of the contracts from which they arose, i.e. within cash flows from operating activities.

17. In addition, proponents of View 2 argue that even assuming that the presentation of cash flows from margin calls is not determined by the presentation of the cash flows from the contracts, the presentation of cash flows from margin call within other activities than operating activities (i.e., financing activities or investing activities) would not be consistent with the requirements of IAS 7. This is explained below in greater detail.

i. Cash flows from financing activities

18. Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity (paragraph 6 of IAS 7). Paragraph 17 of IAS 7 states that the separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the entity. Although the term 'borrowings' is not defined in an exhaustive manner, the paragraph provides a number of examples, including cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings, and cash repayments of amounts borrowed.

19. A Clearing member that receives or makes margin calls payments does not provide capital to the entity. It maintains margin call accounts with opposite balances for the parties of the contract, and the account balances fluctuate on a daily basis depending on the movements in the fair values of the related contract. With this, the margin call account balances can result for the entity not only in a financial asset but also in a financial liability. Economically, the balance of the margin account does not represent capital as it covers losses resulting from the contract. A treasury department within an entity cannot rely on margin calls to fund the entity's operations and/or investments because it neither has access to these funds nor controls the development of those balances. This is also different from a revolving credit facility, where the entity does have control over the amounts withdrawn under the facility. Therefore, cash flows from margin calls do not qualify as cash flows from financing activities.

ii. Cash flows from investing activities

20. Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents (paragraph 6 of IAS 7). According to paragraph 16 of IAS 7, separate disclosure of cash flows arising from investing activities is important because cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Paragraph 17 of IAS 7 provides a number of examples of investing activities, including cash advances and loans made to other parties.

21. Collateral can represent a resource intended to generate future income and cash flows. Similar to a loan or a cash advance, it is intended to be reimbursed to the party that made the deposit after that party has fulfilled its contractual obligations, thereby generating future

cash flows. However, this is not the case with margin calls as the balance of the margin account is not repaid but used for the settlement payment on the settlement date. Therefore, margin calls have a different nature than an advance or a loan.

22. The fact that the margin call accounts generate interest is not an element that should determine their classification for the cash flow statement purposes. In this respect, proponents of View 2 note that trade accounts receivable may also generate interest, which does not result in the presentation of their cash flows as part of investing activities.

23. Proponents of View 2 acknowledge that paragraph 16(g) of IAS 7 mentions cash payments for future and forward contracts not accounted for as a hedge of an identified position[5] as examples of investing cash flows, provided (i) the instrument is not held for dealing or trading purposes, and (ii) the payments are not classified as financing activities. However, in their view, this paragraph applies only to derivatives and not to 'own use' contracts (although this is not explicitly stated). Even though the term 'future or forward contracts' used in paragraph 16(g) of IAS 7 is not specifically defined, inclusion of 'own use' contract in the scope of this paragraph was neither intended nor consistent with current market practice.

iii. Conclusion regarding 'own use" contracts

24. As, according to paragraph 6 of IAS 7, operating activities are activities that are not investing or financing activities, cash flows from margin calls should therefore be considered as part of operating activities.

25. b) Contracts designated as hedging instruments

26. Paragraph 16 of IAS 7 requires that the cash flows of a contract that is accounted for as a hedge of an identifiable position are classified in the same manner as the cash flows of the position being hedged.[6] Moreover, paragraph G.2 of IFRS 9 *Guidance on Implementing* states that cash flows arising from hedging instruments are classified as operating, investing or financing activities, on the basis of the classification of the cash flows arising from the hedged item. The paragraph further clarifies that although the terminology in IAS 7 has not been updated to reflect IFRS 9, the classification of cash flows arising from hedging instruments in the statement of cash flows should be consistent with the classification of these instruments as hedging instruments under IFRS 9.

27. Proponents of View 2 point out that while the 'cash flows of a contract' referred to in paragraph 16 of IAS 7 may be viewed narrowly, the wording in IFRS 9 *Guidance on Implementing* ('cash flows arising from hedging instrument') indicates that the requirement in paragraph 16 of IAS 7 should also be applied to cash flows that do not result directly

[5] According to paragraph 16 of IAS 7 when a contract is accounted for as a hedge of an identifiable position the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

[6] According to some views, this classification requirement should be applied not only to contracts accounted for as hedges of an identifiable position, but generally to all contracts entered into for the purpose of economic risk hedging. Under this view, the reasoning set out in paragraphs 23-26 would also apply to such instruments.

from the hedge instrument but are caused by this instrument and closely related to it, such as cash flows from margin calls, which mirror the fair value fluctuations of the hedging instrument. Moreover, the clearing member is the same counterparty for both payments of margin calls and the settlement payment.

28. Also from an economic perspective, there is an inherent interdependency between the margin calls and the financial instrument to which they relate. Without the underlying financial instrument, there would be no margin calls.

29. In addition, arguments against the inclusion of margin call cash flows in the cash flows from financing activities for 'own use' contracts presented above also apply here.

c) Contracts for trading purposes accounted at fair value through profit or loss

30. Paragraph 14(g) of IAS 7 states that cash receipts and payments from contracts held for dealing or trading purposes shall be classified as operating activities. The proponents of View 2 consider it is generally appropriate for these cash flows to be presented consistently with the settlement cash flows from the contract from which they arose, i.e. within cash flows from operating activities. The above arguments against including the margin cash flows in cash flows from financing and investing activities also apply here.

d) Reclassification of the cash flows on settlement

31. In addition to the arguments presented above, proponents of View 2 point out that the reclassification of cash flows from financing cash flows to operating cash flows does not appear to be in compliance with IAS 7, as the resulting changes in cash flows from financing activities are not due to inflows and outflows of cash and cash equivalents. Such theoretical gross cash inflows and outflows (i.e., a reimbursement of the margin call by the clearing house to the party that has a payable under the contract, followed by a settlement payment by this party back to the clearing house) are not contractually permissible. This would defeat the very purpose of the margin calls, as a repayment of the margin call would re-expose the contracting party that has a receivable under the contract to the full credit risk of the counterparty that has a payable.

2 Request

32. ESMA seeks clarification on whether the cash flows resulting from margin calls for contracts described in paragraphs 2–7 above should be classified as cash flows from operating activities or whether another classification (i.e., as cash flows from financing activities) is compliant with the requirements of IAS 7.