STAFF PAPER

February 2012

IASB meeting

Project	Interpretations Committee		
Paper topic	IAS 2 Inventories - Long-term prepayments for inventory supply contracts		
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Introduction

1. The IFRS Interpretations Committee (the Committee) received a request from ESMA to clarify whether interest should be accreted on long-term prepayments. The Committee noted that according to the revised exposure draft *Revenue from Contracts with Customers* published in November 2011, a seller should consider the effect of the time value of money (whether there is a prepayment or a deferred payment).
2. The objective of the paper is to obtain feedback from the Board on whether it thinks that there should be amendments made in the IFRS literature to clarify that a purchaser should also consider the effect of time value of money.

Structure of the paper

3. This agenda paper includes:
   (a) background information on the issue;
   (b) a summary of the staff analysis that was presented to the Committee at the January 2012 meeting;
   (c) the Committee's decisions at the January 2012 meeting and the questions asked to the Board;

(d) a staff analysis of the concept of time value of money;

(e) a summary of the requirements regarding the time value of money in the revised exposure draft *Revenue from Contracts with Customers* issued in November 2011;

(f) process issues and recommendations to the Board;

(g) Appendix A: Submission;

(h) Appendix B: Extracts from the revised exposure draft *Revenue from Contracts with Customers* issued in November 2011;

(i) Appendix C: Staff analysis presented to the Committee at the January 2012 meeting (Agenda paper 11); and

(j) Appendix D: Simplified example on the impact of accretion of interest on long-term prepayments in the financial statements of the purchaser and the supplier.

Background

4. In November 2011, the Committee received a submission from ESMA seeking clarification on the accounting for long-term supply contracts of raw materials when the purchaser of the raw materials agrees to make prepayments to the supplier. The question is whether the purchaser/supplier should accrete interest on long-term prepayments by recognising interest income/expense, resulting in an increase of the cost of inventories/revenue. The submission is shown in Appendix A.

5. The fact pattern submitted is summarised below. A purchaser (eg a manufacturer) enters into a long-term supply contract for the purchase of raw materials for a period of 10 years. As part of the supply contract, the purchaser agrees to make prepayments to the supplier for the raw materials. These long-term prepayments are non-refundable. The prepayments will be offset against future orders for raw materials. The contract sets the future prices for raw materials between the purchaser and the supplier for each year as well as the quantity of raw materials to be ordered annually. If the purchaser does not order the defined quantity of raw

materials in a specific year, the purchaser loses the (year-specific) portion of the prepayments (ie a take or pay agreement).

6. It should be noted that the supplier is serving a multitude of customers. Consequently, the prepayments do not qualify as an implicit lease in accordance with IFRIC 4. In addition, no derivative arises in connection with the raw materials prepayments (the prepaid raw material orders meet the own-use exception in IAS 39 and the definition of a derivative in IAS 39 paragraph 9 is not met, because there is a significant net initial investment).

7. According to the submitter, in practice, some purchasers of the raw materials accrete interest on the long-term prepayments by recognising interest income and increasing cost of sales in future periods while others account for prepayments at cost. Outreach with national standard-setters confirms that there is diversity in practice (especially in Europe), although it appears that the prevalent practice is not to take into account the time value of money in long-term prepayments.

8. The submission asks the following questions:

    (a) How should purchasers of the raw materials account for the long-term prepayments in their IFRS financial statements?

    (b) Should prepayments be accreted over the term of the agreement by recognising an implied interest income?

    (c) Should the accounting depend on whether an agreed interest rate is included in the supply contract or not?

Summary of the staff's analysis presented to the Committee at the January 2012 meeting

9. It should be noted that there is no general requirements in IFRSs on accounting for the time value of money. The accounting for the time value of money is only specified in individual standards. However, the accounting for the effects of the time value of money on the purchase side of the transaction is not clear.

10. The staff analysis presented to the Committee at the January 2012 meeting is shown in Appendix C of this paper. In summary, we think that there are already implicit or explicit requirements in the IFRS literature to reflect the time value of

money in a transaction, whether there is a payment in advance or a payment in arrears (see View A in Appendix C). We therefore think that both the purchaser and the supplier should accrete interest on long-term prepayments. We provide in Appendix D a simplified example in order to illustrate the impact of accretion of interest on long-term prepayments in the financial statements of the purchaser and the supplier.

Committee's decisions at the January 2012 meeting and questions asked to the Board

11. The Committee observed that there is mixed practice on the issue submitted, and that current IFRSs do not provide clear guidance on this issue. A slim majority of Committee members considered that there is an implicit or explicit requirement in the current IFRS literature to reflect the time value of money in a transaction. Other Committee members considered that it is not appropriate in the current IFRS literature to accrete interest on non-financial assets and liabilities, such as rights to receive raw material in the future.
12. The Committee noted that the revised exposure draft *Revenue from Contracts with Customers* published in November 2011 proposes a principle for accounting the time value of money component in a contract with a customer. That principle would apply to payments in advance and deferred payments.
13. Provided that the requirements in the exposure draft to reflect the time value of money are not changed in the final standard on revenue, this would apply in the seller's financial statements when prepayments are made. The Committee observed that considerations regarding accounting for the time value of money in the purchaser's financial statements are similar to those in the seller's financial statements.
14. The Committee decided to ask the Board whether it agrees with the Committee's observation, and if so, whether amendments should be made in the IFRS literature in order to align the purchaser's accounting with the seller's accounting. Provided that the Board agrees that the purchaser and the seller should account for the time value of money in such contracts similarly and that the Board agrees that it is the Committee that should deal with this matter, the Committee would direct the staff

to further analyse which standards should be amended if guidance were to be provided, and to prepare illustrative examples on the impact of accretion of interest on long-term prepayments.

Concept of time value of money

15. We think that the time value of money is a conceptual principle that should be applied consistently in both the purchaser and the seller's financial statements. We think that not reflecting the financing component in a transaction distorts the assessment of an entity's operating performance, because the margin of the seller is underestimated and the margin of the purchaser (as recognised on the future sales of the goods produced using the raw material purchased) is overestimated. It also distorts the assessment of an entity's financial performance, because the cost of financing is not adequately reflected.
16. In our view, when there is a prepayment, this is equivalent to a deposit made by the purchaser to the seller and the parties presumably considered the prepayment in setting the prices. Indeed, once a prepayment is made, the purchaser has less cash or more borrowings and the seller has more cash or less borrowings. If the prepayment had not been made, the purchaser would have earned additional interest income or would have incurred less interest expense. The seller would have earned less interest income or would have incurred more interest expense. It is reasonable to presume that the purchaser obtains a discount on the price, because financing has a cost for the purchaser. Not reflecting the financing component in a transaction is equivalent to considering that the purchaser has made a free loan and that the seller has received a free borrowing. In our view, this does not represent the economics of the transaction.
17. Consequently, we think that the nominal amount of cash paid/received should be adjusted when determining the cost of an asset or the revenue earned on a sale in order to reflect the financing component. The result is that the purchaser should account for an interest income with a corresponding adjustment to the cost of the raw material purchased and the seller should account for an interest expense with a corresponding adjustment to the revenue recognised on the sale.

18. In such a case, we think that a user of the financial statements is able to appropriately assess the operating and the financing performance of the purchaser and seller and can compare this performance with other entities' performance. For example, if three distinct entities purchase identical goods (such as inventories) and obtain control of these goods at the same time, and assuming that the price paid by these entities would have been the same if they had paid cash at the time of delivery, then the objective of accounting for the time value of money is that each entity should initially measure their goods at the same amount regardless of whether one entity has paid for the goods in advance, the other entity has paid for the goods at the time of delivery, and the last entity has paid for the goods at a time subsequent to delivery. Any difference between the cash paid and the initial measurement of the asset should be recognised as implied interest income (see also simplified example in Appendix D).

19. We acknowledge that in contracts with multiple deliverables (ie contracts in which more than one good or service is transferred), the assessment of the time value of money might be more difficult. We also acknowledge that there are other factors than the financing component that affect the determination of the price of the raw materials in the contract. For example, the purchaser might pay a premium for securing supply or for fixing the price. Although those factors should be considered when identifying the financing component, this does not change the fact that when prepayments are made, there is a financing component in the arrangement that should be separately identified.

20. Lastly, in accordance with IAS 23, we observe that borrowing costs that are attributable to the acquisition, construction or production of a qualifying asset are part of the cost of an asset. This is because when an asset is under development, expenditures must be financed and this financing has a cost that should be incorporated in the total cost of the qualifying asset.

Requirements regarding the time value of money in the revised exposure draft *Revenue from Contracts with Customers*

21. According to the revised exposure draft on revenues issued in November 2011, a seller should consider the effect of the time value of money whether there is a prepayment or a deferred payment. Indeed, the exposure draft states that:

    (a) in determining the transaction price, an entity should adjust the promised amount of consideration to reflect the time value of money if the contract has a financing component that is significant to the contract;

    (b) the objective is to recognise revenue at an amount that reflects what the cash selling price would have been if the customer had paid cash for the promised goods or services at the point that they are transferred to the customer.

22. We also note that in accordance with the exposure draft:

    (a) In assessing whether a financing component is significant to a contract, the seller should consider various indicators provided in the exposure draft;

    (b) As a practical expedient, an entity does not need to recognise the financing component if it is not significant, ie if the period between payment by the customer and the transfer of the goods or services is one year or less.

23. According to the Basis for Conclusions of the revised exposure draft on revenues (BC145), the Board decided that a financing component that is significant should be reflected for the following reasons:

    (a) Entities are not indifferent to the timing of the cash flows in the contract;

    (b) Not recognising the financing component could misrepresent the profit of a contract;

(c) Contracts with explicitly identified financing components would be accounted for consistently with contracts in which the financing component is implicit in the contract price.

24. The Board also decided not to exempt entities from accounting for the time value of money effects of advance payments, because ignoring the time value of money effects of advance payments could substantially skew the amount and pattern of profit recognition if the advance payment is large and occurs well in advance of the transfer of the goods or services to the customer (see BC150). Consequently, the Board decided not to accept some respondents' suggestion that an entity should not reflect the effects of the time value of money associated with advance payments, because this would:

(a) represent a change from existing practices in which an entity typically does not recognise the time value of money implicit in advance payments;

(b) 'gross up' revenue; and

(c) would not reflect the economics of the arrangement when the customer pays in advance for reasons other than financing (for example, the customer is a credit risk or is compensating the entity for incurring upfront contract costs).

25. We also note that the future standard would be effective for annual reporting periods beginning on or after 1 January 2015 and that the requirements on the time value of money would be applied retrospectively.

Process issues and recommendations to the Board

26. We think that the general principle should be to account for the financing component contained in a transaction in order to appropriately assess an entity's operating performance. This principle should be applied both for the purchaser and the seller. We also think that it would be preferable if the accounting for the financing component were to be consistent between the financial statements of the supplier and the financial statements of the purchaser. Lastly, we note that the

reasons put forward in the Basis for Conclusions of the revised exposure draft on revenues for reflecting a financing component contained in a transaction are valid for both the seller and the purchaser.

27. We therefore recommend to the Board that it should clarify that a financing component contained in a purchase contract should be recognised when the impact is significant (including a financing component associated with advance payments). Based on the preliminary work conducted so far, we think that IAS 2 (paragraph 18), IAS 16 (paragraph 23) and IAS 38 (paragraph 32) should be amended, in order to clarify that the cost is the nominal amount of consideration paid, adjusted for the effects of the time value of money.

28. Given that the future standard on revenue recognition would affect the current practice and that retrospective restatement would require extensive work for certain entities, we recommend to the Board that it should align the effective date of the amendments to be made in the IFRS literature on the purchaser's accounting with the effective date of the future revenue standard. We recommend to the Board that it should use the guidance in the future revenue standard (paragraphs 58-62 of the exposure draft) for assessing whether a transaction contains a financing component and whether this financing component is significant for the purchaser. We think that the paragraphs to be amended in IAS 2, IAS 16 and IAS 38 could cross refer to the requirements in the future standard on revenues for the assessment of whether a contract contains a financing component that is significant. In our view, this would result in an orderly transition, assuming that the provisions in the exposure draft are carried through to the standard.

29. We recommend to the Board that it should align the purchaser's accounting with the seller's accounting as part of a separate Board project, with the objective of finalising the amendments at a similar time as the new revenue standard and with the same effective date. We think that the Committee could assist the Board with the identification of the changes needed to clarify IFRSs.

Questions
1. Does the Board think that considerations regarding accounting for the time value of money in the seller's financial statements are similar to those in the purchaser's financial statements? 2. If so, assuming that the proposals in the exposure draft on revenues about time value of money are finalised, does the Board think that there should be amendments made in the IFRS literature to align the purchaser's accounting with the seller's accounting, ie to clarify that a financing component contained in a purchase contract should be recognised when the impact is significant? 3. Given the expected timing of the new revenue standard, does the Board agree that the efforts to address this issue should be made separately from the revenue project but should be coordinated as far as possible to coincide with the finalisation of the revenue project, so that they can take effect at the same time? 4. Does the Board want the Committee to do further work on this issue and to identify the changes needed to clarify IFRSs?

Appendix A: submission

APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1. Description of the case

The entity, a manufacturer in a newly developing industry, has entered into a long-term supply contract for the purchase of raw materials for up to eleven years. The raw materials are also traded on the open market. Growth of the newly developing industry is limited by the supply of raw material (currently limited production capacity).

As part of the supply contract, the manufacturer agreed to make prepayments to the supplier for the raw material. These long-term prepayments are non-refundable. The prepayments will be offset against future raw material orders. The contract sets the future prices for raw materials between the manufacturer and the supplier for each respective year as well as the quantity of raw materials to be ordered annually. If the manufacturer does not order the defined quantity of raw materials in a specific year, the manufacturer loses the (year specific) portion of the prepayments (i.e. a take-or-pay agreement).

The prepayment agreement in question does not include an agreed-upon interest charge. From an economic point of view the prepayments can be seen as the "sharing of investment risk in a new industry with the supplier" since the supplier is expanding its production capabilities. The supplier is significantly larger than the manufacturer, serving a multitude of customers; hence, the prepayments do not qualify as an implicit lease (IFRIC 4 – *Determining Whether an Arrangement Contains a Lease*). In addition, no derivative arises in connection with the raw material prepayments as the prepaid raw materials fall under the own-use exemption in IAS 39 – *Financial Instruments: Recognition and Measurement* paragraph 5.

2. Current practice

In practice, some companies accrete interest on long-term prepayments by recognizing interest income and increasing cost of sales in future periods while many others account for prepayments at amortised cost.

A. Factors supporting accreting interest on long-term prepayments

Proponents of accreting non-current prepayments believe that the long-term supply agreement provides a financing element with respect to the prepayment. They argue that the parties considered this financing element in setting the prices; that is, the cost of the related materials is lower due to manufacturer's willingness to make the upfront payments. The manufacturer uses an implicit interest rate for the duration of the contract (maturity matched interest) to recognize interest income and increase the prepayment balance. When goods are received, the corresponding partial amount of prepayments (including the accreted interest) is expensed. The proponents of accreting prepayments assert that the applied accounting policy is in line with the time concept of money which is applied throughout IAS 39. They also point to, for example, IAS 18 paragraph 11, which states that when an arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest.

Factors against accreting interest on long-term prepayments

Opponents to accreting non-current prepayments to suppliers point out that over the term of the prepayments, the prepayments will not convert into cash but, rather, the entity receives future raw materials for its own use. Therefore, the prepayment is not accounted for as a financial instrument (IAS 32 – *Financial Instruments: Presentation* paragraph AG 11; IAS 39 paragraph 5) and for measurement purposes is scoped out from IAS 39. IFRS provides no special guidance for the measurement of prepayments. At the date the prepayments are made, they are measured at cost. Measurement at historical cost is the measurement method commonly adopted by entities when applying IFRS (paragraph 101 of the Conceptual Framework). The realisation of interest income requires that the contracts yield interest (IAS 18 – *Revenue* paragraph 29). No interest rate was agreed upon and none will be paid. Therefore, there is no basis for the realisation of interest income. The supplier does not owe interest to the manufacturer under any circumstance. In particular, if the market price of the raw material decreases, the manufacturer is not entitled to receive any cash refund ("interest") based on the prepayments. Instead, the manufacturer has to pay the contracted price for the goods or lose its prepayment.

Under IFRS income is only recognised when it can be measured reliably and it has a sufficient degree of certainty that the economic benefits will flow to the entity. (paragraph 92 and 93 of the Conceptual Framework; IAS 18 paragraph 18 and 29). In some cases, such as with contingent assets, the realisation must be virtually certain (IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets* paragraph 33 et seq.). Considering a contract term of over 10 years in a new industry, where the main objective of the contract is to share or transfer investment risk from the supplier to the manufacturer, where product prices and supply costs are volatile and in general are expected to decrease, it is not apparent that such a high degree of certainty of future economic benefit from such prepayment currently exists. Therefore, it is not appropriate to recognize imputed income.

In addition, it can be argued that the riskier the prepayment "investment" (i.e. due to volatility in the raw material price or in general due to the development of new markets in new industries), the higher the interest rate and the resulting accreted interest revenue should be (see IAS 18 paragraph 11). This correlation between risk and income recognition appears not to comply with the basic requirement that income must be probable and reliable in order to be recognized (IAS 18 paragraph 29).

IAS 18 paragraph 11, as argued by the accretion proponents, provides guidance only with respect to postponed customer payments; not to advanced payments. It does not address interest income on prepayments made to suppliers. IAS 18 paragraph 11 states that revenue cannot be recognized unless it is earned. IAS 18 paragraph 11 is in line with the requirement in paragraph 37 of the Conceptual Framework. The analogy to IAS 18 paragraph 11 for an assumed virtual interest income is in contrast to the purpose of the principle because it is not earned.

In the absence of an IFRS standard that specifically applies to a transaction, IAS 8 – *Accounting Policies, Changes in Accounting Estimates and Errors* paragraph 10 requires the manufacturer to establish an accounting policy which reflects the economic substance of the transaction. From an economic point of view the transaction can be seen as a transfer of investment risk in a new industry from the supplier to the manufacturer, instead of simply as a financing transaction. If the business plan is not successful or the production volume is not reached, the prepayment is lost.

In its start-up phase, this industry was impacted by raw material shortages. For the future, the market expects an increase in supply capacity with decreasing prices as the industry matures. The suppliers used the initial lack of supply, however, to persuade customers to enter into long-term supply contracts with significant prepayments (take-or-pay agreements), in order to ensure continued supply of this key raw material, which in fact resulted in a transfer of investment risk. Therefore, ensuring the future supply of the raw materials in light of the shortages was the main motivation for the manufacturer's prepayment, not financing the suppliers' expansion. The prepayment agreement can be viewed as being similar to a lease (or the partial acquisition of property plant and equipment) in that the manufacturer is contractually "leasing" (acquiring) future production capacity. Using IAS 17 – *Leases* as a more appropriate, relevant standard for analogy, no interest would be accreted on prepaid operating lease payments (IAS 17 paragraph 33).

Illustrative Example:

Below please find an illustrative example of the impact of the prepayments' accretion to interest income and operating expense. A contract term of 10 years has been used for illustrative purposes.

term of contract:	10 years;
prepayment (take or pa	1000
assumed interest rate:	6%

Accounting by accreting interest							vs. at amortised cost
year	tons to be delivered	prepayment used	interest income	interest as part of operating exp.	net P/L impact	book value	book value
1	30	30	60	2	58	1028	970
2	50	50	62	6	56	1034	920
3	70	70	62	13	49	1012	850
4	100	100	61	26	34	947	750
5	120	120	57	41	16	843	630
6	120	120	51	50	0	723	510
7	120	120	43	60	-17	586	390
8	130	130	35	77	-42	414	260
9	130	130	25	90	-65	220	130
10	130	130	13	103	-90	0	0
	1000	1000	468	468			

cost per unit (prepaid part) year 1:	1,06
cost per unit (prepaid part) year 10:	1,79
cost per unit without accreting interest:	1,00

In a developing industry, where production and supply are growing significantly, accreted interest income is expected to exceed the additional expense included in cost of sales, thereby resulting in a net benefit to the income statement, in the first years of such long term contract.

3. Questions to the IFRS Interpretations Committee

1. May prepayments made with respect to long-term supply agreements (take-or-pay) be accreted over the term of the agreement?

2. Is there any difference between contracts where an interest rate is included in the contract; that is, if the manufacturer pays in advance, he receives a predetermined discount? Does including an interest rate in the contract change the substance of the contract?

3. Would the accretion of interest be appropriate when viewing the transaction from the suppliers' side (i.e. a long-term prepayment received)? If so, do you believe that prepayments received (vs. paid) should be accreted by recognizing an implied interest expense over the term of the contract, noting that the accreted interest will ultimately be recognized into revenue once the raw materials have been delivered.

Appendix B: Exposure Draft *Revenue from contracts with customers*

A1. The exposure draft (ED) *Revenue from contracts with Customers* was issued in November 2011. Comments are to be received by March 2012. The final standard is expected to be published at the end of 2012. The Board has not yet decided on the effective date of the future standard. However, the Board has decided that it would not be effective sooner than for annual reporting periods beginning on or after 1 January 2015.

A2. According to the ED, an entity should recognise as revenue the amount of the transaction price (allocated to the performance obligation). When determining the transaction price, the entity should consider the effect of the time value of money (whether there is a prepayment or a deferred payment). An entity should apply those requirements retrospectively for existing contracts at the beginning of the reporting period in which the future standard will be applied for the first time.

> 58 In determining the transaction price, an entity shall adjust the promised amount of consideration to reflect the time value of money if the contract has a financing component that is significant to the contract. The objective when adjusting the promised amount of consideration to reflect the time value of money is for an entity to recognise revenue at an amount that reflects what the cash selling price would have been if the customer had paid cash for the promised goods or services at the point that they are transferred to the customer...
>
> 61 To adjust the promised amount of consideration to reflect the time value of money, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception... After contract inception, an entity shall not update the discount rate for changes in circumstances or interest rates.
>
> 62 An entity shall present the effects of financing separately from revenue (as interest expense or interest income) in the statement of comprehensive income.
>
> BC145 The boards decided that an entity should account for the effects of the time value of money if a contract has a financing component that is significant for the following reasons:
>
> (a) entities are not indifferent to the timing of the cash flows in a contract. Therefore, reflecting the time value of money portrays an important economic feature of the contract. A contract in which the customer pays for a good or service when that good or service is transferred to the customer is different from a contract in which the customer pays significantly before or after the good or service is transferred.

> (b) not recognising the financing component could misrepresent the profit of a contract. For example, if a customer pays in arrears, ignoring the financing component of the contract would result in full profit recognition on the transfer of the good or service, despite the ongoing cost to the entity of providing financing to the customer.
>
> (c) contracts with explicitly identified financing components would be accounted for consistently with contracts in which the financing component is implicit in the contract price.
>
> BC149 Some respondents also suggested that the boards should exempt an entity from reflecting in the measurement of the transaction price the effects of the time value of money associated with advance payments from customers. Those respondents commented that accounting for any effects of the time value of money arising from advance payments would:
>
> (a) represent a change from existing practices in which an entity typically does not recognise the time value of money implicit in advance payments;
>
> (b) 'gross up' revenue (for example, if the discount rate implicit in the contract resulted in the accretion of interest of CU21 over 2 years, revenue would be recognised at the amount of the CU121 rather than the CU100 paid in advance); and
>
> (c) not reflect the economics of the arrangement when the customer pays in advance for reasons other than financing (for example, the customer is a credit risk or is compensating the entity for incurring upfront contract costs).
>
> BC150 The boards decided not to exempt entities from accounting for the time value of money effects of advance payments because ignoring the time value of money effects of advance payments could substantially skew the amount and pattern of profit recognition if the advance payment is large and occurs well in advance of the transfer of the goods or services to the customer.

A3. IE8 in the exposure draft illustrates how to account for the effects of the time value of money when an upfront cash payment is paid to the seller for the sale of two products. The seller accounts for an interest expense and an increased revenue.

A4. It should also be noted that, according to the exposure draft (paragraph 60), as a practical expedient, an entity does not need to recognise the financing component if it is not significant, ie if the period between payment by the customer and the transfer of the goods or services is one year or less.

Appendix C: Staff analysis presented in the January 2012 Committee meeting

A5. We present below:

(a) the guidance applicable to prepayments;

(b) the factors supporting/against accretion of interest in long-term prepayments.

Guidance applicable to prepayments

A6. We note that prepayments are not financial instruments (IAS 32 *Financial Instruments: Presentation* AG11) and are scoped out from IAS 39 *Financial Instruments: recognition and Measurement* for measurement purposes.

> IAS 32 AG11 Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets. Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset.

A7. IAS 38 *Intangible Assets* (paragraph 68) states that expenditures on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria in IAS 38. IAS 38 (paragraph 70) also states that paragraph 68 does not preclude an entity from recognising a prepayment as an asset when payment for goods has been made in advance.

> IAS 38.70 Paragraph 68 does not preclude an entity from recognising a prepayment as an asset when payment for goods has been made in advance of the entity obtaining a right to access those goods. Similarly, paragraph 68 does not preclude an entity from recognising

a prepayment as an asset when payment for services has been made in advance of the entity receiving those services.

A8. We note that there is no specific guidance in the IFRS for the measurement of prepayments. We also note that a prepayment is the consideration:

(c) paid by the purchaser for a future delivery of inventories accounted for in accordance with IAS 2 *Inventories*;

(d) received by the supplier for a future sale of goods accounted for in accordance with IAS 18 *Revenue*.

A9. Therefore, the accounting for the prepayment is in our view closely linked to the initial recognition and measurement of the inventory (in the purchaser's financial statements) or to the recognition and measurement of revenue (in the supplier's financial statements). Inventories are initially recognised and measured at cost. Other standards use the cost for initial measurement of non-financial assets. So it might also be useful to look at the guidance provided in these standards on this issue.

View A: factors supporting the accretion of interest in long-term prepayments

A10. Proponents of view A note that the core principle of IAS 18 (paragraph 9) is to measure revenue at the fair value of the consideration received or receivable. IAS 18 specifies that in most cases, the amount of revenue is the amount of cash received. In other words, the principle is that when exchange of goods and services and cash occurs concurrently (or on normal credit terms), there is no financing component. Accordingly, when payment of cash is in advance or in arrears, there must be a financing component. According to proponents of view A, this is because the fair value is the selling price that would have been paid if the purchaser had paid cash for the goods at the date of delivery. In other words, the fair value is the selling price that would have been paid if the transaction did not contain a financing component. Therefore, assessing the fair value of the consideration received requires considering the time elapsed between the date of payment and the date of delivery of the goods in order to adjust the price paid (whether the date of payment is before or after the date of delivery). IAS 18 (paragraph 11) illustrates this principle by explaining that the fair value of the consideration may be less than the nominal amount of cash when, for example, the entity is providing interest-free credit to the buyer. According to proponents of view A, the fact that IAS 18 provides an example only when the payment is deferred does not mean that an entity should not apply the measurement principle described in paragraph 9, which is to determine the fair value of the consideration received when there is a prepayment. As a result, proponents of view A think that when the seller receives a prepayment, the seller should account for an interest expense so that revenue is measured at fair value when the sale of goods is recognised.

> IAS 18.9 Revenue shall be measured at the fair value of the consideration received or receivable.
>
> IAS 18.11 In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable. However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an entity may provide interest-free credit to the buyer or accept a note receivable bearing a below-market interest rate from the buyer as consideration for the sale of goods. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest. The imputed rate of interest is the more clearly determinable of either:
>
> (a) the prevailing rate for a similar instrument of an issuer with a similar credit rating; or
>
> (b) a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.

> The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue in accordance with paragraphs 29 and 30 and in accordance with IFRS 9.

A11. Proponents of view A think that accounting for tangible assets at cost or for inventories at cost does not preclude an entity from recognising the financing component if the goods or services are prepaid. IAS 16 *Property, Plant and Equipment* (paragraph 23) states that the cost of an item of PP&E is the cash price equivalent at the recognition date. Therefore, when payment of cash is in advance or in arrears, there is a financing element and the cost is not the cash paid but is instead the cash price equivalent at the recognition date of the item of PP&E. According to proponents of view A, assessing the cash price equivalent requires adjusting the cash paid to recognise the financing element. Proponents of view A note that IAS 2 *Inventories* (paragraph 18) also refers to arrangements that effectively contain a financing element. Therefore, they think that the same rationale applies to the accounting of inventories at cost in long-term supply contracts, ie financing elements should be recognised as interest income. According to proponents of view A, the fact that IAS 16 and IAS 2 provide examples only when the payment is deferred does not mean that an entity should not apply the principle of 'cash price equivalent at the recognition date' when there is a prepayment. As a result, proponents of view A think that when the purchaser makes a prepayment, the purchaser should account for an interest income so that inventory is measured at cost (ie the cash price equivalent) when the inventory is recognised.

> IAS 2.18 An entity may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing.

> IAS 16.23 The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms,

> the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is capitalised in accordance with IAS 23.
>
> IAS 38.32 If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent. The difference between this amount and the total payments is recognised as interest expense over the period of credit unless it is capitalised in accordance with IAS 23 Borrowing Costs.

A12. Proponents of view A also note that IAS 37 *Provisions, Contingent liabilities and Contingent assets* states that the measurement of a provision should also take into account the effect of the time value of money. They conclude from this that the concept of time value of money is not limited to financial instruments and also applies to non-financial liabilities.

> IAS 37.45 Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.
>
> IAS 37.46 Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting period are more onerous than those where cash outflows of the same amount arise later. Provisions are therefore discounted, where the effect is material.

A13. In conclusion, proponents of view A think that recognising the financing component of a transaction is in line with the concept of time value of money which is applied throughout the IFRSs. They do not think that IFRSs require the recognition of a financing component contained in a transaction only when payments are deferred. The same principle of recognising the financing component should apply when there are prepayments.

A14. Furthermore, they think that it is preferable if the accounting for the financing component is consistent between the financial statements of the supplier and the financial statements of the purchaser, ie the purchaser should account for an interest income resulting in an increase of the cost of inventories and the supplier should account for an interest expense resulting in an increase of revenues.

A15. Some argue that accounting for the effect of the time value of money does not reflect the substance of the arrangement when the prepayment is made for other reasons than financing. For example, the purchaser:

(e) might be in financial difficulty; or

(f) might compensate the supplier for incurring upfront contract costs; or

(g) might transfer an investment risk to the supplier; or

(h) might pay the supplier to secure supply of raw materials in the future years.

A16. Proponents of view A agree that there are other factors than the financing component that affect the determination of the price of the raw materials in the contract. But the existence of those other factors does not change the fact that there might also be a financing component in the arrangement.

A17. Furthermore, proponents of view A note that in the fact pattern submitted, the contract does not contain a lease. The result of the agreement in the IFRS financial statements is to account for the delivery of the raw materials in accordance with IAS 2. They acknowledge that it might be difficult to assess whether payments are in advance or in arrears in certain cases. In that case, the effect of time value of money should be assessed in comparison with typical credit terms for the transaction considered.

A18. With regard to the economic substance of the transaction, proponents of view A think that long-term prepaid supply contracts might include a financing component (whether an interest rate is explicitly identified or not). This financing component might be significant if the contract is longer than one year, ie if the period between payment of the raw materials and delivery of the raw materials is longer than one year. Proponents of view A think that it is reasonable to presume that the purchaser and the seller considered this financing component in setting the prices, ie the price paid for the raw materials is impacted due to the purchaser’s acceptance to make upfront payments. As a result, reflecting the financing component is important because proponents of view A think that it is a significant characteristic of the contract.

A19. With regard to the relevance of the information that is provided to the users of the financial statements, proponents of view A think that not reflecting the financing component distorts the financial statements and the assessment of the entity's performance when the impact is material. If the financial component is not reflected in the financial statements, the consequences would be the following:

(i) For the purchaser (ie the user/consumer of the goods), the margin recognised on the future sales of the goods produced using the raw materials is increased compared with the margin that would be recognised if the financing component is reflected in the financial statements;

(j) For the supplier, the margin recognised on the future sales of the raw materials is reduced compared with the margin that would be recognised if the financing component is reflected in the financial statements.

A20. Some also argue that the financing component should not be recognised because it cannot be measured reliably. Proponents of view A think that the financing component can be measured reliably because it is estimated at the contract inception based on the risk-free interest rate, the credit risk of the party that receives the financing (ie the seller) and the length of the financing in comparison with typical credit terms. This financing component does not depend on the variations of the interest rate or credit risk after the contract inception. It is not affected by the variations of the price of the raw material after contract inception (but volatility might be a factor impacting the determination of the price at contract inception).

A21. Proponents of view A do not think that the recognition of an interest income/expense requires that the contract identifies an explicit interest component or rate. According to proponents of view A, contracts that explicitly identify interests should be accounted for similarly as contract with implicit interests in the contract price. Otherwise, contracts that have similar characteristics would be accounted for differently based on the form rather than on the substance of the contract. This means that the implied interest rate used to accrete interests might be different from the stated interest in the contract.

A22. Some argue that the prepayment agreement can be viewed as being similar to a lease in that the manufacturer is contractually ‘leasing’ future production capacity. Using the requirements in IAS 17 *Leases* (and in SIC 15 *Operating leases-incentives*), no interest would be accreted on prepaid operating lease payments, ie prepayments would be amortised on a straight-line basis. However, Proponents of view A observe that the contract (as described in the fact pattern) is not in the scope of IAS 17 (or IFRIC 4). They acknowledge that the requirements in IAS 17 on operating leases do not reflect the financing component of a transaction. But they note that this is an exception in the IFRS literature. They do not think that analogising to IAS 17 in that case reflects the substance of the transaction or provides useful information to users.

View B: factors against the accretion of interest in long-term prepayments

A23. Proponents of view B note that prepayments are not financial instruments. Prepayments are non-refundable. The purchaser does not have a contractual right to receive cash, but has a right to receive future raw materials for its own use. The supplier does not have a contractual obligation to deliver cash, but has an obligation to deliver future raw materials. Therefore, prepayments are not accounted for as financial assets or liabilities and they are scoped out from IAS 39 for measurement purposes. Proponents of view B think that accreting interests on non-financial assets and liabilities is not appropriate.

A24. Proponents of view B also note that IFRS provides no special guidance for the measurement of prepayments. At the date the prepayments are made, they are measured at cost, which is the amount paid/received. The recognition of interest income requires that the contracts yield interest (IAS 18 paragraph 29). No interest rate was agreed upon and none will be paid. Therefore, according to proponents of view B, there is no basis for the realisation of interest income. The supplier does not owe interest to the manufacturer under any circumstance. In particular, if the market price of the raw materials decreases, the manufacturer is not entitled to receive any cash refund (’interest’) based on the prepayments. Instead, the manufacturer has to pay the contracted price for the goods or lose its prepayment.

A25. Under IFRS, income is only recognised when it can be measured reliably and it has sufficient degree of certainty that the economic benefits will flow to the entity (IAS 18 paragraphs 18 and 29). Considering a contract term of over 10 years in a new industry, where the main objective of the contract is to share or transfer investment risk from the supplier to the manufacturer, where product prices and supply costs are volatile and in general are expected to decrease, it is not apparent that such a high degree of certainty of future economic benefit from such prepayments currently exists. Therefore, according to proponents of view B, it is not appropriate to recognise imputed income.

A26. In addition, it can be argued that the riskier the prepayment ‘investment’ (ie due to volatility in the raw material price or in general due to the development of new markets in new industries), the higher the interest rate and the resulting accreted interest revenue should be (see IAS 18 paragraph 11). This correlation between risk and income recognition appears not to comply with the basic requirement that income must be probable and reliable in order to be recognised (IAS 18 paragraph 29).

A27. IAS 18 paragraph 11, as argued by the accretion proponents, provides guidance only with respect to postponed customer payments and not to advanced payments. It does not address interest income on prepayments made to suppliers. IAS 18 states that revenue cannot be recognised unless it is earned. The analogy to IAS 18 paragraph 11 for an assumed virtual interest income is in contrast to the purpose of the principle because it is not earned.

A28. From an economic point of view, proponents of view B think that the transaction can be seen as a transfer of investment risk in a new industry from the supplier to the manufacturer (instead of simply as a financing transaction). If the business plan is not successful or the production volume is not reached, the prepayment is lost. According to the submission, in its start-up phase, this industry was impacted by raw material shortages. For the future, the market expects an increase in supply capacity with decreasing prices as the industry matures. The suppliers used the initial lack of supply, however, to persuade customers to enter into long-term supply contracts with significant prepayments (take-or-pay prepayments), in order to ensure continued supply of this key raw material, which in fact resulted in a transfer of investment risk. Therefore, ensuring the future supply of the raw material in the light of the shortages was the main motivation for the manufacturer's prepayment, not financing the supplier's expansion.

A29. According to proponents of view B, the prepayment agreement can be viewed as being similar to a lease (or the partial acquisition of property plant and equipment) in that the manufacturer is contractually 'leasing' (acquiring) future production capacity. Using IAS 17 as a more relevant standard for analogy, no interest would be accreted on prepaid operating lease payments (IAS 17 paragraph 33).

Agenda criteria and staff's recommendation

A30. We have assessed the submission against the Committee's criteria. The submission highlights divergent interpretations on this issue. Outreach confirms that there is diversity in practice, although it appears that the prevalent practice is not to take into account the time value of money in long-term prepayments. We think that the issue is widespread and has practical relevance. We also think that financial reporting would be improved through the elimination of the diverse methods.

A31. In our view, a consensus on the issue could be reached on a timely basis and within the confines of existing IFRSs. The staff supports view A for the reasons presented above. We therefore recommend to the Committee to take the issue on its agenda, with the objective to clarify that a financing component contained in a contract should be recognised when the impact is significant (including a financing component associated with advance payments).

A32. However, the issue relates at least partially to the future standard on revenues that will replace IAS 18 and IAS 11. We note that this future standard would be effective for annual reporting periods beginning on or after 1 January 2015 and that the requirements on the time value of money would be applied retrospectively. We think that the proposed requirements in the revenue project confirm our understanding of the existing requirements in IAS 18, IAS 2 and IAS 16.

A33. Given that the future standard on revenue recognition would affect the current practice and that retrospective restatement would require extensive work for certain entities, we recommend to align the effective date of the clarifications to be made in the IFRS literature on the purchaser's accounting with the effective date of the future revenue standard. In our view, it would be preferable if the accounting for the financing component is consistent between the financial statements of the supplier and the financial statements of the purchaser. We also recommend using the guidance in the future revenue standard (paragraphs 58-62 of the exposure-draft) for assessing whether a transaction contains a financing component and whether this financing component is significant. In that case, clarifications would be needed only in IAS 2 (paragraph 18), IAS 16 (paragraph 23) and IAS 38 (paragraph 32). We also note that constituents will be able to comment on the revenue exposure-draft until March 2012 if they do not agree with the rationale developed in paragraphs 58-62 of the exposure-draft.

Questions to the Committee

Does the Committee agree to take the issue on its agenda, with the objective to clarify that a financing component contained in a contract should be recognised when the impact is significant?

Given the expected timing of the new revenue standard, does the Committee agree to align the effective date of the clarifications to be made in the IFRS literature with the effective date of the new revenue standard?

Does the Committee agree that the clarifications should focus on the purchaser's accounting because the new revenue standard will address the seller's accounting?

Appendix D: Illustrative example (simplified)

A34. We present below a simplified example to illustrate the impact of accretion of interest on long-term prepayments in the financial statements of the purchaser and the supplier. For simplicity reasons, the contract term is one year. In the fact pattern submitted, the prepayment is made at the inception of the contract and raw materials are delivered on a 10 year-period. In that case, the impact of accretion might be significant.

A purchaser agrees to make a prepayment of CU100 to the supplier on 1 January 20X1 for a defined quantity of raw materials to be delivered on 31 December 20X1. The prepayment is non-refundable. The market annual interest rate for financing the supplier on a 1 year period (at the date the contract is concluded) is 5%.

	Dr	(Cr)
Financial statements of the purchaser as at 1/01/20X1		
B/S Asset / Prepayments	100	
B/S Cash		100
Being the prepayment of CU100 to the supplier		
Financial statements of the purchaser as at 31 December 20X1		
B/S Asset / Prepayments	5	
P/L Interest income		5
Being the accretion of interest on the prepayment balance		
B/S Inventory	105	
B/S Asset / Prepayments		105
Being the receipt of inventory which had been prepaid by the purchaser		
Financial statements of the supplier as at 1/01/20X1		
B/S Cash	100	
B/S Liability / Cash received in advance		100
Being the receipt of cash from the purchaser as a prepayment for the materials to be delivered at a future date		
Financial statements of the supplier as at 31 December 2011		
P/L Interest expense	5	
B/S Liability / Cash received in advance		5

Being the accretion of interest on the liability/cash received in advance		
B/S Liability / Cash received in advance	105	
P/L Revenue		105
Being the recognition of revenue when raw materials are delivered to the customer		