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STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	IAS 2 *Inventories*		
Paper topic	Long-term prepayments in supply contracts		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Purpose of this paper

1. The IFRS Interpretations Committee (the 'Interpretations Committee') received a request seeking clarification on the accounting for long-term supply contracts of raw materials when the purchaser of the raw materials agrees to make significant prepayments to the supplier. The question is whether the purchaser should accrete interest on long-term prepayments by recognising interest income, resulting in an increase in the cost of inventories and, ultimately, the cost of sales.

2. At its meeting in February 2012 the IASB discussed this issue. (Agenda paper 8A is available at *http://www.ifrs.org/Meetings/Documents/IntComt0212b08A.pdf*) It agreed that a financing component contained in a purchase transaction should be identified and recognised separately. Consequently, at that meeting, the IASB asked the Interpretations Committee to clarify the purchaser's accounting through an Interpretation. The staff have waited until the finalisation of the IASB's proposals on revenue, which includes guidance on the time value of money, before recommencing work on this issue. IFRS 15 *Revenues from Contract with Customers* was issued in May 2015.

Structure of this paper

3. The paper is organised as follows:

    (a) background;

(b) current guidance about prepayments and the time value of money in IFRS;

(c) identification of a significant financing component;

(d) staff summary and recommendation;

(e) Appendix A: Extract from IFRS 15;

(f) Appendix B: Examples that illustrate the time value of money; and

(g) Appendix C: Original submission.

Background

4. The Interpretations Committee received a submission relating to long-term supply contracts in which the purchaser agrees to make prepayments to a supplier for raw materials. The prepayments are non-refundable and are offset against future orders for raw materials. The submitter asked three questions about these types of transactions:

    (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?

5. (The questions submitted were simplified following discussions with the submitter.)

6. At its January 2012 meeting the Interpretations Committee observed that there is mixed practice on the issue submitted. Outreach conducted with national standard-setters on this submission confirmed that there is diversity in practice, especially in Europe. Although responses varied, the prevalent practice was not to take into account the time value of money when accounting for long-term prepayments.

7. At that meeting the Interpretations Committee also noted that the Exposure Draft *Revenue from Contracts with Customers*, published in November 2011, dealt with the time value of money from the supplier's perspective. It stated 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; and that

(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.

8. The Interpretations Committee further observed that the principles regarding accounting for the time value of money in the seller's financial statements are similar to those in the customer's financial statements. At that meeting, the Interpretations Committee decided to ask the IASB whether it agrees with this observation and, if so, whether IFRS should be amended in order to align the purchaser's accounting with the seller's accounting.

9. The IASB discussed this issue at its February 2012 meeting. An extract of the February 2012 *IASB Update* summarises those discussions:

> At the February Board meeting, the Board agreed that a financing component contained in a purchase transaction should be identified and recognised separately. As a result, interest would be accreted on long-term prepayments made in a financing transaction. However, the Board noted that payments made when entering into a long-term supply contract might include premiums paid for securing supply or for fixing prices. In that case, the Board noted that it is not appropriate to accrete interest on these payments. Consequently, the Board tentatively decided that it should be made clear that the clarifications proposed should only apply to financing transactions, ie transactions in which prepayments are made for assets to be received in the future.
>
> The Board asked the Committee to consider addressing the diversity in accounting, not by amending the current literature as part of a separate Board project, but by clarifying the purchaser's accounting through an interpretation. The Board suggested that the interpretation could refer to the requirements in IAS 18 (on the measurement of revenue at the fair value of consideration received), in IAS 16 (on the measurement of cost as the cash price equivalent at the recognition date) and in IAS 23 (on capitalisation of borrowing costs that are attributable to the acquisition of a qualifying asset).

10. Following the finalisation of the revenue proposals, we have extended our analysis to include the requirements of IFRS 15. We also note that a broader, but similar, issue will be discussed at the December meeting of IASB's Emerging Economies Group.

Current guidance about prepayments and the time value of money in IFRS

Prepayments

11. At the meetings of both the Interpretation Committee and the IASB, it was noted that there is little general guidance on prepayments in IFRS.

12. In accordance with paragraph AG11 of IAS 32 *Financial Instruments: Presentation,* prepayments are not financial instruments and are scoped out of IAS 39 *Financial Instruments: Recognition and Measurement* for measurement purposes. Paragraph AG11 of IAS 32 states that:

> 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.

13. This suggests to some that prepayments would not generally be adjusted for the time value of money. We also note that 'advance payments for the acquisition of resources and raw materials' are explicitly excluded from the requirements of Topic 835-30 *Simplifying the Presentation of Debt Issuance Cost* in the *FASB Accounting Standards Codification*® (formerly, Accounting Principles Board 21: Interest on Receivables or Payables).

Time value of money

14. The topic was considered briefly by the *Conceptual Framework* team in their July 2014 Agenda Paper 10L. The paper discusses cash-flow-based measurement bases, and the need to reflect the time value of money in measurement.

15. The paper also includes the following point about discounting:

> A payment of CU100 to be received tomorrow is more valuable than the same payment to be received in 10 years. This difference arises because of the time value of

> money. Discounting the cash flow to be received in 10 years reflects the time value of money and provides useful information about the different values of these payments. Consequently, if an entity measures an item using a cash-flow-based measurement and the effect of the time value of money is significant for the cash flows associated with that item, then the entity should discount those cash flows to reflect the time value of money. This reflects the approach used in most recent Standards.

16. We note, however, that most of these discussions may be deleted in the final proposals as some think that they are too detailed for the *Conceptual Framework*.

17. For current, detailed guidance on the topic both the Interpretations Committee and the IASB referred to individual Standards:

    (a) guidance with respect to the purchase of assets; and

    (b) IFRS 15, which is effective from 1 January 2017.

Guidance with respect to the purchase of assets

18. There is guidance with respect to deferred payments for the acquisition of assets in IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*. Paragraph 18 of IAS 2 states that:

> 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.

19. We think it is clear that it was the IASB's intention that the financing component of the purchase agreement is recognised separately as an interest expense when payment is deferred.

20. Similarly, accounting for the interest expense arising from a financing component of the purchase agreement is addressed in both IAS 16 and IAS 38 in the circumstances when payment is deferred:

> 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.

21. In our view, the fact that all three Standards provide examples only when the payment is deferred and interest expense is incurred does not necessarily mean that an entity should not apply the principle of 'cash price equivalent at the recognition date' in the alternative case when there is a prepayment.

IFRS 15

22. IFRS 15 makes it clear that a seller should consider the effect of financing depending on whether there is a prepayment or a deferred payment:

> 60 In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.
>
> 65 An entity shall present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income. Interest revenue or interest expense is recognised only to the extent that a contract asset (or receivable) or a contract liability is recognised in accounting for a contract with a customer.

23. We have included for convenience an extract from IFRS 15 on the time value of money as Appendix A of this paper.

Summary

24. Based on this analysis, we think that recognising the financing component of a transaction separately, so that the transaction is recognised at its cash price, is applied throughout IFRS. We also think that IFRS 15 clearly shows that a financing component should be recognised both when payments are deferred and when payments are accelerated. In our view, therefore, the principle of recognising the financing component, explicitly required by paragraph 8 of IAS 2 for *deferred* payments, ie transactions financed by the supplier, should apply equally to payments made in advance, ie transactions financed by the purchaser.

25. Furthermore, as noted in the Interpretations Committee's discussions in January 2012, we 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 customer. The purchaser should account for interest income, resulting in an increase in the cost of inventories, and the supplier should account for interest expense, resulting in an increase in recognised revenue.

26. Appendix B to this paper includes an example from IFRS 15 that illustrates the time value of money. It also includes the same example reworked from the purchaser's perspective.

27. By analogy with the revenue guidance, adjusting the cost of inventory and costs of sales provides more relevant information when the contract with the supplier contains a financing component. The effect of the adjustment would be to measure inventory, and costs of sales, at the amount that the purchaser would have paid, excluding changes in the market price, at the time that the raw materials were received, ie at Year 2. This information is more relevant to users because it enables them to compare costs of sales across entities on a like-for-like basis that excludes the effect of financing components.

28. We think that it is the IASB's intention that the measurement basis for both revenue and, by analogy, inventories adjusts the contract price for any significant financing component of the arrangement, whether explicit or implied. It is important to identify, therefore, whether a contract contains a significant financing component.

Identification of a significant financing component

29. IFRS 15 includes guidance on how to identify a significant financing component in a contract with customer:

> 61 … An entity shall consider all relevant facts and circumstances in assessing whether a contract

> contains a financing component and whether that financing component is significant to the contract, including both of the following:
>
> (a) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and
>
> (b) the combined effect of both of the following:
>
> (i) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and
>
> (ii) the prevailing interest rates in the relevant market.

A purchaser that finances its supplier

30. The example included in Appendix B shows the IASB's intention to adjust the transaction for the financing component of a contract. We think that the guidance in IFRS 15 for identifying a financing component could be modified to provide guidance on identifying a significant financing component in a supply contract that gives rise to a prepayment at inception, ie in those circumstances when a purchaser is financing its supplier.

31. However, we think that it is important at this stage to make a distinction between the time value of money as a factor in a cash-flow-derived measurement basis and the objective of measuring both revenue and inventory in a way that excludes the effect of any financing arrangement. This is explained in paragraph BC232 of IFRS 15:

> The boards also decided to remove the term 'time value of money' from the discussion about adjustments for financing components, to reflect their decision that the focus is on whether the payment terms provide the purchaser or the entity with a significant benefit of financing. This is because the term 'time value of money' is a broader economic term that may suggest that it is necessary to adjust the promised amount of consideration in circumstances other than when the cash sales price may differ from the contractual payments.

32. We note that this discussion by the boards reflects a change between the second Exposure Draft and the final Standard; the boards decided to focus on the

narrower concept of a 'financing component', rather than the broader concept of 'time value of money'. In this paragraph the IASB highlights that there are some circumstances in which the transaction price should not be adjusted, ie when the gap between payment date and delivery date arises for reasons other than a financing arrangement.

33. The examples of transactions in IFRS that include a financing element generally reflect the seller financing the customer and not the other way round. The references in IAS 2, IAS 16 and IAS 38 are all related to the *deferral* of payment by the purchaser.

34. We think that these three Standards only refer to deferred payments because it is common commercial practice for a seller to provide a financing component to its purchaser to secure the sale, particularly in consumer or retail transactions. Such transactions often involve the customer purchasing a one-off, optional/ luxury item such as domestic furnishings or conservatories. The supplier offers credit to persuade the customer to make an elective purchase. ('Buy now, nothing to pay for 24 months.')

35. We think that this type of transaction is very different from the example in the submission because a manufacturer purchasing raw materials is a business-to-business transaction, rather than a retail/ consumer transaction. In addition, we note that the financing is the opposite way round in the example in the submission, ie the purchaser finances the supplier . We think that it is unusual in practice for a purchaser to finance its supplier, ie for the purchaser to offer an inducement for the supplier to enter into a contract. Instead we think that some prepayments are more in the nature of a deposit or a holding fee.

36. We have no robust information at this time about how prevalent such contracts are in practice, although informal staff discussions suggest that the circumstances when a purchaser finances its supplier are rare.

Messages received from outreach conducted at the time of the submission

37. On receipt of the original submission, we performed outreach with the national standard-setters. At that time, we were told that practice is mixed, both from one jurisdiction to another and within individual jurisdictions.

38. However, a majority of respondents indicated that the prevalent practice is not to accrete interest on long-term payments. According to the national standard-setters' responses to outreach conducted, prepayment arrangements are generally entered into for operational reasons, for example, to secure the supply of materials in the future or to fix the purchase price of the materials over a future period, and not for financing reasons.

Operational reasons to prepay on the acquisition of inventories

39. We think it is the IASB's intention to adjust the transaction price when there is a significant financing component of the contract and not to adjust the transaction price when there is no significant financing component. The IASB acknowledged that the prepayment may be made for reasons other than financing.

40. A prepayment might arise for operational reasons, such as:

    (a) the purchaser might be in financial difficulty and the supplier requires a deposit against credit risk;

    (b) the purchaser might compensate the supplier for incurring other upfront contract costs, such as plant or equipment, that are necessary to provide the goods or services bought;

    (c) the purchaser might pay the supplier in advance to secure a supply of raw materials in future years, particularly in times when demand exceeds supply; and

    (d) the purchaser might pay in advance to fix the purchase price of raw materials over a future period.

The submitter's example

41. The original submission is included as Appendix C of this paper.

42. It is not clear from the original submission whether the example being discussed includes a significant financing component or whether the prepayment has been made for operational reasons :

> … The contract sets the future prices for raw material… as well as the quantity of raw material 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 (ie a take-or-pay agreement. …
>
> … Growth of the newly developing industry is limited by the supply of raw materials (currently limited production capacity.) …
>
> … Product supply costs are volatile and are in general expected to decrease. …

> … 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. …
>
> … 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 supplier’s expansion. …

Staff summary and recommendation

43. In 2011 we established that there was diversity in practice because some entities reflected the time value of money and others did not. Since that time, IFRS 15 has clarified that the contract amount should be adjusted only if the contract has a significant financing component. .

44. In our view, if the 2011 reported diversity arose because some supply contracts contained a significant financing component and others did not (because the prepayment was made for operational reasons) there would have been no diversity at that time in applying IFRS. The different outcomes observed would be explained by the different facts and circumstance of the two types of transactions.

45. Bearing in mind the distinction made in IFRS 15 between the concept of the time value of money and a measurement objective to measure revenue at the cash price at the date of transfer, we think that we should now re-perform our outreach in a way that clarifies the operating and financing distinction made in IFRS 15.

46. We recommend that we collect more evidence about the nature of these transactions. We suggest conducting detailed outreach that would enable us to draw out how we distinguish, in each transaction, whether the prepayment was made for operational or financing reasons.

47. This would help us to determine whether all similar types of transactions are accounted for in a similar way or whether the reported diversity occurs between transactions of the same type. This outreach would also indicate whether transactions in which a purchaser finances its supplier are widespread.

48. Once that information is received, we could then re-assess this issue against our agenda criteria.

Future steps

49. If the outreach conducted indicates that there is no significant diversity in practice, an agenda decision referring to the distinction between financial and operational prepayments would further clarify the position. If the outreach conducted indicates that this should be taken on to our agenda, however, the staff would prepare an Interpretation incorporating the points discussed in this paper for presentation at a future meeting of the Interpretations Committee.

Question for the Interpretations Committee

Do you agree with the staff's recommendation to conduct outreach, based on the distinction made in IFRS 15 between prepayments to suppliers that arise from a financing component and those that arise from operational considerations?

Appendix A Extracts from IFRS 15

The existence of a significant financing component in the contract

60 In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

61 The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognise revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (ie the cash selling price). An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

(a) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and

(b) the combined effect of both of the following:

(i) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and

(ii) the prevailing interest rates in the relevant market.

62 Notwithstanding the assessment in paragraph 61, a contract with a customer would not have a significant financing component if any of the following factors exist:

(a) the customer paid for the goods or services in advance and the timing of the transfer of those goods or services is at the discretion of the customer.

(b) a substantial amount of the consideration promised by the customer is variable and the amount or timing of that consideration varies on the basis of the occurrence or non-occurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).

(c) the difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 61) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

63 As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

64 To meet the objective in paragraph 61 when adjusting the promised amount of consideration for a significant financing component, 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. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).

65 An entity shall present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income. Interest revenue or interest expense is recognised only to the extent that a *contract asset* (or receivable) or a contract liability is recognised in accounting for a contract with a customer.

Determining whether a contract includes a significant financing component

BC231 The boards considered whether the requirements for identifying a financing component should be based only on whether payment is due either significantly before, or significantly after, the transfer of goods or services to the customer. However, a number of respondents explained that this might have required an entity to adjust for the time value of money when the parties did not contemplate a financing arrangement as part of the negotiated terms of the contract. Those respondents explained that, in some cases, although there is a significant period of time between the transfer of the goods or services and the payment, the reason for that timing difference is not related to a financing arrangement between the entity and the customer. The boards agreed with those respondents and clarified their intention by specifying in paragraph 60 of IFRS 15 that an entity should adjust for financing only if the timing of payments specified in the contract provides the customer or the entity with a significant benefit of financing.

BC232 The boards also decided to remove the term 'time value of money' from the discussion about adjustments for financing components, to reflect their decision that the focus is on whether the payment terms provide the customer or the entity with a significant benefit of financing. This is because the term 'time value of money' is a broader economic term that may suggest that it is necessary to adjust the promised amount of consideration in circumstances other than when the cash sales price may differ from the contractual payments. In addition, the boards decided to refine the factors in paragraph 61 of IFRS 15 that an entity should consider when deciding whether a contract includes a significant financing component. Those factors require evaluation of:

(a) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services. If the entity (or another entity) sells the same good or service for a different amount of consideration depending on the timing of the payment terms, this generally provides observable data that the parties are aware that there is a financing component in the contract. This factor is presented as an indicator because in some cases the difference between the cash selling price and the consideration promised by the customer is due to factors other than financing (see paragraph BC233).

(b) the combined effect of (1) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services and (2) the prevailing interest rates in the relevant market. Although the boards decided that the difference in timing between the transfer of goods and services and payment for those goods and services is not determinative, the combined effect of timing and the prevailing interest rates may provide a strong indication that a significant benefit of financing is being provided.

BC233 In addition, the boards included criteria in paragraph 62 of IFRS 15 to clarify the circumstances in which a contract does *not* provide the customer or the entity with a significant benefit of financing:

(a) the customer has paid for the goods or services in advance and, the timing of the transfer of those goods or services is at the discretion of the customer. The boards noted that for some types of goods or services, such as prepaid phone cards and customer loyalty points, the customer will pay for those goods or services in advance and the transfer of those goods or services to the customer is at the customer's discretion. The boards expected that, in those cases, the purpose of the payment terms is not related to a financing arrangement between the parties. In addition, the boards decided that the costs of requiring an entity to account for the time value of money in these cases would outweigh any perceived benefit because the entity would need to continually estimate when the goods or services will transfer to the customer.

(b) a substantial amount of the consideration promised by the customer is variable and that consideration varies on the basis of factors that are outside the control of the customer or the entity. The boards observed that for some arrangements, the primary purpose of the specified timing or amount of the payment terms might not be to provide the customer or the entity with a significant benefit of financing but, instead, to resolve uncertainties that relate to the consideration for the goods or services. For example, in a royalty arrangement, the entity and the customer might not be willing to fix the price and timing of payment because there are significant uncertainties about the goods or services. The primary purpose of those payment terms may be to provide the parties with assurance of the value of the goods or services rather than to provide significant financing to the customer.

(c) the difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of financing to either the customer or the entity. In some circumstances, a payment in advance or in arrears in accordance with the typical payment terms of an industry or jurisdiction may have a primary purpose other than financing. For example, a customer may retain or withhold some consideration that is payable only on successful completion of the contract or on achievement of a specified milestone. Alternatively, the customer might be required to pay some consideration upfront to secure a future supply of limited goods or services. The primary purpose of those payment terms may be to provide the customer with assurance that the entity will complete its obligations satisfactorily under the contract, rather than to provide financing to the customer or the entity respectively.

BC234 The boards also observed that for many contracts, an entity will not need to adjust the promised amount of customer consideration because the effects of the financing component will not materially change the amount of revenue that should be recognised in relation to a contract with a customer. In other words, for those contracts, the financing component will not be significant. During their redeliberations, the boards clarified that an entity should consider only the *significance* of a financing component at a contract level rather than consider whether the financing is *material* at a portfolio level. The boards decided that it would have been unduly burdensome to require an entity to account for a financing component if the effects of the financing component were not material to the individual contract, but the combined effects for a portfolio of similar contracts were material to the entity as a whole.

Appendix B Examples that illustrate the time value of money

1. IFRS 15 contains an example of accounting for the time value of money in a contract with a customer. In the example, the entity is paid CU4,000 at contract inception, but the goods are not transferred to the customer until two years after contract inception.[1]

2. The following journal entries illustrate how the entity would account for the significant financing component:

    (a) recognise a contract liability for the CU4,000 payment received at contract inception:

Dr Cash	CU4,000	
Cr Contract liability		CU4,000

    (b) during the two years from contract inception until the transfer of the asset, the entity adjusts the promised amount of consideration (in accordance with paragraph 65 of IFRS 15) and accretes the contract liability by recognising interest on CU4,000 at 6 per cent for two years:

Dr Interest expense	CU494	
Cr Contract liability		CU494

    (CU494 = CU4,000 × (6%) pa for two years)

    (c) recognise revenue for the transfer of the asset:

Dr Contract liability	CU4,494	
Cr Revenue		CU4,494

3. In this example, revenue has been increased to reflect the price that would have been paid by the customer at the date of transfer, ie at Year 2. The financing component of the contract with the customer is presented separately and consideration is adjusted accordingly.

4. Mirroring this for the purchaser's perspective would give the following accounting treatment in the financial statements of the purchaser:

    (a) recognise a prepayment for the CU4,000 paid at contract inception:

Dr Prepayment	CU4,000	
Cr Cash		CU4,000

    (b) during the two years from contract inception until the receipt of the inventory, the entity adjusts the cost of acquisition and increases the

[1] In this paper, monetary items are denominated in 'currency units' (CU).

prepaid consideration by recognising interest on CU4,000 at 6 per cent for two years:

Dr Prepayment	CU494	
Cr Interest income		CU494

(c) recognise inventory on receipt of the asset:

Dr Inventory	CU4,494	
Cr Prepayment		CU4,494

Appendix C: Original 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 bal-

ance. 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.