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STAFF PAPER

July 2015

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 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 to clarify 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 considered 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 November 2014 the Interpretations Committee discussed this issue and how the guidance in IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, could inform that discussion. That Standard requires that if a contract contains a significant financing component, it should be reported separately as interest income or expense. At the November 2014 meeting, the Interpretations Committee asked the staff to conduct outreach to collect evidence about the nature of, and the reasons for, the prepayments made by purchasers in long-term supply contracts and to identify whether those supply contracts included a financing component or whether the purchaser made the prepayment for other reasons. The purpose of this paper is to present those findings.

Structure of this paper

3. The paper is organised as follows:

   (a) background;

   (b) recent outreach;

(c) current guidance about the time value of money in IFRS;

(d) assessment against our agenda criteria;

(e) staff summary and recommendation;

(f) Appendix A—Draft tentative agenda decision; and

(g) Appendix B—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 original submission is included as Appendix B of this paper. (The questions submitted were simplified following discussions with the submitter.)

Outreach conducted at the time of the submission

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

7. 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 the 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. The outreach established that there was diversity in practice because some entities reflected the time value of money and others did not.

8. Since those discussions, IFRS 15 has clarified that the contract amount should be adjusted if the contract has a significant financing component. Consequently, 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 could be explained by the different facts and circumstances of the two types of transactions.

9. At the November 2014 meeting you requested that we collect more evidence of the nature of the reported diversity by establishing whether the prepayments were made for operational or financing reasons. 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.

10. This topic has been discussed twice by the Interpretations Committee and once by the IASB. The papers discussed at those meetings are available on our website:

Meeting	Paper	Conclusion
Interpretations Committee January 2012	11	Referred the issue to the IASB.
http://www.ifrs.org/Meetings/Documents/110112AP11Accretinginterestonlongtermprepayments.pdf		
IASB February 2012	8A	Tentatively decided that a financing component should be recognised separately.
http://www.ifrs.org/Meetings/Documents/IntComt0212b08A.pdf		
Interpretations Committee November 2013	6	Asked the staff to conduct further outreach.
http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2014/November/AP06%20-%20Long-term%20prepayments%20in%20raw%20material%20supply%20contracts.pdf		

Recent outreach

High-technology entity

11. In December 2014 we asked a number of accounting firms and securities regulators if they could identify entities that entered into long-term supply contracts so that we could obtain more details about the nature of these arrangements. They were only able to identify one such entity and we had a detailed discussion with that respondent.

12. The respondent to our outreach request was a European preparer in a high-technology sector. The long-term supply contracts related to silicon, which became scarce in 2004–2005 due to an increased demand from a number of high-technology sectors that require silicon in their production process. The

entity entered into these long-term contracts with the supplier in order to secure its future supplies of silicon. The respondent considers that, since China entered into the silicon production, the market is now likely to be oversupplied.

13. In the respondent's view, their contract did not have a financing component—they entered into the contract to secure future supplies. In assessing whether the contract had a financing component, they thought that a key factor is whether the contract negotiations included a discussion of financing or the time vale of money. Because this subject was not considered in the negotiations, explicitly or implicitly, the respondent concluded that the supply contract did not contain a financing component. Accordingly, the entity does not accrete interest on the prepayments.

Global Preparers Forum

14. In March 2015 we asked the Global Preparers Forum (GPF) about this type of transaction. A few of the members of GPF had experience of this type of transaction. Two members said that they thought that this type of transaction was very unusual now, although it had been more common previously. Another member thought that when these types of transactions do occur, however, they would be for large amounts. (The staff note that the original submission date is from 2011.)

The submitter's example

15. The original submission is included as Appendix B of this paper.

16. 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. …

Summary

17. In our recent outreach we were only able to contact one entity that currently has this type of long-term supply contract. We are therefore unable to draw reliable conclusions about this issue. Consequently, we are unable to conclude whether there is diversity in practice or whether the diversity identified in 2011 is due to there being two types of long-term contracts—one type that contains a financing component and another that does not.

Current guidance about the time value of money in IFRS

18. We think, however, that it is clear in IFRS that if a long-term supply contract contained a financing component, that financing component should be recognised separately.

19. IFRS 15 makes it clear that a seller should consider the effect of financing in determining the transaction price:

> 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.

20. There is also guidance with respect to deferred payments for the acquisition of assets in IAS 2 *Inventories* (paragraph 18), IAS 16 *Property, Plant and Equipment* (paragraph 23) and IAS 38 *Intangible Assets* (paragraph 32) that makes it clear that if a contract contains a financing element, the difference between the purchase price on normal credit terms and the amount paid is recognised as interest over the period of financing.

21. 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 would therefore expect that for both revenue and inventories, the contract price would be adjusted for any significant financing component of the arrangement, whether explicit or implied.

Assessment against our agenda criteria

22. We have assessed this issue against the agenda criteria of the current *Due Process Handbook*:

Paragraph 5.16 states that we should address issues:	Agenda criteria satisfied?
that have widespread effect and have, or are expected to have, a material effect on those affected;	**No.** We are unable to conclude whether or not these types of transactions are widespread or whether the effect of recognising any financing component of a supply contract separately would be material.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**No.** We are unable to say whether there is diversity in practise or whether there are two types of long-term supply contracts, one of which has a financing component and another that does not.
that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	**Yes.** We think that the issue could be interpreted within the confines of IFRS 15, IAS 2, IAS 16 and IAS 38.
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)?	**No**. In the absence of evidence about the issue, and a broader range of information about the facts and circumstances of these types of transactions, it is difficult to see how this topic could be addressed in an effective and efficient manner.
The solution developed should be effective for a reasonable time period (paragraph 5.21).	**Yes.** There are no current IASB projects that are likely to affect this issue.

Staff summary and recommendation

23. One entity responded to our request for outreach and the GPF was able to supply only limited input on this occasion. On such a small sample, we are unable to draw conclusions about:

    (a) whether this type of transaction is widespread;

    (b) whether there is diversity in practice or whether the diversity identified in 2011 is due to there being two types of long-term contracts—one type that contains a financing component and another that does not; or

    (c) whether the effect of recognising any financing component separately as interest would be material to the entity.

24. In the absence of evidence about the issue, and details of the facts and circumstances relating to these transactions, it is difficult to see how we could address this topic efficiently and effectively.

25. Consequently, we think that the issue does not meet our agenda criteria and we therefore recommend that the topic is removed from the Interpretation Committee's agenda.

26. We do note, however, that following the issuance of IFRS 15 in May 2014 it is now clear that if a long-term supply contract contains a significant financing component, that financing component of the transaction should be recognised separately.

Questions for the Interpretations Committee
Do you agree with the staff's recommendation to remove this topic from the Interpretations Committee's agenda? Do you agree with the wording of the tentative agenda decision included in Appendix A?

Appendix A—Draft tentative agenda decision

IAS 2 *Inventories*—Prepayments in long-term supply contracts

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 considered 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.

The Interpretations Committee discussed this issue and how the guidance in IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, could inform that discussion. The Interpretations Committee noted that IFRS 15 requires that if a long-term supply contract contains a significant financing component, that financing component of the transaction should be recognised separately as interest income or expense.

The Interpretations Committee conducted outreach on this issue, but the outreach returned very limited results. In the absence of evidence about this issue, and a broader range of information about the facts and circumstances relating to these transactions, the Interpretations Committee thought it would be difficult for it to address this topic efficiently and effectively.

The Interpretations Committee concluded that this issue did not meet its agenda criteria and therefore it [decided] to remove this issue from its agenda.

Appendix B—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.