STAFF PAPER

November 2015

IFRS Interpretations Committee Meeting

Project	**IAS 2–Prepayments in long-term supply contracts**		
Paper topic	Tentative agenda decision: comment letter analysis		
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Introduction

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 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.

3. In that outreach we were only able to contact one entity that currently has this type of long-term supply contract. Our analysis of this issue was discussed in Agenda Paper 3 of the Interpretations Committee's July 2015 meeting.[1]

4. 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

[1] That paper is available on our website: http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2015/July/AP03%20-%20Long-term%20prepayments%20in%20inventory%20supply%20contracts.pdf

effectively. Accordingly, at its July 2015 meeting, the Interpretations Committee tentatively decided not to add this topic to its agenda.

5. This paper analyses the comment letters received in response to that tentative agenda decision.

Paper structure

6. The paper is organised as follows:

   (a) comment letter summary;

   (b) topics discussed in the comment letters;

   (c) summary and staff recommendation; and

   (d) Appendix A—tentative agenda decision for finalisation.

7. The comment letters received on the tentative agenda decision published in *IFRIC Update* in July 2015 are attached as a separate Agenda Paper 6A, Appendix B—Comment letters received.

Comment letter summary

Analysis of respondents

8. We received three comment letters on the tentative agenda decision:

Nature of respondent	**Number**
Accounting firms	2
Standard-setters	1
Total	**3**

Geographical location of respondent	**Number**
Global	2
Europe	1
Total	**3**

9. One respondent, Deloitte, agreed with the decision not to take the issue onto the Interpretation Committee's agenda for the reasons given in the tentative agenda decision.

10. A second respondent, the Accounting Standards Committee of Germany (DRSC), thought that the issue should be taken onto the Interpretations Committee's agenda because it thinks that IFRS does not treat financing arrangements consistently; that the wording of the tentative agenda decision does not add clarity to this issue; and that these transactions are common in its jurisdiction.

11. The third respondent, Ernst and Young Global Limited (EY), also thinks that this issue should be taken onto the Interpretations Committee agenda or, failing that, escalated to the IASB. In its view, there currently is insufficient guidance in IFRS about how to identify and account for financing arrangements. It is also unclear how existing guidance should be applied by analogy to other types of transactions. The respondent is aware of many instances of prepayments in long-term supply contracts, particularly in emerging economies and the commodities sector.

Topics discussed in the comment letters

12. The staff has identified three areas of concern in the comment letters received:

    (a) guidance in IFRS with respect to financing arrangements;

    (b) the incidence of these types of arrangements; and

    (c) how the guidance on financing arrangements in IFRS 15 *Revenue from Contracts with Customers* should be applied in practice to these types of arrangements.

Guidance in IFRS with respect to financing arrangements

13. The DRSC thinks that the guidance with respect to financing arrangements is not consistent within IFRS. In its letter it notes that IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* contain a requirement to account separately for a financing component in the case of a deferred payment, but none of them contain an explicit requirement to require separation of arrangements involving advance payments between financing and non-financing components. EY makes a similar point and goes on to say that there is no presumption of symmetrical accounting between a buyer and a seller in IFRS.

14. This point was also made during the Interpretations Committee's deliberations in Agenda Paper 6 IAS 2 *Inventories—Long-term payments in supply contracts* presented at the Interpretations Committee's November 2015 meeting.[2]

15. The staff still do not think that the omission of guidance on advance payments from IAS 2, IAS 16 and IAS 38 is significant. In the staff's view, these Standards are silent about advance payments because deferred payment is the more common type of financing arrangement in a supply contract, regardless of whether that contract is for inventories, property plant and equipment of intangible assets. The staff further note that the original dates of these Standards (1993, 1993 and 1998 respectively) significantly predates the types of 'newly developing industry' referred to in the submission made in 2011. In its deliberations the Interpretations Committee noted that IFRS 15, issued in 2014, explicitly refers to both advance and deferred payments.

16. The DRSC takes its view of inconsistent guidance further in that it contends that the recent Draft Interpretation *Foreign Currency Transactions and Advance Consideration* is an example of financing arrangements being treated differently in different circumstances because, in that Draft Interpretation, advance revenue is measured using an exchange rate at the point of payment and deferred revenue is measured at the date of service.

17. The staff do not agree that this is an example of inconsistency. Separate accounting for a financing component is based on the financing period being the difference in the timing of performance by the two parties. Each party performs at a potentially different time—the supplier on delivery of the goods and the customer at the time of payment. (In a cash sale, both perform at the same time and there is no financing period.) The staff think, therefore, that the Draft Interpretation proposes a different point in time to identify the exchange rate used to convert an advance payment from the one used to convert a deferred payment in order to reflect the different performance points of either party. This use of a different point in time does not represent applying a different principle to advance payments compared with deferred payments. Instead it recognises that each has a different recognition point with respect to performance.

18. As a final point, EY queries why the title of the tentative agenda decision refers to IAS 38, but not IAS 16. Given that the initial submission related to IAS 2, the staff accept this comment and, instead of including IAS 16, IAS 38 and IFRS 9 in the title, recommend that the original project title, IAS 2 *Inventories—Prepayments in long-term supply contracts*, is used for the final agenda decision.

[2] That paper is available on our website: http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2014/November/AP06%20-%20Long-term%20prepayments%20in%20raw%20material%20supply%20contracts.pdf

Guidance in IFRS 15

19. In its comment letter, EY raises several questions about how the guidance on financing arrangements in IFRS 15 should be applied in practice to these types of arrangements. In particular, it queries whether that Standard's guidance about the identification of financing components and the practical expedient relating to financing arrangements of less than one year should be applied to long-term prepayments in supply contracts.

20. The staff note that IFRS 15 was developed over a number of years with reference to a range of specific types of revenue transactions. All aspects of the Standard were tested against these revenue transactions at each stage in the IASB's deliberations to ensure that the guidance was both specific and clear. In the staff's view, it is not the detail of this guidance, which has been developed with reference to a revenue transaction, that should be applied to supply contracts. Instead, it is the over-riding principle in IFRS 15, ie if an arrangement includes a financing component, that financing component should be accounted for separately from the performance component.

Incidence of these types of transactions

21. Both the DRSC and EY are aware of a number of examples of these types of long-term supply contracts. However, because of the confidential nature of the relationships involved, the IASB still does not have access to detailed information about the types of arrangements made or whether these arrangements were entered into as a financing arrangement or for some other purpose.

22. The staff note that the detailed guidance referred to in paragraph 19 can only be developed by the Interpretations Committee, or the IASB, if it had detailed access to information about these types of transactions.

23. Consequently, the staff do not see that the Interpretations Committee, or the IASB, are yet in a position to address this issue in an efficient or effective manner.

Subsequent outreach

24. In later discussions with one comment letter respondent, they suggested that the tentative agenda decision should be extended to include reference to:

    (a) the Interpretations Committee accepting that there may be reasons, other than financing, for agreeing to an advance payment;

    (b) the absence of guidance in IAS 2, IAS 16 and IAS 38 about guidance on advance payments;

(c) the need to make appropriate disclosures about significant advance payments;

(d) the lack of robust evidence of diversity in outreach; and

(e) a recommendation that the Interpretations Committee refer this issue to the IASB.

25. The staff think that the Interpretations Committee adequately considered all relevant points in its deliberations and does not see a need to revise the wording agreed at the July 2015 meeting of the Interpretations Committee.

Staff summary and recommendation

26. In the staff view, the respondents do not provide any new evidence or information about these transactions that would support a further discussion of the issue by the Interpretations Committee.

27. Consequently, we think that the circumstances as at the Interpretations Committee's July 2015 meeting on this topic remain unchanged, regardless of the comment letters received because:

(a) we still do not know whether there is diversity in practice or whether the differences in accounting 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; and

(b) we do not know whether the effect of recognising any financing component separately as interest would be material to the entity.

28. 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.

29. In addition, we think that the general principle within IAS 2, IAS 16, IAS 38 and IFRS 15 about advance and deferred payments makes it is clear that if a long-term supply contract contains a significant financing component, that financing component of the transaction should be recognised separately.

30. Consequently, we think that the Interpretations Committee's conclusions are still valid and we recommend that it should finalise the tentative agenda decision as it was originally worded in the July 2015 *IFRIC Update*, subject only to a change in title as noted in paragraph 18.

Question for the Interpretations Committee

Do you agree with the staff's recommendation to finalise the tentative agenda decision as worded in the July 2015 edition of *IFRIC Update*, subject only to a change in title?

Appendix A
Tentative agenda decision for finalisation

Inserted text is underlined and deleted text is struck through.

~~**IAS 2 *Inventories* and IAS 38 *Intangible Assets*—Should interest be accreted on prepayments in long-term supply contracts?**~~

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.