Initial measurement of payables when payment is deferred

The South African Financial Reporting Standards Council (FRSC) has drafted this paper with the objective of raising the above-mentioned issue with EEG members and to get their input. In this regard, there are a number of questions that we have posed at the end of this paper.

Summary of the issue

IFRS 15 *Revenue from Contracts with Customers*, applied together with revised IFRS 9 *Financial Instruments* (i.e. containing the consequential amendments from the issue of IFRS 15) have addressed the tension that exists under currently effective standards with respect to significant financing components from the perspective of the seller, when payment does not coincide with the timing of transfer of the goods or service. (Both IFRS 15 and IFRS 9 (revised) are effective from 1 January 2018.) However, no amendments have been made in this regard for the buyer. As a result, the FRSC would like to make submission to the IASB to address this.

What is the issue?

1. The accounting standards applicable to the purchases side of a transaction (IAS 2 *Inventory*, IAS 16 *Property, Plant and Equipment* & IAS 38 *Intangible Assets*) contemplate discounting when the transaction contains a financing element:
    a. Paragraph 18 of IAS 2 states: *"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 over the period of the financing."*
    b. Paragraph 23 of IAS 16 states: *"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 Borrowing Costs."*
    c. Paragraph 32 of IAS 38 states: *"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 an interest expense over the period of credit unless such interest is capitalised in accordance with IAS 23 Borrowing Costs."*
2. In contrast, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 (including the version containing the consequential amendments from the issue of IFRS 15), which are applicable to the payables side of the transaction, require the payables to be recognised initially at their fair value[1], unless the effect of not discounting is immaterial, in which case they can be recognised at their face value[2]. In environments where interest rates are moderate to high, the

[1] IAS 39. 43 and paragraph 5.1.1 of IFRS 9
[2] In previous versions of IAS 39, this was explicitly stated in AG79 of the Application Guidance; and for IFRS 9, this was previously stated in paragraph B5.4.12. When IFRS 13 *Fair Value Measurement* was issued, this guidance was removed from IAS 39, since IFRS 13 provides guidance on determining fair value. Subsequently, BC 138A was added to the Basis for Conclusions to IFRS 13 to clarify that the removal of this explicit guidance

effect of not discounting may not be immaterial for periods less than 12 months; and hence could be material for periods as short as 3 or 6 months. In South Africa, the current prime interest rate is 10.5% pa. Depending on credit risk, the actual borrowing rate applicable to an entity could be higher or lower. Clothing retailers in South Africa provide 6-months' interest-free credit. In other words, the cash price is the same as the price that needs to be paid over 6 months if a customer has been granted such credit.

3. It is acknowledged (as it is acknowledged and specifically addressed in IFRS 15.62(c)) that payment may not coincide with the timing of transfer of the goods or service for reasons other than the providing of finance. For example, a customer may be able to retain or withhold payment until the successful completion of the project or reaching a particular milestone. However, it is submitted that, using the principles in IFRS *13 Fair Value Measurement* the fair value of the payables would take account of the time value of money (unless immaterial) regardless of the reasons why payment does not coincide with the timing of receipt of the goods or services. Hence, there is tension between the debit and credit sides of the transaction for the buyer. If there is no financing component:
    a. the purchases side of the transaction can ignore the deferral of payment and be recognised at the face value of the consideration payable;
    b. however, the payable side needs to reflect the effect of the time value of money, if material.
4. The tension in the aforementioned paragraph also exists under currently effective standards for the seller for similar reasons. However, once IFRS 15 and the revised IFRS 9 are applied, this tension for the seller is removed. This is because IFRS 9[3] has been amended to address the initial measurement of trade receivables which do not contain a significant financing component as set out in IFRS 15 (or to which the practical expedient[4] in IFRS 15 has been applied). IFRS 9 revised includes an exception to the general principle that all financial instruments should be measured initially at fair value. Hence, these aforementioned receivables are measured at the same amount as the revenue determined under IFRS 15. However, there is no equivalent exception for the initial measurement of the payable which the buyer would recognise in the same transaction. The FRSC believes that there should be symmetry for the buyer and the seller in this regard. In addition, it would be misleading for an entity that buys and sells goods on credit terms of say 6 months, to reflect the receivable at its face value and the payable at its present value (if the effect of not discounting is not immaterial).
5. In addition, the FRSC continues to be concerned about the wording in IAS 2, IAS 16 and IAS 38 which imply that there may *only* be a financing element if payment is deferred 'beyond *normal* credit terms'. What are '*normal* credit terms'? It is submitted that it might be *normal* (i.e. usual

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was not intended to imply that it no longer applied. Materiality is a concept that should always be applied, and that IAS 8.8 already permits entities not to apply IFRS requirements when the effect is immaterial.

[3] Per paragraph 5.1.3 of IFRS 9, despite the general requirement in paragraph 5.1.1 to use fair value on initial recognition; trade receivables that do not have a significant financing component under IFRS 15 are measured at their transaction price.

[4] IFRS 15.63, provides a practical expedient which allows an entity not to adjust the amount of promised consideration for the effects of a significant financing component if the entity expects, at inception of the contract, that the period between when the entity transfers a promised good or service and when the customer pays for that good or service will be one year or less.

or customary) to provide customers with 6-months' interest-free credit in a particular industry in a particular jurisdiction; while in others it may not. It is contended that even though such credit terms might be *normal*, there could still be a significant financing element if interest rates are moderate to high. Accordingly, the FRSC believes that there is no conceptual basis for using what is *normal* as a means to determine whether there is a financing component. The FRSC believes that such wording should be deleted.

Request to the IASB

6. The FRSC is considering making submission to the IASB to consider the issue and to align the treatment for payables with that of receivables by make the following amendments:
   a. Align the wording in IAS 2, IAS 16 and IAS 38 relating to financing elements to the wording in IFRS 15 on significant financing components (and in so doing delete the notion of '*normal* credit terms'), including the practical expedient of 12-months, such that there is consistency/symmetry with respect to the measurement of the financial instruments arising from both sales and purchase transactions; and
   b. Amend IFRS 9 to contain an exception for payables similar to that for receivables which do not contain a significant financing component or to which the practical expedient has been applied.

Questions to EEG members

1 Do you agree that there is tension under currently effective standards between the debit and credit side of a purchase transaction? If not, please explain why. If yes:
   a. Does this cause an issue in practice? If not, please explain why.
   b. How does your jurisdiction deal with it?
   c. Is there published guidance or interpretations in your jurisdiction?
   d. Is there diversity in practice?

2 What types of payment periods are common in your jurisdiction? For example, do you have 6 months' interest-free credit?

3 What are current interest rates in your jurisdiction?

4 Do you believe that the IASB should address this issue? Please explain why.

5 What is your suggestion as to how the IASB should address this issue?