IFRIC Update June 2021

IFRIC *Update* is a summary of the decisions reached by the IFRS Interpretations Committee (Committee) in its public meetings. Past *Updates* can be found in the IFRIC *Update* archive.

The Committee met on 8–9 June 2021, and discussed:

Committee's tentative agenda decisions

- TLTRO III Transactions (IFRS 9 *Financial Instruments* and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*)—Agenda Paper 4
- Economic Benefits from Use of a Windfarm (IFRS 16 *Leases*)—Agenda Paper 5

Agenda decisions for Board consideration

- Costs Necessary to Sell Inventories (IAS 2 *Inventories*)—Agenda Paper 2
- Preparation of Financial Statements when an Entity is No Longer a Going Concern (IAS 10 *Events after the Reporting Period*)—Agenda Paper 3

Other matters

- Work in Progress—Agenda Paper 6

Addendum to IFRIC Update—Committee's agenda decisions

- Costs Necessary to Sell Inventories (IAS 2 *Inventories*)—Agenda Paper 2
- Preparation of Financial Statements when an Entity is No Longer a Going Concern (IAS 10 Events after the Reporting Period)—Agenda Paper 3

Related information

The work plan

Supporting consistent application

Committee's tentative agenda decisions

The Committee discussed the following matters and tentatively decided not to add standard-setting projects to the work plan. The Committee will reconsider these tentative decisions, including the reasons for not adding standard-setting projects, at a future meeting. The Committee invites comments on the tentative agenda decisions. Interested parties may submit comments on the open for comment page. All comments will be on the public record and posted on our website unless a respondent requests confidentiality and we grant that request. We do not normally grant such requests unless they are supported by a good reason, for example, commercial confidence. The Committee will consider all comments received in writing up to and including the closing date; comments received after that date will not be analysed in agenda papers considered by the Committee.

TLTRO III Transactions (IFRS 9 *Financial Instruments* and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*)—Agenda Paper 4

The Committee received a request about how to account for the third programme of the targeted longer-term refinancing operations (TLTROs) of the European Central Bank (ECB). The TLTROs link the amount a participating bank can borrow and the interest rate the bank pays on each tranche of the operation to the volume and amount of loans it makes to non-financial corporations and households.

The request asks:

a. whether the TLTRO III tranches represent loans with a below-market interest rate and, if so, whether the borrowing bank is required to apply IFRS 9 or IAS 20 to account for the benefit of the below-market interest rate;
b. if the bank applies IAS 20 to account for the benefit of the below-market interest rate:
   i. how it assesses in which period(s) it recognises that benefit; and
   ii. whether, for the purpose of presentation, the bank adds the amount of the benefit to the carrying amount of the TLTRO III liability;
c. how the bank calculates the applicable effective interest rate;
d. whether the bank applies paragraph B5.4.6 of IFRS 9 to account for changes in estimated cash flows resulting from the revised assessment of whether the conditions attached to the liability have been met; and
e. how the bank accounts for changes in cash flows related to the prior period that result from the bank's lending behaviour or from changes the ECB makes to the TLTRO III conditions.

Applying the requirements in IFRS Standards

The Committee observed that IFRS 9 is the starting point for the borrowing bank to determine its accounting for TLTRO III transactions because each financial liability arising from the bank's participation in a TLTRO III tranche is within the scope of IFRS 9. The bank:

a. determines whether it bifurcates any embedded derivatives from the host contract as required by paragraph 4.3.3 of IFRS 9;
b. initially recognises and measures the financial liability, which includes determining the fair value of the financial liability, accounting for any difference between the fair value and the transaction price and calculating the effective interest rate; and
c. subsequently measures the financial liability, which includes accounting for changes in the estimates of expected cash flows.

The Committee noted that the questions the request asks are unrelated to the existence of an embedded derivative and, therefore, this agenda decision does not discuss the requirements in IFRS 9 with respect to the separation of embedded derivatives.

Initial recognition and measurement of the financial liability

Applying paragraph 5.1.1 of IFRS 9, at initial recognition a bank measures each TLTRO III tranche at fair value plus or minus transaction costs, if the financial liability is not measured at fair value through profit or loss. A bank therefore determines the fair value of the liability using the assumptions that market participants would use when pricing the financial liability as required by IFRS 13 *Fair Value Measurement*. The fair value of a financial instrument at initial recognition is normally the transaction price—that is, the fair value of the consideration given or received (paragraphs B5.1.1 and B5.1.2A of IFRS 9). If the fair value at initial recognition differs from the transaction price, paragraph B5.1.1 requires a bank to determine whether a part of the consideration given or received is for something other than the financial liability.

The Committee observed that determining whether an interest rate is a below-market rate requires judgement based on the specific facts and circumstances of the relevant financial liability. Nonetheless, a difference between the fair value of a financial liability at initial recognition and the transaction price might indicate that the interest rate on the financial liability is a below-market rate.

If a bank determines that the fair value of a TLTRO III tranche at initial recognition differs from the transaction price and that the consideration received is for only the financial liability, the bank applies paragraph B5.1.2A of IFRS 9 to account for that difference.

If a bank determines that the fair value of a TLTRO III tranche at initial recognition differs from the transaction price and that the consideration received is for more than just the financial liability, the bank assesses whether that difference represents a government grant as defined in IAS 20. The Committee noted that if the difference represents a government grant, paragraph 10A of IAS 20 applies *only* to that difference. The bank applies IFRS 9 to account for the financial liability.

Do TLTRO III tranches contain a government grant in the scope of IAS 20?

IAS 20 defines government as referring to ‘government, government agencies and similar bodies whether local, national or international’. IAS 20 also defines government grants as ‘assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity’.

Paragraph 10A of IAS 20 requires an entity to treat as a government grant the benefit of a government loan at a below-market rate of interest and apply IAS 20 to account for that benefit. The benefit of a below-market interest rate is the difference between the initial carrying amount of the loan determined by applying IFRS 9 and the proceeds received. Paragraphs 7, 12 and 20 of IAS 20 specify requirements for the recognition of government grants in profit or loss.

The Committee observed that TLTRO III tranches would contain a government grant in the scope of IAS 20 only if it were determined that:

a. the ECB meets the definition of government in IAS 20;

b. the interest rate charged on the TLTRO III tranches is a below-market interest rate; and
c. the TLTRO III transactions with the ECB are distinguishable from the borrowing bank's normal trading transactions.

The Committee observed that making these determinations require judgement based on the specific facts and circumstances. The Committee therefore said it is not in a position to conclude on whether the TLTRO III tranches contain a government grant in the scope of IAS 20.

The Committee acknowledged that judgement may also be required to identify the related costs for which the grants, if any, are intended to compensate. The Committee nonetheless concluded that if the TLTRO III tranches contain a government grant in the scope of IAS 20, the requirements in IAS 20 provide an adequate basis for the bank to determine how to account for that government grant.

Calculating the effective interest rate on initial recognition of the financial liability

For the purpose of measuring financial liabilities, Appendix A to IFRS 9 defines both the amortised cost of a financial liability and the effective interest rate. Calculating the effective interest rate requires an entity to estimate the expected cash flows through the expected life of the financial liability.

In calculating the effective interest rate for a TLTRO III tranche on initial recognition, the question arises as to what to consider in estimating the expected future cash flows and, specifically, whether the expected future cash flows reflect an assessment of whether the bank will satisfy the conditions attached to the liability. The Committee noted that the question of what to consider in estimating the expected future cash flows for the purpose of calculating the effective interest rate is also relevant to fact patterns other than that described in the request. The Committee therefore concluded that considering how to reflect uncertain conditions in calculating the effective interest rate is a broader matter, which it should not analyse solely in the context of TLTRO III tranches. This is because such an analysis could have unintended consequences for other financial instruments, the measurement of which involves similar questions about the application of IFRS Standards. The Committee is therefore of the view that this matter should be considered as part of the post-implementation review of the classification and measurement requirements in IFRS 9, together with similar matters already identified in the first phase of that review.

Subsequent measurement of the financial liability at amortised cost

The contractual terms of the TLTRO III tranches require interest to be settled in arrears on maturity or on early repayment of each tranche. There is therefore only one cash flow on settlement of the instrument.

The original effective interest rate is calculated based on estimated future cash flows at initial recognition as required by IFRS 9. The Committee noted that whether a bank adjusts the effective interest rate over the life of a tranche depends on the contractual terms of the financial liability and the applicable requirements in IFRS 9. Paragraphs B5.4.5 and B5.4.6 of IFRS 9 specify requirements for how an entity accounts for changes in estimated future cash flows.

Paragraph B5.4.5 applies to floating-rate financial liabilities, the estimated future cash flows of which are revised to reflect movements in the market rates of interest. Periodic re-estimations of those cash flows to reflect such movements alter the effective interest rate. IFRS 9 does not elaborate on what is meant by floating rate. However, the Committee observed that a financial instrument with variable contractual cash flows—which can periodically be adjusted to reflect movements in the market rates of interest—is a floating-rate financial instrument.

The Committee also observed that a floating-rate financial instrument may consist of a variable interest rate element, which is reset to reflect movements in the market rates of interest (for example, the ECB rate on the main refinancing operations) plus or minus other elements, which are fixed and therefore not reset to reflect movements in the market rates of interest (for example, the fixed 50 basis points discount given by the ECB on particular TLTRO III tranches for a fixed period).

When considering how to account for changes in cash flow estimates, the Committee noted that paragraph B5.4.5 of IFRS 9 applies only to the variable interest rate element of a floating-rate instrument (as far as it reflects movements in the market rates of interest) and not to other interest rate elements of the instrument (which are typically not reset to reflect movements in the market rates of interest).

Paragraph B5.4.6 of IFRS 9 applies to changes in estimated future cash flows of financial liabilities other than those dealt with in paragraph B5.4.5, irrespective of whether the change arises from a modification or another change in expectations. However, when changes in contractual cash flows arise from a modification, an entity assesses whether those changes result in the derecognition of the financial liability and the initial recognition of a new financial liability by applying paragraphs 3.3.2 and B3.3.6 of IFRS 9.

The Committee considered a situation in which, as a result of a modification that does not result in derecognition or other changes in expected future cash flows, a bank estimates the final repayment cash flow relating to a TLTRO III tranche to be different from that used in determining the carrying amount. In such a situation, the bank adjusts the carrying amount to reflect the modification or other change in expected future cash flows and recognises the difference immediately in profit or loss. The bank therefore makes no adjustment to interest recognised in prior periods.

The Committee also noted that application of paragraph B5.4.6 of IFRS 9 relates to a bank's estimates of expected future cash flows in calculating the effective interest rate on initial recognition of the financial liability. This is because, applying B5.4.6, the original effective interest rate is used to discount the revised cash flows.

The Committee observed that the question of whether conditions attached to the interest rate should be reflected in the estimates and revisions of expected future cash flows when determining the effective interest rate is part of a broader matter, which it should not analyse solely in the context of TLTRO III tranches. The Committee is therefore of the view that this matter should be considered as part of the post-implementation review of the classification and measurement requirements in IFRS 9, together with similar matters already identified in the first phase of that review.

Disclosure

If a bank determines that the ECB meets the definition of government in IAS 20 and that it has received government assistance from the ECB, the bank needs to provide the information required by paragraph 39 of IAS 20 with respect to government grants and government assistance that does not meet the definition of a government grant.

In addition, given the judgements required and the risks arising from the TLTRO III tranches, a bank needs to consider the requirements in paragraphs 117,122 and 125 of IAS 1 *Presentation of Financial Statements,* as well as paragraphs 7, 21 and 31 of IFRS 7 *Financial Instruments: Disclosures*. Those paragraphs require a bank to disclose information that includes its significant accounting policies and the assumptions and judgements that management has made in the process of applying the bank's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Conclusion

The Committee concluded that if the bank determines that the TLTRO III tranches contain a government grant in the scope of IAS 20, the requirements in IAS 20 provide an adequate basis for an entity to determine how to account for that government grant.

With respect to the question of whether conditions attached to the interest rate should be reflected in the estimates and revisions of expected future cash flows when determining the effective interest rate, the Committee concluded that the matters described in the request are part of a broader matter that, in isolation, are not possible to address in a cost-effective manner and should be reported to the Board. The Board should consider this matter as part of the post-implementation review of the classification and measurement requirements in IFRS 9.

For these reasons, the Committee [decided] not to add a standard-setting project to the work plan.

Economic Benefits from Use of a Windfarm (IFRS 16 *Leases*)—Agenda Paper 5

The Committee received a request about whether, applying paragraph B9(a) of IFRS 16, an electricity retailer (customer) has the right to obtain substantially all the economic benefits from use of a windfarm throughout the term of an agreement with a windfarm generator (supplier). In the fact pattern described in the request:

a. the customer and supplier are registered participants in an electricity market, in which customers and suppliers are unable to enter into contracts directly with each other for the purchase and sale of electricity. Instead, customers and suppliers make such purchases and sales via the market's electricity grid, the spot price for which is set by the market operator.
b. the customer enters into an agreement with the supplier. The agreement:
    i. swaps the spot price per megawatt of electricity the windfarm supplies to the grid during the 20-year term of the agreement for a fixed price per megawatt, and is settled net in cash. In effect, the supplier receives a fixed price per megawatt for the electricity it supplies to the grid during the period of the agreement and the customer settles with the supplier the difference between that fixed price and the spot prices per megawatt for that volume of electricity.
    ii. transfers to the customer all renewable energy credits that accrue from use of the windfarm.

Paragraph 9 of IFRS 16 states that 'a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration'. To control the use of an identified asset for a period of time, the customer—throughout the period of use—must have both the right to obtain substantially all the economic benefits from use of the identified asset and the right to direct the use of that asset (paragraph B9 of IFRS 16).

Paragraph B21 of IFRS 16 specifies that ‘a customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or sub-leasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realised from a commercial transaction with a third party’.

The Committee observed that, in the fact pattern described in the request, the economic benefits from use of the windfarm include the electricity it produces (as its primary output) and the renewable energy credits (as a by-product or other economic benefit from use of the windfarm).

The agreement results in the customer settling with the supplier the difference between the fixed price and the spot prices per megawatt of electricity the windfarm supplies to the grid throughout the 20-year term of the agreement. That agreement, however, gives rise to neither the right nor the obligation for the customer to obtain any of the electricity the windfarm produces and supplies to the grid. Although the customer has the right to obtain the renewable energy credits (which represent a portion of the economic benefits from use of the windfarm), the customer does not have the right to obtain substantially all the economic benefits from use of the windfarm because it has no right to obtain any of the electricity the windfarm produces throughout the period of the agreement.

The Committee therefore concluded that, in the fact pattern described in the request, the customer does not have the right to obtain substantially all the economic benefits from use of the windfarm. Consequently, the contract does not contain a lease.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for a customer that enters into an agreement as described in the request to determine whether it has the right to obtain substantially all the economic benefits from use of an identified asset. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

Agenda decisions for Board consideration

Costs Necessary to Sell Inventories (IAS 2 *Inventories*)—Agenda Paper 2

The Committee considered feedback on the tentative agenda decision published in the February 2021 IFRIC *Update* about the costs an entity includes as the 'estimated costs necessary to make the sale' when determining the net realisable value of inventories.

The Committee reached its conclusions on that agenda decision. In accordance with paragraph 8.7 of the IFRS Foundation's *Due Process Handbook*, the Board will consider this agenda decision at its June 2021 meeting. If the Board does not object to the agenda decision, it will be published in June 2021 in an addendum to this IFRIC *Update*.

Preparation of Financial Statements when an Entity is No Longer a Going Concern (IAS 10 *Events after the Reporting Period*)—Agenda Paper 3

The Committee considered feedback on the tentative agenda decision published in the February 2021 IFRIC *Update* about the accounting applied by an entity that is no longer a going concern.

The Committee reached its conclusions on that agenda decision. In accordance with paragraph 8.7 of the IFRS Foundation's *Due Process Handbook*, the Board will consider this agenda decision at its June 2021 meeting. If the Board does not object to the agenda decision, it will be published in June 2021 in an addendum to this IFRIC *Update*.

Other matters

Work in Progress—Agenda Paper 6

The Committee received an update on the current status of open matters not discussed at its meeting in June 2021.

Addendum to IFRIC Update—Committee’s agenda decisions

Agenda decisions, in many cases, include explanatory material. Explanatory material may provide additional insights that might change an entity's understanding of the principles and requirements in IFRS Standards. Because of this, an entity might determine that it needs to change an accounting policy as a result of an agenda decision. It is expected that an entity would be entitled to sufficient time to make that determination and implement any necessary accounting policy change (for example, an entity may need to obtain new information or adapt its systems to implement a change). Determining how much time is sufficient to make an accounting policy change is a matter of judgement that depends on an entity's particular facts and circumstances. Nonetheless an entity would be expected to implement any change on a timely basis and, if material, consider whether disclosure related to the change is required by IFRS Standards.

The Committee discussed the following matters and decided not to add standard-setting projects to the work plan.

Costs Necessary to Sell Inventories (IAS 2 *Inventories*)—Agenda Paper 2

Published in June 2021[1]

The Committee received a request about the costs an entity includes as the ‘estimated costs necessary to make the sale’ when determining the net realisable value of inventories. In particular, the request asked whether an entity includes all costs necessary to make the sale or only those that are incremental to the sale.

Paragraph 6 of IAS 2 defines net realisable value as ‘the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale’. Paragraphs 28–33 of IAS 2 include further requirements about how an entity estimates the net realisable value of inventories. Those paragraphs do not identify which specific costs are ‘necessary to make the sale’ of inventories. However, paragraph 28 of IAS 2 describes the objective of writing inventories down to their net realisable value—that objective is to avoid inventories being carried ‘in excess of amounts expected to be realised from their sale’.

The Committee observed that, when determining the net realisable value of inventories, IAS 2 requires an entity to estimate the costs necessary to make the sale. This requirement does not allow an entity to limit such costs to only those that are incremental, thereby potentially excluding costs the entity must incur to sell its inventories but that are not incremental to a particular sale. Including only incremental costs could fail to achieve the objective set out in paragraph 28 of IAS 2.

The Committee concluded that, when determining the net realisable value of inventories, an entity estimates the costs necessary to make the sale in the ordinary course of business. An entity uses its judgement to determine which costs are necessary to make the sale considering its specific facts and circumstances, including the nature of the inventories.

[1] In accordance with paragraph 8.7 of the *Due Process Handbook*, at its June 2021 meeting, the International Accounting Standards Board discussed, and did not object to, this agenda decision.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine whether the estimated costs necessary to make the sale are limited to incremental costs when determining the net realisable value of inventories. Consequently, the Committee decided not to add a standard-setting project to the work plan.

Preparation of Financial Statements when an Entity is No Longer a Going Concern (IAS 10 *Events after the Reporting Period*)—Agenda Paper 3

Published in June 2021[1]

The Committee received a request about the accounting applied by an entity that is no longer a going concern (as described in paragraph 25 of IAS 1 *Presentation of Financial Statements*). The request asked whether such an entity:

a. can prepare financial statements for prior periods on a going concern basis if it was a going concern in those periods and has not previously prepared financial statements for those periods (Question I); and
b. restates comparative information to reflect the basis of accounting used in preparing the current period's financial statements if it had previously issued financial statements for the comparative period on a going concern basis (Question II).

Question I

Paragraph 25 of IAS 1 requires an entity to prepare financial statements on a going concern basis 'unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so'. Paragraph 14 of IAS 10 states that 'an entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so'.

Applying paragraph 25 of IAS 1 and paragraph 14 of IAS 10, an entity that is no longer a going concern cannot prepare financial statements (including those for prior periods that have not yet been authorised for issue) on a going concern basis.

The Committee therefore concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity that is no longer a going concern to determine whether it prepares its financial statements on a going concern basis.

Question II

Based on its research, the Committee observed no diversity in the application of IFRS Standards with respect to Question II. Therefore, the Committee has not obtained evidence that the matter has widespread effect.

For the reasons noted above, the Committee decided not to add a standard-setting project on these matters to the work plan.