IFRIC® *Update*

From the IFRS® Interpretations Committee

November 2018

IFRIC *Update* is a summary of the decisions reached by the IFRS Interpretations Committee (Committee) in its public meetings.

Decisions on an IFRIC Interpretation become final only after the Committee has taken a formal vote. IFRIC Interpretations require ratification by the International Accounting Standards Board (Board).

The Committee met in London on **27 November 2018**, and discussed:

- **Items on the current agenda**
- Lack of exchangeability (IAS 21 *The Effects of Changes in Foreign Exchange Rates*)—Agenda Papers 8–8B
- **Committee's tentative agenda decisions**
- Sale of output by a joint operator (IFRS 11 *Joint Arrangements*)—Agenda Paper 2
- Physical settlement of contracts to buy or sell a non-financial item (IFRS 9 *Financial Instruments*)—Agenda Paper 3
- Over time transfer of constructed good (IAS 23 *Borrowing Costs*)—Agenda Paper 4
- Customer's right to access the supplier's software hosted on the cloud (IAS 38 *Intangible Assets*)—Agenda Paper 5
- Credit enhancement in the measurement of expected credit losses (IFRS 9 *Financial Instruments*)—Agenda Paper 6
- Curing of a credit-impaired financial asset (IFRS 9 *Financial Instruments*)—Agenda Paper 7
- **Other matters**
- Committee work in progress—Agenda Paper 9

Contact us

IFRS Interpretations Committee
The Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Tel: +44 (0)20 7246 6410
Fax: +44 (0)20 7246 6411
Email: **ifric@ifrs.org**
Website: **www.ifrs.org**

Next IFRS Interpretations Committee meeting

The next meeting will be held on:

16 January 2019

Meeting dates, tentative agendas and additional details about the next meeting will be posted to the IFRS **website** before the meeting. Further information about the activities of the IFRS Interpretations Committee and instructions for submitting requests to it can be found **here**.

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Items on the current agenda

Lack of exchangeability (IAS 21 *The Effects of Changes in Foreign Exchange Rates*)—Agenda Papers 8–8B

The Committee discussed possible narrow-scope standard-setting aimed at addressing situations in which the spot exchange rate (as defined in IAS 21) is not observable. Such situations arise when exchangeability between two currencies is lacking.

The Committee was not asked to make any decisions.

Next step

The Committee will continue its discussion at a future meeting.

Committee's tentative agenda decisions

The Committee discussed the following matters and tentatively decided not to add them to its standard-setting agenda. The Committee will reconsider these tentative decisions, including the reasons for not adding the items to its standard-setting agenda, at a future meeting. The Committee encourages interested parties to submit their responses on the open for comment page by 6 February 2019. The Committee will place all such correspondence on the public record unless a respondent specifically requests that its response should remain confidential. Such requests must be made for a good reason, for example, commercial confidentiality.

Sale of output by a joint operator (IFRS 11 *Joint Arrangements*)—Agenda Paper 2

The Committee received a request about how a joint operator accounts for output arising from a joint operation (as defined in IFRS 11) when the output it receives in a reporting period is different from the output to which it is entitled. In the fact pattern described in the request, the joint operator has the right to receive a fixed proportion of the output arising from the joint operation and is obliged to pay for a fixed proportion of the production costs incurred. For operational reasons, the output received by the joint operator and transferred to its customers in a particular reporting period is different from the output to which it is entitled. That difference will be settled through future deliveries of output arising from the joint operation—it cannot be settled in cash. Applying IFRS 15 *Revenue from Contracts with Customers*, the joint operator recognises revenue as a principal for the transfer of all the output to its customers.

The request asks whether, in the fact pattern described, the joint operator recognises revenue to depict the transfer of output to its customers in the reporting period or, instead, to depict its entitlement to a fixed proportion of the output produced from the joint operation's activities in that period.

In relation to a joint operator's interest in a joint operation, paragraph 20(c) of IFRS 11 requires the joint operator to recognise revenue from the sale of its share of the output arising from the joint operation. Accordingly, the revenue recognised by a joint operator depicts the output it has received from the joint operation and sold, rather than for example the production of output. The joint operator accounts for the revenues relating to its interest in the joint operation applying the IFRS Standards applicable to the particular revenues (paragraph 21 of IFRS 11).

The Committee concluded that, in the fact pattern described in the request, the joint operator recognises revenue that depicts only the transfer of output to its customers in each reporting period, ie revenue recognised applying IFRS 15. This means, for example, the joint operator does not recognise revenue for the output to which it is entitled but has not received from the joint operation and sold.

The Committee concluded that the principles and requirements in existing IFRS Standards provide an adequate basis for a joint operator to determine its revenue from the sale of its share of output arising from a joint operation as described in the request. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Physical settlement of contracts to buy or sell a non-financial item (IFRS 9 *Financial Instruments*)—Agenda Paper 3

The Committee received a request about how an entity applies IFRS 9 to particular contracts to buy or sell a non-financial item in the future at a fixed price. The request describes two fact patterns in which an entity accounts for such contracts as derivatives at fair value through profit or loss (FVPL) but nonetheless physically settles the contracts by either delivering or taking delivery of the underlying non-financial item.

IFRS 9 must be applied to contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if those contracts were financial instruments, with one exception. That exception applies to contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements ('own use scope exception' in paragraph 2.4 of IFRS 9).

In the fact patterns described in the request, the entity concludes that the contracts are within the scope of IFRS 9 because they do not meet the own use scope exception. Consequently, the entity accounts for the contracts as derivatives measured at FVPL. The entity does not designate the contracts as part of a hedging relationship for accounting purposes.

At the settlement date, the entity physically settles the contracts by either delivering or taking delivery of the non-financial item. In accounting for that settlement, the request explains that the entity records the cash paid (in the case of the purchase contract) or received (in the case of the sale contract) and derecognises the derivative.

In addition, the entity:

a. recognises inventory for the non-financial item at the amount of the cash paid plus the fair value of the derivative on the settlement date (in the case of the purchase contract); or
b. recognises revenue for the sale of the non-financial item at the amount of the cash received plus the fair value of the derivative on the settlement date (in the case of the sale contract). The request assumes the entity has an accounting policy of recognising revenue on a gross basis for such contracts.

This accounting results in the entity recognising inventory or revenue at the market price of the non-financial item on the settlement date.

The requests asks whether, in accounting for the physical settlement of these contracts, the entity is permitted or required to make an additional journal entry that would:

a. reverse the accumulated gain or loss previously recognised in profit or loss on the derivative (even though the fair value of the derivative is unchanged); and
b. recognise a corresponding adjustment to either revenue (in the case of the sale contract) or inventory (in the case of the purchase contract).

The additional journal entry would result in the entity recognising inventory or revenue at the cash paid or received on settlement.

The Committee observed that, in the fact pattern described in the request, the contracts are settled by the receipt (or delivery) of a non-financial item in exchange for both cash and the settlement of the derivative asset or liability. The Committee also observed that the accounting for contracts that do not meet the own use scope exception in IFRS 9 (and are accounted for as a derivative) is different from the accounting for contracts that meet that exception (and are not accounted for as a derivative). Similarly, the accounting for contracts designated in a hedging relationship for accounting purposes is different from the accounting for contracts that are not designated in such relationships. Those differences in accounting reflect differences in the respective requirements. IFRS 9 neither permits nor requires an entity to reassess or change its accounting for a derivative contract solely because that contract is ultimately physically settled.

Accordingly, the additional journal entry described in the request would effectively negate the requirement in IFRS 9 to account for the contract as a derivative because it would reverse the

accumulated fair value gain or loss on the derivative without any basis to do so. The additional journal entry would also result in the recognition of income or expenses that do not exist.

Consequently, the Committee concluded that IFRS 9 neither permits nor requires an entity to make the additional journal entry described in the request.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to conclude on whether it is permitted or required to make the additional journal entry described in the request. Consequently, the Committee [decided] not to add the matter to its standard-setting agenda.

Over time transfer of constructed good (IAS 23 *Borrowing Costs*)—Agenda Paper 4

The Committee received a request about the capitalisation of borrowing costs in relation to the construction of a residential multi-unit real estate development (building).

In the fact pattern described in the request:

a. a real estate developer (entity) constructs the building and sells the individual units in the building to customers.
b. the entity borrows funds specifically for the purpose of constructing the building and incurs borrowing costs in connection with that borrowing.
c. before construction begins, the entity signs contracts with customers for the sale of some of the units in the building (sold units).
d. the entity intends to enter into contracts with customers for the remaining part-constructed units (unsold units) as soon as it finds suitable customers.
e. the terms of, and relevant facts and circumstances relating to, the entity's contracts with customers (for both the sold and unsold units) are such that, applying paragraph 35(c) of IFRS 15 *Revenue from Contracts with Customers*, the entity transfers control of each unit over time and, therefore, recognises revenue over time. The consideration promised by the customer in the contract is in the form of cash or another financial asset.

The request asks whether the entity has a qualifying asset as defined in IAS 23 and, therefore, capitalises any directly attributable borrowing costs.

Applying paragraph 8 of IAS 23, an entity capitalises borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. Paragraph 5 of IAS 23 defines a qualifying asset as 'an asset that necessarily takes a substantial period of time to get ready for its intended use or sale'.

Accordingly, the entity assesses whether, in the fact pattern described in the request, it recognises an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Depending on the particular facts and circumstances, the entity might recognise a receivable, a contract asset and/or inventory.

The Committee concluded that, in the fact pattern described in the request, the entity does not capitalise borrowing costs. The Committee observed that:

a. any receivable that the entity recognises is not a qualifying asset. Paragraph 7 of IAS 23 specifies that financial assets are not qualifying assets.
b. any contract asset that the entity recognises is not a qualifying asset. The contract asset (as defined in Appendix A to IFRS 15) would represent the entity's right to consideration that is conditioned on something other than the passage of time in exchange for transferring control of a unit. The intended use of the contract asset—to collect cash or another financial asset—is not a use for which it necessarily takes a substantial period of time to get ready.
c. any inventory (work-in-progress) for unsold units under construction that the entity recognises is not a qualifying asset. In the fact pattern described in the request, this asset is ready for its intended sale in its current condition—ie the entity intends to sell the part-constructed units as soon as it finds suitable customers and, on signing a contract with a customer, will transfer control of any work-in-progress relating to that unit to the customer.

The Committee concluded that the principles and requirements in IAS 23 provide an adequate basis for an entity to determine whether to capitalise borrowing costs in the fact pattern described

in the request. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Customer's right to access the supplier's software hosted on the cloud (IAS 38 *Intangible Assets*)—Agenda Paper 5

The Committee received a request about how a customer accounts for 'Software as a Service' cloud computing arrangements. In these arrangements, the customer contracts to pay a fee in exchange for a right to access the supplier's application software for a specified term. The supplier's software runs on cloud infrastructure managed and controlled by the supplier. The customer accesses the software on an as-needed basis over the internet or via a dedicated line.

Does the customer receive a software asset at the contract commencement date or a service over the contract term?

The first step is to decide whether the customer receives a software asset at the contract commencement date or a service over the contract term.

The Committee noted that a customer receives a software asset at the contract commencement date if either (a) the contract contains a software lease, or (b) the customer otherwise obtains control of software at the contract commencement date.

A software lease

IFRS 16 *Leases* defines a lease as 'a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration'. Paragraphs 9 and B9 of IFRS 16 explain that a contract conveys the right to use an asset if, throughout the period of use, the customer has both:

a. the right to obtain substantially all the economic benefits from use of the asset (an identified asset); and
b. the right to direct the use of that asset.

Paragraphs B9-B31 of IFRS 16 provide application guidance on the definition of a lease. Among other requirements, that application guidance specifies that a customer generally has the right to direct the use of an asset by having decision-making rights to change how and for what purpose the asset is used throughout the period of use. Accordingly, in a contract that contains a lease the supplier has given up those decision-making rights and transferred them to the customer at the lease commencement date.

The Committee observed that, if a contract conveys to the customer only the right to receive access to the supplier's application software over the contract term, the contract does not contain a lease. A right to receive future access to the supplier's software running on the supplier's cloud infrastructure does not give the customer any decision-making rights about how and for what purpose the software is used—the supplier would have those rights by, for example, deciding how and when to update or reconfigure the software, or deciding on which hardware (or infrastructure) the software will run.

A software intangible asset

IAS 38 defines an intangible asset as 'an identifiable non-monetary asset without physical substance'. It notes that an asset is a resource controlled by the entity and paragraph 13 specifies that an entity controls an intangible asset if it has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits.

The Committee observed that, if a contract conveys to the customer only the right to receive access to the supplier's application software over the contract term, the customer does not receive a software intangible asset at the contract commencement date. A right to receive future access to the supplier's software does not, at the contract commencement date, give the customer the power to obtain the future economic benefits flowing from the software itself and to restrict others' access to those benefits.

Consequently, the Committee concluded that a contract that conveys to the customer only the right to receive access to the supplier's application software in the future is a service contract. The customer receives the service—the access to the software—over the contract term. If the customer

pays the supplier before it receives the service, that prepayment gives the customer a right to future service and is an asset for the customer.

If the contract contains a software lease, does the customer apply the requirements in IFRS 16 or those in IAS 38?

If the contract contains a software lease, the next step would be to consider whether the customer applies IFRS 16 or IAS 38 to account for the lease.

Paragraph 6 of IAS 38 states that 'rights held by a lessee under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights are within the scope of this Standard and are excluded from the scope of IFRS 16'. Paragraph 3(e) of IFRS 16 similarly excludes such rights from its scope.

IAS 38 does not define a licensing agreement. However, IFRS 15 *Revenue from Contracts with Customers* specifies that a licence (including a licence of software) establishes a customer's rights to the intellectual property of a supplier. IFRS 15 also identifies that a licence can provide the customer with a right to use the supplier's intellectual property.

Consequently, the Committee concluded that a software lease is a licensing agreement within the scope of IAS 38, and not of IFRS 16.

Is a right to use software recognised as an intangible asset at the contract commencement date?

A right to use software is an identifiable non-monetary item without physical substance. A customer controls that right-of-use if it has the power to obtain the future economic benefits flowing from the right-of-use and to restrict others' access to those benefits (paragraph 13 of IAS 38).

To have the right to use software, the customer must have both (a) the right to obtain substantially all the economic benefits from use of the software, and (b) the right to direct the use of that software throughout the contract term. Having those rights would mean that the entity also controls the right to use the software applying the criteria for control in IAS 38.

Consequently, the Committee concluded that, if the customer has the right to use software, it recognises that right-of-use as an intangible asset at the contract commencement date (subject to the recognition criteria in paragraph 21 of IAS 38).

Assessing whether a customer's rights are sufficient to give it the right to use software requires judgement considering the terms and conditions of the contract. Paragraphs B58–B62 of IFRS 15 include application guidance that might be helpful in making this assessment.

How does a customer measure an intangible asset recognised applying IAS 38?

If the customer recognises an intangible asset applying IAS 38, the next step would be to measure the asset.

Paragraph 24 of IAS 38 requires intangible assets to be measured initially at cost.

The Committee concluded that the requirements in existing IFRS Standards provide an adequate basis for an entity to account for fees paid or payable to access the supplier's application software in Software as a Service arrangements. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Credit enhancement in the measurement of expected credit losses (IFRS 9 *Financial Instruments*)—Agenda Paper 6

The Committee received a request about the effect of a credit enhancement on the measurement of expected credit losses when applying the impairment requirements in IFRS 9. The request asked whether the cash flows expected from a financial guarantee contract or any other credit enhancement can be included in the measurement of expected credit losses if the credit enhancement is required to be recognised separately applying IFRS Standards.

For the purposes of measuring expected credit losses, paragraph B5.5.55 of IFRS 9 requires the estimate of expected cash shortfalls to reflect the cash flows expected from collateral and other

credit enhancements that are part of the contractual terms and are not recognised separately by the entity.

Accordingly, the Committee observed that the cash flows expected from a credit enhancement are included in the measurement of expected credit losses if the credit enhancement is both:

a. part of the contractual terms; and
b. not recognised separately by the entity.

The Committee concluded that, if a credit enhancement is required to be recognised separately by IFRS Standards, an entity cannot include the cash flows expected from it in the measurement of expected credit losses. An entity applies the applicable IFRS Standard to determine whether it is required to recognise a credit enhancement separately. Paragraph B5.5.55 of IFRS 9 does not provide an exemption from applying the separate recognition requirements in IFRS 9 or other IFRS Standards.

The Committee concluded that the requirements in existing IFRS Standards provide an adequate basis for an entity to determine whether to include the cash flows expected from a credit enhancement in the measurement of expected credit losses in the fact pattern described in the request. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Related discussion at the ITG

In December 2015, the Transition Resource Group for Impairment of Financial Instruments (ITG) discussed a related but separate matter about the inclusion of cash flows from collateral and other credit enhancements in the measurement of expected credit losses. Specifically, the ITG discussed what is meant by 'part of the contractual terms' in paragraph B5.5.55 of IFRS 9 (Agenda Paper 5).

Curing of a credit-impaired financial asset (IFRS 9 *Financial Instruments*)—Agenda Paper 7

The Committee received a request about how an entity presents amounts recognised in the statement of profit or loss when a credit-impaired financial asset is subsequently cured (ie paid in full or no longer credit-impaired).

When a financial asset becomes credit-impaired, paragraph 5.4.1(b) of IFRS 9 requires an entity to calculate interest revenue by applying the effective interest rate to the amortised cost of the financial asset. This results in a difference between (a) the interest that would be calculated by applying the effective interest rate to the gross carrying amount of the credit-impaired financial asset, and (b) the interest revenue recognised for that asset. The request asked whether, following the curing of the financial asset, an entity can present this difference as interest revenue or, instead, is required to present it as a reversal of impairment losses.

Appendix A to IFRS 9 defines a credit loss as 'the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (ie all cash shortfalls), discounted at the original effective interest rate...'. Appendix A also defines the gross carrying amount as 'the amortised cost of a financial asset, before adjusting for any loss allowance'. The Committee noted that, based on the definitions in Appendix A to IFRS 9, the gross carrying amount, amortised cost and loss allowance are discounted amounts, and changes in these amounts during a reporting period include the effect of the unwinding of the discount.

Paragraph 5.5.8 of IFRS 9 requires an entity to 'recognise in profit or loss, as an impairment gain or loss, the amount of expected credit losses (or reversal) that is required to adjust the loss allowance at the reporting date to the amount that is required to be recognised in accordance with this Standard'.

The Committee observed that, applying paragraph 5.5.8 of IFRS 9, an entity recognises in profit or loss as a reversal of expected credit losses the adjustment required to bring the loss allowance to the amount that is required to be recognised in accordance with IFRS 9 (zero if the asset is paid in full). The amount of this adjustment includes the effect of the unwinding of the discount on the loss allowance during the period that the financial asset was credit-impaired, which means the reversal of impairment losses may exceed the impairment losses recognised in profit or loss over the life of the asset. Accordingly, the Committee concluded that, in the statement of profit or loss, an entity is

required to present the difference described in the request as a reversal of impairment losses following the curing of a credit-impaired financial asset.

The Committee concluded that the requirements in existing IFRS Standards provide an adequate basis for an entity to recognise and present the reversal of expected credit losses following the curing of a credit-impaired financial asset in the fact pattern described in the request. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Other matters

Committee work in progress—Agenda Paper 9

The Committee received a report on one request for consideration at a future meeting. The Committee will discuss this request at a future meeting.

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