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HKFRS / IFRS UPDATE 2016/02

IFRS INTERPRETATIONS COMMITTEE - AGENDA REJECTIONS (NOVEMBER 2015)

STATUS
Final

EFFECTIVE DATE
Immediate

ACCOUNTING IMPACT
Clarification of IFRS requirements. May lead to changes in practice.

Background

This Update summarises issues that the IFRS Interpretations Committee (the Interpretations Committee) decided not to take onto its agenda at its November 2015 meeting, which were reported in its public newsletter (the IFRIC Update). Although these agenda rejections do not represent authoritative guidance issued by the International Accounting Standards Board (IASB), in practice they are regarded as being highly persuasive. All entities that report in accordance with IFRS need to be aware of these agenda rejections, and may need to modify their accounting approach. More detailed background about agenda rejections is set out below.

The Interpretations Committee is the interpretative body of the IASB. The role of the Interpretations Committee is to provide guidance on financial reporting issues which have been identified and which are not specifically addressed in IFRS, or where unsatisfactory or conflicting interpretations either have developed, or appear likely to develop.

Any party which has an interest in financial reporting is encouraged to submit issues to the Interpretations Committee when it is considered to be important that the issue is addressed by either the Interpretations Committee itself, or by the IASB. When issues are raised, the Interpretations Committee normally consults a range of other parties, including national accounting standard setting bodies, other organisations involved with accounting standard setting, and securities regulators.

At each of its meetings, the Interpretations Committee considers new issues that have been raised, and decides whether they should be added to its agenda. For those issues that are not added to the agenda, a tentative agenda decision is published in the IFRIC Update newsletter which is issued shortly after each of the Interpretations Committee's meetings. These tentative agenda decisions are open to public comment for a period of 60 days, after which point they are taken back to the Interpretations Committee for further consideration in the light of any comment letters which have been received and further analysis carried out by the Staff. The tentative agenda decision is then either confirmed and reported in the next IFRIC Update, or the issue is either subjected to further consideration by the Interpretations Committee's agenda or referred to the IASB.

Interpretations Committee agenda decisions do not represent authoritative guidance. However, they do set out the Interpretations Committee's rationale for not taking an issue onto its agenda (or referring it to the IASB). It is noted on the IFRS Foundation's website that they 'should be seen as helpful, informative and persuasive'. In practice, it is expected that entities reporting in accordance with IFRS will take account of and follow the agenda decisions and this is the approach which is followed by securities regulators worldwide.

Given that HKFRS is fully converged with IFRS, these agenda decisions are also informative and persuasive to HKFRS financial statements preparers. HKFRS has identical financial reporting standard and paragraph references as IFRS. For example, if a reference is made to "paragraph 18 of IAS 2" the equivalent HKFRS paragraph is "paragraph 18 of HKAS 2".

Agenda decisions that were finalised at the November 2015 meeting

IAS 2	*Inventories* – Prepayments in long – term supply contracts

Tentative agenda decisions at the November 2015 meeting

IFRS 9/IAS 39	*Financial Instruments/Financial Instruments: Recognition and Measurement* – Derecognition of modified financial assets
IFRS 9	*Financial Instruments* – Determining hedge effectiveness for net investment hedges
IAS 16/IAS 38	*Property, Plant and Equipment / Intangible assets* – Variable payments for asset purchases
IAS 20	*Accounting for Government Grants and Disclosure of Government Assistance* – Accounting for recoverable cash payments
IAS 32	*Financial Instruments: Presentation* – Offsetting and cash pooling
IAS 36	*Impairment of Assets* – Recoverable amount and carrying amount of a cash-generating unit

Each of these is discussed below, split between those which are expected to have wide application and those which are narrower in focus.

Agenda decisions at the November 2015 meeting – wide application

IAS 2 *Inventories* – Prepayments in long–term supply contracts

The issue that was brought to the Interpretations Committee relates to the accounting for long-term supply contracts for inventories when the purchaser agrees to make significant prepayments to the supplier.

The question 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.

It was noted that paragraph 18 of IAS 2 *Inventories* requires that when an entity purchases inventories on deferred settlement terms, and the arrangement contains a financing element, the difference between the purchase price on normal credit terms and the amount paid is recognised separately as interest expense over the period of financing. In this sense, it was also noted that IAS 36 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* include similar requirements when the payment for the asset is deferred. Moreover, IFRS 15 *Revenue from Contracts with Customers* requires that the financing component of a transaction should be recognised separately in circumstances of prepayment and deferral of payment.

The Interpretations Committee observed that when a financing component is identified in a long–term supply contract, that financing component should be accounted for separately.

In the absence of evidence about this issue, and of a broader range of information about the facts and circumstances relating to these transactions, it was concluded that this issue did not meet the agenda criteria and therefore it was decided to remove it from the agenda.

BDO comment

The decision illustrates that significant implicit and explicit financing components in the form of prepayments are recognised separately. This is not only consistent with current IFRSs but also new guidance in IFRS 15 which includes an explicit reference to arrangements which give rise to a financing component.

Tentative agenda decisions at the November 2015 meeting – wide application

IAS 16/IAS 38 *Property, Plant and Equipment/Intangible Assets*–Variable payments for asset purchases

The Interpretations Committee was asked to address the accounting for variable payments to be made for the purchase of an item of property, plant and equipment or an intangible asset outside of a business combination. After being put on hold, this issue was revisited at the meetings in September and November 2015.

No consensus was reached on whether the variable payments that depend on the purchaser's future activity should be recognised as a liability until that activity is performed and what the initial measurement of this liability should be. Some members of the Interpretations Committee were of the view that all variable payments met the definition of a liability and should be initially recognised and measured at fair value. Other members did not think that variable payments that depend on the purchaser's future activity meet the definition of a liability for the purchaser until the activity occurs.

After considering the additional concepts proposed for the definition of a liability in the *Conceptual Framework* Exposure Draft issued in May 2015 and observing that during the deliberations on the proposals in the Exposure Draft *Leases* the members of the IASB had expressed mixed views on whether variable payments linked to the future performance or use of the underlying asset in a lease met the definition of a liability, it was observed that this issue is too broad for the Interpretations Committee. Hence, it was (decided) not to add this issue to the agenda.

BDO comment

We are not convinced by the Interpretations Committee's tentative decision, and believe that this should be revisited. The focus should be on whether a particular arrangement gives rise to a financial liability within the scope of the financial instruments standards, or instead within the scope of another standard.

IAS 32 — Financial Instruments: Presentation–Offsetting and cash pooling

The Interpretations Committee received a request to address an issue related to whether certain cash pooling arrangements would meet the requirements for offsetting under IAS 32 *Financial Instruments: Presentation.* Specifically, the question was whether the regular physical transfers of balances (but not at the reporting date) into a netting account would be sufficient to demonstrate an intention to settle the entire period-end account balances on a net basis in accordance with paragraph 42(b) of IAS 32.

For the purposes of the analysis, the Interpretations Committee considered a cash pooling arrangement involving a number of subsidiaries within a group, each of which have legally separate bank accounts. In considering whether the group could demonstrate an intention to settle on a net basis in accordance with paragraph 42 (b) of IAS 32, the Interpretations Committee observed that:

(a) as highlighted in paragraph 46 of IAS 32, net presentation more appropriately reflects the amounts and timings of the expected future cash flows only when there is an intention to exercise a legally enforceable right to set off; and

(b) in accordance with paragraph 47 of IAS 32, when assessing whether there is an intention to net settle, an entity should consider normal business practices, the requirements of the financial markets and other circumstances that may limit the ability to settle net.

It was observed that in the example presented it was stated that prior to the next net settlement date the period end balances might change as group entities place further cash on deposit or withdraw cash to settle other obligations. Because it is not expected to settle the period end balances on a net basis due to the expected future activity prior to the next net settlement date, the Interpretations Committee noted that it would not be appropriate for the entity to assert that it had the intention to settle the entire period-end balances on a net basis. Therefore, presenting these balances net would not appropriately reflect the amounts and timings of the expected future cash flows, taking into account the entity's normal business practice. However, it was also observed that in other cash pooling arrangements, an entity may not expect the period end balances to change prior to the next settlement date and consequently it was noted that an entity would then be required to apply its judgement in determining whether there was an intention to settle on a net basis in those circumstances.

In the light of the results of the outreach activity carried out and given the existing IFRS requirements, the Interpretations Committee considered that neither an amendment to IAS 32 nor an Interpretation was necessary and consequently (decided) not to add the issue to its agenda.

IAS 36 — Impairment of Assets–Recoverable amount and carrying amount of a cash–generating unit

The Interpretations Committee was requested to clarify the application of paragraph 78 of IAS 36 *Impairment of Assets*. This paragraph sets out the guidance for considering recognised liabilities for determining the recoverable amount of a cash-generating unit (CGU) within the context of an impairment test for a CGU.

The submitter observed that this approach for making the CGU's carrying amount comparable with its recoverable amount has no effect, because the recognised liability is required to be deducted both from the CGU's carrying amount and from its value in use (VIU). It was asked whether an alternative approach should be required.

The Interpretations Committee observed that when a CGU's fair value less costs of disposal (FVLCD) takes a recognised liability into account, paragraph 78 requires both the CGU's carrying amount and its VIU to be adjusted by the carrying amount of the liability. This is a straightforward and cost effective way of making a comparison of recoverable amount to carrying value meaningful.

In the light of the existing IFRS requirements it was determined that neither an Interpretation nor an amendment to a Standard was necessary and therefore it was (decided) not to add this issue to the agenda.

Tentative agenda decisions at the November 2015 meeting – narrow application

IFRS 9/IAS 39 *Financial Instruments/Financial Instruments: Recognition and Measurement*– Derecognition of modified financial assets

It was discussed whether to progress a potential narrow-scope project to clarify the guidance about when a modification or exchange of financial assets results in the derecognition of the original asset.

Many members of the Interpretations Committee observed that the circumstances in which financial assets that have been modified or exchanged should be derecognised is an issue that arises frequently in practice. However, it was noted that, because of the broad nature of the issue, it could not be resolved through an interpretation and instead would require an amendment to the Standards.

Consequently, it was (decided) not to progress further consideration of such a project at this time.

IFRS 9 *Financial Instruments*–Determining hedge effectiveness for net investment hedges

The Interpretations Committee was requested to clarify how hedge effectiveness should be determined when accounting for net investment hedges in accordance with IFRS 9 *Financial Instruments*. Specifically, it was asked whether the 'lower of' test that is required for cash flow hedges should also be applied for determining the effective portion of the gains or losses arising from the hedging instrument when accounting for net investment hedges.

The Interpretations Committee observed the following:

(a) paragraph 6.5.13 of IFRS 9, combined with a reference to paragraph 6.5.11, indicates that the 'lower of' test should be applied when determining the effective portion of the gains or losses arising from the hedging instruments when accounting for net investment hedges;
(b) the application of the 'lower of' test for determining the effective portion of the gains or losses arising from the hedging instruments when accounting for net investment hedges avoids the recycling of exchange differences arising from the hedged items that have been recognised in other comprehensive income prior to the foreign operation being disposed of. It was noted that such an outcome would be aligned to the requirements and principles of IAS 21 *The Effect of Changes in Foreign Exchange Rates*.

The Interpretations Committee noted that:

(a) no evidence had been identified of significant diversity by entities using IAS 39 when determining the effective portion of the gains or losses arising from the hedging instruments by applying the 'lower of' test when accounting for net investment hedges;
(b) few entities have yet adopted the hedging requirements in IFRS 9; consequently, it is too early to assess whether the issue is widespread.

Due to the above, the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary and therefore (decided) not to add this issue to its agenda.

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* – Accounting for recoverable cash payments

The issue received by the Interpretations Committee related to whether cash payments made by a government to help an entity finance a research and development project should be accounted for as a liability when received (on the basis that it is a forgivable loan as defined in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance)* or recognised in profit or loss when received (on the basis that it is a government grant as defined in IAS 20). The cash payment received from the government is repayable in cash only if the entity decides to exploit and commercialise the results of the research phase of the project. The terms of the repayment can result in the government receiving up to twice the amount of the original cash payment if the project is successful. If the entity decides not to proceed with the results from the research phase, the cash payment is not refundable and the entity must transfer the rights to the research to the government.

The Interpretations Committee noted that the entity had obtained financing for its research & development project and the appropriate accounting would depend on the specific terms and conditions of the cash payment received. It was observed that the arrangement described in the submission was a financial liability within the scope of IFRS 9 *Financial Instruments*. Nevertheless, many members of the Interpretations Committee thought that the arrangement also met the definition of a forgivable loan as defined in IAS 20. It was observed that judgement would be required in making this assessment and in determining when there is a reasonable assurance that the entity will meet the terms for forgiveness of the loan.

It was noted that there was sufficient guidance in the Standards to help determine the appropriate accounting for the cash payment received from a government.

The Interpretations Committee decided that, in the light of existing IFRS requirements and the feedback received from its outreach activities, neither an Interpretation nor an amendment to a Standard was necessary and therefore (decided) not to add this issue to its agenda.

BDO's support and assistance on HKFRS/IFRS

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