IFRS INTERPRETATIONS COMMITTEE - AGENDA DECISIONS (SEPTEMBER 2017)

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2017/10

STATUS

Final

EFFECTIVE DATE

Immediate

ACCOUNTING IMPACT

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

Background

This Bulletin summarises issues that the IFRS Interpretations Committee (the Interpretations Committee) decided not to take onto its agenda at its September 2017 meeting, which were reported in its public newsletter (the IFRIC Update). Although these agenda decisions 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 decisions, and may need to modify their accounting approach. More detailed background about agenda decisions 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, 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.

Agenda decisions that were finalised at the September 2017 meeting

IFRS 1	*First-time Adoption of International Financial Reporting Standards – Subsidiary as a first-time adopter*
IFRS 9	*Financial Instruments – Financial assets eligible for the election to present changes in fair value in other comprehensive income*
IAS 12	*Income taxes – Interest and penalties related to income taxes*
IAS 38	*Intangible Assets – Goods acquired for promotional activities*

Tentative agenda decisions at the September 2017 meeting

IFRS 15	*Revenue from Contracts with Customers – Revenue recognition in a real estate contract*
IAS 28	*Investments in Associates and Joint Ventures – Contributing property, plant and equipment to an associate*

Agenda decisions that were finalised at the September 2017 meeting – Wide Application

IFRS 1 — *First-time Adoption of International Financial Reporting Standards – Subsidiary as a first-time adopter*

The Interpretations Committee received a request to clarify how a subsidiary entity adopting IFRS later than its parent should measure cumulative translation differences on its own foreign operations. Specifically, the request asked to clarify whether the subsidiary is permitted to recognise cumulative translation differences at the amount that would be included in the parent's consolidated financial statements, based on the parent's date of transition to IFRS.

Although paragraph D16 permits a subsidiary on first-time adoption of IFRS to measure assets and liabilities at the same amount as they are included in its parent's IFRS-compliant financial statements, cumulative translation differences recognised in equity are neither an asset nor a liability. The Interpretations Committee therefore concluded that a subsidiary cannot apply the exemption in paragraph D16 of IFRS 1, and on its date of transition to IFRS, the subsidiary should either measure the separate component of equity for cumulative translation differences relating to its own foreign operations at:

- zero (the transitional relief available to any first-time adopter); or
- on a retrospective basis as if it had always applied IFRS.

IFRS 9 — *Financial Instruments – Financial assets eligible for the election to present changes in fair value in other comprehensive income*

The Interpretations Committee were asked to consider whether an investor can classify certain instruments as being at fair value through other comprehensive income for equities under paragraph 4.1.4 of IFRS 9 *Financial Instruments*. The specific instruments in question are those which, although not meeting the definition of equity, are presented as equity by the issuer through application of paragraphs 16A–16D of IAS 32 *Financial Instruments: Presentation*.

The Committee concluded that because such instruments do not meet the definition of an equity instrument in IAS 32, the investor cannot elect to account for those instruments as being at fair value through other comprehensive income for equities. This conclusion is further supported by paragraph BC5.21 of IFRS 9, which states that '…in particular circumstances a puttable instrument (or an instrument that imposes on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation) is classified as equity. However, the IASB noted that such instruments do not meet the definition of an equity instrument.'

IAS 12 — *Income taxes – Interest and penalties related to income taxes*

IFRS standards do not address the accounting for interest and penalties related to income taxes, specifically whether such amounts should be presented as part of the income tax charge or as either finance and operating items respectively. Therefore the Interpretations Committee considered whether to add a project on interest and penalties to its standard-setting agenda.

It decided not to do so because it concluded such a project would not result in an improvement in financial reporting that would be sufficient to outweigh the costs. Nonetheless it observed that an entity:

- does not have an accounting policy choice between applying IAS 12 *Income Taxes* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to such amounts;
- should apply judgement to decide whether amounts payable or receivable for interest and penalties are an income tax (in which case it applies IAS 12) or not (in which case it applies IAS 37), with the judgement made disclosed in accordance with paragraph 122 of IAS 1 *Presentation of*

Financial Statements if it is part of the judgements that had the most significant effect on the financial statements; and

- are required by paragraph 79 of IAS 12 to disclose the major components of tax income and expense and by paragraphs 84-85 of IAS 37 to disclose a reconciliation of each class of provision. Therefore, regardless of whether an entity applies IAS 12 or IAS 37 the entity would disclose information about interest and penalties if material.

IAS 38 Intangible Assets – Goods acquired for promotional activities

The Interpretations Committee received a request to clarify how an entity accounts for goods that it distributes as part of its promotional activities. The submitter described a situation in which a pharmaceutical entity acquires goods (such as refrigerators, air conditioners and watches) to distribute to doctors as part of its promotional activities. The submitter asked how the entity accounts for any such goods that remain undistributed at its reporting date.

If an entity acquires goods to be used to undertake advertising or promotional activities, paragraph BC46B of IAS 38 explains that such goods have no other purpose than to undertake those activities. In other words, the only benefit of those goods for the entity is to develop or create brands or customer relationships, which in turn generate revenues. However, applying IAS 38, the entity does not recognise internally generated brands or customer relationships as assets.

Accordingly, paragraph 69 of IAS 38 requires an entity to recognise any expenditure on such goods acquired solely for promotional activities as an expense when the entity has a right to access the goods. Paragraph 69A of IAS 38 states that an entity has a right to access goods when it owns them. The entity, therefore, recognises any expenditure on these goods as an expense when it owns the goods, or otherwise has a right to access them, regardless of when it distributes the goods.

Tentative agenda decisions at the September 2017 meeting – Wide Application

IFRS 15 Revenue from Contracts with Customers – Revenue recognition in a real estate contract

The Interpretations Committee received a request to clarify whether revenue from the sale of a residential unit in a multi-unit complex (real estate unit) should be recognised over time as construction progresses.

Paragraph 35 of IFRS 15 sets out the three circumstances when revenue should be recognised over time and the assessment in any particular circumstance requires an analysis of the rights and obligations created by the contract, taking into account the legal environment within which the contract is enforceable. The conclusion will, therefore, ultimately depend on the particular facts and circumstances that pertain to any contract.

In the fact pattern considered by the Interpretations Committee, the contract for the real estate unit includes the following features:

(i) The real estate developer (entity) and the customer enter into a contract for the sale of a real estate unit in a residential multi-unit complex before the entity begins construction.

(ii) The entity's obligation under the contract is to deliver the completed real estate unit as specified in the contract, i.e. it cannot change or substitute the unit agreed to in the contract. The entity retains legal title to the real estate unit (and any land attributed to it) until construction is complete.

(iii) The customer pays a portion of the purchase price for the real estate unit as it is constructed, and pays the remainder (a majority) of the purchase price to the entity after construction is complete.

(iv) The contract gives the customer a right to the real estate unit under construction. The customer cannot cancel the contract, except as noted in (vi) below, nor can it change the structural design of the unit. The customer can resell or pledge the right to the real estate unit as it is being constructed, subject to the entity performing a credit risk analysis of the new buyer of the right. (No credit check is required if the customer has already paid the entire purchase price for the unit).

The following legal rights of the entity and customer are also relevant:

(v) If the entity is in breach of its obligations under the contract, the customer, and other customers who have agreed to buy real estate units in the multi-unit complex, have the right to together decide to remove the entity and hire another real estate developer to complete the construction of the complex.

(vi) Although the contract is irrevocable under local law, the courts have accepted requests to cancel contracts in specific circumstances, mainly when it has been proven that the customer is not financially able to fulfil the terms of the contract, e.g. if the customer becomes unemployed or has a major illness that affects the customer's ability to work. In this situation, the customer can cancel the contract and is entitled to receive most, but not all, of the payments it has already made to the entity. The remainder is retained by the entity as a termination penalty. The entity may also agree to sell the real estate unit at auction if the customer defaults on its payments.

The Committee observed that the nature of the promise in the contract is to deliver a completed real estate unit to the customer and that any land attributed to the real estate is not distinct. Therefore there is only one performance obligation in the contract

Applying the three circumstances in paragraph 35 of IFRS 15, the Interpretations Committee concluded as follows.

- The customer does not simultaneously receive and consume the benefits of the real estate unit during its construction. Therefore the condition for recognising revenue over time, as specified in paragraph 35(a) of IFRS 15, is not met.

- Paragraph 35(b) of IFRS 15 requires revenue to be recognised over time if control of the real estate unit passes to the customer during construction. In order to decide if this applies, it is necessary to assess whether the customer has the ability to direct the use of, and obtain substantially all the remaining benefits from, the partly-constructed real estate unit. In this case the Interpretations Committee observed that:
  - although the customer can resell or pledge the its contractual right to the real estate unit under construction, it is unable to sell the real estate unit itself without holding legal title to it
  - the customer has no ability to direct the construction or structural design of the retail unit as it is constructed, nor can it use the part-constructed real estate unit in any other way;
  - the customer's legal right (together with other customers) to replace the entity, only in the event of the entity's failure to perform as promised, is protective in nature and is not indicative of control; and
  - the customer's exposure to changes in the market value of the real estate unit may indicate that the customer has the ability to obtain substantially all of the remaining benefits from the real estate unit. However, it does not give the customer the ability to direct the use of the unit as it is constructed.

  Therefore the condition for recognising revenue over time, as specified in paragraph 35(b) of IFRS 15, is not met.

- As the entity cannot change or substitute the real estate unit specified in the contract with the customer, and thus the customer could enforce its right to the unit if the entity sought to direct the asset for another use, the contractual restriction is substantive and the real estate unit does not have an alternative use. Therefore one of the two conditions specified in paragraph 35(c) of IFRS 15 necessary for recognising revenue over time is met. However, the entity does not have an enforceable right to payment for performance completed to date (the second necessary condition specified in paragraph 35(c) of IFRS 15) because in the event of the customer cancelling the contract, it would only be entitled to a termination penalty. This would not compensate the entity for performance completed to date. Because both conditions are not met, application of paragraph 35(c) of IFRS 15 does not result in revenue being recognised over time.

Based on the fact pattern described, therefore, the Committee observed that none of the three circumstances set out in paragraph 35 of IFRS 15 apply and tentatively decided that the entity should recognise revenue at a point in time by applying paragraph 38 of IFRS 15.

IAS 28 Investments in Associates and Joint ventures – Contributing property, plant and equipment to an associate

The Interpretations Committee received a request about how an entity accounts for a transaction in which it contributes property, plant and equipment (PPE) to a newly-formed associate, dealing specifically with:

- whether IFRS standards provide a general exception or exemption from applying the requirements in a particular standard to common control transactions (Question A);
- whether an investor recognises any gain or loss on contributing PPE to an associate to the extent of other investors' interests in the associate (Question B); and
- how an investor determines the gain or loss on contributing PPE to the associate and whether cost of its resulting interest should be based on the fair value of the PPE contributed or the fair value of the acquired interest (Question C).

Question A

The Interpretations Committee observed that paragraph 7 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires an entity to apply an IFRS Standard to a transaction when that Standard applies specifically to the transaction. Therefore, unless a Standard specifically excludes common control transactions from its scope, an entity should apply the applicable requirements in the Standard to common control transactions.

Question B

Paragraph 28 of IAS 28 requires an entity to recognise gains and losses from transactions with associates only to the extent of unrelated investors' interests. The Interpretations Committee observed that the term 'unrelated investors' refers to investors other than the entity (including its consolidated subsidiaries) and does not mean the opposite of 'related' as used in the definition of a related party in IAS 24 *Related Party Disclosures*.

Accordingly, the Interpretations Committee concluded that an entity recognises any gain or loss on contributing PPE to an associate to the extent of other investors' interests in the associate.

Question C

The Interpretations Committee:

- notes that this question is only relevant if, rarely, it is determined that the fair value of PPE contributed differs from the fair value of the equity interest in the associate received in exchange. If there is initially any indication that the fair values differ, the investor should first assess the reasons for the difference and reviews the procedures and assumptions it has used to determine fair value;
- observed that an entity is required to recognise a gain or loss on contributing PPE, and a carrying amount for the investment in the associate, based on the fair value of the PPE contributed; and
- noted that if it is determined that the fair value of the PPE is more than the fair value of the acquired interest in the associate, this would provide objective evidence that the entity's interest in the associate might be impaired.

For all three questions, the Interpretations Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to account for the contribution of PPE to an associate. Consequently, it tentatively decided not to add this matter to its standard-setting agenda.

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