IFRIC® *Update*

From the IFRS® Interpretations Committee

IFRS

September 2017

Welcome to the September IFRIC *Update*

The 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 on the Interpretation. IFRIC Interpretations require ratification by the International Accounting Standards Board (Board).

The Committee met in London on **12 September 2017**, and discussed:

- **Items on the current agenda**
- IAS 28 *Investments in Associates and Joint Ventures*—Acquisition of an associate or joint venture from an entity under common control (Agenda Paper 5F)
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*—Costs considered in assessing whether a contract is onerous (Agenda Paper 5D)
- **Item recommended to the Board for Annual Improvements**
- IAS 41 *Agriculture*—Taxation in fair value measurements (Agenda Paper 3)
- **Committee's tentative agenda decisions**
- IFRS 15 *Revenue from Contracts with Customers*—Revenue recognition in a real estate contract (Agenda Paper 2)
- IAS 28 *Investments in Associates and Joint Ventures*—Contributing property, plant and equipment to an associate (Agenda Paper 4)
- **Committee's agenda decisions**
- IFRS 1 *First-time Adoption of International Financial Reporting Standards*—Subsidiary as a first-time adopter (Agenda Paper 5C)
- IFRS 9 *Financial Instruments*—Financial assets eligible for the election to present changes in fair value in other comprehensive income (Agenda Paper 5A)
- IAS 12 *Income Taxes*—Interest and penalties related to income taxes (Agenda Paper 5B)
- IAS 38 *Intangible Assets*—Goods acquired for promotional activities (Agenda Paper 5E)
- **Other matters**
- Committee work in progress (Agenda Paper 6)

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Next IFRS Interpretations Committee meeting

The next meetings is:

20 November 2017

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 the IFRS Interpretations Committee can be found **here**.

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Items on the current agenda

IAS 28 *Investments in Associates and Joint Ventures*—Acquisition of an associate or joint venture from an entity under common control (Agenda Paper 5F)

The Committee discussed a request about how to account for the acquisition of an interest in an associate or joint venture from an entity under common control.

The Board will discuss the matter at a future Board meeting in the light of the comments on the tentative agenda decision published in June 2017.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*—Costs considered in assessing whether a contract is onerous (Agenda Paper 5D)

The Committee discussed a request asking which costs an entity considers when assessing whether to recognise an onerous contract provision applying paragraph 68 of IAS 37.

The Committee decided to research possible narrow-scope standard-setting aimed at addressing the question.

Next steps

The Committee will consider this research at a future meeting.

Item recommended to the Board for Annual Improvements

IAS 41 *Agriculture*—Taxation in fair value measurements (Agenda Paper 3)

The Committee discussed a request to consider removing from paragraph 22 of IAS 41 the reference to cash flows for taxation.

The Committee recommended that as part of the next Annual Improvements Cycle, the Board propose an amendment to paragraph 22 of IAS 41 to remove the requirement to exclude cash flows for taxation when measuring fair value.

Next steps

The Board will discuss the Committee's recommendation at a future Board meeting.

Committee's tentative agenda decisions

The Committee discussed the following matters and tentatively decided not to add them to its standard-setting agenda. Instead, each tentative agenda decision includes explanatory material referring to the relevant principles and requirements in IFRS Standards. The Committee will reconsider these tentative decisions, including the reasons for not adding the items to the standard-setting agenda, at a future meeting. The Committee encourages interested parties to submit their responses on the Open for comment page by 20 November 2017. The Committee will place all such correspondence on the public record unless the writer specifically requests it remain confidential. In that case, the writer must support the request with good reason, for example, commercial confidentiality.

IFRS 15 *Revenue from Contracts with Customers*—Revenue recognition in a real estate contract (Agenda Paper 2)

The Committee received a request about revenue recognition in a contract for the sale of a unit in a residential multi-unit complex (real estate unit). The real estate developer (entity) and the customer enter into a contract for the sale of the real estate unit before the entity constructs it. Specifically, the request asked about the application of paragraph 35 of IFRS 15, which specifies when an entity recognises revenue over time.

In considering this request, the Committee first considered the requirements in IFRS 15 and then discussed the application of those requirements to the fact pattern described in the request.

Identifying performance obligations in the contract

Before applying paragraph 35 of IFRS 15, an entity applies paragraphs 22–30 in identifying as a performance obligation each promise to transfer to the customer a good or service that is distinct.

Applying paragraph 35 of IFRS 15

Paragraph 35 of IFRS 15 specifies that an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if any one (or more) of the three criteria in paragraph 35 is met. Paragraph 32 of IFRS 15 states that if an entity does not satisfy a performance obligation over time, it satisfies the performance obligation at a point in time. Accordingly, the Committee observed that, at contract inception, an entity assesses each of the three criteria in paragraph 35 to determine whether it recognises revenue over time.

Applying paragraph 35(a), an entity recognises revenue over time if the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. In a contract for the sale of a real estate unit that the entity constructs, the Committee observed that paragraph 35(a) is not applicable because the entity's performance creates an asset, ie the real estate unit, that is not consumed immediately.

Applying paragraph 35(b), an entity recognises revenue over time if the customer controls the asset that an entity's performance creates or enhances as the asset is created or enhanced. Control refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

Paragraph BC129 of IFRS 15 explains that the Board included the criterion in paragraph 35(b) to 'address situations in which an entity's performance creates or enhances an asset that a customer clearly controls as the asset is created or enhanced'. Accordingly, the Committee observed that, in applying paragraph 35(b), an entity assesses whether there is evidence that the customer clearly controls the asset that is being created or enhanced (for example, the part-constructed real estate unit) as it is created or enhanced. An entity considers all relevant factors in making this assessment—no one factor is determinative.

In applying paragraph 35(b), it is important to apply the requirements for control to the asset that the entity's performance creates or enhances. In a contract for the sale of a real estate unit that the entity constructs, the asset created is the real estate unit itself. It is not, for example, the right to obtain the real estate unit in the future. The right to sell or pledge this right is not evidence of control of the real estate unit itself.

Paragraph BC131 of IFRS 15 explains that the Board developed a third criterion in paragraph 35(c) for recognising revenue over time because it observed, in some cases, it may be unclear whether the asset that is created or enhanced is controlled by the customer.

Applying paragraph 35(c), an entity recognises revenue over time if (a) the asset created by an entity's performance does not have an alternative use to the entity; and (b) the entity has an enforceable right to payment for performance completed to date.

Paragraph 36 of IFRS 15 specifies that the asset created does not have an alternative use to an entity if the entity is restricted contractually from readily directing the asset for another use during the creation of that asset or limited practically from readily directing the asset in its completed state for another use.

Paragraph 37 of IFRS 15 states that, to have an enforceable right to payment, at all times throughout the duration of the contract the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer for reasons other than the entity's failure to perform as promised. In assessing whether it has an enforceable right to payment, an entity considers the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms.

The Committee observed that the assessment of enforceable rights as described in paragraph 35(c) is focussed on the existence of the right and its enforceability. The likelihood that the entity would exercise the right is not relevant to this assessment. Similarly, if a customer has the right to terminate the contract, the likelihood that the customer would terminate the contract is not relevant to this assessment.

The Committee concluded that the principles and requirements in IFRS 15 provide an adequate basis for an entity to determine whether to recognise revenue over time or at a point in time for a contract for the sale of a real estate unit. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Illustration of the application of the requirements to the fact pattern in the request

The assessment of whether revenue is recognised over time requires an entity to consider the rights and obligations created by the contract, taking into account the legal environment within which the contract is enforceable. Accordingly, the Committee observed that the outcome of an entity's assessment depends on the particular facts and circumstances pertaining to the contract.

In the fact pattern described in the request, the contract for the real estate unit includes the following features:

a. 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 constructs the unit.
b. the entity's obligation under the contract is to deliver the completed real estate unit as specified in the contract—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.
c. the customer pays a portion of the purchase price for the real estate unit as the unit is being constructed, and pays the remainder (a majority) of the purchase price to the entity after construction is complete.
d. the contract gives the customer a right to the real estate unit under construction. The customer cannot cancel the contract, except as noted in b. 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 the unit 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 request also noted the following legal rights of the entity and the customer:

a. 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.
b. 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 (for example, 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.

Identifying the performance obligation

The nature of the promise in the contract is to deliver a completed real estate unit to the customer. Any land attributed to the real estate unit is not distinct applying paragraphs 22–30 of IFRS 15. Accordingly, the Committee observed that there is one performance obligation in the contract.

Paragraph 35(a)

The customer does not simultaneously receive and consume the benefits provided by the entity's construction of the real estate unit as the unit is being constructed. This is because the entity's performance creates an asset that is not consumed immediately—the part-constructed real estate unit. Consequently, the Committee observed that the criterion in paragraph 35(a) of IFRS 15 is not met.

Paragraph 35(b)

The entity's performance creates the real estate unit under construction. Accordingly, the entity assesses whether, as the unit is being constructed, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the part-constructed real estate unit. The Committee observed the following:

a. although the customer can resell or pledge 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.
b. the customer has no ability to direct the construction or structural design of the real estate unit as the unit is constructed, nor can it use the part-constructed real estate unit in any other way.

c. 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.
d. 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.

The Committee observed that, based on the fact pattern described in the request, the customer does not have the ability to direct the use of the real estate unit as it is being constructed, and thus the customer does not control the part-constructed unit.

Paragraph 35(c)

The entity cannot change or substitute the real estate unit specified in the contract with the customer, and thus the customer could enforce its rights to the unit if the entity sought to direct the asset for another use. Accordingly, the Committee observed that the contractual restriction is substantive and the real estate unit does not have an alternative use to the entity.

The entity, however, does not have an enforceable right to payment for performance completed to date. This is because the customer has the legal right to cancel the contract and, in the event of doing so, the entity is entitled only to a termination penalty that does not compensate the entity for the performance completed to date.

Based on the fact pattern described in the request, the Committee observed that none of the criteria in paragraph 35 of IFRS 15 are met. Accordingly, the entity would recognise revenue at a point in time applying paragraph 38 of IFRS 15.

IAS 28 *Investments in Associates and Joint Ventures*—Contributing property, plant and equipment to an associate (Agenda Paper 4)

The 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 in exchange for shares in the associate.

In the fact pattern described in the request:

a. three entities, collectively referred to as investors, set up a new entity. The investors are all controlled by the same government—ie they are under common control.
b. the investors each contribute items of PPE to the new entity in exchange for shares in that entity. The PPE contributed by the investors is not a business (as defined in IFRS 3 *Business Combinations*).
c. each investor has significant influence over the new entity. Accordingly, the new entity is an associate of each of the investors. The investors do not have control or joint control of the entity.
d. the transaction is carried out on terms equivalent to those that would prevail in an orderly transaction between market participants.

The request asked:

a. about the application of IFRS Standards to transactions involving entities under common control (common control transactions)—ie whether IFRS Standards provide a general exception or exemption from applying the requirements in a particular Standard to common control transactions *(Question A)*;
b. whether an investor recognises any gain or loss on contributing PPE to the associate to the extent of other investors' interests in the associate *(Question B)*; and
c. how an investor determines the gain or loss on contributing PPE to the associate and the cost of its investment in the associate. In particular, the request asked whether the cost of each investor's investment in the associate is based on the fair value of the PPE contributed or the fair value of the acquired interest in the associate *(Question C)*.

In analysing the request, the Committee assumed the contribution of PPE to the associate has commercial substance as described in paragraph 25 of IAS 16 *Property, Plant and Equipment*.

Question A

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. The

Committee observed, therefore, that unless a Standard specifically excludes common control transactions from its scope, an entity applies 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 resulting from upstream and downstream transactions with an associate only to the extent of unrelated investors' interests in the associate. Paragraph 28 includes as an example of a downstream transaction the contribution of assets from an entity to its associate.

The Committee observed that the term 'unrelated investors' in paragraph 28 of IAS 28 refers to investors other than the entity (including its consolidated subsidiaries)—ie the word 'unrelated' does not mean the opposite of 'related' as it is used in the definition of a related party in IAS 24 *Related Party Disclosures*. This is consistent with the premise that financial statements are prepared from the perspective of the reporting entity, which in the fact pattern described in the request is each of the investors.

Accordingly, the 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

This question has an effect only if the fair value of the PPE contributed differs from the fair value of the equity interest in the associate received in exchange for that PPE. The Committee observed that in the fact pattern described in the request, it would generally expect the fair value of PPE contributed to be the same as the fair value of the equity interest in the associate that an entity receives in exchange. If there is initially any indication that the fair value of the PPE contributed might differ from the fair value of the acquired equity interest, the investor first assesses the reasons for this difference and reviews the procedures and assumptions it has used to determine fair value.

The Committee observed that applying the requirements in IFRS Standards, an entity recognises a gain or loss on contributing PPE, and a carrying amount for the investment in the associate, that reflects the determination of those amounts based on the fair value of the PPE contributed—unless the transaction provides objective evidence that the entity's interest in the associate might be impaired. If this is the case, the investor also considers the impairment requirements in IAS 36 *Impairment of Assets*.

If, having reviewed the procedures and assumptions used to determine fair value, 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 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 in the fact pattern described in the request. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Committee's agenda decisions

IFRS 1 *First-time Adoption of International Financial Reporting Standards*—Subsidiary as a first-time adopter (Agenda Paper 5C)

The Committee received a request about the accounting applied by a subsidiary that becomes a first-time adopter of IFRS Standards later than its parent. The subsidiary has foreign operations, on which it accumulates translation differences as part of a separate component of equity. The submitter asked whether, applying paragraph D16 of IFRS 1, the subsidiary is permitted to recognise cumulative translation differences at an amount that would be included in the parent's consolidated financial statements, based on the parent's date of transition to IFRSs.

Paragraph D16 of IFRS 1 provides a subsidiary that becomes a first-time adopter of IFRS Standards later than its parent with an exemption relating to the measurement of its assets and liabilities. Translation differences that the subsidiary accumulates as part of a separate component of equity are neither assets nor liabilities. Accordingly, the Committee concluded that paragraph D16 of IFRS 1 does not permit the subsidiary 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 IFRSs.

The Committee also concluded that the subsidiary cannot apply the exemption in paragraph D16 of IFRS 1 to cumulative translation differences by analogy—paragraph 18 of IFRS 1 explicitly prohibits an entity from applying the exemptions in IFRS 1 by analogy to other items.

Accordingly, when the subsidiary becomes a first-time adopter of IFRS Standards, the subsidiary accounts for cumulative translation differences applying paragraphs D12–D13 of IFRS 1. These paragraphs require the subsidiary to recognise cumulative translation differences either at zero or on a retrospective basis at its date of transition to IFRSs.

The Committee concluded that the requirements in IFRS Standards provide an adequate basis for a first-time adopter to determine how to account for cumulative translation differences. Consequently, the Committee decided not to add this matter to its standard-setting agenda.

Research

The Committee decided to research possible narrow-scope standard-setting for components of equity when a subsidiary becomes a first-time adopter of IFRS Standards later than its parent. The Committee will consider this research at a future meeting.

IFRS 9 *Financial Instruments*—Financial assets eligible for the election to present changes in fair value in other comprehensive income (Agenda Paper 5A)

The Committee received a request asking whether particular financial instruments are eligible for the presentation election in paragraph 4.1.4 of IFRS 9. That election permits the holder of particular investments in equity instruments to present subsequent changes in fair value in other comprehensive income, rather than in profit or loss. The submitter asked whether financial instruments are eligible for that presentation election if the issuer would classify them as equity applying paragraphs 16A–16D of IAS 32 *Financial Instruments: Presentation*.

The Committee observed that the presentation election in paragraph 4.1.4 of IFRS 9 refers to particular investments in equity instruments. 'Equity instrument' is a defined term, and Appendix A of IFRS 9 specifies that it is defined in paragraph 11 of IAS 32. IAS 32 defines an equity instrument as 'any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities'. Consequently, a financial instrument that meets the definition of a financial liability cannot meet the definition of an equity instrument.

The Committee also observed that paragraph 11 of IAS 32 specifies that, as an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument by the issuer if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32.

Accordingly, the Committee concluded that a financial instrument that has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32 is not eligible for the presentation election in paragraph 4.1.4 of IFRS 9. This is because such an instrument does not meet the definition of an equity instrument in IAS 32. This conclusion, based on the requirements in IFRS 9 and IAS 32, is supported by the Board's explanation in paragraph BC5.21 of IFRS 9 of its decision in this respect.

The Committee concluded that the requirements in IFRS 9 provide an adequate basis for the holder of the instruments described in the request to classify those instruments. Consequently, the Committee decided not to add this matter to its standard-setting agenda.

IAS 12 *Income Taxes*—Interest and penalties related to income taxes (Agenda Paper 5B)

IFRS Standards do not specifically address the accounting for interest and penalties related to income taxes (interest and penalties). In the light of the feedback received on the draft IFRIC Interpretation *Uncertainty over Income Tax Treatments*, the Committee considered whether to add a project on interest and penalties to its standard-setting agenda.

On the basis of its analysis, the Committee concluded that a project on interest and penalties would not result in an improvement in financial reporting that would be sufficient to outweigh the costs. Consequently, the Committee decided not to add a project on interest and penalties to its standard-setting agenda.

Nonetheless, the Committee observed that entities do not have an accounting policy choice between applying IAS 12 and applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to interest and penalties. Instead, if an entity considers a particular amount payable or receivable for interest and penalties to be an

income tax, then the entity applies IAS 12 to that amount. If an entity does not apply IAS 12 to a particular amount payable or receivable for interest and penalties, it applies IAS 37 to that amount. An entity discloses its judgement in this respect applying paragraph 122 of IAS 1 *Presentation of Financial Statements* if it is part of the entity's judgements that had the most significant effect on the amounts recognised in the financial statements.

Paragraph 79 of IAS 12 requires an entity to disclose the major components of tax expense (income); for each class of provision, paragraphs 84–85 of IAS 37 require a reconciliation of the carrying amount at the beginning and end of the reporting period as well as other information. Accordingly, regardless of whether an entity applies IAS 12 or IAS 37 when accounting for interest and penalties, the entity discloses information about those interest and penalties if it is material.

The Committee also observed it had previously published agenda decisions discussing the scope of IAS 12 in March 2006 and May 2009.

IAS 38 *Intangible Assets*—Goods acquired for promotional activities (Agenda Paper 5E)

The Committee received a request about how an entity accounts for goods it distributes as part of its promotional activities. In the fact pattern described in the request, a pharmaceutical entity acquires goods (such as refrigerators, air conditioners and watches) to distribute to doctors as part of its promotional activities. The entity and the doctors do not enter into agreements that create enforceable rights and obligations in relation to those goods. The request asked how the entity accounts for any such goods that remain undistributed at its reporting date.

Paragraph 5 of IAS 38 states that IAS 38 applies to expenditure on advertising activities. Accordingly, the Committee concluded that if an entity acquires goods solely to be used to undertake advertising or promotional activities, it applies the requirements in paragraph 69 of IAS 38. Paragraph 69 requires an entity to recognise expenditure on such goods as an expense when the entity has a right to access those goods. Paragraph 69A of IAS 38 states that an entity has a right to access goods when it owns them. The entity, therefore, recognises expenditure on those goods as an expense when it owns the goods, or otherwise has a right to access them regardless of when it distributes the goods.

In explaining the Board's rationale for the requirements in paragraph 69, paragraph BC46B of IAS 38 states that goods acquired to be used to undertake advertising and promotional activities 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.

The Committee concluded that the requirements in IFRS Standards provide an adequate basis for an entity to account for the goods 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 6)

The Committee received a report on one request for consideration at a future meeting. In addition the Committee was informed of one tentative agenda decision for which the comment letter period has ended. An analysis of the comments received will be presented at a future meeting.

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