

HKFRS / IFRS UPDATE 2018/01

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IFRS INTERPRETATIONS COMMITTEE - AGENDA DECISIONS (NOVEMBER 2017)



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 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 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 standards and paragraph references as IFRS. For example, if a reference is made to "paragraph 2(b) of IFRS 3" the equivalent HKFRS paragraph is "paragraph 2(b) of HKFRS 3".

Agenda decisions that were finalised at the November 2017 meeting

IFRS 3 Business Combinations – Acquisition of a group of assets that does not constitute a business

Tentative agenda decisions at the November 2017 meeting

IFRS 9 & IAS 1 Financial Instruments & Presentation of Financial Statements – Presentation of interest revenue for particular financial instruments

IFRS 15 Revenue from Contracts with Customers – Revenue Recognition in a Real Estate Contract that Includes the Transfer of Land

IFRS 15 Revenue from Contracts with Customers – Right to payment for performance to date

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

IFRS 3 Business Combinations – Acquisition of a group of assets that does not constitute a business

When a group of assets and liabilities is purchased that does not constitute a business, paragraph 2(b) of IFRS 3 requires the purchaser to allocate the cost of purchase to the individual assets and liabilities on the basis of their relative fair values at the date of purchase.

The Interpretations Committee received a request to clarify how this requirement should be applied when:

- the sum of the individual fair values of the identifiable assets and liabilities is different from the transaction price; and
- the group includes identifiable assets and liabilities initially measured both at cost and at an amount other than cost.

The Interpretations Committee considered two possible ways of accounting for the transaction. Firstly, an entity could account by:

- identifying the individual identifiable assets acquired and liabilities assumed that it recognises at the date of the acquisition;
- determining the individual transaction price for each identifiable asset and liability by allocating the cost of the group based on the relative fair values of those assets and liabilities at the date of the acquisition; and then
- applying the initial measurement requirements in applicable Standards to each identifiable asset acquired and liability assumed. The entity would account for any difference between the amount at which the asset or liability is initially measured and its individual transaction price applying the relevant requirements.

Alternatively, for any identifiable asset or liability initially measured at an amount other than cost, an entity could initially measure that asset or liability at the amount specified in the applicable IFRS Standard. The entity would then deduct the amounts allocated to the assets and liabilities initially measured at an amount other than cost from the transaction price of the group, and then allocate the residual transaction price to the remaining identifiable assets and liabilities based on their relative fair values at the date of the acquisition.

The Interpretations Committee:

- concluded that a reasonable reading of the requirements in paragraph 2(b) of IFRS 3 could result in one of either of the two approaches being applied. This would be an accounting policy choice (i.e. applied consistently to all such transactions); and
- observed that it had not obtained evidence to suggest that the outcomes of applying the two approaches outlined would be expected to have a material effect on the amounts that entities report.

Consequently, the Interpretations Committee decided not to add this matter to its standard-setting agenda.

However, the Interpretations Committee noted that amendments to be made to IFRS 3 is likely to increase the range of transactions that will be accounted for as the acquisition of a group of assets. Consequently, the issue will be monitored after the amendments to IFRS 3 become effective.

Tentative agenda decisions at the November 2017 meeting – Wide Application

IFRS 9 & IAS 1 Financial Instruments and Presentation of Financial Statements – Presentation of Interest Revenue for Particular Financial Instruments

The Interpretations Committee received a request concerning the consequential amendment that IFRS 9 made to paragraph 82(a) of IAS 1. This amendment requires an entity to present interest revenue calculated using the effective interest rate method separately from other sources of revenue. Specifically, the request asked whether that requirement prohibits an entity from presenting particular cash flows on such derivatives that are not part of a designated and effective hedging relationship (for example, the accrued and realised cash flows on an interest rate swap) as 'interest revenue' in profit or loss, separately from other movements in fair value.

The Interpretations Committee noted that amortised cost accounting, including interest revenue calculated using the effective interest method and credit losses calculated using the expected credit loss impairment model, is only applied to financial assets that are subsequently measured at either amortised cost or fair value through other comprehensive income. It is not applied to financial assets that are subsequently measured at fair value through profit or loss.

Therefore, the requirement in paragraph 82(a) of IAS 1 does not apply to derivatives that are subsequently measured at fair value through profit or loss. However, that requirement would apply to adjustments arising from a hedging relationship accounted for in accordance with IFRS 9 or IAS 39, to the extent that this affects amounts included in interest revenue.

IFRS 15 Revenue from Contracts with Customers – Revenue Recognition in a Real Estate Contract that Includes the Transfer of Land

The Interpretations Committee received a request to clarify how an entity accounts for the sale of land and a building to be constructed on the land. Specifically, the request asked whether (a) the sale of land and construction represents one or two performance obligations and (b) for each performance obligation whether revenue is recognised at a point in time or over time.

In the fact pattern described in the request, the contract includes the following features:

- The entity and the customer enter into a non-cancellable contract for the sale of a building yet to be constructed by the entity.

- At contract inception, the entity irrevocably transfers to the customer legal title to the land on which the entity will construct the building. The contract specifies a price for the land, which the customer pays on signing the contract.
- The entity and the customer agree upon the structural design and specification of the building before the contract is signed. As the building is being constructed:
 - if the customer requests changes to the structural design or specification, the entity prices the proposed changes based on a methodology specified in the contract; the customer then decides whether to proceed with the changes. The entity can reject the customer's request for changes only for a limited number of reasons, such as when the change would breach planning permission.
 - the entity can request changes to the structural design or specification only if not doing so would lead to an unreasonable increase in costs or delay to construction. The customer must approve those changes.
- The customer is required to make milestone payments throughout the construction period. However, these payments do not necessarily correspond to the amount of work completed to date.

Issue 1: What are the performance obligations in the contract?

An entity identifies performance obligations by applying paragraphs 22-30 of IFRS 15. A performance obligation is a good or service (or bundle of goods or services) that is distinct, or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Paragraph 27 of IFRS 15 specifies that a good or service promised to a customer is distinct if:

- a) the customer can benefit from the good or service on its own or together with other resources readily available to the customer (i.e. the good or service is capable of being distinct); and
- b) the entity's promise to transfer the good or service is separately identifiable from other promises in the contract (i.e. the promise to transfer the good or service is distinct within the context of the contract).

The Interpretations Committee noted that the assessment of these criteria requires judgement.

In the fact pattern submitted, the land and the building are each capable of being distinct. This is because the customer could benefit from the land on its own or together with other resources readily available to it. For example, the customer could hire another developer to construct a building on the land. In reaching this conclusion, the Interpretations Committee noted that Paragraph BC100 explains that an entity disregards any contractual limitations that might preclude the customer from, for example, appointing a different contractor to carry out the construction.

Paragraph 29 specifies some factors that indicate whether two or more promises to transfer goods or services are distinct within the context of a contract for the purposes of satisfying paragraph 27(b). The Interpretations Committee also noted that, as explained in paragraphs BC 105, BC116J and BC 116K, the notion of whether two or more promises are distinct within the context of a contract is influenced by whether the risk an entity assumes to fulfil one obligation is separable from the risk relating to others, which requires an assessment of the level of integration, interrelation or interdependence among the promises. Therefore, rather than considering whether one item by its nature, depends on the other, it is necessary to evaluate whether there is a transformative relationship between two promises in the process of fulfilling a contract. In the context of a contract for the sale of land and construction services, the Interpretations Committee observed that:

- although there is a functional relationship between the land and the building (the building cannot exist without the land because its foundations will be built into the land) this does not necessarily mean that the risks to which the entity is exposed in transferring the land to the customer are inseparable from the risks of constructing the building.
- the entity is able to fulfil its promise to transfer the land even if the customer purchased the construction services from another developer, and it would be able to fulfil its promise to construct the building had the customer purchased the land from another party.

The Interpretations Committee therefore concluded that the promise to transfer land would be separately identifiable from the construction services (i.e. distinct in the context of the contract) if, as is the case in the fact pattern provided:

- its performance in constructing the building would be the same regardless of whether the customer had purchased the land from it or another party;
- it would be able to fulfil its promise to construct the building even if the customer had purchased the land from another party; and
- it would be able to fulfil its promise to transfer the land even if the customer had purchased the construction services from other providers.

Issue 2: Should revenue be recognised at a point in time or over time?

Paragraph 35 sets out three circumstances when revenue should be recognised over time, namely:

- a) the customer simultaneously receives and consumes benefits provided by the entity's performance as the entity performs;
- b) the entity's performance creates or enhances an asset (for example work-in-progress) that the customer controls as the asset is created or enhanced; or
- c) the entity's performance does not create an asset with alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Regarding the promise to transfer the land, the land is not consumed immediately (hence the criterion in paragraph 35(a) is not met), and the entity's performance does not create or enhance the land (hence the criteria in paragraphs 35(b) and 35(c) are not met). Therefore revenue from the transfer of land is recognised at a point in time.

Regarding the construction services, the Interpretations Committee concluded that the criterion in paragraph 35(b) is met because the customer has the ability to:

- direct the use of the building as it is being constructed through its control of the previously transferred land, by being able to change the structural design and specification of the building as it is constructed. The customer is also able to prevent others from directing the use of the building; and
- obtain substantially all of the remaining economic benefits from the building as a result of signing the contract because it cannot redirect the building for another use or to another entity.

IFRS 15 Revenue from Contracts with Customers – Right to payment for performance to date

The Interpretations Committee received a request relating to the sale of a residential unit in a multi-unit complex. Specifically it was asked to clarify whether, in a specified fact pattern, the vendor has an enforceable right to payment for performance completed to date resulting in revenue being recognised over time in accordance with paragraph 35(c) of IFRS 15.

Relevant facts to the analysis are:

- the customer pays 10% of the purchase price for the real estate unit at contract inception, and pays the remainder of the purchase price to the entity after construction is complete.
- the customer has the right to cancel the contract at any time before construction is complete. If the customer cancels the contract the vendor is legally required to make reasonable efforts to resell the real estate unit to a third party. On resale, the vendor enters into a new contract with the third party – i.e. the original contract is not novated to the third party. If the resale price to be obtained from the third party is less than the original purchase price (plus selling costs), the original customer is legally obliged to pay the difference to the vendor.

The Interpretations Committee observed that, based on the fact pattern, the nature of the payment from the customer to which the entity has a right under the contract is a payment for the difference between the resale price and the original purchase price (i.e. compensation for loss of profit).

The Interpretations Committee also observed the following requirements of IFRS 15:

- Paragraph 37 states that to have an enforceable right to payment, an entity must be entitled at all times throughout the duration of the contract to an amount that compensates it for performance to date if the contract is terminated for reasons other than the vendor's failure to perform as promised; and

- Paragraph B9 states that an amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods / services transferred to date. Therefore, a right to compensation for loss of profit would not constitute an enforceable right to payment for performance completed to date resulting in the criterion in paragraph 35(c) not being met.

Consequently, the Interpretations Committee concluded that the criteria in paragraph 35(c) for recognising revenue over time were not met.

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