EXPOSURE DRAFT OF A PROPOSED CIRCULAR X/2017

DETERMINING REVENUE/PURCHASES AS A RESULT OF FINANCING COMPONENTS

February 2017

This exposure draft (ED) of a proposed Circular x/2017 - *Determining Revenue/Purchases as a Result of Financing Components* has been issued by The South African Institute of Chartered Accountants (SAICA) for public comment.

Comments received on this exposure draft will be considered in finalising the Circular for issue.

One copy of written comment should be addressed to:
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Your comments should be dispatched so as to be received by no later than **8 March 2017**. All replies will be regarded as being on public record unless confidentiality is requested.

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Determining Revenue/Purchases as a result of financing components

Introduction

.01 There are many revenue or purchase transactions in which there is a delay between the recognition of revenue or the item purchased and payment of the consideration. These transactions potentially contain a financing component which may need to be accounted for separately from the revenue or purchase. Currently there is diversity in practice as to the identification and accounting for these potential financing elements.

.02 The International Accounting Standards Board (IASB) has issued new guidance on revenue recognition and financing elements contained in revenue transactions with the release of IFRS 15 – *Revenue from Contracts with Customers* (IFRS 15). The International Financial Reporting Interpretations Committee (IFRIC) has also debated financing elements contained within transactions for both revenue and purchases under the current accounting standards (IAS 18). The IFRIC debates have often referred to the guidance provided in IFRS 15, which therefore allows an analogy to be drawn between the guidance contained in IFRS 15 and the existing standards.

.03 This Circular considers these developments and updates the previous guidance contained in Circular 09/2006 – *Transactions giving rise to adjustments to revenue/purchases* relating to financing elements of revenue and purchases.

Scope

.04 This circular only deals with the initial accounting by sellers or buyers of goods in transactions that contain financing elements. The assessment of whether the financing component is significant is at a contract or transaction level and not at a portfolio level. The circular only considers the specific topic of extended payment terms. Other factors such as subsequent measurement of the debtors or creditors or the deferred tax implications are not addressed.

.05 Sellers that have applied IFRS 15, and have elected to apply the practical expedient in IFRS 15 paragraph 63, should not apply the guidance provided in paragraph .16 -.19 of this circular.

Financing elements - purchases

.06 Paragraph 18 of IAS 2 addresses deferred settlement terms and states that when the arrangement effectively contains a financing element, that element must be recognised as interest over the period of the financing. It also provides an example of a financing element i.e. where there is a difference between the purchase price for normal credit terms and the amount paid.

.07 In considering whether transactions contained a financing component, the IFRIC in their discussions referred to IFRS 15, as noted in Appendix A. The discussions focused on the identification of significant financing elements and how these should be applied in determining whether a purchase transaction includes a financing element. IFRS 15 provides the relevant guidance on the assessment of significant financing elements in IFRS 15 paragraph 61 and 62.

.08 The assessment of whether the transaction contains a financing element begins by first using qualitative factors. If a transaction contains a financing element, the guidance then requires a quantitative assessment to determine whether the financing element is material to the transaction. Only if the financing element identified is considered material to the transaction must it be accounted for as a separate element as indicated in the decision tree (paragraph.20) below. As noted in the scope, the transaction that is being assessed to contain a financing element is considered to be the individual contract and therefore the assessment should be made on a contract by contract basis. This should not be performed on a portfolio basis.

.09 **An entity should therefore identify if, at inception, a transaction contains a financing element by first assessing qualitative factors**. . In performing this assessment an entity should consider whether it intended to provide financing to the counterparty as part of the transaction or if the deferral exists for other reasons. An entity should consider the following non-exhaustive factors:

a) Differential pricing between the cash payment price and the price paid on deferred settlement terms;
b) Settlement terms deferred beyond industry norms and practice;
c) The date from which an entity is entitled to levy interest on overdue payments;
d) The transaction initiation process and the extent of credit assessments performed;
e) Any collateral required for the transaction or payment;
f) A substantial amount of the transaction price is variable and the amount or timing of that consideration varies basis of the occurrence or non-occurrence of a future event that is not substantially within the control of both parties to the transaction, or
g) The business purpose for the different timing between delivery of the goods/ services and the payment.

.10 If an entity determines that the transaction was not intended to provide the counterparty with financing then no financing element exists. However, if an entity determines that financing is an element of the transaction then an entity should perform a quantitative assessment to determine if this is material to the transaction.

.11 IAS 39 (and IFRS 9 when adopted) requires that financial instruments be initially recognised at fair value. This applies to both payables and receivables and takes into account the effect of the time value of money or financing elements. BC 138A clarifies that the requirement to recognise at fair value is met for short-term receivables and payables recognised at the transaction amount where the effect of discounting is not material to the individual transaction. This requirement is similar to those contained in IFRS 15/IAS 2 and IAS 16/IAS 38. An entity should use the guidance in IFRS 13 to determine if the financing element is material to the individual transaction (for e.g. this assessment should not be performed as a percentage on total sales). The assessment should be performed by first considering if a potential financing element exists and if it does then considering whether the potential financing element is quantitatively material to the individual transaction. Only if the financing element is material to the individual transaction should the fair value of the receivable and payable be adjusted for the financing element.

.12 Further the IFRIC discussion on financing elements contemplate that the entity should first determine the transaction price for the revenue or purchase side of the transaction. The related receivable or payable is then, in the absence of another element (such as a material financing element) being identified in the transaction, measured on initial recognition at the amount of the revenue or purchase side transaction.

.13 The assessment of whether the financing element is material to the transaction should be performed on initial recognition of the transaction and only consider the expected payment of the purchase based on facts and circumstances on this date. Any subsequent changes to these expectations such as delays in payment or changes in the amount of the payment form part of the subsequent measurement of the payable and do not affect the determination of the financing element on initial recognition.

.14 In considering the expected payment terms of payables, paragraph 47 of IFRS 13 provides guidance that the entity's expectation of payment cannot exceed the contractual terms of the contract. Therefore, the calculation should be limited to the contractual terms rather than the expected terms of payment.

.15 If an entity determines that the financing element is material to the transaction, then the financing element should be accounted for separately from the purchase, i.e. record the purchase (and the recognition of the payable) at the present value of the future cash flows and accrue an interest expense until date of payment. Conversely, if an entity determines that the financing element is not material to the transaction then there is no requirement to account for the financing element separately from the purchase.

Financing elements – revenue

.16 Revenue should be measured at the fair value of the consideration received or receivable. If a transaction contains a financing element this element should be accounted for separately as the consideration for the revenue transaction comprises two elements and hence the fair value of the consideration for the original revenue transaction should exclude the revenue for the financing element.

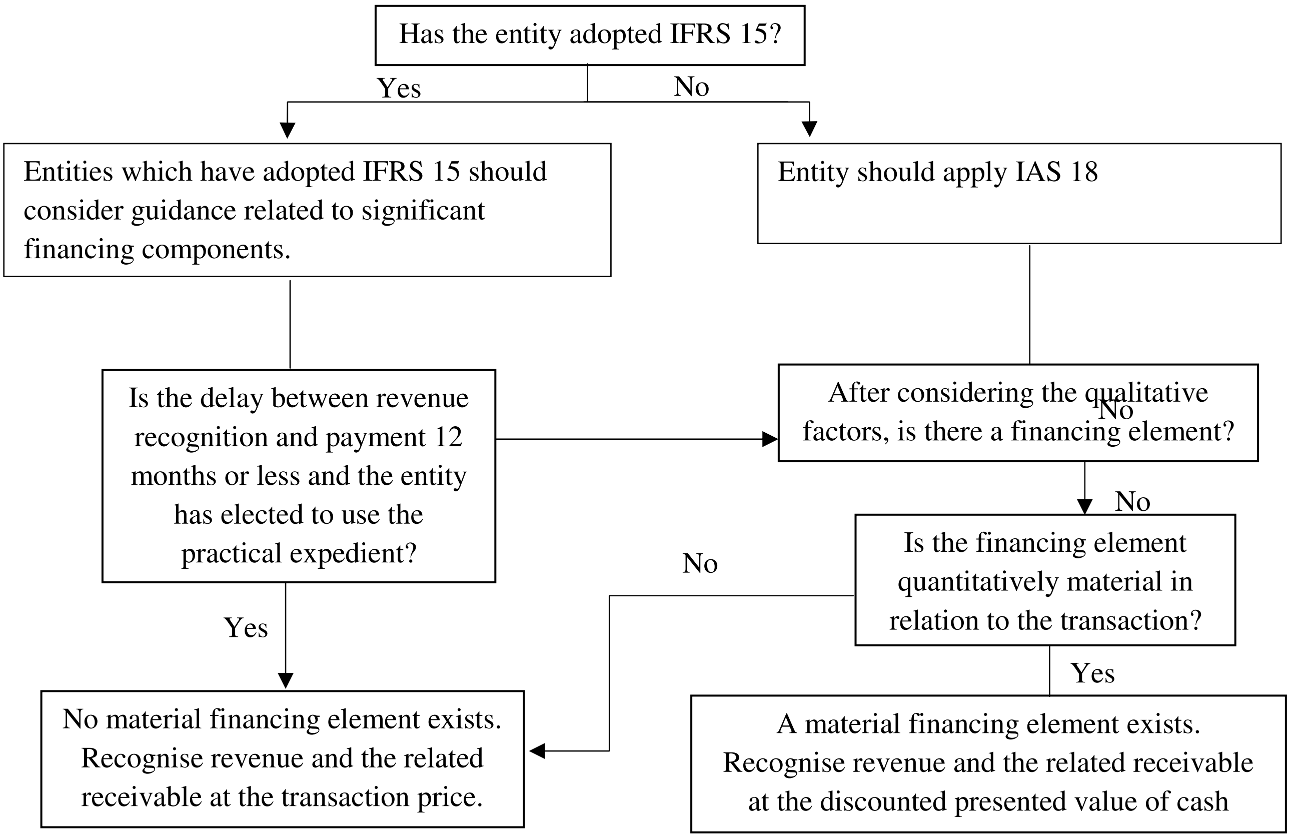
.17 To determine whether a financing element exists in a transaction, the entity should first perform the qualitative assessment in paragraph 09. Only if an entity determines that a financing element exists should an entity perform a quantitative assessment to determine if the financing element is material to the transaction, otherwise the separation of a financing element is not required. The determination of whether the financing element is material to the transaction should be performed using the guidance in paragraphs .10-.12.

.18 If an entity determines that the financing element is material to the transaction, then the financing element should be accounted for separately from the revenue, i.e. recognise the revenue (and the related receivable) at the present value of the future cash flows and subsequently accrue interest income until date of expected payment. IFRS 13 paragraph B13 requires that an entity should consider the date of expected payment in measuring fair value. This includes both considering the impact on the timing of the expected cash flows and the related discount rate. Conversely, if an entity determines that the financing element is not material to the transaction then the financing element is not required to be accounted for separately from the revenue.

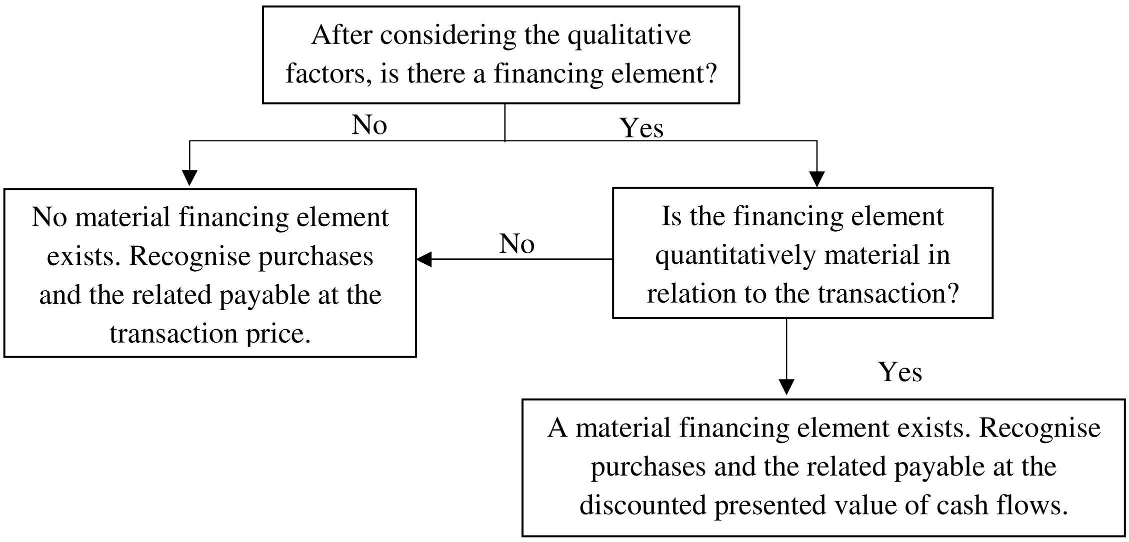
.19 Entities which have adopted IFRS 15 should consider guidance related to significant financing components to determine if a revenue transaction contains an embedded financing element which should be accounted for separately. The accounting for the related receivable follows from the application of IFRS 15 to the revenue transaction.

Decision tree

.20 The following decision tree may assist entities in applying the guidance to determine whether a revenue transaction contains a financing element:



.21 The following decision tree may assist entities in applying the guidance to determine whether a purchase transaction contains a financing element:



Revenue examples

Example 1

.22 Entity A sells goods to Entity B for CU 1 000 on 30 day payment terms and expects payment in 30 days. Entity A does not charge its customers interest. Entity A has determined after considering qualitative factors that a financing element does not exist. Entity A should therefore recognise revenue for the sale of goods of CU 1000.

Example 2

.23 Entity A sells goods to Entity B for CU 1 500 on 150 day payment terms and expects payment in 150 days. Entity A does not charge its customers interest. Entity A has determined after considering qualitative factors that the deferred payment is intended to provide Entity B with a financing element. Entity A should therefore perform an assessment to determine if the financing element is material to the transaction. Entity B could borrow a similar amount from a bank with similar terms at an interest rate of 13%.

.24

Transaction price	CU 1 500
Present value	CU 1 427 (discounted over 150 days using 13%)
Financing element	CU 73

.25 Entity A should therefore determine if the financing element of CU 73 is considered to be material when compared to the transaction price of CU 1 500. If entity A concludes that the financing element is material, revenue for the sale of goods is recognised at CU 1 427, with interest over the 150 days payment term totalling CU 73.

.26 If Entity A concludes that the financing element is not material, then revenue for the sale of goods of CU 1500 is recognised.

Example 3

.27 Entity A sells goods to Entity B for CU 1 500 on 150 day payment terms and expects payment in 180 days. Entity B does not charge its customers interest .Entity A has determined after considering qualitative factors that the deferred payment is intended to provide Entity B with a financing element. Entity A should therefore perform an assessment to determine if the financing element is material to the transaction. Entity B could borrow a similar amount from a bank with similar terms “i.e. 150 days” at an interest rate of 15%. The interest rate has already been adjusted to take into account the expected late payment and therefore the increased credit risk.

.28

Transaction price	CU 1 500
Present value	CU 1 416 (discounted over 150 days using 15%)
Financing element	CU 84

.29 Entity A should therefore determine if the financing element of CU 84 is considered to be material when compared to the transaction price of CU 1 500. If entity A concludes that the financing element is material, revenue for the sale of goods is recognised at CU 1 416, with interest over the 150 days payment term totalling CU 84.

.30 If Entity A concludes that the financing element is not material, then revenue for the sale of goods of CU 1500 is recognised.

Purchase examples

Example 4

.31 Entity A purchases goods from Entity B for CU 1 000 on 120 day payment terms and expects to make payment in 120 days. Entity B does not charge its customers interest. Entity A has determined after considering qualitative factors that the deferred payment is intended to provide itself with a financing element. Entity A should therefore perform an assessment to determine if the financing element is material to the transaction. Entity A could borrow a similar amount from a bank with similar terms at an interest rate of 13%.

.32	Transaction price	CU 1 000
	Present value	CU 961(discounted over 120 days using 13%)
	Financing element	CU 39

.33 Entity A should therefore determine if the financing element of CU is considered to be material when compared to the transaction price of CU 1 000. If entity A concludes that the financing element is material, the goods purchased are recognised at CU 961, with interest over the 120 days payment term totalling CU 39.

.34 If Entity A concludes that the financing element is not material, then the cost of the goods purchased is initially measured at CU 1000.

Example 5

.35 Entity A purchases goods from Entity B for CU 1 500 on 150 day payment terms and expects to make payment in 180 days. Entity B does not charge its customers interest. Entity A has determined based on considering qualitative factors that the deferred payment is intended to provide itself with a financing element. Entity A should therefore perform an assessment to determine if the financing element is material to the transaction. Entity A could borrow a similar amount from a bank with similar terms at an interest rate of 13%.

.36	Transaction price	CU 1 500
	Present value	CU 1 427 (discounted over 150 days using 13%)
	Financing element	CU 73

.37 Note that even although Entity A only expects to make payment after 180 days, the contractual terms are 150 days. Paragraph 47 of IFRS 13 requires a liability to be recognised at its full value on earliest date payment can be demanded. Therefore Entity A can only discount the payable over the 150 day contractual terms.

.38 Entity A should therefore determine if the financing element of CU 73 is considered to be material when compared to the transaction price of CU 1 500. If entity A concludes that the financing element is material, the goods purchased are recognised at CU 1 427, with interest over the 150 days payment term totalling CU 73.

.39 If Entity A concludes that the financing element is not material, then the cost of the goods purchased is initially measured at CU 1500.

Conclusion

.40 Where there is a delay between the recognition of revenue or the item purchased and payment of the consideration.an entity should identify if a financing element exists based on qualitative factors as set out in paragraph 07. If a financing element exists an assessment should be performed to determine if the financing element is material to the transaction. Only if the financing element is material to the transaction should it be accounted for separately.

.41 Entities should account for any change in terms of IAS 8(AC 103) – *Accounting Policies, Changes in Accounting Estimates and Errors*.

Responsibility

.42 Members should determine the necessary action required in the context of their responsibility.

Johannesburg
February 2017

Dr Terence Nombembe
Chief Executive Officer

Appendix A: Accounting references

Accounting standard references

Paragraph 10 of IAS 2 states *"The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition."*

Paragraph 11 of IAS 2 states *"The costs of purchase of inventories comprise the purchase price, import duties and other taxes, and transport, handling and other costs…. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase."*

Paragraph 18 of IAS 2 states *"An entity may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing."*

Paragraph 10 of IAS 18 states *"The amount of revenue arising on a transaction is usually determined by agreement between the entity and the buyer or user of the asset. It is measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity."*

Paragragh 14 of IFRS 13 states: "Whether the asset or liability is a stand-alone asset or liability, a group of assets, a group of liabilities or a group of assets and liabilities for recognition or disclosure purposes depends on its unit of account. The unit of account for the asset or liability shall be determined in accordance with the IFRS that requires or permits the fair value measurement, except as provided in this IFRS.

Paragraph 47 of IFRS 13 states "*The fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid."*

Paragraph B13 of IFRS 13 states "*Present value (i.e. an application of the income approach) is a tool used to link future amounts (e.g. cash flows or values) to a present amount using a discount rate. A fair value measurement of an asset or a liability using a present value technique captures all the following elements from the perspective of market participants at the measurement date:*

a) An estimate of future cash flows for the asset or liability being measured.
b) Expectations about possible variations in the amount and timing of the cash flows representing the uncertainty inherent in the cash flows.
c) the time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that
d) Coincide with the period covered by the cash flows and pose neither uncertainty in timing nor risk of default to the holder (i.e. a risk-free interest rate).
e) The price for bearing the uncertainty inherent in the cash flows (i.e. a risk premium).
f) Other factors that market participants would take into account in the circumstances.
g) For a liability, the non-performance risk relating to that liability, including the entity's (i.e. the obligor's) own credit risk."

Paragraph 60 of IFRS 15 states *"In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the* customer *or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is* *explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract."*

Paragraph BC138A of IFRS 13 states "*After issuing IFRS 13, the IASB was made aware that an amendment to IFRS 9 and IAS 39, which resulted in the deletion of paragraphs B5.4.12 and AG79 respectively, might be perceived as removing the ability to measure short-term receivables and payables with no stated interest rate at invoice amounts without discounting, when the effect of not discounting is immaterial. The IASB did not intend to change the measurement requirements for those short-term receivables and payables, noting that paragraph 8 of IAS 8 already permits entities not to apply accounting policies set out in accordance with IFRSs when the effect of applying them is immaterial."*

Paragraph 61 of IFRS 15 states *"The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognise revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (i.e. the cash selling price). An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:*

a) The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and

b) The combined effect of both of the following:

i. The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and
ii. The prevailing interest rates in the relevant market."

Paragraph 62 states *"Notwithstanding the assessment in paragraph 61, a contract with a customer would not have a significant financing component if any of the following factors exist:*

a) The customer paid for the goods or services in advance and the timing of the transfer of those goods or services is at the discretion of the customer.

b) A substantial amount of the consideration promised by the customer is variable and the amount or timing of that consideration varies on the basis of the occurrence or non-occurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).

c) The difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 61) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract."

Paragraph BC234 of IFRS 15 states *"BC234 The boards also observed that for many contracts, an entity will not need to adjust the promised amount of customer consideration because the effects of the financing component will not materially change the amount of revenue that should be recognised in relation to a contract with a customer. In other words, for those contracts, the financing component will not be significant.*

During their redeliberations, the boards clarified that an entity ***should consider only the significance of a financing component at a contract level rather than consider whether the financing is material at a portfolio level****. The boards decided that it would have been unduly* *burdensome to require an entity to account for a financing component if the effects of the financing component were not material to the individual contract, but the combined effects for a portfolio of similar contracts were material to the entity as a whole."*

Paragraph 23 of IAS 16 states*: The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is capitalised in accordance with IAS 23.*

Paragraph 32 of IAS 38 states*: If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent. The difference between this amount and the total payments is recognised as interest expense over the period of credit unless it is capitalised in accordance with IAS 23 Borrowing Costs.*

IFRIC meeting discussions

Paragraph 20 of agenda paper 3 from the July 2015 IFRIC meeting states "*There is also guidance with respect to deferred payments for the acquisition of assets in IAS 2 Inventories (paragraph 18), IAS 16 Property, Plant and Equipment (paragraph 23) and IAS 38 Intangible Assets (paragraph 32) that makes it clear that if a contract contains a financing element, the difference between the purchase price on normal credit terms and the amount paid is recognised as interest over the period of financing."*

Paragraph 21 of agenda paper 3 from the July 2015 IFRIC meeting states "*Based on this analysis, we think that recognising the financing component of a transaction separately, so that the transaction is recognised at its cash price, is applied throughout IFRS. We would therefore expect that for both revenue and inventories, the contract price would be adjusted for any significant financing component of the arrangement, whether explicit or implied."*

Paragraph 31 of agenda paper 6 from the November 2014 IFRIC meeting states "*However, we think that it is important at this stage to make a distinction between the time value of money as a factor in a cash-flow-derived measurement basis and the objective of measuring both revenue and inventory in a way that excludes the effect of any financing arrangement. This is explained in paragraph BC232 of IFRS 15: The boards also decided to remove the term 'time value of money' from the discussion about adjustments for financing components, to reflect their decision that the focus is on whether the payment terms provide the purchaser or the entity with a significant benefit of financing. This is because the term 'time value of money' is a broader economic term that may suggest that it is necessary to adjust the promised amount of consideration in circumstances other than when the cash sales price may differ from the contractual payments."*

Paragraph 32 of agenda paper 6 from the November 2014 IFRIC meeting states "*We note that this discussion by the boards reflects a change between the second Exposure Draft and the final Standard; the boards decided to focus on the narrower concept of a 'financing component', rather than the broader concept of 'time value of money'. In this paragraph the IASB highlights that there are some circumstances in which the transaction price should not be adjusted, i.e. when the gap between payment date and delivery date arises for reasons other than a financing arrangement."*

Paragraph 39 of agenda paper 6 from the November 2014 IFRIC meeting states "*We think it is the IASB's intention to adjust the transaction price when there is a significant financing component of the contract and not to adjust the transaction price when there is no significant financing component. The IASB acknowledged that the prepayment may be made for reasons other than financing."*

The IFRIC agenda decision on 14 July 2015: *IAS 2 Inventories and IAS 38 Intangible Assets—should interest be accreted on prepayments in long-term supply contracts?* States "*The Interpretations Committee received a request seeking clarification on the accounting for long-term supply contracts of raw materials when the purchaser of the raw materials agrees to make significant prepayments to the supplier. The question considered 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.*

The Interpretations Committee discussed this issue and 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 the financing. It also noted that IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets include similar requirements when payment for an asset is deferred. IFRS 15 Revenue from Contracts with Customers, issued in May 2014, additionally includes the requirement that the financing component of a transaction should be recognised separately in circumstances of both prepayment and deferral of payment.

*The Interpretations Committee conducted outreach on this issue, but the outreach returned very limited results. In the absence of evidence about this issue, and of a broader range of information about the facts and circumstances relating to these transactions, the Interpretations Committee thought it would be difficult for it to address this topic efficiently and effectively. The Interpretations Committee observed, however, that when a financing component is identified in a long-term supply contract of raw materials, that financing component should be accounted for separately. The Interpretations Committee acknowledged that **judgement is required to identify when individual arrangements contain a financing component*** [emphasis added].

The Interpretations Committee concluded that this issue did not meet its agenda criteria and therefore it [decided] to remove this issue from its agenda."

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