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Must know

Presentation of interest revenue for certain financial instruments

At a glance

The IFRS Interpretations Committee has concluded that a separate interest revenue line item that contains only interest income on assets that are measured at amortised cost or fair value through other comprehensive income (subject to the effect of applying hedge accounting to derivatives in designated hedge relationships) should be presented in the income statement.

This will be a change to current practice for some entities. It is likely to have the most significant impact on financial services entities, such as banks for whom interest revenue or net interest margin is a key performance indicator.

What is the issue?

IFRS 9 introduced a consequential amendment to paragraph 82(a) of IAS 1, under which interest revenue calculated using the effective interest method is required to be presented separately on the face of the income statement.

The IFRS Interpretations Committee (the 'Committee') has issued an agenda decision which concludes that this separate line item can be used only for interest on those financial assets that are measured at amortised cost or fair value through other comprehensive income (subject to the effect of applying hedge accounting to derivatives in designated hedge relationships).

This means that interest income on items that are not measured at amortised cost or fair value through other comprehensive income will no longer be able to be included in the same line item.

What is the impact?

This change is likely to have the most significant impact on financial services entities, such as banks. Some such entities currently include interest income on certain assets measured at fair value through profit or loss ('FVTPL') in the same line item as interest income on assets measured at amortised cost or fair value though other comprehensive income, but they will no longer be able to do this.

Depending on an entity's existing presentation policy, this change might impact the presentation of gains and losses on some or all of the following:

- derivatives including 'economic hedges' to which hedge accounting has not been applied; however, where hedge accounting is applied, hedging gains and losses can continue to be presented in the same interest revenue line item as the interest on the hedged item;
- non-derivative assets to which the fair value option has been applied;
- non-derivative assets that fail the 'solely payments of principal and interest' requirements in IFRS 9; and
- non-derivative assets that fall within the 'other' business model in IFRS 9.

Can additional line items be presented?

Some entities might wish, as a matter of accounting policy, to present additional line items, on the face of the income statement, for 'interest' on instruments measured at FVTPL. Whilst not addressed by the Committee, IAS 1 permits an entity to present additional line items where doing so is relevant to an understanding of the entity's financial performance. If such a presentation is adopted, the additional line items should be appropriately presented and labelled. Also, the entity's accounting policy, including how such amounts are calculated and on which instruments, should be disclosed.

Some local regulators have expressed views on the presentation of interest income for financial instruments measured at FVTPL, in which case regard should be had to those views.

When does it apply?

The Committee's agenda decision is effective at the same time as IFRS 9 (that is, for accounting periods beginning on or after 1 January 2018).

Accounting for fixed consideration in licence arrangements in the pharmaceutical and life sciences industry

At a glance

IFRS 15, 'Revenue from contracts with customers', significantly impacts the accounting for many companies in the pharmaceutical and life sciences (PLS) industry.

Issue

Licences that provide a right to use intellectual property

A licence granted by a PLS company (the licensor) generally provides the customer (the licensee) with the right to use, but not to own, the licensor's intellectual property (IP). A common example in the PLS industry is a company that 'out-licenses' to a customer the IP that it developed in relation to a drug that has not yet received regulatory approval. Often, under the terms of the licence, the licensee can further develop the IP, and manufacture and/or sell the resulting commercialised product. The licensor typically receives an upfront fee, milestone payments for specific clinical or other development-based outcomes, and sales-based royalties as consideration for the licence. Revenue is generally recognised at a point in time for arrangements in which there is a single performance obligation (that is, the transfer of a 'right to use' licence). This publication focuses on arrangements in which the transfer of a 'right to use' licence is the only performance obligation. As a result, the accounting treatment described here might differ for arrangements in which there are two or more performance obligations, or those in which there are multiple goods and services combined into a single performance obligation.

Fees payable in annual

In certain out-licensing transactions, licensors receive annual fees payable by the licensee on each anniversary of the inception of the contract until the end of the stated licence term. These fees are sometimes paid for the transfer of additional distinct goods or services to the customer, or they might be payable to the licensor to fund its patent maintenance or patent defence efforts. In general, a commitment to maintain or defend an existing patent would not constitute a distinct good or service, and so it does not result in a separate performance obligation.

If the 'right to use' licence is the only performance obligation in the arrangement, these annual fees should be recognised at the time when control transfers to the licensee and the licence term begins. This is because a fixed, non-contingent fee (such as a fee payable in annual instalments), in exchange for a promised good or service, is not variable consideration that is contingent on the occurrence or non-occurrence of a future event. This is likely to result in an acceleration of revenue compared to the current accounting treatment for this payment type.

Minimum guaranteed royalties

Out-licensing arrangements in the PLS industry might contain minimum royalty guarantees. The minimum guarantee, in some cases, is negotiated due to uncertainty about the customer's performance and its ability to successfully exploit the IP.

In other cases, the minimum guarantee is established as a cash flow management tool, to provide the licensor with predictable timing of some cash flows under the contract. The minimum amount could be paid at the beginning of the licence term, or it could be settled either periodically or at the end of the licence term in the event that the sales- or usage-based royalties are lower than the guaranteed amount.

Assuming that the minimum royalty guarantee is binding and not contingent on the occurrence or non-occurrence of a future event (such as regulatory approval), it constitutes fixed consideration that should be recognised at the time when the company transfers control to the licensee and the licence term begins. This would be the case irrespective of whether the minimum guarantee is payable upfront, over time, or at the end of the licence term. However, any royalty amounts above the minimum guarantee should be recognised when the subsequent sale or usage has occurred. Recognising the minimum guarantee amount upfront is likely to result in an acceleration of revenue compared to the current accounting treatment for this type of arrangement.

Related key judgements

The following are key judgements that companies will need to make when accounting for delayed fixed consideration.

Collectability

A company will need to determine, at the beginning of an arrangement, whether it is probable that it will collect the consideration to which it is entitled. The assessment must reflect both the customer's ability and intent to pay as amounts become due, and it would include an evaluation of all elements of the transaction price, including delayed fixed consideration. Importantly, if the company concludes that collection is not probable, it is not permitted to recognise revenue related to the arrangement until certain criteria are met. Specifically, revenue cannot be recognised unless the consideration received is non-refundable and either the contract has been terminated or the company has no obligation to transfer additional goods or services.

A company that concludes that collection is not probable is required to continue to reassess this conclusion throughout the term of the arrangement.

Determining the contract term

It is important for companies to evaluate the contract term, in order to determine the period of time during which both parties have enforceable rights and obligations under the contract. This could impact the determination of the transaction price and recognition of revenue; that is, it will dictate the amount of fees payable in annual instalments or minimum guaranteed royalties to recognise on an accelerated basis under IFRS 15 when compared to current practice.

Companies will be required to assess whether a contract is cancellable when making this determination and, if so, whether there is a substantive termination penalty in the event that the contract is cancelled. We believe that termination penalties could take various forms, including cash payments or the forfeiture of a valuable right to the licensed IP on cancellation without refund of amounts paid for such rights. Significant judgement might be involved in assessing whether forfeiture of a right to IP is substantive in the context of the arrangement.

A contract that can be cancelled without a substantive termination penalty only has enforceable rights and obligations for the period that is non-cancellable. Accordingly, the transaction price would exclude fees that the customer could avoid paying by cancelling the contract (for example, certain delayed fixed payments). Companies will also need to assess, in this situation, whether the contract contains a material right related to future optional purchases.

Significant financing component

Given the long-term nature of these arrangements and the existence of fixed consideration payable on a delayed basis, companies in the PLS industry will need to evaluate the timing of these payments relative to the transfer of control of the licensed IP, in order to determine if a significant financing component exists.

There might be a significant financing component, since cash will often be received many years in arrears of performance. If so, the initial amount of revenue recognised on the transfer of control of the licence should be discounted for the time value of money, and a portion of the consideration received (or receivable) should be recognised as interest income (rather than revenue).

Impact of adoption
Companies should be mindful that the adoption method selected (that is, full retrospective or modified retrospective) will impact a company's ability to present these accelerated amounts as revenue in the income statement for contracts that were entered into, and performance obligations that were satisfied, before the adoption of IFRS 15.

IASB revises the Conceptual Framework

At a glance

The IASB has revised its Conceptual Framework. This will not result in any immediate change to IFRS, but the Board and Interpretations Committee will use the revised Framework in setting future standards. It is therefore helpful for stakeholders to understand the concepts in the Framework and the potential ways in which they might impact future guidance.

What is the issue?

IASB revises the Conceptual Framework

The IASB has revised its Conceptual Framework. The primary purpose of the Framework is to assist the IASB (and the Interpretations Committee) by identifying concepts that it will use when setting standards.

What is the impact and for whom?

The Framework is not an IFRS standard and does not override any standard, so nothing will change in the short term. The revised Framework will be used in future standard-setting decisions, but no changes will be made to current IFRS. Preparers might also use the Framework to assist them in developing accounting policies where an issue is not addressed by an IFRS.

Key changes

Key changes include:

- Increasing the prominence of stewardship in the objective of financial reporting, which is to provide information that is useful in making resource allocation decisions.
- Reinstating prudence, defined as the exercise of caution when making judgements under conditions of uncertainty, as a component of neutrality.
- Defining a reporting entity, which might be a legal entity or a portion of a legal entity.
- Revising the definition of an asset as a present economic resource controlled by the entity as a result of past events.
- Revising the definition of a liability as a present obligation of the entity to transfer an economic resource as a result of past events.
- Removing the probability threshold for recognition, and adding guidance on derecognition.
- Adding guidance on the information provided by different measurement bases, and explaining factors to consider when selecting a measurement basis.
- Stating that profit or loss is the primary performance indicator and that, in principle, income and expenses in other comprehensive income should be recycled where the relevance or faithful representation of the financial statements would be enhanced.

The Board did not make any changes that address challenges in classifying instruments with characteristics of both liability and equity. That will be addressed through the IASB's standard-setting project on that topic. Other amendments to the Framework might be needed at the conclusion of that project.

When does it apply?

The Board and Interpretations Committee will immediately begin using the revised Framework. It is effective for annual periods beginning on or after 1 January 2020 for preparers that develop an accounting policy based on the Framework.

Issues of the month

Disclosures required in interim financial statements on the initial adoption of IFRS 15

At a glance

IFRS 15 is required to be applied for annual reporting periods beginning on or after 1 January 2018. Many entities will be required to issue interim financial statements under IAS 34, 'Interim Financial Reporting', before they issue their first annual financial statements applying IFRS 15.

Regulators, investors and other stakeholders might focus on disclosures related to the adoption of IFRS 15.

What is the issue?

What disclosures are required in interim financial statements in the year in which IFRS 15 is adopted?

IFRS 15 made consequential amendments to IAS 34 that require disclosure of:

- the recognition or reversal of an impairment loss from assets arising from contracts with customers, as an additional example of the events and transactions for which disclosures would be required if they are significant; and
- the 'disaggregation of revenue from contracts with customers' required by paragraphs 114 to 115 of IFRS 15.

In addition to complying with these specific requirements in each interim report, entities should comply with paragraph 16A(a) of IAS 34, which requires a description of the nature and effect of any changes to their accounting policies and methods as compared with the most recent annual financial statements.

What is the impact and for whom?

The extent of the disclosures will depend on an entity's circumstances. Entities apply judgement to determine the extent of the disclosure, taking into consideration, for example:

- the requirements or expectations of local regulators: entities should consider any guidance issued by regulators that might require specific disclosures or information to be included in interim reports; some regulators might require all of the disclosures required in annual financial statements to be included in the interim report; for instance, the European Securities and Markets Authority has stated that it expects the disclosures required by paragraph C8 of IFRS 15 to be provided where the modified retrospective transition approach is adopted; and
- the significance of the changes: the extent of disclosures might vary depending on the effect on the financial statements of the initial adoption of IFRS 15; disclosures might be less extensive where the impact is not qualitatively or quantitatively material.

The disclosures might include:

- a description of the nature and effect of the change resulting from the new accounting policies (this disclosure is required by paragraph 16A(a) of IAS 34);
- the key judgements made by management in applying IFRS 15;
- details of the impact on the amounts presented in the interim financial statements, including earnings per share and the opening balance of retained earnings;
- the transition method selected, together with any transitional practical expedients applied (entities that elect to apply the modified retrospective transition approach should consider whether the requirements of paragraph C8 of IFRS 15 for annual financial statements could be used to explain the nature and effect of the change in accounting policy); and
- disclosures specific to the entity – entities should consider whether the requirements in paragraph 28 of IAS 8, which will be applicable for the annual financial statements, could be used to explain the nature and effect of the change in accounting policy when IFRS 15 is first applied.

Entities should also consider whether any of the detailed disclosures required by IFRS 15 in annual financial statements are useful to comply with the requirements of IAS 34, although these disclosures are not mandatory in interim reports.

When does it apply?

IFRS 15 is applicable for annual reporting periods beginning on or after 1 January 2018. Any interim financial statements issued before the first annual financial statements applying IFRS 15 will need to consider the above guidance.

IFRS 9 disclosures by banks in 2018 interim reporting and transition documents

At a glance

Before banks issue their first annual financial statements applying IFRS 9, many will issue interim financial statements under IAS 34. This reporting is likely to receive a lot of focus from investors, regulators and other key stakeholders.

What is the applicable guidance?

Unlike some other new accounting standards, IFRS 9 made no consequential amendments to IAS 34, 'Interim financial reporting', to bring in specific new interim disclosure requirements. So the key requirement for interim reports prepared under IAS 34 is the general requirement in paragraph 16(a) of IAS 34. This states that an entity should provide *"a statement that the same accounting policies and methods of computation are followed in the interim financial statements as compared with the most recent annual financial statements or, if those policies or methods have been changed, a description of the nature and effect of the change"* (emphasis added). Paragraph 6 of IAS 34 also states that the interim financial report is intended to provide an update on the latest complete set of annual financial statements and, accordingly, it focuses on new activities, events and circumstances.

In certain jurisdictions, there might also be local rules that need to be considered for interim reporting and/or a separate transition document. These could include listing rules, securities legislation or other regulatory requirements.

What does this mean in practice?

Given the lack of prescriptive requirements, judgement will be required by banks in designing disclosures for IAS 34 interim reporting and transition documents.

In assessing the appropriate extent of disclosure, a number of factors are likely to be relevant. In particular, regulators might have expectations on the extent and nature of disclosures that are considered appropriate. In addition, the extent of the disclosures should be proportionate to the impact of IFRS 9 adoption. For example, if the impact of adoption is not significant in monetary terms, or it is restricted to a small number of financial statement line items, extensive disclosure might not be warranted. When considering the appropriate extent of disclosure, the potential future impacts of IFRS 9 should be taken into account, as well as the impact at the time of adoption. The extent of disclosures expected of larger, more sophisticated banks is also likely to be greater than for smaller, simpler banks.
However, it would generally be expected that the IAS 34 requirements could be met by disclosing:

- New accounting policies – A statement of the new policies required by IFRS 9 in the first set of interim reporting, given that these will not have been disclosed previous financial statements or interim reports. As well as explaining the new expected credit loss (ECL) impairment and classification and measurement models, disclosure should be provided of relevant policy choices that have been applied. Examples might include whether or not:

- the low credit risk exemption has been applied;

- the 30 / 90 days past due presumptions have been rebutted, as an indicator of significant increase in credit risk / default respectively; And

- comparative amounts have been restated.

- Classification and measurement changes – Quantitative and qualitative disclosures of the changes to classification and measurement arising from the adoption of IFRS 9 will be key to users' understanding of the interim reporting. These aspects of disclosure are discussed in more detail in paragraphs 42I, 42J, 42L and 42O of IFRS 7. In addition to the business model and SPPI tests, changes might arise from modification gains and losses on financial assets recognised in accordance with paragraph 5.4.3 of IFRS 9, and similar effects from modified financial liabilities as clarified by the IASB in paragraph BC 4.253 of the October 2017 amendment to IFRS 9.

- Impairment provision reconciliation – The reconciliation of the closing IAS 39 impairment provision to the opening IFRS 9 provision (as per paragraph 42P of IFRS 7) will help users to understand the adoption impacts of IFRS 9, as well as to start developing expectations of how different portfolios might be affected by IFRS 9 from period to period. To enable users to understand why the movements have arisen, this should be accompanied by qualitative information explaining the main reasons for the changes. A related disclosure that is likely to be a key focus for analysts will be the percentage of loans reported, at transition, as stage 1, 2 or 3, or purchased or originated credit-impaired, and the ECL provision coverage for each.

Key judgements – A key focus for readers will naturally be those areas that mattered most in implementing IFRS 9 and where the greatest judgement was required. Areas likely to be most relevant for ECL, where most analyst comment and industry debate has focused, include: the criteria for identifying a significant increase in credit risk; how forward-looking information has been incorporated (including the use of multiple macro-economic scenarios); the lives used for revolving credit facilities, such as overdrafts and credit cards; and the definition of default. Where any of these areas is not a key judgement for a bank, it might nonetheless help users if this is stated explicitly in disclosures. This will avoid the risk that users look to disclosures made by peer banks on these judgements and mistakenly assume that they also apply to the bank in question. Key judgements relating to classification and measurement should also not be overlooked. These might include, for example, a judgement on whether prepayment features in a material portfolio of loans do not only provide 'reasonable additional compensation' and so prevent measurement at amortised cost, or a judgement on the level of sales considered consistent with a 'Hold To Collect' business model.

Other relevant disclosures – Appropriate disclosures should be given about other aspects not discussed above that are necessary for a user to understand the impacts at transition, the reasons for those impacts and the key judgements that will impact the financial statements going forward.

Cannon Street press

The April 2018 IASB update has been published and the work plan updated.

The topics, in order of discussion, were:

- Primary Financial Statements
- Business Combinations under Common Control
- Goodwill and Impairment
- Dynamic Risk Management
- Disclosure Initiative
- Implementation

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