

Beyond the GAAP

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The SEC's report on the work plan for the endorsement of IFRSs, published last July, made a great impression, since it was entirely free of any recommendations for adoption of IFRSs by the United States. After the shock come the reactions, and the cautious attitude of the US is causing some gritting of teeth. Convergence at any cost is coming under more and more criticism, and the FASB's recent decision to withdraw from the compromise on the impairment of financial assets will hardly ease anyone's mind. The European Commission believes that 2013 will be the year of truth as far as US participation in IFRSs is concerned.

Happy reading!

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Editorial

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News

The IFRS Foundation publishes proposals for establishing the ASAF

On 1 November 2012, the IFRS Foundation published its proposals on the constitution of a consultative group to be known as the Accounting Standards Advisory Forum (ASAF). Comments are invited until 17 December 2012.

The ASAF is intended to improve the dialogue between the IASB and the national accounting standard-setters and regional bodies with an interest in financial reporting. Its main aim would be the provision of technical advice to the IASB. The creation of such an advisory group was one of the main recommendations of the Trustees' review, published in February 2012.

This document can be accessed on the IASB web site at: <http://www.ifrs.org/The-organisation/Governance-and-accountability/Documents/ASAF-Consultation-Paper-November-2012.pdf>

The IFRS Foundation responds to the SEC report on the work plan for the endorsement of IFRS

On 23 October 2012, the Trustees of the IFRS Foundation published an analysis of the SEC report entitled "Work Plan for the Consideration of Incorporating international Financial Reporting Standards into the Financial Reporting System for U.S.", published on 13 July 2012. This document can be accessed on the IASB web site at: <http://www.ifrs.org/Use-around-the-world/Global-convergence/Convergence-with-US-GAAP/Documents/Analysis-of-SEC-Final-Staff-Report.pdf>

➤ The IASB updated its work plan

On 25 October 2012 last, the IASB made some changes to its updated work plan, though this was in fact revised quite recently (see September's Beyond the GAAP):

- *IFRS 9: Accounting for macro hedging*: the publication of the Discussion Paper, initially expected in the first quarter of 2013, has been postponed to the second half of 2013.
- The project *IAS 8: effective date and transition methods* has finally been suspended pending wider discussions of disclosures as part of the Conceptual Framework project.
- A new limited amendment affecting IAS 16 and IAS 38, entitled *Revenue-based methods of depreciation and amortisation*, has been included in the work plan, and an exposure draft is anticipated by the end of the year.

Regarding this last project, it should be noted that:

- these amendments were originally to have formed part of the Annual Improvements Cycle 2011-2013;
- the question is whether it is possible to apply a method of depreciation based on the economic benefits generated by the asset (e.g. the revenue generated) ;
- at first sight, the answer would be no, because such a method would not be based on the consumption of economic benefits, as required by the existing texts.

➤ Measuring the fair value of unquoted equity instruments within the scope of IFRS 9

The IFRS Foundation, assisted by a group of valuation specialists, has undertaken to produce an educational guide to support the application of IFRS 13. The guide is structured to address the different aspects of measurement in a series of individual chapters.

On 18 October 2012, the IFRS Foundation published the first chapter of its guide on measuring fair value in draft form.

This chapter relates solely to the measurement of the fair value of unquoted equity instruments within the scope of IFRS 9, *Financial Instruments*.

The draft first chapter can be accessed until the end of November on the IASB web site, at:

<http://www.ifrs.org/Use-around-the-world/Education/FVM/Documents/Educational-material-FVM-Unquoted-equity-instruments.pdf>

There is no invitation to comment, and the IASB has only put it online for the purposes of information.

➤ Reopening IFRS 9 phase 1, *Classification and measurement* : the case of regulated interest rates

During its October 2012 meeting, the IASB discussed the particular case of financial assets bearing an interest rate regulated by an authority (government, central bank, etc.).

The IASB decided to retain in the ED the tentative decision of last February concerning the amendment to the definition of 'principal and interest' criterion.

It will be remembered that the "principal and interest" criterion must be met to avoid measuring a financial asset at fair value in profit or loss (see Beyond the GAAP No 53, February 2012).

The board nevertheless intends to take the opportunity, by means of the exposure draft, to gather the stakeholders' views on the application of this criterion to instruments where the contractual interest rate is regulated.

This point will then be reconsidered on the basis of the information collected.

European matters

➤ European perspective on the move towards global accounting standards

On 11 October 2012, EFRAG and the Trustees of the IFRS Foundation held a joint conference to discuss an *EU perspective on the move towards global accounting standards*. The conference highlighted the fact that:

- endorsement by the EU 2002 catalysed the global move towards the adoption of IFRS;
- European Union had always supported the objective of one single set of high quality globally applied accounting standards; and
- the European Union's aim is to adopt all IFRS issued by the IASB, provided that they are acceptable to and meet the needs of European constituents.

During the meeting, European Commission representatives expressed disappointment with the recent developments in the US, referring to the recent SEC report which contained no recommendations for adoption. It was stated that:

- the momentum behind IFRS could perhaps be slowed down by a final negative decision in the US, but could no longer be stopped;
- Convergence with US GAAP was a means but should not be a goal in itself, that it should not come at the expense of high quality financial reporting, and that the improvement of financial reporting should be the priority of the standard-setting process.
- 2013 would be the "year of truth" regarding US participation in IFRS.

The full EFRAG report can be accessed at: <http://www.efrag.org/Front/n1-1022/An-EU-Perspective-on-the-Move-towards-Global-Accounting-Standards.aspx>

➤ ESMA: 12th extract from the database of enforcement

On 10 October 2012, the ESMA (The European Securities and Markets Authority) published the 12th extract from its database of enforcement, containing nine decisions relating to the 2008, 2009 or 2010 accounts:

- IAS 38 – Recognition of a 'candidate database' generated internally by a specialist recruitment service;
- IAS 27: Control over a subsidiary;
- IAS 40/IAS 1 – Measuring fair value and underlying assumptions;
- IAS 18 – Revenue recognition criteria;
- IFRS 8 – Identification of chief operating decision maker as one operating segment;
- IAS 36 – Discount rate used in determining value in use;
- IAS 36 – Sensitivity to reasonable changes in the estimate of a key assumption;
- IAS 36 – Cash flow projections on reasonable and supportable assumptions;
- IAS 36 – Disclosure of cash-generating units for which the carrying amount of goodwill or intangible assets with indefinite useful lives is significant.

Note that European regulators have been paying particular attention to impairment issues, which are the subject of four of the nine decisions which have just been published.

This 12th extract from the ESMA database of enforcement can be consulted at: <http://www.esma.europa.eu/system/files/2012-656.pdf>

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A Closer Look

IFRS 9 – Impairment: left with a compromise, the IASB must make up its mind.

➤ A financial crisis as the starting point

The IASB and the FASB launched their joint project "impairment of financial assets" in 2009. Against a background of financial crisis, the G20 had ordered them to devise a new accounting approach that would avoid the procyclical effects of the existing incurred loss model.

The two boards therefore aimed to move towards an impairment model based on expected losses. From the start of the project, sharply divergent views were apparent.

➤ Difficult beginnings: two boards a world apart

Very early on, the IASB came out in favour of an approach that would reflect the economic reality of banking management: at portfolio level, expected losses on loans should be covered by the credit margin charged. As the credit margin is recognised over the lifetime of the portfolio, the IASB proposed that the recognition of expected losses should also be spread with a view to matching income and expenses. This approach was put forward in the exposure draft published in November 2009. This model, which reflects the economic reality, was nevertheless accompanied by a number of operational constraints which the IASB attempted to incorporate in a supplementary document published in January 2011.

For its part, the FASB took a very different approach from the start. Unlike the IASB, its primary objective was not to reflect the economic reality but instead to ensure that there was always an amount of 'provision' available sufficient to meet all the expected losses on the portfolio. Consequently, as soon as a bank issues a loan portfolio, it ought - in the view of the FASB - to provision all the expected losses immediately. An expense would thus be recognised from inception, while the associated revenue would continue to be spread over the lifetime of the portfolio. At a time of financial crisis, this approach had the merit of being prudent.

In 2010 there were therefore two radically different opposing projects. The IASB model was criticised for the complexity of its implementation; the FASB approach, instead, was criticised for the absence of any economic justification, other than prudence, for the immediate recognition of expected losses on a portfolio of newly granted loans. Convergence was going to take time, the two Boards being worlds apart.

➤ A compromise for the sake of convergence

Encouraged by the G20, the two boards sought to find a third way, a compromise between their two approaches. This compromise finds expression in a draft text which does provide for immediate provisioning (i.e. from the date of origin of the loan portfolio) but for an amount limited to the expected losses at one year (a concept which also has the merit of to some extent converging with the Basel prudential indicators).

The focus of debate was the remaining expected losses recognition pattern. In spring 2012, it seemed that agreement had been reached involving the recognition of these remaining expected losses in the event of credit quality deterioration accompanied by the probable occurrence of a loss event. This time the project appeared to be on track, at least until July 2012.

A Closer Look

➤ The FASB withdraws, abandoning the IASB to its compromise

During the summer of 2012, the FASB decided to withdraw from the compromise which had taken so long to return to its original position - the immediate recognition of all expected losses.

Somewhat put out by its counterpart's decision, the IASB Board nevertheless decided to finalise the compromise text and to publish it in the form of a new exposure draft before the end of 2012.

During the October 2012 meeting, some members of the IASB asked the staff to prepare a paper explaining the reasons why the board had abandoned its initial approach. The IASB seems to be hesitating.

➤ Time for the IASB to choose

The IASB, now abandoned to its compromise, will have to make a choice between the three following alternatives:

- retaining the draft text of the compromise. This is currently the board's official position. But in its October 2012 report, the IASB chose to mention that this decision has now been questioned by some stakeholders;
- returning to its original proposal. Now that convergence is out of the question, the IASB may consider that the compromise draft no longer has sufficient merit;
- adopting the FASB's approach and complete its about-face. Would this be a victory for convergence, or for the FASB?

We will probably have a first indication of the IASB's intentions when we read the exposure draft which is due to appear before the end of the year. And beyond this next stage in the process, the commentators will have a key role to play in the IASB's final choice.

It is therefore essential that everyone express their views to the IASB. This will certainly be the last opportunity to help the board to find its way out of the impasse.

A Closer Look

On-going joint redeliberations on Revenue Recognition

In October 2012 the IASB and the FASB resumed their joint redeliberations on the revenue recognition project.

This month, the following topics were discussed:

- contract modifications;
- measuring progress toward complete satisfaction of a performance obligation.

The following decisions are as yet tentative pending the publication of the definitive standard.

➤ Contract modifications

In the second exposure draft published in November 2011 ("the 2nd ED"), the two boards proposed that contract modifications should be recognised differently depending on whether the modification affected the scope and/or price of the contract (see *Beyond the GAAP* of November 2011). This means that the accounting treatment consisting of making retrospective catch-up adjustments to the amount of revenue recognised to date will not be systematically applied, since some modifications will in future be treated prospectively.

These proposals were fairly well received, and stakeholders agreed that the changes from the first exposure draft of June 2010 went in the right direction.

However, commentators wanted the guidance which will be provided in the final standard to be simpler and clearer than the 2nd ED, particularly in respect of the following subjects.

a) Contract claims

In practice, contract claims are currently included in the contract revenue if it is probable that they will result in revenue and if they can be measured reliably, without these modifications having been approved by the parties (the state of advancement of the negotiations must be such that it is probable that the customer will accept the claim).

The 2nd ED precludes the accounting consequences of these contract claims where the modification to the scope or price of the contract has not been approved by the parties.

This poses a problem for long-term contracts, since the claims are frequent and it is not usual to seek the formal approval of the parties every time.

At the October 2012 meeting, the boards:

- confirmed that the accounting treatment of contract claims should follow the broad principles set out in the 2nd ED;
- also decided to clarify that a contract modification, including a contract claim, would be approved when the modification creates or changes the enforceable rights and obligations of the parties to the contract;
- decided, for reasons of consistency, to retain the 2nd ED proposals on identifying the contract concluded with a customer on the identification of approval of a contract modification.

b) Contract modifications only resulting in a change of transaction price

In accordance with the 2nd ED, these modifications should be treated by effecting a 'catch-up', during the period in which they take place, of the amount of revenue which ought to have been recognised for the performance obligations satisfied at the time of the modification (i.e. as if the modification had been known from the start).

A Closer Look

This treatment reflected the proposals in the exposure draft for modifications of the transaction price (a subject addressed later in the ED, in the section on the allocation of the transaction price to separate performance obligations).

The boards have decided to delete the provisions in the 2nd ED relating to a modification that results only in a change to the transaction price. All contract modifications will therefore be treated in accordance with paragraph 22 of the 2nd ED, which deals with contract modifications affecting both scope and price, when these cannot be analysed as separate contracts.

c) Contracts for the provision of distinct goods or services where the prices are not specific to these goods or services (i.e. the price does not correspond to the price at which the entity would sell the additional good or service separately to a customer) – see § 22(a) of the 2nd ED.

The two boards have decided to clarify that the consideration received from the customer available for allocation to the remaining separate performance obligations should be:

- the amount of consideration received from the customer but not yet recognised as revenue plus
- any remaining consideration that the customer has promised to pay that has not been recognised as revenue.

The two boards have also indicated that the cumulative effect of a change in the estimate of a variable price (where the consideration to which the entity is entitled is variable) should be recognised:

- in the period during which the change takes place (cumulative catch-up basis) if it relates to satisfied performance obligations;
- prospectively, if the change relates to performance obligations which are not yet satisfied.

⇒ Measuring progress toward complete satisfaction of a performance obligation.

The IASB and the FASB discussed the following two topics:

- the use of methods of measuring progress towards complete satisfaction of a performance obligation such as units produced or units delivered;
- adjustments that should be made to input methods (such as costs incurred, or hours of work carried out).

a) The use of methods of measuring progress toward complete satisfaction of a performance obligation such as units produced or units delivered:

The boards tentatively decided that these methods could provide a reasonable proxy for the entity's performance in satisfying a performance obligation when the transfer of control to the customer is gradual over time, in the following circumstances:

- A units produced method: the value of any work in progress at the end of the reporting period must be immaterial;
- A units delivered method: two conditions must be met:
 - the value of any work in progress at the end of the reporting period must be immaterial; and
 - the value of any units produced but not yet delivered to the customer at the end of the reporting period is immaterial.

In practice, these methods will be relevant where large volumes of standardised products are produced with a short production cycles.

A Closer Look

b) Adjustments that should be made to input methods

Paragraph 46 of the 2nd ED states that adjustments should be made when an input method is used and the services related to the goods are delivered significantly after the customer has obtained control of the goods.

In this instance, the 2nd ED stipulates that the best way to reflect the entity's performance may be for the entity to recognise revenue for the transferred goods in an amount equal to the costs of those goods if both of the following conditions are present at contract inception:

- (i) the cost of the transferred goods is significant relative to the total expected costs to completely satisfy the performance obligation;
- (ii) the entity procures the goods from another entity and is not significantly involved in designing and manufacturing the goods (but the entity is acting as a principal).

Comments have been formulated by the stakeholders on these provisions, which have not always been well understood, in order to clarify their scope and their practical application.

The boards decided to clarify the provisions of the future standard by explaining that the adjustments to the input method are intended to ensure that it meets the objective of measuring progress that is specified in the 2011 ED - that is, to depict the entity's performance. The boards also tentatively decided to refine the fact pattern in Illustrative Example 8 in the 2nd exposure draft to help clarify the scope of the requirements.

Further considering the adjustments necessary when using an input method, the boards responded to those commentators who had pointed out that it might be difficult to identify and monitor wasted materials and other inefficiencies by tentatively deciding that an entity measuring progress by costs incurred should make adjustments to that measure of progress if including some of those costs incurred (for example, wasted materials) would distort the entity's performance in the contract.

➤ Next steps

In November 2012, the boards will return to the subjects discussed in recent weeks but where no final decision has been taken (see Beyond the GAAP, July and September 2012), namely:

- licences
- constraints on the cumulative amount of revenue from ordinary activities recognised
- collectability

Frequently asked questions

- How to consolidate a mutual venture capital company when the parent company controls the management company and holds units in the fund.
- Accounting for earn-outs related to the acquisition of non-controlling interests.
- Determining the proportion of goodwill to be transferred in the event of partial disposal of an operation.
- Accounting for dividends relating to preference shares.

Upcoming meetings of the IASB, IFRS Interpretations Committee and EFRAG

IASB

19 - 23 November 2012

13 - 19 December 2012

29 - 31 January 2013

Committee

13 - 14 November 2012

22 - 23 January 2013

12 -13 March 2013

EFRAG

12 - 14 December 2012

16 - 18 January 2013

27 February - 1 March 2013

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